Deeper Integration and Trade in Services in the Euro-Mediterranean Region

Southern Dimensions of the European Neighbourhood Policy

Daniel Müller-Jentsch
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THE WORLD BANK

EUROPEAN COMMISSION
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FOREWORD

This study was prepared in the run up to European Union enlargement and in view of its economic implications for the countries on the southern European periphery. The paper analyzes the importance of trade in services for the integration of non-EU members into the European Single Market. It is a timely contribution to the European Neighbourhood Policy of the European Union, which was launched in March 2003 and is now gaining momentum. The paper’s focus on trade in services, also provides a contribution to the ongoing debates on the World Trade Organization’s Doha Round and the Doha Development Agenda.

The study suggests that further liberalization of trade in services would be a critical factor to deeper integration with the enlarged European Union—which accounts for a quarter of global GDP and foreign direct investment. The urgent need for a trade-driven growth strategy for the countries of the region was highlighted by the World Bank study “Trade, Investment, and Development in the Middle East and North Africa—Engaging with the World,” published in 2003.

The planned Euro-Mediterranean free trade area for goods is a first step into that direction, but additional measures are needed. The study argues that the liberalization of services trade would be an essential part of this integration process. This study analyzes the adjustment needs and policy options associated with deeper integration. Besides a general discussion of deeper integration and trade in services liberalization, the study contains detailed assessments of individual sectors—especially the backbone services (transport, telecommunication, financial markets, electricity) and other sectors of relevance for deeper integration (tourism, IT-enabled services, distribution services).

Effective donor coordination is crucial to help realize the ambitious reform strategy that needs to be implemented to take advantage of the opportunities offered by the European Neighbourhood Policy. The European Commission and the World Bank are two key players in the region and have a strong track record of working together. This report was prepared by a joint World Bank–European Commission program and is thus testimony of such partnership in action.

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The Programme on Private Participation in Mediterranean Infrastructure (PPMI) is a joint World Bank–European Commission program based in Brussels. Its mandate is to promote infrastructure sector reform in the countries of the southern Mediterranean. PPMI carries out research; provides direct policy advice to governments; organizes conferences and training seminars; and helps its parent institutions prepare and coordinate technical assistance projects related to infrastructure policies and private sector development. The assessment and recommendations presented in this paper do not necessarily represent the views of the World Bank and the European Commission, but are meant as a contribution to the economic policy debate in the region.

This is the fourth regional study prepared by the PPMI program. For further information, please visit the PPMI website at www.ppmi.org
ABSTRACT

Deeper economic integration with the enlarged European Union—which accounts for a quarter of global GDP and foreign direct investment—could become a main driver for economic development in the southern Mediterranean countries. The planned Euro-Mediterranean free trade area for goods is a first step into that direction, but additional measures are needed. Especially the liberalization of services trade and the comprehensive domestic reforms this entails would strengthen the linkages with global and European markets. This study analyzes the adjustment needs and policy options associated with deeper integration between the two sides of the Mediterranean Sea. It puts specific emphasis on the dynamics of deeper integration at the company level and their respective policy implications. Besides a general discussion of deeper integration and trade in services liberalization, the study contains detailed assessments of individual sectors—especially the backbone services (e.g. transport, telecommunication, financial markets, electricity) and other sectors of relevance for deeper integration (tourism, IT-enabled services, distribution services). Even though the focus is on regional integration, multilateral liberalization issues are factored into the analysis (e.g. the GATS, the WTO Doha Round) and options for the pursuit of an “open regionalism” are explored.
ABBREVIATIONS AND ACRONYMS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>AA</td>
<td>Association Agreement</td>
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<tr>
<td>ANRT</td>
<td>Agence Nationale de Réglementation des Télécommunications</td>
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<td>ASA</td>
<td>air service agreement</td>
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<tr>
<td>Baltrel</td>
<td>Baltic Ring Electricity Cooperation Committee</td>
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<td>BPO</td>
<td>business process outsourcing</td>
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<td>CEE</td>
<td>Central and Eastern Europe</td>
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<td>CEEC</td>
<td>Central and Eastern European country</td>
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<td>CEER</td>
<td>Council of European Energy Regulators</td>
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<td>CEPS</td>
<td>Centre for European Policy Studies</td>
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<td>CSP</td>
<td>Country Strategy Paper</td>
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<td>DDA</td>
<td>Doha Development Agenda</td>
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<td>DSB</td>
<td>Dispute Settlement Body (of the WTO)</td>
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<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
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<td>ECAA</td>
<td>European Civil Aviation Area</td>
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<td>EDI</td>
<td>electronic data interchange</td>
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<td>EEA</td>
<td>European Economic Area</td>
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<td>EFTA</td>
<td>European Free-Trade Association</td>
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<td>EIB</td>
<td>European Investment Bank</td>
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<td>EMP</td>
<td>Euro-Mediterranean Partnership</td>
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<td>ENP</td>
<td>European Neighbourhood Policy</td>
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<td>ETSO</td>
<td>European Association of Transmission System Operators</td>
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<td>EU</td>
<td>European Union</td>
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<td>EURATEX</td>
<td>European Apparel and Textile Organisation</td>
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<td>FDI</td>
<td>foreign direct investment</td>
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<td>FEMISE</td>
<td>EU-sponsored economic research network for the southern Mediterranean</td>
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<td>FSAP</td>
<td>Financial Sector Assessment Program</td>
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<tr>
<td>FTA</td>
<td>free trade area</td>
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<tr>
<td>FTAA</td>
<td>Free Trade Area of the Americas</td>
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<td>GAFTA</td>
<td>Greater Arab Free Trade Area</td>
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<td>GATS</td>
<td>General Agreement on Trade in Services</td>
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<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
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<td>GCC</td>
<td>Gulf Cooperation Council</td>
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<tr>
<td>GDP</td>
<td>gross domestic product</td>
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<td>GNI</td>
<td>gross national income</td>
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<td>GNP</td>
<td>gross national product</td>
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<td>GPA</td>
<td>Government Procurement Agreement (of the WTO)</td>
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<tr>
<td>Acronym</td>
<td>Full Form</td>
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<tr>
<td>GSM</td>
<td>Global System for Mobile Communications (a technical standard)</td>
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<td>IAS</td>
<td>international accounting standard</td>
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<td>IASC</td>
<td>International Accounting Standards Committee</td>
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<td>ICT</td>
<td>information and communication technology</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IPP</td>
<td>independent power plant</td>
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<td>IT</td>
<td>information technology</td>
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<td>ITU</td>
<td>International Telecommunication Union</td>
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<td>JIT</td>
<td>just-in-time production</td>
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<td>MEDA</td>
<td>Mesure d’Accompagnement (EU financial assistance program for the MPs)</td>
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<td>MEED</td>
<td>Middle East Economic Digest</td>
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<td>MENA</td>
<td>Middle East and North Africa</td>
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<tr>
<td>MERCOSUR</td>
<td>Common Market of the South (Mercado Commún del Sur)</td>
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<td>MFN</td>
<td>most-favored-nation principle</td>
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<td>MP</td>
<td>Mediterranean Partner</td>
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<td>NAFTA</td>
<td>North American Free Trade Agreement</td>
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<td>NMS</td>
<td>new member state</td>
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<tr>
<td>NT</td>
<td>national treatment (WTO principle)</td>
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<td>NTB</td>
<td>non-tariff barrier</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<td>OPT</td>
<td>outward processing trade</td>
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<tr>
<td>PPMI</td>
<td>Programme on Private Participation in Mediterranean Infrastructure</td>
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<tr>
<td>PPI</td>
<td>private participation in infrastructure</td>
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<td>PPP</td>
<td>purchasing power parity</td>
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<td>PTA</td>
<td>preferential trade agreement</td>
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<td>QIZ</td>
<td>qualified industrial zone</td>
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<tr>
<td>ROOs</td>
<td>rules of origin</td>
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<tr>
<td>SME</td>
<td>small and medium enterprise</td>
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<tr>
<td>TA</td>
<td>technical assistance</td>
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<tr>
<td>TNC</td>
<td>transnational corporation</td>
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<tr>
<td>TRIPS</td>
<td>Agreement on Trade-Related Aspects of International Property Rights</td>
</tr>
<tr>
<td>TSO</td>
<td>transmission system operator</td>
</tr>
<tr>
<td>UCTE</td>
<td>Union for the Coordination of the Transmission of Electricity</td>
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<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
</tr>
<tr>
<td>U.S.</td>
<td>United States of America</td>
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<tr>
<td>WTO</td>
<td>World Trade Organization</td>
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EXECUTIVE SUMMARY

Many countries of the Middle East and North Africa (MENA) region have experienced two decades of economic stagnation and marginalization in the global economy. The exports of the region are small, non-dynamic, and poorly diversified. The entire MENA region with its 300 million inhabitants, for instance, has fewer non-oil exports than Finland or Hungary—with 5 and 10 million inhabitants respectively. Foreign direct investment (FDI) accounts for only half a percent of GDP and a mere two percent of Europe’s FDI go to its southern neighbors. With the exception of a few countries (e.g. Tunisia, Israel) and markets (e.g. textiles), the region has failed to use trade and FDI as an engine for economic development—in stark contrast to countries such as Chile, Malaysia, or Slovakia. EU enlargement to the East and fierce global competition by countries like China or India, threaten to further erode their international competitiveness.

The large performance gap between the southern Mediterranean and comparator countries in terms of exports and FDI has, however, an important positive implication. By closing only half of this gap over the coming decade, the region could quadruple its per capita growth rate from one to four percent of GDP. This is urgently needed to raise living standards and to create jobs for a rapidly growing population. To achieve this, the southern Mediterranean countries should develop a strategy for better integration into the global economy. With the neighboring European Single Market accounting for a quarter of world trade and outward investment, deeper integration with the EU should be a core element in any such strategy. This will require the southern Mediterranean countries to implement comprehensive policy reforms as a means to improve the investment climate, raise productivity, and eliminate a host of trade barriers.

The Euro-Mediterranean Partnership, launched in 1995 between the European Union (EU) and its 12 Mediterranean Partners (MPs), has not yet translated into better trade and FDI performance for the eight Arab MPs. The agreed upon free trade area is for goods only and excludes the two-thirds of total value added that is being generated in the services sectors and in agriculture. Not surprisingly, most studies that have estimated the potential welfare gains of the Euro-Mediterranean free trade area for the MPs, expect static growth effects of merely 2 percent of GDP. Even the limited free trade area that has been agreed upon will take about 20 years to implement, as the deadline for its completion is slipping from 2010 to 2015. In contrast, one of the few studies that looked at the potential effects of deeper integration came to the conclusion that they range from 4 to 20 percent of GDP, depending on the depth of integration. The European Neighbourhood Policy (ENP) that the enlarged EU is developing vis-à-vis its neighbors could provide an appropriate framework for a deepening of the Euro-Mediterranean free trade area with the objective to unlock that growth potential.

When contemplating integration options, it should be recalled that the ultimate objective is to reap the gains from trade arising from comparative advantage, scale economies, import competition, knowledge spillovers, and FDI flows. Besides tariffs or quotas, a multitude of non-tariff barriers (NTBs) obstruct economic transactions and resource flows across borders. Most of these frictions are induced by inefficiencies in the legal, regulatory, and institutional framework. The objective of deeper integration measures is to remove such non-tariff barriers (NTBs) in order to permit economies to mesh at the micro-level (individual firms or markets). As deeper forms of integration

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1 Two MPs have acceded to the EU in May 2004 (Cyprus and Malta) and two have a special status (Turkey has a customs union with the EU and Israel is a high-income country). The focus of this report is the more homogenous group of the eight Arab MPs: Morocco, Algeria, Tunisia, Egypt, Jordan, Syria, Lebanon, and West Bank and Gaza.
remove a wider range of policy distortions, they tend to yield larger welfare gains. However, since
they can also entail significant negotiation, transition, or compliance costs, deeper integration should
be pursued in a selective manner. Governments should identify priority sectors and policy areas and
they should deepen integration gradually over time. In political economy terms, an advantage of
deeper integration is that it provides a compelling long-term vision (full economic integration with
global and European markets), but that it can be implemented selectively (à la carte) and at multiple
speeds (starting with countries or sectors that are ready to go ahead).

In principle, multilateral trade liberalization is preferable to regional liberalization. The reason is that
it minimizes trade diversion and negotiation costs; it increases transparency for traders; and it gives
countries recourse to the dispute settlement mechanisms of the World Trade Organization (WTO).
On the other hand, there are also important arguments in favour of regional agreements. They might
be easier to negotiate; they permit for progress in areas where multilateral reforms are less advanced;
and they are particularly relevant in markets where geographic or cultural proximity matters.
Especially beneficial for developing countries can be North-South integration with industrialized
neighbors. These types of agreements offer greater potential for trade driven by complementary
resource endowments, knowledge spillovers, FDI flows, and the external anchoring of domestic
reforms. The Euro-Mediterranean free trade area is such a North-South agreement and the Arab MPs
could benefit substantially from deepening this agreement. The ideal scenario, however, would be a
type of "open regionalism"—with the MPs giving priority to multilateral liberalization and
complementing it through carefully selected deeper integration efforts at the regional level.

In developing such a strategy, it is useful to draw policy lessons from two precedent cases of North-
South integration: the North American Free Trade Agreement (NAFTA) and the process of Eastern
European enlargement. Thanks to NAFTA and domestic reforms, Mexico tripled its annual trade
during the 1990s (to $280 billion) and attracted $85 billion of FDI between 1994 and 2000 alone.
Progress in the Central and Eastern European countries (CEECs) was equally impressive. A good
indicator for the dynamics of North-South integration is trade: both the share of the CEECs in total
EU imports and the share of Mexico in total U.S. imports doubled between 1994 and 2000 (to 4 and
11 percent respectively). This is in stark contrast to the eight Arab MPs, whose share in total EU
imports stagnated below 1.5 percent during the same period. That is not surprising, since both
NAFTA and European enlargement involved deeper forms of integration than that between the EU
and its southern neighbors. NAFTA liberalized trade in services, trade in agricultural products, trade
related to public procurement, and it pursued regulatory harmonization in a few selected areas (e.g.
product standards). The CEECs not only liberalized trade vis-à-vis the EU, but they also adopted the
entire set of EU rules and regulations (the acquis communautaire). In both of these cases of North-
South integration, the developing partners also implemented far-reaching domestic reforms.

Full regulatory harmonization, as required for EU accession, however, is a complex way to remove
non-tariff barriers. Most NTBs can best be removed through domestic reforms (e.g. a streamlining of
customs procedures). In other cases, more limited forms of regulatory convergence suffice. The MPs
should only pursue regulatory convergence with EU rules in policy areas, where those are in line
with international best practice and could thus facilitate domestic economic adjustment. Since the
optimal type of regulation often varies with the level of economic development, regulatory
convergence in North-South agreements should be confined to policy areas where that is not the case.
Given these and other considerations, the ideal policy tools to achieve deeper integration have to be
assessed on a case-by case basis. In economic terms, deeper integration between the EU and the MPs
can be conceptualized as the extension of the "four freedoms" of the Single Market to the South (the
movement of goods, services, capital, and labor). This, however, does not necessarily require the full
adoption of the acquis communautaire, as was the case in the CEECs. A targeted removal of tariff and
non-tariff barriers through trade liberalization, domestic reforms, and partial regulatory convergence would go a long way in achieving this objective. Overall, the large income gap between the EU and the MPs suggests that the NAFTA model of deeper integration is more appropriate than the CEEC model.

As the MPs seek to identify priority areas for deeper integration, reforms in the backbone services—such as transport, telecommunications, or financial services—seem particularly urgent. These services facilitate economic transactions and resource flows across borders and thus act as connectors between economies. To appreciate the importance of backbone services, it is useful to understand the dynamics of outward processing trade (OPT). Due to business trends such as outsourcing and a focus on core competencies, the production process is becoming increasingly fragmented and labor-intensive production stages are being transferred to developing countries. The “production blocks” in these sliced value chains are being connected by “service links” (e.g. communication, logistics, legal and financial services). Participating in the tightly integrated production networks of the global economy—with just-in-time production and sophisticated supply-chain management—requires access to efficient backbone services. So far, however, the Arab MPs barely participate in international production sharing, which partly reflects the deficiencies in their backbone services. For instance, Turkey or Poland each imported as many parts and components in 2000 as all eight Arab MPs taken together, while their exports of parts and components were twice (for Turkey) and four times (for Poland) as high.

Furthermore, the combination of EU enlargement and fierce competition in labor-intensive manufacturing by countries such as China, threatens to erode the competitive position of the Arab MPs in the few markets were they still effectively participate. These countries will need to harness new sources of comparative advantage, and their geographic and cultural proximity to European markets seems to be the most promising one. Exploiting that proximity, however, will require deeper integration efforts and especially more efficient backbone services. In tourism and IT-enabled services, for instance, proximity (common time zone, common languages) can create an advantage, but efficient transport and telecom markets are required to exploit this. In time-sensitive manufacturing—like just-in-time delivery of car parts or in-season replenishments in the garment industry—geographic proximity is also critical. Yet again, it only translates into a comparative advantage if combined with state-of-the-art communications and logistics. Being next door to European markets is a great advantage, but effectively participating in these markets will require comprehensive reforms and the improvement of services and infrastructure in the MPs.

For a number of reasons, trade in services liberalization could become a powerful policy vehicle for trade-driven growth in the MPs. First, services sectors account for an average of 57 percent of GDP in the eight Arab MPs. Many of these sectors have long been shielded from competition and services liberalization could bring important efficiency gains. Second, services are an important input in other economic activities (they tend to account for 10-20 percent of production costs) and a liberalization of trade in goods without liberalization of trade in services would increase effective rates of protection for the latter. Third, the liberalization of trade in services require comprehensive domestic reforms. As most services are non-tangible and non-storable, their exchange usually requires physical interaction between buyer and seller. Most trade barriers thus come in the form of behind-the-border policies. Lifting these barriers will require very similar reforms as those needed for the sake of domestic economic adjustment (e.g. liberalization of market access, elimination of red tape, breakup of state-owned monopolies). Not surprisingly, the gains from liberalization in services trade usually exceed the gains from liberalization in merchandise trade.

Trade in services can occur through four modes of delivery: cross-border supply (e.g. online services), consumption abroad (e.g. tourism), commercial presence (e.g. foreign bank branches or
supermarkets), and the presence of natural persons (e.g. engineers overseeing a construction project). The relevance of the different modes varies significantly between services. However, since commercial presence tends to be the dominant mode, services trade is often associated with FDI and the employment of domestic workers by foreign service suppliers. Consumption abroad is mainly relevant for tourism, while technological progress is making cross-border supply a feasible mode for an increasing number of services. The presence of natural persons for the purpose of service delivery should not be confused with migration, as it is of a temporary nature. Policymakers should not distort the optimal modal mix and thus liberalization should occur across modes.

At the multilateral level, trade in services is being liberalized through the General Agreement on Trade in Services (GATS) under the auspices of the WTO. The GATS entered into force in 1995, after the conclusion of the Uruguay Round of multilateral trade negotiations. Separate negotiations on telecommunications and financial services were subsequently completed. Except for a few sectors, such as tourism and telecommunications, liberalization has not progressed very far and most countries have only committed to reforms that they had already undertaken unilaterally. A broadening and deepening of multilateral commitments under the GATS is thus one of the main objectives of the ongoing WTO Doha Round, which was launched in 2001. Each WTO member can select those sectors for which it is willing to subject itself to GATS disciplines—such as the most-favored nation principle, the national treatment principle, the transparency principle, or the institutionalized dispute settlement mechanisms of the WTO. For each of these “bound” sectors, any remaining trade restriction has to be explicitly listed in the country’s GATS schedule of commitments (“positive list”). Schedules consist of a matrix of commitments for various sectors and sub-sectors, as well as the four modes of supply.

The GATS commitments of the eight Arab MPs has been limited so far. Four of these countries are not yet WTO members (Algeria, Lebanon, Syria, and West Bank and Gaza). Of the other four, Tunisia has bound only 3 out of 11 possible sectors, Egypt 4, Morocco 7, and Jordan 11. Tourism and financial services are those sectors that were most frequently bound (by four of the eight Arab MPs), followed by telecommunications, construction, and transport services (bound by three countries each). Overall, the region lags considerably behind the commitments made by comparator regions such as Eastern Europe or the Balkans. As part of the Doha negotiations, the MPs countries should not only bind a greater number of sectors, but they should also deepen their relatively limited commitments in bound sectors. They should consider to make greater use of precommitments—in other words inscribe liberalization measures into their schedules, which they plan to implement in the future. Just like a regular commitment, this can send an important signal to investors, it can externally anchor domestic reforms, and it discourages vested interests to lobby for trade protection.

At the regional level, the Euro-Mediterranean free trade area does not yet extend to any of the services sectors. While the bilateral Association Agreements under the Euro-Med Process foresee an opening of negotiations on services trade within five years upon their entry into force, this deadline has already lapsed for Tunisia and Morocco. A number of regional policy documents call for an extension of the free trade area to services and Euro-Mediterranean Ministers of Trade have established a working group to study different policy options. In any case, the most-favored nation (MFN) obligations of the GATS, limit the scope for preferential trade agreements at the regional level. The best strategy thus seems to be the pursuit of an “open regionalism”: multilateral commitments and the associated domestic reforms would receive priority attention. They could then be “topped up” by regional integration in sectors where the GATS framework is poorly developed (e.g. air transport and electricity), or where institutional cooperation is needed for deeper integration (e.g. between electricity regulators, customs authorities, or the mutual recognition of professional qualifications). In services sectors, where cultural and geographic proximity matter, regional patterns
are likely to emerge even in the case of multilateral liberalization (e.g. regional branch networks of banks or supermarkets). Given the cultural homogeneity of the Arab MPs, there also seems to be significant potential for South-South integration in some services sectors.

One priority sector for deeper integration is transport, which is an important facilitator for trade and tourism. The examples of Mexico and Eastern Europe show that regional integration and transport reforms should go hand-in-hand. Currently, transport inefficiencies in the eight Arab MPs impose economic costs between €3 and 7 billion per year. In maritime transport, reforms would involve the liberalization of port services, the concessioning of major terminals to private operators, and the establishment of landlord ports. Priorities in air transport are increasing private sector participation in key airports and in the sector as a whole, the introduction of competition in ground handling, the restructuring of flag carriers, and the liberalization of international traffic rights. The ultimate objective should be the transition towards open skies regimes and the creation of a regional civil aviation area. In land-based transport, priorities should be given to the restructuring of national railway companies, policy coordination along regional corridors, the liberalization of road freight, and harmonization of standards for cross-border traffic. For a seamless integration of the multimodal system, the streamlining of customs procedures, a removal of frictions at modal interfaces, and policies to increase containerization rates are needed. Given the rather limited GATS provisions on transport and the importance of geographic proximity, liberalization in this sector is best pursued through domestic reforms and regional initiatives.

Financial services (banking, insurance, capital markets) are also critical for integration into the global economy. In this sector, domestic reforms anchored by multilateral commitments should be priorities for the MPs. There is much less economic rationale for regional policy initiatives than in the case of transport and the EU policy framework in the sector does not seem readily transferable to less developed neighbors. In most MPs, the degree of state-ownership remains high; capital markets are small and immature; and there is relatively little foreign investment in the sector. This contrasts with the situation in Eastern Europe, where comprehensive policy reforms during the 1990s allowed foreign financial institutions to bring new capital, modern management, and competition to the sector. MPs should strengthen prudential regulation, privatize financial institutions, and gradually open financial markets to foreign investors. These domestic reforms should be anchored by a deepening of GATS commitments in the sector. As Latin America and Eastern Europe have shown, scale economies and the importance of cultural proximity are likely to lead to the emergence of regional branch networks and market structures.

Another important backbone service—both for economic development and connection to the global economy—is telecommunications. In telecom, just like in financial markets, the GATS framework is well developed and multilateral liberalization, in combination with domestic sector reforms should be the priority. Even though the rules of the EU Single Market largely reflect international best practice, there is little need for regulatory coordination or specific infrastructure linkages at the regional level. Telecom happens to be the backbone service, where reforms in the MPs are most advanced. The introduction of private participation and competition in mobile telephony through the tendering of licenses to mostly foreign investors, has been a huge success. This raised fiscal revenues, triggered significant investments in new infrastructure, and brought dynamic competition with falling prices and an explosive growth in the subscriber bases. In several MPs, the number of mobile connections now exceeds that of fixed lines. Several MPs have also established independent regulators, started to privatize national operators, and liberalized value-added services (e.g. internet access). Overall, however, reforms in fixed-wire have lagged considerably behind those in mobile telephony. A strengthening of pro-competitive regulation (e.g. interconnection rules and more autonomous
regulators), the complete privatization of telecom companies, the issuing of third mobile licenses, and the full liberalization of value added services are needed to complete the reform process.

Electricity is not a backbone service in the sense that it facilitates economic integration in other sectors, but in the sense that physical infrastructure is needed for cross-border transactions. With the exception of Jordan and to a lesser extent Morocco, electricity sector reforms in most MPs are still at an early stage, if compared to regions like Latin America or Eastern Europe. The sector remains dominated by vertically integrated, state-owned, and insufficiently regulated monopolies. With demand growing rapidly, very large investments will be needed in the coming years, but so far private participation is limited to a few independent power plants. As physical interconnection is a precondition for electricity trade and deeper forms of integration (e.g. power pools) are only possible among neighboring countries, cross-border liberalization in this sector should primarily be pursued at the regional level. In any case, electricity is one of the sectors where the GATS framework is least developed. Comprehensive reforms at the national level are a necessary condition for trade and deeper forms of integration in the electricity market. EU-internal rules for the sector provide a good template for the dual pursuit of domestic reforms and cross-border integration and could serve as a basis for regional integration efforts.

Trade in IT-enabled services could become one of the fastest growing segments of Euro-Mediterranean trade. Similar to the fragmentation of the production chain, specialized services (e.g. accounting, billing, call centers) are increasingly being outsourced and relocated to developing countries. It has been estimated that up to 25 percent of traditional IT jobs will be transferred from industrialized to developing countries by 2010 and that 30 percent of large European companies will build “offshoring” in their business plans. India is the developing country that has most benefited from such business process outsourcing so far. IT-related services exports already account for $8 billion per year and are supposed to triple by 2008, and 100,000 people work in call centers alone. In principle, the southern Mediterranean countries seem well placed to provide IT-enabled services to European markets. They have low wages, a large number of unemployed with higher education, and they enjoy both geographic proximity (same time zone) and cultural proximity (proficiency in European languages). So far, however, the MPs have barely started to exploit those sources of comparative advantage. To do so, they need a more competitive telecom sector, a more conducive business environment for foreign investments, and full liberalization of IT-enabled services.

Tourism is by far the most important services export of most MPs and arguably the sector where deeper integration between the two shores of the Mediterranean Sea is most advanced. Tourism accounts for around 20 percent of total exports in Egypt, Jordan, and Morocco, and for a high 44 percent in Lebanon. With geographic proximity an important factor, the vast majority of tourists come from Europe. The eight Arab MPs earn tourist receipts in the magnitude of $11 billion per year, and in Morocco alone 600,000 people are directly or indirectly employed in the sector. Tourism also happens to be one of the services sectors that is most liberalized across the region (few restrictions to foreign entry, low levels of state-ownership, dynamic competition, far-reaching GATS commitments). While reform needs are few, several MPs are trying to proactively develop this sector through infrastructure investments, the rehabilitation of historic sites, or better marketing. Liberalization of air transport would also help to develop this sector.

Two services that can also be regarded as backbone services facilitating economic transactions and resource flows across borders are distribution services and business services. Efficient business services—including accounting, management consulting, or legal advice—are an important part of the overall business environment for any country. Generally speaking, these services are fairly liberalized in most MPs, but some restrictions regarding rights of establishment and the recognition
of professional qualifications remain (e.g. for lawyers, doctors, or architects). Given the importance of cultural proximity in many business services (e.g. language, business practices, legal traditions), there seems to be substantial potential for South-South integration among the Arab MPs. Mutual recognition agreements and similar reforms would facilitate deeper integration. In distribution services (retailing and wholesaling), most MPs maintain relatively stringent market access restrictions (e.g. for foreign supermarkets or branded retailers). They should consider more far-reaching GATS commitments in this sector. While there is no economic rational for preferential market access, regional patterns (e.g. cross-border networks of retail outlets) are likely to emerge in response to multilateral liberalization.

Besides the sectors reviewed above, a number of other policy areas are relevant for deeper integration. Most important of these is perhaps agriculture. While beyond the scope of this analysis, markets for agricultural products remain among the most protected and distorted on both sides of the Mediterranean. Given different resource endowments, the potential gains from trade driven by comparative advantage are substantial once policy restrictions are removed. More effective cross-border competition in public procurement—which accounts for about 10 percent of GDP—would also be an important instrument to deepen integration with global and European markets. Stricter competition policies in the MPs and the harmonization of product standards are other areas where the economic payoffs from domestic reforms and regulatory convergence are likely to be significant.

Given this wide range of policy areas, MP governments should start with those sectors and themes where welfare gains are expected to be greatest. They should not pursue cross-border integration for its own sake, but use it strategically to accelerate and anchor economic reforms at the national level. While multilateral liberalization of trade is often the first best option, a well-balanced form of "open regionalism" seems sensible. Geographic and cultural proximity to European markets are an important source of comparative advantage for many MPs and removing non-tariff barriers to these markets—including inefficiencies in the backbone services—is critical to exploit this. Multilateral commitments should be "topped-up" by more far-reaching regional integration measures in policy areas where multilateral negotiations are progressing slowly or in areas where proximity matters.

The EU could use its European Neighbourhood Policy to reinvigorate the partnership with its southern periphery and to provide stronger incentives for economic reforms in the Arab MPs. Specific and binding Action Plans, additional financial assistance for fast reforming countries, and the reciprocal exchange of trade concessions (e.g. access to agricultural markets, more temporary working visas), could all be part of a more highly-geared incentive regime. A clear vision and a well-designed policy framework for regional integration would also facilitate donor coordination.
INTRODUCTION

This study analyzes how the southern Mediterranean countries could use the liberalization of trade in services as a policy vehicle for deeper integration with the global economy—and particularly with the large European market at their doorstep. Two developments have motivated this analysis: The need to reassess the Euro-Mediterranean Partnership in the wake of EU enlargement and the serious marginalization of the Arab countries in the global economy.

Integrating the Southern Mediterranean into the Global Economy

An increasing number of low and middle income countries have successfully used integration with global markets to attract foreign direct investment, generate export-led growth, and create jobs in trade-related industries. Examples include the East Asian “tiger” economies; Mexico; and the countries of Central and Eastern Europe. The Middle East and North Africa (MENA) region, however, has almost entirely missed out on the opportunities offered by the process of globalization over the past two decades. An extensive World Bank study, published in 2003, analyzes the low level of trade integration of the MENA countries. Whereas most regions increased their trade-to-GDP ratio, the one of MENA actually fell in each of the five-year periods between 1985-99. Diversification of exports away from petrochemicals and raw materials, measured by different concentration indices, has been slow and lags far behind other regions. “Finland, with 5 million people, has almost twice the non-oil exports of the entire MENA region,” with its almost 300 million inhabitants. “And the Czech Republic and Hungary, with populations of about 10 million, each had greater non-oil exports” (World Bank 2003b). Other indicators tell the same story: Intra-industry trade ratios lag considerably behind those of comparator countries and the percentage of dynamic products (i.e. with growth rates over 15 percent) in the region’s non-fuel exports fell from 9.8 percent in 1988 to 2.6 percent in 2000.

Besides the low levels of trade integration illustrated by these statistics, the MENA countries have also been sidelined with respect to global capital flows. Between 1986 and 1996, foreign direct investment (FDI) accounted for less than half a percent of regional GDP. Many emerging economies achieved a multiple of that figure. Despite geographic proximity, a mere 2 percent of European outward investment goes to the MENA region. The low performance of the southern Mediterranean with regard to exports and FDI inflows becomes obvious, if benchmarked against average figures for countries with similar levels of per capita income, natural resource endowments, and population. Compared to their potential non-oil exports and FDI inflows, virtually all MENA countries underperform significantly (see diagram on the following page). “Only Jordan and Morocco had exports close to what would be predicted. The world’s three biggest underperformers are MENA countries (Algeria, Egypt, and Islamic Republic of Iran), and the other MENA countries are all underperformers.” In 2000, Algeria, Morocco, and Syria attracted negligible amounts of FDI. Egypt, Tunisia, Jordan, and Lebanon also remained significantly below their potential. This is in stark contrast to emerging economies in Eastern Europe or Asia, who have used global integration as a catalyst for economic development.

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2 World Bank (2003b). The World Bank definition of the Middle East and North Africa (MENA) region does include the eight Arab MPs—but not Turkey and Cyprus. On the other hand, it extends to several countries that are not part of the EMP—such as Malta, Libya, Iran, Iraq, Djibouti, and the countries of the Arab peninsula.

3 The respective figures were -4.2 (1985-89), -0.2 (1990-94), and -0.8 (1995-99), compared to +2.7, +6.5, and +5.9 percent respectively for Latin America.

4 Benchmarking and calculation of the “potential” levels from a sample of 42 countries (World Bank 2003b).
A positive interpretation of these structural deficiencies is that a closure of the performance gap could lead to a dramatic increase in economic growth and job creation—an increase that MENA countries with their high unemployment rates and stagnating per capita income urgently need. “Even if only half the region’s trade and private investment potential were realized over the next 10 years, per capita GDP growth would jump from 1 percent to about 4 percent a year—half from more private investment, and half from the greater productivity that openness would encourage.” To achieve such trade-driven growth, however, the southern Mediterranean countries will need to reduce tariff and non-tariff barriers, improve their investment climate, and accelerate the process of economic adjustment. This study argues that a liberalization of trade in services and deeper integration with their large industrialized neighbor, the European Union, should be core elements of any such reform strategy.

Diagram: Non-oil Exports and FDI Inflows Compared to Potential Values (2000)

Source: World Bank (2003). 1.0 = potential export and FDI values (conditioned on openness, natural resources, and population); sample size = 42.

Reinvigorating the Euro-Mediterranean Partnership

Eight years after the launch of the Euro-Mediterranean Partnership (EMP), and following EU enlargement towards Central and Eastern Europe (CEE), the time also seems ripe for a reassessment of the relationship between the European Union and its Mediterranean Partners (MPs). The Barcelona Conference of November 1995 raised hopes that the EMP would lead to the creation of a “region of shared peace and prosperity” around the Mediterranean Sea. So far, however, the economic impact on Europe’s southern neighbors has been limited. While the reasons for this are many, progress towards the establishment of the regional free-trade area (FTA) for goods—the economic centerpiece of the partnership—has been slower than expected. The deadline for its completion is likely to slip from 2010 to 2015. Even if implemented as planned, most estimates regarding the economic gains from the agreed tariff reductions are rather small—usually below 5 percent of GDP. Moreover, the EMP has not yet become a catalyst for economic and social reforms in the southern Mediterranean, as initially hoped for. This study argues that deeper integration and the liberalization of trade in services offer a promising strategy for reinvigorating the economic dimension of the Barcelona Process.

EU enlargement creates additional impetus for a reassessment. In May 2004, eight CEE countries and two MPs (Cyprus and Malta) have acceded to the European Union. A third MP (Turkey) has entered into a customs union with the EU and is an official accession candidate. Israel, as the only high-income economy in the region, might eventually become part of the European Free Trade
Association (EFTA). The process of EU enlargement has two key implications for the southern Mediterranean. First, the EMP will largely boil down to a partnership between the EU on the one hand and the eight Arab MPs on the other. With EU membership not a realistic scenario, the question arises of how the partnership could progress beyond the rather limited FTA that is now under implementation. Second, the full integration of eight CEE countries into the European Single Market will make it more difficult for the Arab MPs to compete for European imports and outward investment. They will need to develop mechanisms to better plug into the enlarged Single Market. Deeper forms of economic integration and especially an extension of the FTA to the services sectors seems to offer a way forward. The European Neighbourhood Policy, launched by the European Commission in 2003 for countries bordering the enlarged EU, could provide a well-suited policy framework for such an ambitious undertaking.

The first chapter of this study argues that economic integration—both with regional trading partners and with the global economy—is a continuum between shallow and deeper forms of integration. It explains that the European Single Market is the most deeply integrated block in the world and that a system of concentric circles has emerged around the EU—in which countries closer to the center are more deeply integrated economically, than those on the periphery. Chapter 1 also discusses the implications of EU enlargement for the MPs and it explores policy options for deeper integration between the EU and its southern neighbors. In particular, it looks at the importance of trade-related services for such deeper integration. The second chapter discusses linkages between trade in services liberalization and national regulatory reform. It assesses to what extent the liberalization of services trade could become a vehicle for deeper Euro-Mediterranean integration. In that context, it explores how regional services liberalization through the Barcelona Process and multilateral liberalization through the WTO could be combined to achieve a type of open regionalism. The third and fourth chapters apply the general insights derived from these discussions to key services sectors (e.g. transport, financial markets, tourism) and cross-sector policies (e.g. public procurement, competition policy, norms and standards).

The geographic focus of this study are the eight Arab MPs. These countries have a number of things in common: they are at a similar level of economic development, they share similar reform challenges, and they all do not yet know how deeply they will eventually integrate with the EU. Despite this emphasis on the Arab MPs, references will also be made to Israel and Turkey. Turkey already has a customs union with the EU and is recognized as an accession candidate. Israel is the only high-income country in the region and could in theory participate in the European Single Market. Whereas these two MPs face different domestic reform challenges and integration options, any comprehensive regional strategy has to take them into account.

5 Morocco, Algeria, Tunisia, Egypt, Jordan, Syria, Lebanon, West Bank and Gaza.
Chapter 1

Deeper Integration

1.1 The Continuum of Deeper Integration
1.2 The Importance of Backbone Services
1.3 Concentric Circles of European Integration
1.4 EU Enlargement and Prospects for Euro-Mediterranean Integration
1. DEEPER INTEGRATION

The European Union (EU) is the most important trading partner of the southern Mediterranean countries, accounting for more than half of their trade (see diagram 1.1). Trade integration of the Maghreb countries with the EU is more pronounced than that of the Mashrek. Despite the relatively high EU shares in trade of the Mediterranean Partners (MPs), however, the absolute size and composition of trade flows suggests that much of the trading potential between the EU and its Arab neighbors remains unexploited. For example, Turkey and Israel—with their 70 million inhabitants—trade as much with the EU as the eight Arab MPs, with their 160 million inhabitants (see table 1.1). Moreover, the vast majority of exports from the Arab MPs to the EU consist of raw materials (e.g. oil, gas, phosphate) and low value added manufactures (e.g. garments). Extreme cases are Algeria and Syria, where 96 and 86 percent respectively of exports to Europe are petrochemicals (Handoussa and Reiffers 2001). In principle, geographic proximity to the world’s second largest market and the emerging regional free trade area provide the opportunity to develop trade-driven growth strategies (see page 11 for a map of the region). This, however, would require accelerated economic reforms in the southern Mediterranean countries and with European and global markets.

1.1 The Continuum of Deeper Integration

Reducing trade barriers to the outside world can yield significant benefits to a country. Gains from trade can derive from comparative advantage, economies of scale, import competition, knowledge spillovers, and foreign direct investment. In principle, multilateral trade liberalization is the first-best option to reap these gains, but in practice regional trade blocks have often been important building blocks for the global trading system. Economic integration between countries can be regarded as a continuum leading from loose integration (e.g. the removal of tariffs and quantitative restrictions) to deep integration (e.g. the removal of legal, regulatory, and institutional barriers). Since deeper forms of integration remove a wider range of distortions between national economies, they tend to yield greater welfare gains than shallow integration. Geographic proximity facilitates economic integration between countries and deeper forms of integration, in particular, can best be achieved at the regional level.

Deeper cross-border integration entails domestic policy reforms. Whereas trade liberalization has traditionally been focused on the removal of tariffs and quotas, a range of non-tariff barriers (NTBs) can also segment national markets. Product standards, market access restrictions, government procurement rules, and other elements of the regulatory framework can disrupt or distort economic

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6 The relative merits of regional and multilateral liberalization are discussed in Annex C.
An OECD study analyzing trade patterns in the region also found that MP “trading capabilities are weak in those sectors that are most often associated with rapid progress in developing countries” and with participation in global production networks (Petri 1997). The export bundles of these countries are not dynamic (few products for which trade grows disproportionately), not sophisticated (low proportion of high value-added exports), show little compositional change over time (an indicator of economic transformation), and are characterized by low shares of intra-industry trade (an indicator for deeper integration). As table 1.2 shows, the situation in the southern Mediterranean contrasts dramatically with Eastern Europe or the East Asian “tiger” economies. Malaysia, for instance—with a smaller population than Algeria or Morocco—exports more than 20 times as many parts and components to OECD countries than all the Arab MPs jointly. Moreover, its exports are far greater than its imports and the share of parts and components in its manufactures trade has risen significantly.

Box 1.2 Rules of Origin as an Obstacle to Deeper Regional Integration

A major impediment for the development of regional production networks (besides inefficient “backbone” services) are frictions arising from rules of origin (ROOs). If imports from one party of a preferential trade agreement are to qualify for tariff exemptions in another, these goods have to “originate” from the exporting country. ROOs define the conditions that a good has to meet to obtain that status—such as a minimum content of domestic value added or specific processing steps performed in the exporting country. The current system of ROOs in the Euro-Mediterranean constitutes an important barrier to deeper regional integration and the expansion of trade. The problem is that the regional free trade area is being implemented through a patchwork of bilateral agreements, with incompatibilities between the ROOs used in different agreements. If all trade were on a purely bilateral basis, this would not be a problem. Due to the fragmentation of the production chain, however, many goods cross multiple borders as they are being processed from raw material to final product. Depending on the sequence of trades this entails, different ROOs apply. If these rules are incompatible, two things happen. First, companies involved in cross-border supply-chains will incur substantial information and transaction costs. Second, goods traded within the free trade area may not qualify for tariff exemptions, even if produced entirely within the region. The system of ROOs that currently exists across the Mediterranean unnecessarily hampers and distorts trade flows. In particular, obstacles to the cumulation of origin discourage the creation of regional production networks and industry clusters. The need for reforms has been widely recognized and in July 2003, a regional meeting of Trade Ministers endorsed an overhaul of the system of ROOs within the Euro-Mediterranean free trade area. (For a detailed discussion, see Annex B.)
1.3 Concentric Circles of European Integration

The European Union, which had 15 member states and 375 million inhabitants in 2003, is by far the most deeply integrated economic block in the world. During its 50-year history, it has gradually moved along the continuum of deeper integration. After liberalizing trade in goods and creating a customs union (1963), it established the European Single Market (1992) with a harmonized regulatory framework and free factor mobility.\textsuperscript{14} Besides its "four freedoms" for the movement of goods, services, labor, and capital, the EU has a joint monetary policy that gradually progressed from a fixed exchange rate system to a single currency (1999). There are also common rules on a wide range of other economic policies, including tax regimes and fiscal deficits. Some of the most recent economic reforms in the EU have transformed its network industries (telecoms, electricity, gas, transport, postal services) and an ongoing reform package is doing the same for financial markets.\textsuperscript{15} The \textit{acquis communautaire}, the corpus of EU law, comprises a total of about 80,000 pages—covering all policy areas, not just economic policy. In many areas of economic policy, EU regulations have not only facilitated cross-border integration between member states, but also triggered economic reforms at the national level.\textsuperscript{16} A unique feature of the EU is the transfer of national sovereignty to supranational institutions—for instance, the European Commission enforces competition and state aid rules and the European Central Bank conducts monetary policy.

The EU has not only successively broadened its membership and deepened the integration among members.\textsuperscript{17} It has also gradually intensified economic integration with neighboring countries. In fact, European economic integration can be compared to a system of concentric circles—in which countries in the inner circles are more deeply integrated, than those in the outer circles.\textsuperscript{18} The EU member states with their fully integrated Single Market form the core of this regional economic block. The second ring comprises the EFTA countries (Norway, Iceland, Switzerland), which participate in the Single Market and have adopted the majority of EU regulations. The third ring is formed by the accession countries of Central and Eastern Europe (CEECs), which are part of the agreement on Pan-European Rules of Origin and which are bringing their laws and regulations in line with those of the EU. The MPs, which have signed bilateral Association Agreements and will enter into a regional free-trade area with the EU, constitute a fourth ring. Turkey and the Balkan countries are somewhat between the CEECs and the MPs in terms of deeper integration. In summary, the closer a country is to the core of this system of concentric circles (the EU), the more it has progressed along the continuum of economic integration.

There is also a dynamic dimension to this analogy of concentric circles. The inner circles on a water surface set in motion, gradually expand to replace what were formerly the outer circles. A similar development can be observed in the process of European integration. Just as the "hard core" of this regional economic block grows (through successive rounds of EU enlargement) and as the inner layers "harden" (through a deepening of economic reforms), the economic ripple effects of the EU radiate further and further into neighboring regions. Over time, most countries in the EU's proximity have moved towards deeper forms of integration. The majority of former EFTA countries, such as Austria or Sweden, have graduated to EU membership and most of the remaining ones have

\textsuperscript{14} The "1992 program" consisted of 280 legislative measures to tackle regulatory, tax-based, and other barriers that segmented national markets. Ten years after this "big bang," the framework of the Single Market is still being fine-tuned.
\textsuperscript{16} Especially in small member states, more than half of new legislation is nowadays being initiated at the EU level.
\textsuperscript{17} Originally, the EU had six members (France, Germany, Belgium, the Netherlands, Luxemburg, and Italy). Great Britain, Ireland, and Denmark joined in 1973; Greece in 1981; Spain and Portugal in 1986; and Sweden, Finland, and Austria in 1995—bringing the membership to 15 countries prior to the May 2004 enlargement.
\textsuperscript{18} In the literature, different concepts of concentric circles can be found, such as Baldwin (1994) and Emerson (2004).
deepened their links to the EU through the establishment of the common European Economic Area (EEA). Eight CEECs have joined the union in May 2004 and the Balkan countries are expected to eventually follow. What makes the EU a suitable partner for deeper integration with neighboring countries is not only its economic size, but also its supranational policy framework. Many of its common laws, regulations, and institutions can be adopted relatively easily by neighboring countries.\(^\text{19}\)

The diversity of existing bilateral agreements between the EU and its neighbors illustrates that deeper economic integration with the EU may in principle be pursued in a selective manner (à la carte). The agreements with the EFTA countries on the European Economic Area (EEA), for instance, provide for the adoption of the Single Market acquis, as well as for participation in technological, academic, and other cooperation programs. Switzerland decided to negotiate a slightly less comprehensive package of bilateral agreements with the EU, instead of joining the EEA. Among the EU’s southern neighbors, Israel and Turkey have agreed to comply with certain provisions of the EU acquis—such as on product standards or competition and state aid rules. Moreover, Turkey entered into a customs union with the EU in 1995 (Kabaalioglu 1997). These examples show that it is possible to participate in selected parts, or even in the totality of the European Single Market, without official EU membership. In other words, there are precedents for a gradual or partial extension of the Single Market to the Arab MPs.

Box 1.3 The European Neighbourhood Policy

The European Commission’s *Communication on Wider Europe–Neighbourhood* of March 2003 defined principles for a European Neighbourhood Policy (ENP) of an enlarged EU. It proposes that neighboring countries not on the road to full membership “should be offered the prospect of a stake in the EU's Internal Market and further integration and liberalization to promote the free movement of persons, goods, services and capital.” It “recognized that geographic proximity increases the value of developing a comprehensive policy of close association” and reiterates that the Barcelona Process envisages the extension of free trade to the services sectors. The document also notes that “efficient border management and interconnected transport, energy, and telecommunications networks will become more vital to expanding mutual trade and investment.” It states that the EU acquis “could serve as a model for countries undertaking institutional and economic reform,” but does not specify the desirable degree of regulatory convergence. To implement the agenda of deeper integration, the communication calls for “better targeted EU development assistance,” a closer partnership with other donors, and additional financial assistance “conditional on meeting agreed targets for reform.” It calls for Action Plans with clear reform benchmarks, and at a later stage possibly European Neighbourhood Agreements. With the elaboration of the ENP being coordinated by the Commission’s DG Enlargement, the extensive adjustment experience gained in the enlargement process could become available to the MPs.

Following this communication, further implications of the ENP have emerged.\(^\text{20}\) One likely consequence for the Barcelona Process is that the EU could offer selected MPs “preferential relations within a differentiated framework which responds to progress made by the partner countries in defined areas, in particular political and economic reform” (EC 2003c). The main instrument to implement this policy of differentiation will be the above-mentioned Action Plans. These should set out “clearly the over-arching strategic policy targets, common objectives, political and economic benchmarks used to evaluate progress in key areas, and a timetable for their achievement [...]”. They should be concise, complemented where necessary by more detailed plans for sector-specific cooperation, and should inform financial assistance to those countries. A communication on a new Neighbourhood Instrument has been issued and the next step in the elaboration of the ENP strategy is the proposal of specific Action Plans, starting in July 2004. Of the 10 remaining MPs, after Cyprus and Malta have acceded to the EU, Turkey already enjoys preferential status (a customs union and accession candidate status). Israel, as the only high-income country in the southern Mediterranean, could eventually be offered full participation in the EU Single Market through EEA membership.\(^\text{21}\) For the eight Arab MPs, the deeper integration strategy developed in this study, could provide useful inputs to the preparation of the Action Plans.

\(^{19}\) This is one of the main differences to the other precedent for North-South integration: NAFTA.

\(^{20}\) More information can be found on the official ENP website: [http://europa.eu.int/comm/world/enp/index_en.htm](http://europa.eu.int/comm/world/enp/index_en.htm).

\(^{21}\) *Financial Times* (18 June 2003). This possibility was raised by Günter Verheugen, Commissioner for Enlargement.
The Euro-Mediterranean Free-Trade Area

- EU Member States
- Mediterranean Partners
- New Member States (as of May 2004)
- EU Accession Candidates
The key question for the southern Mediterranean countries is how far and how fast they will move within this dynamic system of concentric circles. While EU membership is not on the cards for most MPs, a number of policy options exist for their increased participation into the Single Market. Domestic reforms combined with a unilateral adoption of certain EU rules is the most straightforward alternative. Amendments to bilateral Association Agreements (AAs) would take more time and determination, but would give external credibility to domestic reforms. Second generation AAs could be signed to bundle several amendments into a give-and-take package for both sides. For instance, the MPs could be granted access to EU markets for agricultural products in return for the liberalization of trade in services. In addition, the multilateral WTO negotiations, and in particular the national commitment schedules under the General Agreement on Trade in Services (GATS) should also be used as an instrument for deeper integration with global and European markets. An appropriate mix of unilateral, regional, and multilateral initiatives would permit for “open regionalism.” The optimal mix will vary between individual sectors and policy areas (see chapters 3 and 4 for detailed recommendations).

1.4 EU Enlargement and Prospects for Euro-Mediterranean Integration

In May 2004, enlargement increased the number of EU member states from 15 to 25 and the total population of the economic bloc from 375 to 450 million. With average per capita GDP in the new member states (NMS) less than half of that in the EU-15, however, nominal GDP of the European Union increased by a mere 4 percent. EU enlargement is relevant for the MPs for at least three reasons. First, the process of economic integration between the EU and the NMS during the last decade provides valuable lessons for Euro-Mediterranean integration. Several of these are being discussed throughout this study. Second, EU enlargement entails trade liberalization between the MPs and the accession countries. Hence, it creates opportunities for increased trade between the NMSs and the MPs. Third, eastern European and southern Mediterranean countries compete for certain export markets and investment flows. EU enlargement is likely to shift the balance in this competition to the detriment of the MPs—unless they also find ways to deepen their integration with the EU. Two factors reinforcing the reform challenge arising from EU enlargement are increased global competition in low value-added goods and multilateral trade liberalization.

The combination of EU enlargement and multilateral trade liberalization is eroding the economic relevance of the Euro-Mediterranean free trade area. Deeper integration between an ever larger group of countries (EU enlargement) reduces the relative attractiveness of the MPs (the “outs”) as a trading partner and FDI destination of EU countries (the “ins”). Such trade diversion is caused by a change

<table>
<thead>
<tr>
<th>Table 1.3 CEECs: Population, GNI, Trade</th>
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<tr>
<td>Pop. (m)</td>
</tr>
<tr>
<td>Czech Rep.</td>
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<tr>
<td>Estonia</td>
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<td>Hungary</td>
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<td>Latvia</td>
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<td>Slovenia</td>
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<td>Total</td>
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GNI = Gross National Income (=GDP plus net income from abroad)  

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22 The NMSs are Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Malta, and Cyprus.
23 This contrasts to a population increase by 20 percent and a GDP increase in terms of purchasing power parity (PPP) by 9 percent. Average GDP in the NMS is about twice as high as in the MPs (Martens 2003).
24 This mechanism lies at the heart of the “domino theory of regional integration” (Baldwin 1994).
in relative prices for traded goods, resulting from asymmetric changes in tariff and non-tariff barriers. At the same time, the value of preferential trade agreements of the southern Mediterranean countries with the EU is being eroded through multilateral trade liberalization, under the General Agreement on Tariffs and Trade (GATT). Since World War II, eight rounds of GATT negotiations have reduced global trade-weighted most-favored nation tariffs of manufactures from about 40 to 4 percent. This also reduces trade barriers between Europe and countries that do not enjoy preferential trade with the EU. Both developments change relative prices for traded goods to the disadvantage of the MPs. With those changes in the trade environment underway, the MPs' position will deteriorate, unless they strengthen their competitiveness and seek deeper forms of integration with the EU.

After a decade of trade liberalization, economic adjustment, and regulatory convergence with the rules of the Single Market, most accession countries are already conducting two-thirds of their trade with the EU (Piazolo 2001). At the company level, many Eastern European manufacturers have been tightly integrated into EU supply networks and have thus “become part of the intra-product division of labor around the EU.” Trade in the office and telecommunication equipment, furniture, and car industries—industries which play a central role in manufacturing trade—increased from $6 billion to $28 billion between 1993 and 1998. “In 1989 not a single CEEC had the revealed comparative advantage in assembling […]. Czech Republic, Hungary, Slovakia, and Slovenia already acquired it in 1993 and by 1997 Poland and Estonia have also become specialized in assembly operations” (Kaminski and Ng 2001). The same trends are reflected in the share of parts and components in CEEC trade (see table 1.2). This interpenetration between western and eastern European economies poses a challenge for the Arab MPs. Until the fall of the Berlin Wall in 1989, they were the main low-wage region with geographic proximity to the EU, but now the fast-reforming CEECs have emerged as important competitors.

**Box 1.4 The Planned U.S.-Middle East Free Trade Area**

Another regional integration initiative could bring additional momentum to economic reforms in the southern Mediterranean: in May 2003, the U.S. government launched an initiative to create a U.S.-Middle East free trade area over the course of the coming decade. Unlike the Euro-Mediterranean Partnership, the initiative comprises of Iraq and the Gulf countries, but excludes Turkey. In contrast to the Association Agreements of the EU, the United States will only offer bilateral free trade agreements to countries that show upfront commitment to economic reform. In fact, the explicit objective of the initiative is to accelerate economic reforms in one of the most stagnant regions of the world. As an integral part of the scheme, the United States wants to actively support accession to the WTO (only half of the 22 countries of the Arab League are currently signatories) and to provide more targeted assistance for economic adjustment. The United States already has bilateral agreements with Israel, Jordan, and Morocco. Trade with the latter expanded dramatically from $7 million in 1987 to $420 million in 2002—partly thanks to the use of qualified industrial zones (QIZs). Products of joint ventures between Jordanian and Israeli companies located in these QIZs enjoy privileged access to the U.S. market. The United States hopes to emulate the success of trade liberalization with Jordan in other countries. Negotiations with Morocco were concluded in March 2004; talks with Bahrain and possibly Egypt are to be launched by the end of 2004.

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25 EU membership will reduce the price of NMS products and services relative to those from the MPs. While most tariffs between the EU and the NMS were already abolished prior to accession, full integration into the EU Single Market will remove additional non-tariff barriers.

26 OECD (2001). It should also be noted that the EU has concluded dozens of preferential trade agreements with other countries and thus the MPs are by no means privileged in this respect.

27 A FEMISE-sponsored research project, consisting of three papers, analyzed the competition for EU export markets and FDI between the two regions. It found that competition varied widely between sectors and countries. Especially the more advanced MPs, with economic profiles similar to the CEECs, seem to be exposed. See Alessandrini (2001).

28 Information in this text-box from Financial Times (22 January, 9 and 10 May, and 24 June 2003).
It is thus not surprising that EU trade and investments are being further diverted from the southern Mediterranean to Eastern Europe. As was seen in diagram 1.2, these shifts have already been dramatic. Between 1993 and 2001, the share of the 8 Arab MPs in EU imports slightly decreased, while that of the NMS doubled—in other words, virtually all the relative growth of trade between the EU and its neighbors occurred at the eastern periphery. The same patterns can be found in FDI flows (see diagram 1.3). The NMS have attracted much higher FDI flows than the MPs. In 2000, FDI inflows were 6.2 percent of GDP in the NMS, but only 2.1 percent in the MPs. Relative to the population size, the gap was even higher. In absolute terms, the NMS attracted €31 billion from the EU between 1998 and 2000 while the MPs (with a much larger population) attracted a mere $5 billion. It should be noted, however, that some MPs (such as Tunisia) perform much better. Moreover, the fact that much of the FDI hike around 2000 was due to some large privatization deals in the telecom sector shows that adequate economic reforms in the MPs could change the negative trend of the past decade. The potential for the MPs to benefit from a trade creation effect through EU enlargement appears to be rather low, since trade between the MPs and the NMS remains below 4 percent of the total. In the longer term, however, there might be potential for increased trade between the two EU peripheries—for instance southern Mediterranean fruits or tourism services in exchange for cars or machine tools manufactured in Eastern Europe.

Whereas Eastern European enlargement is eroding the MP’s comparative advantage of geographic proximity vis-à-vis the EU, fierce global competition in low value-added manufactures is putting the squeeze on their other main source of comparative advantage: cheap labor. Most Arab MPs are specialized in the export of raw materials and low value-added manufactures. Especially the latter segment of world trade, however, is becoming highly competitive. As countries such as China or India are gaining market share and put further pressure on prices, smaller and slow-reforming developing countries are likely to suffer (see box 1.5). While fast-reforming middle-income countries in Eastern Europe or East Asia have successfully moved up on the “ladder of dynamic comparative advantage,” towards higher value-added activities, the MPs have remained stuck at the lower end. Most Arab MPs are specialized in exports of raw materials and low value-added manufactures.

Eastern European enlargement, multilateral trade liberalization, and global competition in labor intensive manufactures create the need for the Arab MPs to redefine their sources of comparative advantage. The most obvious ones are geographic and cultural proximity to Europe, but translating those into increased exports will require far-reaching economic reforms and especially more

29 The general difficulties of the Arab MPs to compete in EU markets despite their proximity, is also illustrated by the fact that the broader Middle East and North Africa region was not only the developing region whose merchandise trade with the world grew slowest in the decade to 1997, but also the one whose trade with the EU grew slowest. From 1987 to 1997, MENA merchandise trade grew at 6.5 percent, and with the EU at only 3.6 percent—compared to 9.6 percent for the Eastern Europe and Central Asia Region (OECD 2001). Another indicator that tells the same story is the degree of trade openness. That of the NMS significantly exceeds that of the MPs: In 2000, they had a trade-to-GDP ratio of 0.3 versus 0.7 (Jbil and Koranchelian 2003).
30 NMS market share increased by 78 percent, while that of the MPs declined by 10 percent (Martens 2003).
31 In 2002, the MPs accounted for 1.8 percent of NMS trade, while the NMS accounted for 4.1 percent of MP trade (IMF 2002). Intra-regional trade was much higher among the NMS (about 13 percent) than in the MPs (about 3 percent). (Martens 2003).
competitive services sectors, as the following examples show.\textsuperscript{32} Tourism, where geographic proximity matters, is already the main services export for the MPs. Business process outsourcing and other IT-enabled services—where linguistic proximity and a common time zone are relevant—is another potentially significant export industry. The MPs might also have a comparative advantage in higher value-added segments of manufacturing, where short lead times (and thus geographic proximity) are crucial. Examples are the car part industry with its just-in-time production or those segments of the textile industry, where a rapid response to fashion trends and demand fluctuations is important (see Annex D). To compete in these markets with their tightly managed supply-chains, however, the MPs will need much more efficient "backbone" services. The development of a comparative advantage in all these markets will thus require comprehensive services sector reforms.\textsuperscript{33}

Another set of lessons from EU enlargement for the Euro-Mediterranean Partnership concerns the type of assistance instruments deployed to support the process of economic adjustment.\textsuperscript{34} While the requirement to comply with the acquis created a detailed roadmap for reforms in the NMS, most reform-related provisions in the AAs are non-binding declarations of intent (e.g. regarding regulatory convergence, the harmonization of norms, or the liberalization of trade in services). Whereas the 1997 adoption of the "reinforced pre-accession strategy" focused the EU's financial assistance purely on reforms required for EU membership, the MEDA program remains largely demand-driven and insufficiently focused on measures geared at regional integration. Similarly, the bilateral "Accession Partnerships" for the NMSs created a programming framework that identified clear reform priorities and policy measures to be implemented. In addition, the accession negotiations—subdivided into 31 sectoral and thematic "chapters"—and annual "Progress Reports" for each candidate made the policy dialogue both substantive in content and ambitious in pace. By basing the decision of which CEEC to accept for membership conditional on the reform progress made, the EU created strong incentives to implement structural reforms. Similar mechanisms are now being proposed under the European Neighbourhood Policy: Action Plans, the principle of differentiation, and possibly European Neighbourhood Agreements could provide a suitable framework to develop more effective partnership instruments for the MPs.

In this context, an important difference to the enlargement process must be stressed. In the public debate, the four freedoms (goods, services, capital, labor) are often seen as synonymous with the adoption of the acquis communautaire—but this is not the case. In economic terms, full participation in the Single Market entails the four freedoms—and this should be the ultimate objective for enlargement and ENP countries alike. The way to achieve this, in the case of the enlargement process, was the complete adoption of the acquis by the accession candidates. For the countries participating in the European Neighbourhood Policy, however, this would be an unrealistic and possibly dangerous strategy, as explained in more detail below. For these neighbors, the objective should be the removal of the main tariff and non-tariff barriers that obstruct the free flow of goods, services, capital, and labor vis-à-vis the EU. The optimal way to do this depends on the state of economic development in the respective country and the desired degree of deeper integration. It is

\textsuperscript{32} Geographic distance (measured in kilometers) is only one determinant of economic distance (which can be measured in time, cost, organizational complexity, and reliability of economic transactions between countries).

\textsuperscript{33} Traditional concepts of comparative advantage focus on a country's given endowment of labor, land, capital, and natural resources. They tend to assume immobility of factors of production (i.e., no FDI), perfect markets, and identical technology or social capital. Hence, the methodology of traditional trade theory does not take account of dynamics at the company level that drive outward processing trade. 'New' trade theory, however, also factors the "role of input trade [...] friction in international trade and investment flows due to geography, institutions, transport, and information costs [...], the transmission of knowledge across borders" and technological differences into the analysis. Two important implications are that geography matters and that policies can undermine or build new comparative advantages (e.g. education, quality of infrastructure, efficiency of institutions). See Ferranti et al. (2002).

the objective of this report to review the policy principle and reform options for achieving the four freedoms across the Euro-Mediterranean.

A few final words should be said about the geographic constellation of the Euro-Mediterranean Partnership after EU enlargement. Libya, the only country of the southern Mediterranean rim that is not yet part of the EMP, is increasingly likely to join in the medium term. As an accession candidate and non-Arab country, Turkey has long been the odd one out among the MPs. However, its economic size, privileged relationship with the EU, and geographic location (as the “hinge” between Europe and the Middle East) suggests that it could develop into an economic hub for the eastern Mediterranean. In particular, it could become “a force of modernization in the region through the increased adoption of EU [...] standards. This is likely to entail, however, an accentuation of sub-regionalism in the Mediterranean with Turkey being the focus of an increasing drive towards liberalization in the Mashrek and with the Maghreb countries still focused on the southern EU” (Brenton and Manchin 2002). If the Middle East peace process were successful and Israel became a member of the EEA, it could fulfill similar functions. But the future role of Turkey and Israel in regional integration are not the only question to remain unresolved. Discussions are also ongoing between the Gulf Cooperation Council (GCC) and the EU regarding a free trade agreement. As a group of wealthy Arab countries, the GCC already accounts for a significant share of FDI in the MPs. Given the potential for further synergies, strategies should be developed to draw the GCC into deeper integration efforts between the EU and the Arab MPs.

In summary, the main conclusions of chapter 1 are the following. Deeper integration with the global economy and especially North-South integration with a large industrialized neighbor like the EU can be a powerful catalyst for economic development. Trade and FDI flows are increasingly driven by outward processing trade and efficient backbone services are needed to participate in international production networks. So far, however, the eight Arab MPs have failed to effectively plug into the global economy at large and into the EU Single Market in particular. Eastern European enlargement and increasing global competition in low value added manufactures threatens to further marginalize the region. Accelerated structural adjustment and a strategy for deeper integration with international markets will be needed to reverse that trend. The lessons of EU enlargement offers guidance and the EU’s European Neighbourhood Policy provides a framework for the reinvigoration of the Euro-Mediterranean Partnership. As far as implementation mechanisms are concerned, the liberalization of trade in services could help the MPs to externally anchor domestic economic reform and to pursue deeper integration with the outside world.
Box 1.5 China's Emergence as the World's Manufacturer of Last Resort

The global competition in low value added manufactures that forces the MPs to reassess their sources of comparative advantage is driven by several factors. Yet, China's competitiveness in labor-intensive goods, its rapid ascens as a key trading nation, and its sheer size are one of them. In terms of purchasing power parity, China is already the second largest economy in the world and accounts for 12 percent of global GDP. It recorded average GDP growth of 10 percent between 1980 and 1999 and continues to grow at that pace. China's exports doubled in the past five years. At $322 billion they account for about 5 percent of world exports and the country had a trade surplus of $30 billion in 2001 alone. In the same year, China became the world's largest recipient of FDI and attracted $53 billion worth of capital from other countries—much of this into export-related industries. In 2002, China joined the WTO and its full integration into the global trading system should make it an even more formidable competitor for other developing countries in the years to come. The phase-out of the Multifibre Arrangement by 2005, for instance, will liberalize global textile markets and the World Bank estimates that China's share of world garment exports will increase from the current 20 percent to 50 percent within a decade.

One of the most striking features of the Chinese economy is its quasi unlimited supply of cheap labor. Out of a population of 1.3 billion, approximately 170 million people are currently unemployed. This is more than the combined population, let alone workforce, of the eight Arab MPs. Since 68 percent of the Chinese population still lives in the countryside and since ailing state-owned industries continue to shed surplus labor, China has a pool of hundreds of millions of people that still need to be absorbed into the labor force. "With manufacturing wages in China averaging about 60 cents an hour—5 percent of the American average, and 10 percent of that in some neighboring Asian economies—and a seemingly infinite supply of workers, China does look asthough it could out-compete other economies in the manufacturing of almost anything labor intensive." A Confucian work ethic and enormous scale economies further add to China's competitiveness.

Standard trade theory suggests that all economies gain from trade. Even if one country is more competitive in every industry, its trading partners can specialize in those markets, where they have a comparative advantage. For a number of reasons, however, this might not apply to the trade relationship between China and other developing countries. First, the standard theory assumes full factor use. However, with hundreds of millions of unemployed Chinese, the country's economy and exports may continue to grow for a long time, without a notable increase in real wages. The second potential adjustment mechanism that could reduce China's international competitiveness, the exchange rate, might also fail to create breathing space for other countries, as the government continues to accumulate foreign currency reserves. Third, in a multilateral trading system that is dominated by a giant low value-added exporter (China) and some very large high value-added exporters (USA, EU, Japan), smaller economies competing in the low value-added segment might become marginalized. Even Mexico (see box 1.1) is already feeling the heat, as about 300 manufacturing plants have moved to China during the past two years. 36


35 In dollar terms, China is the sixth largest economy.
36 The Economist (26 July 2003). Partly thanks to an artificially low exchange rate, labor costs in China are about a quarter of those in Mexico. Global trade liberalization and China's WTO accession are eroding the privileged access Mexico enjoys to the U.S. market under NAFTA. The main problem, however, is that Mexico has done too little to counter these threats to its competitive advantage through better education, productivity-enhancing economic reforms, or a better integration of outward-processing plants into the local economy (only 1 percent of inputs used in the maquiladora plants comes from Mexican suppliers). (See Annex A for details on NAFTA.)
Chapter 2

Trade in Services

2.1 The Need for Services Sector Reform
2.2 The Policy Implications of Trade in Services
2.3 Multilateral Liberalization through the GATS
2.4 Regional Liberalization in the Euro-Mediterranean
trade in services," half of which is intra-EU trade. Over the past two decades, the share of services increased from 15 to 20 percent of world exports, but still appears significantly below its true potential. One of the fastest growing sources of FDI flows, services sectors already account for more than half of total FDI stocks in developed economies and around one-third in developing countries (UNCTAD 2001). Because services are an important input into most other economic activities, policy reforms in these sectors have economy-wide spillover effects. “Typically, services make up 10-20 percent of production costs and all the costs of trading—communications, transport, trade finance and insurance, and distribution services” (Hodge 2002). According to an OECD report (2001) on linkages between trade and development, “all studies show that liberalization of trade in services generates substantial welfare gains. These are at least of the same magnitude as those derived from goods liberalization, in some cases exceeding them significantly.” This general insight is being confirmed by a modeling exercise regarding the effects of trade in services liberalization on the Egyptian economy. This study came to the conclusion that a liberalization of import barriers would add 13 percent to GNP and a liberalization of access to EU markets could increase that figure to 21 percent (Hoekman and Konan 1999). For Tunisia, a study on the effects of trade liberalization in six services sectors calculated gains of more than 5 percent of GDP—three times the benefits expected from the liberalization of trade in goods (see diagram 2.1). The largest gains are expected from liberalization of financial services, telecommunications, and transport (Konan and Maskus 2000).

2.2 The Policy Implications of Trade in Services

Due to the peculiar nature of services, cross-border liberalization in these sectors entails far-reaching regulatory reform at the national level. A key difference between goods and services is that the latter are intangible and non-storable. “Non-storability requires that the production of the service and its consumption are simultaneous and the supplier and the consumer must interact with each other” (Braga and Hoekman 1999). Therefore trade in services tends to involve significant flows of capital, people, information, and intellectual property rights between jurisdictions. Four modes of delivery are recognized by the General Agreement on Trade in Services (GATS), under the auspices of the World Trade Organization (WTO): (1) Cross-border supply, where consumer and producer do not physically interact (back office or computer services transacted online). (2) Consumption abroad, whereby the consumer moves to the producer (tourism or port services). (3) Commercial presence, whereby the producer comes to the consumer (bank branches or retail outlets). This mode requires rights of establishment and the flow of foreign direct investment (FDI) 38 (4) Presence of natural persons, which entails temporary labor mobility (short-term assignments for engineers or intra-company transferees).

The relative importance of the different modes of supply varies considerably between sectors. For instance, mode 2 is a must for tourism, but not an option for construction services (Hodge 2002). “Commercial presence tends to be the dominant mode of supply for all but transport and tourism services; cross-border trade is the next most important. Trade through the presence of natural persons is typically small for all sectors, and consumption abroad is only significant for tourism.” The nature of trade impediments varies between modes of supply and in many sectors the optimal modal mix is being distorted by trade barriers. Different modes of delivery tend to be complementary (e.g. the need for temporary staff secondments to establish commercial presence) and thus liberalization initiatives should cut across modes. Many services have traditionally been considered non-tradable, but technological progress (e.g. in information and communication technology), changing business

37 Maurer and Chauvet (2002). Services trade is difficult to measure and these statistics normally underestimate the volume of trade in services (e.g. services imbedded in traded goods are not included).
38 Barriers to FDI can pertain to establishment, ownership and control, or operations.
models (e.g. outsourcing of back office functions), and deregulation have considerably increased the scope for services trade. The predominance of commercial presence has three important consequences. First, it makes trade in services liberalization a powerful vehicle for FDI inflows. Second, the replacement of inefficient domestic suppliers by more efficient foreign suppliers does not automatically lead to a net loss of domestic jobs. Third, FDI tends to be associated with human capital formation and knowledge-spillovers (e.g. demonstration effect of using new management techniques).

Whereas the main trade barriers for goods are tariffs and quotas enforced at national borders, restrictions to trade in services come as “behind-the-border” laws, regulations or administrative barriers. These tend to be targeted at the service provider, rather than at the service itself. If cross-border trade in services is to be liberalized, a wide range of domestic policies need to be reformed. They include rights of establishment (e.g. for foreign banks to set up branches); rules for market access (e.g. network access in telecommunications or electricity); licensing regimes (e.g. for accountants or medical staff); investment rules (e.g. restrictions to foreign ownership or the repatriation of profits); restrictions to the temporary movement of workers (e.g. stringent visa requirements); and competition policies (e.g. monopolies or cartels). Policy measures to liberalize trade in services can be of a cross-sector nature (e.g. general rights of establishment or competition policy) as well as sector-specific. Due to the multitude of regulations affecting services, the negotiation and implementation of liberalization commitments for trade in services is a demanding task for most developing countries.

Many of the reforms required for a liberalization of services trade are similar to those required for domestic structural adjustment. The reason is that obstacles to market entry by foreign firms also tend to undermine competition, private sector development, and thus overall economic efficiency at the national level. Examples are legal exclusivity rights, state-owned monopolies, anticompetitive behavior by incumbents, or bureaucratic red tape. Other than tariffs in the case of goods, such restrictions do not generate fiscal revenue and thus entail a high deadweight loss to the economy. The liberalization of trade in services can also help to raise low levels of FDI, as the successful tendering of GSM licenses to international operators in several MPs has demonstrated. In summary, the liberalization of trade in services has broad implications for domestic reforms, and MP governments should develop integrated reform strategies to address this dual agenda. Such strategies should specify the nature, timing, and sequencing of reform measures; the scope and nature of external liberalization commitments, and the concessions desired from trading partners. They also need to strike a balance between multilateral trade liberalization, regional integration, and bilateral trade agreements.
Box 2.1 Regulatory Convergence versus Regulatory Harmonization

The term "deeper integration" generally refers to the removal of non-tariff barriers (NTBs), which tend to arise behind the border as a result of laws, regulations, and institutions. Even though deeper integration is often understood as a harmonization of policy frameworks between economies, the adoption of unilateral reforms that address NTBs can often be sufficient. An extreme example for deeper integration through comprehensive regulatory harmonization is EU enlargement, in which the accession countries transpose the entire EU *acquis communautaire* (corpus of EU law) into their national legal systems. Such a degree of harmonization would be unrealistic, and in fact undesirable, for the Arab MPs. In which policy areas, and to what extent harmonization is needed, has to be assessed on a case-by-case basis. In principle, a country seeking regulatory convergence has the option to (i) take over the rules of the partner country; (ii) negotiate a new set of rules that both sides adopt; (iii) agree with the partner on mutual recognition; (iv) define minimum standards that both sides comply with; or (v) agree that both sides should adopt the rules of a third party (e.g. international accounting standards). In the case of the Euro-Mediterranean free trade area, the most realistic options appear to be (i) and (v).

A number of considerations can help determine the optimal degree of regulatory convergence from an economic perspective. First, different types of regulation are often appropriate for different levels of development. Regulatory convergence in North-South agreements should be confined to policy areas where this is not the case. Second, regulatory convergence for the sake of deeper integration should only be sought if the common standards are in line with international best practice (i.e. no convergence to sub-optimal policies) and if they are really needed to remove NTBs. The integration of Mexico into NAFTA shows that domestic reforms focused on enhancing efficiency and trade reforms focused on the removal of key NTBs do not have to involve a high degree of regulatory convergence. Third, regulatory convergence should only be sought where its benefits outweigh the associated negotiation and compliance costs. This is especially relevant for government with limited implementation capacity. Fourth, in cases where domestic reforms are prevented by vested interest groups, external convergence to the more liberal regulatory regime of a trading partner may have important political economy benefits. This effect is demonstrated by the comprehensive reforms that the adoption of the EU *acquis* triggered in the accession countries.

For the MPs the above considerations have several implications. They should only adopt EU rules where those are in line with best practice; where they help remove significant non-tariff barriers; where they can be implemented at a reasonable cost; and where they help overcome the resistance of vested interests to domestic reforms. This will have to be assessed on a case-by-case basis and it will vary considerably between sectors and policy areas. Harmonization with EU rules for its own sake, however, should be avoided. As MP governments have to simultaneously tackle domestic economic adjustment, regional integration, and multilateral liberalization, integrated reform strategies have to be developed and priorities need to be set. Generally speaking, economic adjustment and multilateral liberalization should be on top of the agenda. Measures that promote deeper regional integration could then be factored into domestic reforms and multilateral commitments. Especially for more advanced MPs, however, a gradual participation in the Single Market through a well-defined program of regulatory convergence seems desirable.

2.3 Multilateral Liberalization through the GATS

The Uruguay Round of multilateral trade negotiations (1986-1994) was a watershed for global trade. GATT commitments led to a worldwide reduction of quotas and tariffs on goods. Uruguay also initiated the liberalization of services under the GATS and culminated in the establishment of the World Trade Organization in 1995. In early 2004, 147 countries—accounting for the vast majority of

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39 Given the difficulties that EU countries already have in agreeing on EU-internal rules, they are unlikely to negotiate changes to the acquis with third countries (option (ii)). Due to weak regulatory frameworks in many MPs, the EU will also be reluctant to accept mutual recognition (option (iii)). Regarding option (iv), it should be noted that most EU rules actually define minimum standards to be adopted by member states. In other words, they are explicitly designed to be inserted into national policy frameworks and thus regulatory convergence with Single Market rules implies a fair amount of flexibility regarding the modalities of implementation.
world trade—were WTO members and more than two dozen were seeking accession. The WTO administers a rules-based framework for trade that includes general principles applicable to all members (e.g. nondiscrimination, transparency); legally binding commitments by individual countries (liberalization schedules); and institutionalized dispute settlement mechanisms. Reciprocity, whereby members exchange trade privileges, has been a driving force behind multilateral tariff dismantling. With all EU countries and about half of the MPs parties to the WTO, the GATT and GATS framework also governs trade between them. The Euro-Med Association Agreements explicitly stipulate that all bilateral provisions need to be compatible with WTO rules. The WTO, on the other hand, permits preferential trade agreements (PTAs) between members as long as they are notified and fulfill the criteria as set out in the relevant WTO agreements.

The GATS liberalization measures for services agreed upon during the Uruguay Round were rather limited. Separate negotiations on telecommunications and financial services were subsequently completed and, especially in the former, most commitments were substantial. Reciprocity has thus far played a more limited role in the GATS process and most countries confined commitments to liberalization measures they had already implemented unilaterally. The new round of multilateral negotiations (Doha Round), launched at the Fourth Ministerial Meeting of the WTO in November 2001, addresses several key issues that were left unresolved by the Uruguay Round. Particularly relevant for the MPs is the further liberalization of trade in services under the GATS; the planned liberalization of trade in agricultural products; and the Doha Development Agenda (DDA). The DDA seeks to help developing countries integrate trade reforms into their development strategies; to participate more effectively in global trade and investment flows; and to mobilize technical assistance that permits these countries to better negotiate and implement liberalization commitments. WTO Members submitted first commitment proposals in 2003 and the Doha Round was to be concluded by January 2005. This timetable, however, has slipped after the collapse of the WTO Ministerial Conference in Cancun in late 2003 and substantial delays and changes are expected.

The European Commission Strategy on Trade and Development

Besides various Euro-Mediterranean policy documents calling for a liberalization of trade in services, there is a broader Commission strategy that is of relevance. The 2002 Communication on Trade and Development reviews the linkages between trade reforms and economic development and it defines the Commission strategy on how to contribute to the Doha Development Agenda. It stresses that priority should be given to the multilateral track of trade liberalization, but that regional integration can "reinforce the multilateral trading system." It argues that the value added of such regional agreements "is enhanced when cooperation goes beyond border measures and is extended to deeper integration, including the convergence of domestic policies such as investment and competition policies, regulatory convergence and/or the adoption of harmonized [...] standards." More specifically, the communication calls for "the development of regional financial services and the coordinated provision of infrastructure such as regional telecommunications, energy and transport networks." It notes that "high transport costs, unreliable utilities, poor telecommunication and inefficient financial services" are among the main obstacles for developing countries to reap the full gains from trade. The communication also discusses instruments the Commission intends to deploy to advance this agenda. It wants to mainstream trade in its assistance strategies for developing countries by factoring its implications into the Country Strategy Papers and Regional Strategy Papers, and by reinforcing the "trade component in the programming exercise in EU development assistance," such as the MEDA program of financial assistance to the MPs.

40 Turkey, Cyprus, Malta, Israel, Egypt, Tunisia, and Morocco all joined the WTO when it was founded in 1995. Jordan became a member in 2000. In late 2003, Lebanon and Algeria were negotiating accessions; West Bank and Gaza is not a sovereign country eligible for membership; and Syria has yet to apply.

41 Preferential liberalization in services is covered by GATS Article V and Vbis. It requires "substantially all trade" between parties to be covered in terms of trade volume, sectoral coverage, and modes of supply. For further details on the multilateral trading system, see the glossary of WTO and GATS terms in Annex E.
GATS commitments combine “positive lists” and “negative lists.” Each member country specifies the sectors to which GATS rules should apply (positive list). For each of these “bound” sectors, a negative list of remaining restrictions is then submitted (only trade barriers that are explicitly listed may be maintained). This considerably increases the transparency of the regulatory framework for traders and investors. GATS schedules are divided into horizontal commitments (e.g. general rights of establishment) and sector-specific commitments. For each sector, commitment in all four modes of supply can be made regarding market access and national treatment (a commitment matrix). Countries have the option to make “full” or “partial” commitments (subject to restrictions). A potentially powerful instrument are “precommitments,” whereby countries oblige themselves to implement specific liberalization measures by a future date. This can send a credible reform signal to the investor community and helps governments to overcome pressure of vested interest groups opposing reforms. So far, however, little use has been made of precommitments under the GATS. Even though the multilateral liberalization of trade in services remains at an early stage, GATS schedules already tend to be long and complex. Commitments can include several hundred elements and that of the EU alone is 90 pages long.

### Table 2.2 Sectors Bound under the GATS (2002)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Egypt</th>
<th>Jordan</th>
<th>Morocco</th>
<th>Tunisia</th>
<th>Total</th>
<th>Israel</th>
<th>Turkey</th>
<th>WTO*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
<td>2</td>
<td>x</td>
<td>x</td>
<td>71%</td>
</tr>
<tr>
<td>Communications</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>3</td>
<td>x</td>
<td>x</td>
<td>68%</td>
</tr>
<tr>
<td>Construction</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>3</td>
<td>x</td>
<td>51%</td>
<td></td>
</tr>
<tr>
<td>Distribution</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td>1</td>
<td></td>
<td></td>
<td>36%</td>
</tr>
<tr>
<td>Education</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td>x</td>
<td></td>
<td>32%</td>
<td></td>
</tr>
<tr>
<td>Environmental</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
<td>1</td>
<td>x</td>
<td></td>
<td>37%</td>
</tr>
<tr>
<td>Financial</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>4</td>
<td>x</td>
<td></td>
<td>73%</td>
</tr>
<tr>
<td>Health / Social</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td>1</td>
<td></td>
<td>x</td>
<td>33%</td>
</tr>
<tr>
<td>Tourism</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>4</td>
<td>x</td>
<td>x</td>
<td>88%</td>
</tr>
<tr>
<td>Recreational</td>
<td>x</td>
<td></td>
<td></td>
<td></td>
<td>1</td>
<td></td>
<td></td>
<td>43%</td>
</tr>
<tr>
<td>Transport</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>3</td>
<td>x</td>
<td></td>
<td>58%</td>
</tr>
<tr>
<td>Total</td>
<td>4</td>
<td>11</td>
<td>7</td>
<td>3</td>
<td>24/77</td>
<td>5</td>
<td>9</td>
<td></td>
</tr>
</tbody>
</table>

*percentage of WTO members with sector commitments. Algeria, Lebanon, Syria and West Bank and Gaza are not yet members.

Source: World Trade Organization.

To date, the southern Mediterranean countries have made more limited commitments under the GATS than many other countries at similar levels of economic development. Looking at the sub-sector level, Tunisia has bound less than 20 sub-sectors; Egypt, Israel, and Morocco between 21 and 60; and only Jordan and Turkey more than 61 (Adlung et al. 2002). In contrast, all EU as well as most Eastern European and Balkan countries fall into the latter category. The same pattern can be observed at the more general sector level. Table 2.2 shows which of the 11 main sectors under the GATS have been bound by the southern Mediterranean countries. Four of the Arab MPs are not yet WTO members (Algeria, Lebanon, Syria, West Bank and Gaza). Morocco has bound 7 sectors, Egypt a mere 4 and Tunisia only 3. Jordan has the most extensive GATS commitments among Arab MPs—which reflects both its liberal policies and the fact that it joined the WTO after 1995. It is interesting to note, that Jordan is also the country with the highest share of services in GDP. As far as

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42 The GATS schedules of all WTO member countries can be found the WTO website (www.wto.org).

43 The European Commission has the mandate to conduct trade negotiations (bilateral and multilateral) on behalf of all EU member states. However, both the EU as a whole and the individual EU countries are WTO members.

44 See Annex F for WTO sector classifications.
individual sectors are concerned, the most far-reaching commitments have been made for tourism—the most frequently committed sector under the GATS. Financial services, communications, transport, and construction are also reasonably well committed, but especially in the former three, the substance of the commitments is still limited. In air and maritime transport as well as in electricity, the GATS framework is less developed and thus unilateral reforms and regional integration measures should receive priority. Business services are among those services, where most MPs maintain rather liberal regulatory regimes, but their GATS schedules do not yet seem to fully reflect this. In distribution services, important for deeper regional integration in goods markets, competition in the southern Mediterranean remains limited and only Jordan has bound this sector.

In the Doha Round negotiations, MP governments should generally increase the number of bound sectors, while deepening their commitments. Where restrictions to competition are maintained for public policy objectives, governments should use economic instruments that minimize the associated trade distortions and domestic welfare loss (e.g. auctions of entry licenses instead of quantitative restrictions; gradual phase-out of infant-industry protection). As far as horizontal commitments are concerned, more far-reaching provisions on rights of establishment and cross-border supply ought to be made. GATS commitments should at least reflect the status of domestic reforms and greater use should be made of precommitments. Such external anchoring of implemented or planned domestic reforms is a necessary signaling device for investors, given the large location-specific sunk costs (FDI) in many services sectors. It should not be forgotten, however, that international trade agreements cannot be a substitute for a genuine commitment to domestic economic reforms in the services sectors. The nexus between such unilateral reforms, regional integration, and multilateral liberalization should determine the negotiation strategies of the MPs and the substance of their commitments. At the institutional level, this will require that government officials in charge of trade negotiations maintain a tight interface with their colleagues responsible for economic reforms in specific sectors.

**Box 2.3 Regional versus Multilateral Trade Liberalization**

As MP governments face limited implementation capacity in their pursuit of domestic reforms, regional integration, and multilateral trade liberalization, priorities will have to be set. This raises the question of the relative merits of regional, as compared to multilateral liberalization. In principle the latter can be regarded as first best, since it reduces negotiation costs, minimizes the risk of trade diversion, permits to reap gains from trade with the rest of the world, increases transparency for traders, and gives recourse to the enforcement mechanisms of the multilateral system (e.g. dispute settlement). In practice, however, regional negotiations might be more manageable, can facilitate the use of reciprocity, and may allow for deeper forms of integration, which are only feasible between neighbors (e.g. regional power pools or cooperation between regulatory authorities). Especially in those services sectors in which the multilateral framework is not yet sufficiently developed (e.g. in air transport or electricity), regional liberalization may offer an important way forward. If progress at the multilateral level is not forthcoming during the current Doha Round, regional liberalization could also become a second-best substitute. In services sectors where geographic, cultural, and linguistic proximity matters, the balance of the argument is generally tilted towards regional integration. The benefits of regional integration also increase if the trading partner is a large, developed economy (such as the EU). Fortunately, the trade-off between regional and multilateral liberalization is less stark than it might seem. As a general rule, domestic economic reforms and multilateral liberalization should be given priority. In policy areas where geography matters or the multilateral framework is less developed, multilateral commitments can be “topped-up” by additional integration measures at the regional level. Until the success of the Doha Round is ensured, MP governments should pursue services negotiation at both the regional and at the multilateral level.45

45 More detailed recommendations on the optimal policy mix by sector and theme can be found in chapters 3 and 4. Annex C contains a comprehensive review of the debate on regional versus multilateral liberalization.
2.4 Regional Liberalization in the Euro-Mediterranean

The Euro-Mediterranean Partnership (EMP) was launched at the Barcelona Conference in 1995 between the 15 countries of the European Union and their 12 Mediterranean Partners. Its economic centerpiece is the establishment a free-trade area (FTA) for goods over the coming decade. The implementation mechanism for this regional FTA is a series of bilateral Association Agreements (AAs) between the EU and each of the MPs, combined with South-South agreements between MPs. All MPs (except Syria) have successfully completed negotiations with the EU and the AAs are now at different stages of the ratification and implementation process. Regarding the South-South dimension, more than a dozen bilateral agreements have been signed and in 2001, four MPs (Tunisia, Morocco, Jordan, Egypt) launched negotiations for a plurilateral agreement, open to participation by other MPs ("Agadir Process"). If the current pace of these initiatives is maintained, the regional FTA for goods could be completed around 2015.46

Regarding services trade, the AAs contain virtually no binding commitments but are confined to declarations of intent. In Tunisia's AA, for instance, Title III (Right of Establishment and Services) contains only two articles with less than half a page of text: Article 32 pertains to compliance of bilateral commitments with GATS rules (which is a must for all WTO members). Article 31 is a "rendezvous" clause in which the signatories express their will to extend the scope of the AA to rights of establishment and services trade. It stipulates that the Association Council should make recommendations, starting with a review no later than five years after the entry into force of the AA. For the first MPs (Tunisia and Morocco) this deadline has already lapsed. The lack of momentum regarding the liberalization of trade in services in the Arab MPs contrasts with the situation in the new member states Cyprus and Malta as well as enlargement candidate Turkey. These countries are bringing their services sector policies in line with those of the Single Market. Upon accession, they not only have to remove barriers to services trade with other EU members, but they also need to comply with GATS commitments of the European Union vis-à-vis third countries.47

As far as actual trade in services is concerned, this accounts for only one-fifth to one-quarter of total MP trade (see table 2.3). Transport and travel make up the bulk of services exports of the Arab MPs

<table>
<thead>
<tr>
<th>Table 2.3 Services Trade in the MPs (2001)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Country</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Algeria</td>
</tr>
<tr>
<td>Egypt</td>
</tr>
<tr>
<td>Jordan</td>
</tr>
<tr>
<td>Lebanon</td>
</tr>
<tr>
<td>Morocco</td>
</tr>
<tr>
<td>Syria</td>
</tr>
<tr>
<td>Tunisia</td>
</tr>
<tr>
<td>WB&amp;G*</td>
</tr>
<tr>
<td>Total/Avg.</td>
</tr>
<tr>
<td>Israel</td>
</tr>
<tr>
<td>Turkey</td>
</tr>
</tbody>
</table>


46 To enter into force, AAs need to be ratified by the parliaments of the respective MP and all 15 national EU parliaments—which takes around three years. Tariff reduction generally begin in the 4th year and ends in the 12th year after entry into force. Negotiations, ratification, and phase-in all make for a very time-consuming process. The 12-year phase-out period for tariffs will end in 2008 for Tunisia, followed by Morocco in 2012.

47 The modalities of the compliance of NMS with EU commitments in the WTO are still to be determined.
This includes tourism, the main service export for several of these countries. Other services, such as communication, financial or business services, account for a much larger share of imports. Israel is the MP with the highest share of other services in exports (62 percent)—which seems to reflect a higher level of development and more dynamic services sectors. Due to a number of measurement problems, however, statistics on services trade have to be interpreted with caution. Nonetheless, the magnitude and pattern of services trade of the MPs suggests that a significant increase and diversification of exports seem feasible, if the necessary policy reforms were to be implemented.

For most Arab MPs, Europe is the primary trading partner and the EU tends to account for half to two-thirds of their trade. For many of these countries, the Euro-Mediterranean free trade area will expose large parts of their economies to import competition and will require comprehensive structural adjustment (mise à niveau). If the MPs liberalize trade in goods without liberalizing trade in services, they risk increasing their effective rates of protection for goods. This and the significant trade in services potential with the EU provide further arguments for a broadening (more sectors) and deepening (regulatory reform) of the FTA. In economic terms, such reforms may also be conceptualized as the gradual or partial extension of the Single Market to the South. Especially infrastructure sectors, as "connectors" between economies, and financial markets, appear well suited for deeper integration and a liberalization of trade in services between the EU and its southern neighbors.

In this context it should be noted, that the Single Market represents an interesting case for the liberalization of trade in services between sovereign countries. First, two fundamental principles of the Single Market applying to all sectors are the right of establishment and the right to provide services. Second, full capital mobility and an integration of capital markets, as well as labor mobility and a mutual recognition of professional qualifications are in force. Third, comprehensive liberalization programs have opened the network industries (e.g. telecoms, transport, electricity) to foreign investment and competition. Fourth, the EU's strict competition and state aid rules outlaw anticompetitive behavior and government subsidies that could distort cross-border competition between member states. As a consequence of these policies, all modes of supply and most services sectors have been successfully liberalized. Hence, the EU has the most deeply integrated services markets among any group of sovereign countries in the world.

The Single Market experience, however, also highlights a potential problem with deeper integration in the Euro-Mediterranean region, which will need to be resolved: whereas the EU has strong institutional mechanisms to enforce integration commitments between its members, no equivalent mechanisms yet exist within the EMP context. Wherever possible, multilateral enforcement mechanisms should be used for regional integration (another aspect of "open regionalism"). In some cases, the extension of EU-internal enforcement mechanisms to neighboring countries could be considered as part of a the European Neighbourhood Strategy. A third option would be to develop Euro-Mediterranean enforcement instruments, possibly similar to the ones used between EFTA and the EU.

**Box 2.4 Migration and the Temporary Movement of Workers**

Presence of natural persons (mode 4) is the most contentious of the four modes of services delivery, but could potentially play an important role for deeper integration. The boundary with migration is somewhat blurred and in fact the two are often being confused. Examples of temporary movement of workers for the sake

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48 For a detailed discussion of these measurement problems, see: Maurer and Chauvet (2002).

49 Locally produced services usually constitute a significant part of the cost base for manufacturing companies. In the absence of liberalization, these services will be more expensive than on the world market. The higher price of these services inputs acts like a tax (or an implicit tariff) on goods produced for export. Together with the tariff on intermediate goods (imported), it might well outweigh the tariff protection on the final goods to be exported.
of services delivery are the employees of foreign firms sent to a country to establish commercial presence; auditors or management consultants serving foreign subsidiaries; or engineers participating in construction projects abroad. As these examples show, mode 4 is often intrinsically linked to other modes of delivery and the full liberalization of many services will require complementary commitments in different modes. In the GATS negotiations, many developing countries (endowed with a surplus of cheap labor) press for liberalization in mode 4, while developed countries (who fear “wage dumping” and unemployment) are reluctant to make such commitments. As the EU is more eager to liberalize cross-border supply and commercial presence (modes 1 and 3) and the MPs are more interested in progress on mode 4, it might be possible to exchange reciprocal concessions between modes. One mechanism that has been proposed to achieve such trade-offs are “foreign labor content entitlements”—in other words, MPs could obtain temporary work permits for their citizens, proportionate to the increase of EU services exports resulting from liberalization in other modes (Mattoo 2001).

As far as actual migration across the Mediterranean is concerned, up to ten million people from the MPs currently live in the EU. France alone has three million inhabitants of southern Mediterranean descent—including 1.5 million from Algeria; 1 million from Morocco; 350,000 from Tunisia; 315,000 from Turkey; and 100,000 from Lebanon. Germany has two million immigrants from Turkey and several other EU member states also have sizable expatriate communities from the MPs. While most Maghreb and Turkish emigrants reside in Europe, those from Egypt and Jordan are concentrated in the Gulf states. Several hundreds of thousands of Syrians live in Lebanon and an even larger number of Palestinians are refugees in Jordan, Syria, and Lebanon. The Lebanese that have left their country are widely dispersed and supposedly more Lebanese now live abroad than in Lebanon proper. One of the main economic effects of these migration patterns are workers’ remittances. These amount to about $1 billion annually in Algeria, Egypt, Jordan, and Morocco—mostly exceeding FDI inflows by a significant margin (World Bank 1999). Another effect is the increase of regional transport flows, as migrants travel home for holidays and other occasions. About half a million Tunisians, for instance, travel to their country of origin each year. The number is similar for Algeria and about twice as high in the case of Morocco (Eurostat 2001).

But there are also other reasons why migrants and temporary workers are important catalysts for deeper integration. They establish border-spanning personal networks that facilitate the flow of ideas and business contacts. Returning migrants bring back skills, set up firms, invest in real estate, or work for foreign companies with a commercial presence. Having experienced life in another country, they can act as change agents in the process of socio-economic modernization. These effects can already be observed in the region, but efforts should be made to more effectively mobilize the resources of MP expatriates for the mise-à-niveau process in their home countries. Programs to systematically place emigrant professionals in temporary jobs in their country of birth or to encourage return migration could also be launched. Using the internet to build “virtual” exile communities for the exchange of information, jobs, and business opportunities could soon become the most powerful tool to reconnect émigrés with their countries of origin. Worldwide, several dozen such internet networks already exist. Another option would be to allow MPs to participate in EU-internal exchange programs for university students and researchers. More temporary work permits for qualified workers from the MPs should also be considered (in the past most migrants were poorly qualified). In fact, EU member states have asked the Commission to prepare a study on how an immigration quota system could be set up. In summary, the challenge is to change the composition of North-South migration (towards high-skilled and temporary workers) and to better tap the resources of expatriate communities for the mise-à-niveau process in the MPs.

For a detailed discussion on mode 4, see Chanda (2002).

Researchers have “tracked down 41 diaspora networks, tied to 30 different countries.” (The Economist, 2 November 2002). One interesting example is “Thailand’s Reserve Brain Drain project, a website that gives Thai expatriates detailed information about investment incentives and opportunities, business and residence regulations, and possible joint-venture partners in their home country.” (Financial Times, 21 August 2001).

Financial Times (15 September 2003). One proposal is the creation of an EU-sponsored fund, cofinanced by the private sector, that would offer internships or trainee programs for selected graduates from the MPs in European firms. A key element of such a program would be the establishment of information channels (internet market place) to match companies and workers. See Diwan et al. (2002).
It should also be noted that there might be significant scope for South-South trade in certain services sectors, for several reasons. First, the eight Arab MPs have a similar language and culture. "Commonality of culture provides a strong bonding element in any region. Dominant history, language, and religion facilitate personal interactions, with favorable impact on trading relations, tourism, labor and investment flows" (El-Erian and Fischer 1996). Additional cohesive factors among the Arab MPs are similar legal systems as well as the relative ease of transport and communication via a common sea. Second, the Arab MPs are a group of mostly small economies and a de-segmentation of markets could help them exploit the economies of scale inherent to most service sectors. Third, differences in human capital endowment (e.g. high levels of human capital in countries such as Lebanon and Tunisia) could also give rise to service trade driven by comparative advantage. Before Lebanon’s civil war, for instance, the country was the banking center of the region and Egypt has now partly taken over that function. South-South integration in the services sectors would also make the region more attractive for foreign investors.

Given the capital and human capital-intensity of many service sectors, some developing countries fear that developed countries could exploit their comparative advantage to dominate these sectors. However, since commercial presence is the main mode in most sectors, much of this trade would take place via foreign direct investment and thus help upgrade the capital, technology, and skill base of the MPs. Not surprisingly, most studies analyzing the effects of trade in services liberalization expect much more limited adjustment costs than those arising from the liberalization of trade in goods. For Tunisia, it has been calculated that only 3 percent of the workforce would have to change sectors as part of the restructuring process—compared to 6.6 percent as a result of goods liberalization. Moreover, a parallel liberalization of access to EU agricultural markets and the removal of remaining restrictions to access in manufactures (e.g. textiles) would permit the MPs to specialize in sectors in which they have a comparative advantage. A broadening and deepening of the Euro-Mediterranean free-trade area could thus bring important benefits to these countries. Especially the liberalization of trade in services provides an opportunity to give the economic dimension of the Euro-Mediterranean Partnership new impetus.

Even though little liberalization of trade in services has occurred in the southern Mediterranean to date, it is a declared political objective. As mentioned above, the bilateral AAs contain rendezvous clauses for negotiations on this issue and those should soon start in the case of Morocco and Tunisia. At the regional level, a Ministerial Conference on Trade launched a working group on trade in services in May 2001. At the follow-up conference in 2002, Ministers “demanded that the working group on trade in services continue to meet in order to exchange experiences, tackle horizontal work, assess the issues at stake, and organize some in-depth examination of various key service sectors. They confirmed that this group [...] should contribute to the preparation of negotiations both at the multilateral level and bilateral level, in the context of the association

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54 An example for such South-South trade in services is South Africa, which “exports a full range of financial and business services to the southern African region” (a study cited in Hodge, 2002).
55 A related argument for South-South integration is that the regional market can act as a platform for the participation of MP companies in global markets. It serves as a “classroom” for exporters (e.g. on product design or foreign market penetration), helps them gain scale economies, build reputation, and be exposed to competition (Nicita, Olarreaga, and Soloaga 2001).
56 Konan and Maskus (2000). A reallocation of resources (including labor) is inevitable if economic reforms are to unlock efficiency gains. Long term benefits should outweigh these short term transition costs.
57 The AA between Tunisia and the EU, for instance, states under Title III (Right of Establishment and Services) that “the parties agree to widen the scope of the Agreement to cover the right of establishment [...] and liberalization of the provision of services” and that “the Association Council will make a first assessment of the achievements in this objective no later than five years after the Agreement enters into force.”
agreements, thus ensuring good coordination between both levels. These various declarations indicate a political commitment to liberalize trade in services throughout the Euro-Mediterranean. The challenge now is to translate political will into tangible progress on the ground.

Box 2.5 Trade in Services Liberalization in Latin America and the Balkans

Two other developing regions could offer lessons for the liberalization services trade in the southern Mediterranean. The Latin American experience is instructive because of its various sub-regional agreements on services, whereas the Balkans is of interest as another developing region bordering the EU. Regarding the former, countries in the Western Hemisphere have concluded 14 sub-regional agreements comprising disciplines on trade in services since 1994. These vary in scope, depth, and the modalities of liberalization. Some of these agreements use “positive lists,” while others use “negative lists” (the advantage of the latter is enhanced transparency through a publishing of all relevant trade impediments). An interesting feature of the MERCOSUR agreement are annual rounds of progressive negotiations with the aim to eliminate all restrictions on services trade over a 10-year period. In contrast, the Andean Community started with a comprehensive inventory of all measures affecting trade in services among members. Some of the agreements address mutual recognition of licenses and certifications for providers of professional services. The MERCOSUR agreement, for example, stipulates that technical, qualifications, and certification standards must be objective and transparent (similar to the principles of the GATS). Some agreements contain disciplines regarding exclusive service providers and monopolies; others contain specific annexes on priority sectors. A closer analysis of the regional agreements in Latin America should be conducted to extract lessons for liberalization efforts in the Euro-Mediterranean.

In the Balkans, two official accession candidates (Bulgaria and Romania) and several other countries (Albania, Bosnia and Herzegovina, Croatia, Macedonia, Serbia and Montenegro) hope to eventually accede to the EU. Five of these countries are already WTO members and the others have applied for membership. Most Balkan countries have embarked on broad programs of economic reform, which include measures to liberalize trade in services. The five countries that are part of the GATS, have made an average of 280 commitments (45 percent of the maximum possible), which is more than double the average for low and middle income countries (16 percent) and almost as high as the average for high income countries (47 percent). Commitments are particularly extensive in construction services (61 percent), communication and distribution services (55 percent each) as well as tourism, business, and environmental services (between 50 and 54 percent). It should be noted, however, that these quantitative aggregates are only a crude measure for the status of reforms, since they say little about the nature of the commitments or the degree of implementation. As part of the EU and World Bank-sponsored regional Stability Pact for the Balkans, seven countries signed a Memorandum of Understanding in which they committed themselves to pursue further liberalization measures in services trade. Those countries gearing up for EU membership will have to adopt the entire acquis and thus embrace comprehensive services sector liberalization.

In summary, the main conclusions of this chapter are the following. Services sectors account for more than half of value added in the MPs and many of these sectors are characterized by a significant reform backlog. Given the close linkages between domestic and cross-border liberalization, trade in services liberalization could act as an important catalyst for structural adjustment in the MPs. Regional and multilateral liberalization (through the EMP and the WTO frameworks respectively)

59 This is being reiterated in other key policy documents: The Commission Communication “Reinvigorating the Barcelona Process” (2000) notes that “Liberalization of market access and improved regulation of trade in services will form an important dimension of the economic development of the Mediterranean Partners.” The Communication regarding the Euro-Med meeting of Foreign Ministers in Valencia (2002) calls on governments to “identify priorities for bilateral negotiations to liberalize trade in services [...], taking into consideration the progress made in the Doha Round [...]. Mediterranean Partners and the Commission should also identify needs for technical assistance, in particular in the field of adopting and harmonizing the regulatory framework.”
60 For a detailed review, see Stephenson and Prieto (2002).
61 For a more extensive overview, see Michalopoulos and Panousopoulos (2002).
can be both complements and substitutes. Integrated reform strategies will be needed to achieve the right mix between the two. "Open regionalism" could thus have a number of facets. First, multilateral reform commitments can be "topped-up" by complementary regional agreements (e.g. on regulatory cooperation). Second, even where multilateral liberalization might theoretically be first best, regional liberalization can be a more viable alternative, due to lack of progress in multilateral negotiations (e.g. in air transport or electricity). Third, regional patterns of economic activity might emerge under multilateral liberalization (e.g. regional distribution networks or bank mergers). Such patterns, however, should be determined by market forces and not be preempted by policymakers through preferential trade agreements.
Chapter 3

The Main Backbone Services

3.1 Transport and Logistics
3.2 Financial Services
3.3 Telecommunications
3.4 Electricity
3. THE MAIN BACKBONE SERVICES

Whereas the first two chapters reviewed general policy issues associated with deeper integration and services trade, the following chapters will discuss reform implications for specific sectors and policy themes. Or phrased differently: the first chapter argued that deeper integration was desirable; the second argued that trade in services liberalization at the regional and multilateral level would be an appropriate instruments for pursuing it; and the next two chapters will show how the optimal policy mix differs across sectors and policy areas. Each section discusses the respective best practice in sector policy; reviews the relevant policy framework and reform trends in the European Single Market; analyzes sector performance and reform needs in the MPs; extracts policy lessons from other cases of North-South integration, notably NAFTA and EU enlargement; and assesses the role that GATS commitments could play in the dual process of economic reform and regional integration.

Even though perceptions of what constitutes backbone services differ, a broad definition of the term would include transport and logistics, financial services, information and communication services, electricity, business services, and distribution services. One reason why the concept is slightly fuzzy is the fact that there are at least two defining characteristics. First, backbone services can be seen as those “connecting” economies by facilitating cross-border transactions or resource flows (capital, labor, information). Second, one can take a more “physical” view and regard backbone services as those where tangible infrastructure crosses national borders (e.g. roads, railways, power grids, phone lines). In such “network industries,” the presence of natural monopolies makes procompetitive regulation necessary. The main policy implication for deeper integration in those backbone sectors is thus the fact that it requires regulatory reform and some degree of regulatory cooperation across jurisdictions. Financial markets are another service sector, where market failure (information asymmetries and externalities) necessitate regulation as a complement for cross-border liberalization.

Given the ambiguous definition of backbone services, the division into “main” backbone services and “other” services is not clear-cut. However, the main backbone services, analyzed in greater detail in this chapter, have an important thing in common: they all require comprehensive regulatory reform at the national level (to achieve economic efficiency) and a high degree of regulatory cooperation at the cross-border level (to achieve deeper integration). The “other” backbone services, reviewed in chapter 4, are not characterized by structural market failure. In business services and IT enabled services the outstanding reform needs in most MPs are limited. The same holds for tourism, which is not a backbone service, but one of the main services traded within the region. In distribution services the reform needs are straightforward (i.e. liberalization of market access and rights of establishment) and involve few cross-border policy issues.

3.1 Transport and Logistics

The smooth flow of goods and people across the Euro-Mediterranean free trade area will require a seamlessly integrated multimodal system (air, maritime, rail, and road). As long as cross-border transport remains more costly, time-consuming, or unreliable than domestic transport, it will constitute a non-tariff barrier. A wide range of bottlenecks in individual modes, at modal interfaces,

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62 High fixed costs make it economically inefficient to construct more than one network. Regulation can help redress the natural monopoly problem through unbundling (vertical separation of the network function from potentially competitive activities); through interconnection rules (giving competitors access to the network for the provision of services); or through price regulation (to prevent the monopolist from extracting monopoly rents).
Reforms of the multilateral framework for air transport (based on the Chicago Convention) have thus far proven elusive, but many countries have liberalized their bilateral ASAs or entered into regional agreements. The United States, for instance, has developed a set of “open skies” provisions to be inserted into the bilateral ASAs it negotiates. In fact, an interesting precedent for air transport liberalization between the EU and the MPs might be the open skies agreements between the United States and several Latin American countries. These agreements, mostly concluded in 1997, had impressive effects (see table 3.1). Within a year, countries with open skies regimes experienced an average growth of traffic to and from the United States of 20.5 percent. During the same period, countries that maintained restrictive policies, saw virtually no traffic growth (1.6 percent on average). Even flag carriers in countries that liberalized air traffic registered higher growth in turnover than those in countries without open skies, despite the fact that most of them lost market share in a growing market. Similar growth dynamics unfolded in Lebanon, the first MP that unilaterally adopted an open skies regime. The country experienced traffic growth of 20 percent in 2003 (while global air traffic stagnated) and the national airline MEA did not lose any business.71

The most ambitious model for regional air transport liberalization, however, is actually the EU itself. Among its 15 members, all regulatory distinctions between international and domestic services were abolished. Bilateral ASAs between countries have ceased to exist. And with national ownership restrictions practically abolished, airlines no longer have a “nationality.” Non-EU ownership is still limited to 50 percent, but among EU countries no nationality restrictions apply. Moreover, a common regulatory framework (e.g., ground-handling regulation, rules for slot allocation) provides a harmonized business environment and a level playing field between carriers. This EU-internal civil aviation area is now being extended across the continent. Negotiations between the EU and the accession candidates in Central and Eastern Europe for the creation of the European Civil Aviation Area (ECAA) were concluded in mid-2001, obliging the CEECs to comply with all EU-internal policies in the sector. This sector-specific extension of the Single Market, however, is now being overtaken by full EU accession of most of these countries. While an extension of ECAA to the MPs might not be realistic in the short-term, the creation of a

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71 Lebanon offers all partners a liberalization of ASA provisions, without asking for reciprocity. Ticket prices for key destinations have dropped (e.g. to as low as $100 to Dubai).
less comprehensive Euro-Mediterranean civil aviation area would be desirable. Another option would be to negotiate a new generation of “bilaterals” between the EU and its southern neighbors (see box 3.3). With the EU accounting for 30 to 80 percent of international air traffic of the MPs, such liberalization seems a natural priority (Eurostat 2002).

Box 3.3 The European Neighbourhood Policy and Air Transport Liberalization

Air transport could become the first service sector, where the European Neighbourhood strategy is being translated into specific policy instruments to deepen integration with neighboring countries. While bilateral ASAs have been abolished within the Single Market, member state governments retained the right to negotiate them with third countries. A decision of the European Court of Justice in November 2002, however, curtailed these rights and gave the European Commission a mandate to negotiate certain provisions that fall under Community competence. Since the delineation of responsibilities remains complex, EU governments decided to provide the European Commission with a more explicit negotiating mandate. This comprises a full mandate for an open skies agreement with the United States (including issues that remain under member state competency) and a “horizontal mandate” to negotiate amendments to existing bilaterals on provisions now under Community competence. For selected third countries, especially those that are participate in the European Neighbourhood Policy, the Commission might soon receive a mandate to negotiate comprehensive “Community agreements,” replacing the existing patchwork of bilateral agreement. While the exact nature of such a mandate and the countries to which it applies are yet to be determined, such negotiations could lead to a far-reaching liberalization of air traffic between the EU and its southern neighbours. Morocco has long expressed interest in an open skies agreement with the EU and it could be one of the first countries with whom the EU negotiates a “Community agreement.”

In maritime transport, the most urgent reforms in the southern Mediterranean will have to be implemented at the national level. Port inefficiencies are the main source of bottlenecks in maritime chains and port reforms involve few cross-border policy issues. The creation of landlord ports, as a means to separate operational and commercial functions in major ports, should be a cornerstone of reforms. The introduction of competition and private participation in port services; the concessioning of large container and bulk terminals to private operators; the reduction of border-related red-tape and the improvement of hinterland connections are additional policy issues that most MPs should address. While reform needs are less pronounced for sea-side issues, remaining state-owned shipping lines ought to be privatized, port integration into international route networks be improved, and collusive practices among shipping lines be tackled. As far as land transport is concerned, the markets for road haulage in most MPs are relatively competitive. Nonetheless, additional measures should be implemented to fully liberalize market access and tariffs and to reduce frictions at border crossings. In rail transport, the restructuring of state-owned companies, the opening of major routes for private cargo operators, as well as a reduction of frictions at modal interfaces and border crossings are called for.

Besides these reforms in individual modes, modal interfaces, port hinterland connections, and logistics-related banking and insurance services need to be rendered more efficient. Border-related controls ought to be streamlined and documentation requirements reduced. Customs inefficiencies are among the most notorious sources of delays and the example of Lebanon illustrates the benefits of customs reform (see diagram 3.3). Within a year and a half, clearance times were reduced by a third (from 6 to 4 days), while more selective checks permitted a quadrupling of shipments cleared without inspections (the “green line ratio” increased from 10 to 40 percent). Another priority should be the creation of a more conducive policy framework for the third-party logistics industry (e.g.

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72 This Council Decision was in response to a Commission Communication (EC 2003a).
73 For a case study on Lebanon’s customs reforms, see Daniel Müller-Jentsch (2002). For a case study on Morocco’s customs reforms, see De Wulf and Finateau (2002).
freight forwarders, express carriers, integrators), which plays a critical role in the provision of multimodal services. Containers also dramatically reduce the time and cost associated with modal transfer and therefore policies geared at increasing the low containerization rates in the MPs are needed (e.g. more container-friendly customs procedures, modern transfer equipment in ports). Given the interdependencies in the multimodal network, governments should develop national transport sector strategies with the explicit aim of facilitating trade and deeper regional integration. The role that multilateral liberalization can play in the creation of a regional transport space seems rather limited. While the GATS can provide an external anchor for domestic reforms, multilateral rules for transport sector liberalization remain rudimentary. The coverage of the GATS Annex on Air Transport Services, for instance, is limited. To date, WTO members can only make commitments on auxiliary services ("soft rights")—notably aircraft maintenance and repair, selling and marketing, and computer reservation systems. The critical traffic rights ("hard rights") are explicitly excluded. This means that the liberalization of bilateral ASAs ("open skies" agreements) and preferably the gradual transition towards a regional civil aviation area with the EU, are the most promising strategy for air transport liberalization across the Mediterranean. Maritime transport has not yet been included into the GATS (sector negotiations were suspended in 1996) but is back on the negotiating table for the Doha Round (Al Khouri 1999). A distinction is made between shipping, cargo-related services in ports, and port services provided to vessels. Land transport has thus far received little attention under the GATS, because it is mainly of interest to countries that are direct neighbors and is thus best be addressed at the bilateral or regional level. Morocco, Egypt, and Jordan are the only Arab MPs to have made GATS commitments in transport. Of those three, the commitments of the former two are very limited.

Given these considerations, what does the ideal combination between national reforms and regional initiatives look like in the transport sector? The optimal policy mix seems to vary considerably between modes. In maritime and land-based transport services, domestic sector reforms will suffice and there is little need for regulatory harmonization. The main exception are cross-border transport corridors, along which infrastructure investments and facilitation measures should be coordinated. In air transport, cross-border liberalization will require a modification of ASAs, while national-level reforms—such as the restructuring of airlines, the privatization of airports, and the liberalization of ground handling—could be anchored through bilateral or regional agreements. As far as the removal of transport frictions at national borders is concerned, much of this is a question of domestic reforms, including the streamlining of customs procedures. However, it should be complemented by administrative cooperation with neighboring countries—for instance, through juxtaposed border controls or an exchange of information between customs authorities. In the end, however, a

74 Network externalities and other sources of scale economies in the logistics industry are an important argument for transport sector integration between small economies, such as those of the MPs. They arise when additional connections to a network increase the value or reduce the costs for existing users (e.g. airline or shipping routes).

75 Extending the scope of the GATS Annex on Air Transport would require the consent of two-thirds of all WTO members (i.e. about 100 countries) and might be difficult to achieve.
combination between these national and cross-border reforms will be needed to create a common transport space between the two sides of the Mediterranean Sea.

3.2 Financial Services

Financial sector policies are critical for both economic adjustment and regional integration. Properly functioning financial markets encourage higher savings and investments; supply entrepreneurs and private companies with capital; allocate scarce financial resources to the most promising ventures; help reduce inflation and real interest rates; and ensure the smooth flow of capital across borders (emigrant remittances, foreign investment, government debt). Microfinance (for small-scale entrepreneurs), rural-finance (for farmers and villagers), or low-income housing finance contribute to poverty reduction. If financial markets do not function properly, high lending premiums may impose excess costs on savers and investors. Bad loans can lead to bank insolvencies and costly government bailouts. Systemic banking crises or the crowding out by government debt may starve the private sector of funding. Fragile institutions and inadequate regulation may aggravate macroeconomic shocks—thus triggering inflation, exchange rate volatility, or capital flight. Since the late 1970s, 112 cases of large-scale banking crises were recorded and fiscal costs averaged 14.3 percent in the developing countries sampled (Honohan and Klingebiel 2000). In summary, efficient financial markets are vital for the entire economy.

The financial sector is complex and can be divided into several sub-sectors. In most countries, especially in developing economies, the main market segment are banks. Their primary functions as intermediaries between savers and investors are to provide a range of financial instruments (e.g. savings accounts, mortgages, loans) and to manage risk arising in the process. In more mature economies, savers and investors interact directly through capital markets via tradable securities (e.g. bonds, stocks, derivatives). Institutions such as stock markets, clearing houses, and investment banks are needed to facilitate those interactions. Key determinants of capital market efficiency is their depth (market capitalization), liquidity (turnover), and diversity (range of financial instruments). A third important sub-sector is the insurance industry (e.g. life and non-life insurance companies, insurance brokers, reinsurance firms). Insurance markets help allocate risk and provide long-term savings instruments. Finally, institutional investors—such as pension funds, mutual funds, or asset managers—play an important role in the development of more sophisticated financial markets.

A sound and transparent policy framework is a sine qua non for well functioning financial markets. This involves modern prudential regulation and corporate governance; adequate bankruptcy and accounting laws; independent regulators; a separation between financial and non-financial institutions (to avoid directed credit or politically motivated loans); and a judicial system that permits the enforcement of property rights. Failure to implement such policies can be costly. In Turkey, for instance, poor supervision and political meddling led to a banking crisis in 2001, which cost $47 billion, or 32 percent of GDP.76 Important flanking measures for financial market reforms include pension reforms (to foster the emergence of institutional investors and to increase savings rates); privatization programs (to enhance stock market capitalization and liquidity); as well as fiscal adjustment (streamlined tax regimes, lower deficits). Once a conducive regulatory framework is in place, competition and private management can become the main drivers of efficiency improvements. If banks and other financial institutions have to compete for clients and can no longer rely on a captive market or business generated by government loans, they will be more inclined to provide credit to private firms. In fact, insufficient access to capital for small and medium enterprises (SMEs) is an

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76 Estimate by the Turkish Banking Regulation and Supervision Agency (Financial Times, 17 November 2003).
important impediment to private sector development in many countries. A well functioning banking sector can also help mobilize savings that were previously held in cash or in off-shore accounts.

Such reforms at the national level tend to be the main priority, but cross-border integration can bring additional benefits, especially for small financial markets as those of the MPs. Regional integration increases liquidity and competition. It allows investors to hold more diversified portfolios and gives firms better access to capital. It helps unlock economies of scale and scope for financial institutions (larger banks and stock markets, greater range of financial products). Among the benefits of integration are a better match between supply and demand, diversification of risk, lower prices, and enhanced customer choice. One of the most beneficial types of cross-border integration is the entry of foreign banks. This can be encouraged through a removal of nationality restrictions, a liberalization of market access, and the sale of state-owned banks. Foreign banks can bring technical know-how, such as modern risk-management. They often raise governance standards, introduce new financial products (e.g. mortgages, leasing), and tend to have better access to international capital than their local peers. Foreign banks may also help the MPs to “import” modern prudential regulation, since they are being scrutinized by the home regulator of the parent institution. In Latin America and Eastern Europe, foreign investors have also driven the process of regional consolidation. For instance, the two Spanish banks BSCH and BBVA invested $13 billion in 30 major banks across Latin America. Other policies that facilitate integration between financial markets are the removal of restrictions to cross-border capital flows or foreign exchange transactions. As the Asian crisis and other examples show, however, the liberalization of a country’s capital account can introduce dangerous volatility, unless it is backed up by comprehensive regulatory reforms and healthy financial institutions.

In the EU, where financial services account for more than seven percent of GDP, the reform and integration of financial markets is well-advanced. The cross-border flow of capital was one of the “four freedoms” of the 1992 Single Market program and thus many barriers between capital markets were already removed a decade ago. The Euro, launched in 1999, facilitates integration by eliminating currency risk and by reducing transaction costs. It has also triggered initiatives to further harmonize and streamline sector regulation across the EU. Potential benefits of comprehensive reforms have been estimated to be 0.5 percent of EU GDP, or €43 billion annually. The Financial Services Action Plan of the EC, which spells out a strategy to fully integrate financial markets by 2005, is under implementation. It contains proposals for 42 pieces of legislation for the wholesale market; the retail market; prudential regulation; and the harmonization of taxes on pensions and financial products. Biannual Progress Reports by the Commission monitor the status of financial market reforms and identify areas for further action. Three high-level committees of national regulators are being established (for securities, banking, and insurance) to help develop an EU-wide regulatory framework. These committees might become the nucleus for pan-European regulatory structures, which would also include the European Central Bank.

By international standards, EU markets are competitive and well integrated, but reforms still have a long way to go. Industry representatives have voiced concern that a broad and complex reform

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77 World Bank (2002c). This report reviews empirical evidence on the economic benefits of FDI in the banking sector of developing countries.
78 For information on the risks of capital account liberalization, see Prasad et al. (2003).
79 United Kingdom Chancellor of the Exchequer (2002).
80 European Commission website: [http://europa.eu.int/comm/internal_market/en/finances/general/action.htm](http://europa.eu.int/comm/internal_market/en/finances/general/action.htm). Policy measures for the wholesale market include a revision of the prospectus, company law and investment services directives. Retail market measures include revised rules for investment funds and a new directive on distance marketing.
81 The Economist (15 February 2003). This is referred to as the “Lamfalussy process.”
agenda is being implemented in a rush—leading to sub-optimal legislation and additional red tape. For two reasons, the EU acquis might not be the adequate template for financial sector reforms in the MPs. First, it is still work in progress and second, developed financial sectors need a different regulatory framework than those of developing countries. Many EU rules, for instance, are complex pieces of legislation for modern securities markets, while basic banking and insurance reforms are the priority for most MPs. Nonetheless, the MPs should try to plug into the Single Market for financial services, by encouraging cross-border linkages between banks, stock markets, and insurance companies. They should also implement comprehensive domestic reforms to prepare their financial markets for the challenges and opportunities of regional integration. More efficient and better integrated financial markets across the region would facilitate deeper integration. Financial services are required for a range of cross-border transactions, including trade finance and insurance, cross-border direct or portfolio investment, or the transfer of workers’ remittances.

Box 3.4 Financial Market Reform and Regional Integration in Eastern Europe

Policy reforms and regional integration in the financial markets of Central and Eastern Europe (CEE) provide a number of lessons for the MPs. During the transition years of the 1990s, most CEE countries lived through banking crises—with economic costs amounting to 10-25 percent of GDP. This triggered far-reaching sector restructuring, including bank privatization, regulatory reform, and a harmonization of sector policies with EU rules. Cross-border integration at the policy level was associated with consolidation at the company level. About two-thirds of banking assets are now foreign-owned. Multinational banks have “successfully transferred management know-how—especially skills in marketing and credit control. They are bringing into the region a host of little-known products, such as sophisticated money-management operations for corporate clients and everything from credit cards to long-term investment funds for retail investors.” A handful of EU banks have driven the process of cross-border integration (e.g. KBC of Belgium, Société Générale of France, or Bank Austria). Strong competition between them drove up privatization receipts and accelerated market restructuring to the benefit of the host economies. Eventually, mergers are also expected among stock markets, most of which lack critical mass. One option would be the creation of a regional stock exchange, but with consolidation also underway in the EU, CEE stock markets might directly be integrated into broader European structures. As far as assistance to reforms is concerned, the European Bank for Reconstruction and Development (EBRD) played a crucial role in financial market reform. It invested in more than 80 banks in transition countries (usually accompanied by a foreign strategic investor), and channeled EU funds to SMEs via local banks—complemented by technical assistance (e.g. training of loan officers) and commercial incentives (subsidies linked to performance of loan portfolios). Replicating such programs in the MPs could play a catalytic role in the reform and integration of financial markets.

Another example of the linkages between regional integration and financial market reform is Mexico. As part of a broad economic adjustment program and its integration into NAFTA, the country restructured its financial sector, but encountered a severe backlash on the way. The first generation reforms were lopsided and led to the banking crisis of 1994—whose fiscal costs alone amounted to 19 percent of GDP. The main problem was that rapid deregulation of interest rates and the capital account went hand-in-hand with lax supervision and excessive risk-taking by newly-privatized

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82 Financial Times (26 November and 1 December 2003).
83 Information in this text box from The Economist (14 September 2002) and Financial Times (18 November 2002).
84 Financial Times (18 November 2002).
85 Most information on Mexico in this paragraph from Giugale et al. (2001).
banks. With the sector still largely bank-based (capital markets were in their infancy), most of the expansion came in the form of short-term credit, instead of longer-term debt or equity finance. Following the banking crisis and a severe macroeconomic shock, a second generation of reforms was implemented. Banks were recapitalized and supervision strengthened (stricter risk management, enhanced accounting and disclosure standards, tight capital adequacy rules). As far as regional integration in the sector is concerned, the North American Free Trade Agreement (NAFTA) relaxed restrictions to foreign ownership in banking. The share of foreign ownership in Mexican bank assets increased from 1 percent in 1994, to around 50 percent in 2000, and 85 percent in 2002. Cross-border consolidation of financial markets has both facilitated and been driven by increased trade, investment flows, and the lucrative business of transferring remittances of Mexicans living in the United States ($10 billion each year).

At the multilateral level, financial services are the second most frequently committed sector under the GATS (after tourism). Following the Uruguay Round, separate financial services negotiations were concluded in 1997. At that time, commitments were made by 97 WTO members—accounting for 95 percent of global trade in the sector (EC 1998). With a few exceptions (e.g. central bank activities), the entire spectrum of financial services is covered. Mode 3 (commercial presence) and mode 1 (cross-border supply) are the most relevant for financial markets. Most commitments have been in mode 3. Only limited use has been made of precommitments. The so-called “prudential carve-out” provision, contained in the GATS Annex on Financial Services, allows regulatory authorities to take measures to ensure the integrity of the financial system, even if they restrict trade. There is also a formula for making advanced commitments, by adopting the Understanding of Commitments in Financial Services, which 31 members have thus far signed up to (mostly developed countries). These add-on liberalization measures entail significant improvements on commercial presence. Most EU and Eastern European countries made very far-reaching financial services commitments under the GATS (Mattoo 1999). As table 3.2 shows, the MPs have thus far been more cautious. Only four of the Arab MPs are WTO members and even they have generally made weaker commitments than the EU and many of their Eastern European peers. Nonetheless, financial markets are one of the sectors where the GATS commitments of the MPs are relatively liberal.

In most southern Mediterranean countries, financial markets remain bank-dominated, while capital markets are underdeveloped. Banking reforms, which thus constitute a natural policy priority, are well advanced in countries like Morocco or Lebanon (with a strong tradition in private-sector banking), but have barely begun in Syria or Algeria. The degree of public ownership remains high in most Arab MPs: 46 percent of total bank assets in Tunisia, 70 percent in Egypt, 95 percent in Algeria,

| Table 3.2 Financial Services Commitments under the GATS |
|-----------------|----------------|----------------|
|                | Banking | Insurance | Securities |
| Algeria         | --      | --        | --         |
| Egypt           | 0.21    | 0.57      | 0.12       |
| Jordan          | n.a     | n.a       | n.a        |
| Lebanon         | --      | --        | --         |
| Morocco         | 0.20    | 0.22      | 0.09       |
| Syria           | --      | --        | --         |
| Tunisia         | 0.44    | 0.47      | 0.43       |
| Israel          | 0.30    | 0.45      | 0.28       |
| Turkey          | 0.44    | 0.35      | 0.41       |
| EU              | 0.54    | 0.49      | 0.50       |
| Hungary         | 0.50    | 0.49      | 0.50       |
| Romania         | 0.73    | 0.27      | 0.52       |
| Slovakia        | 0.21    | 0.45      | 0.37       |

0=not committed; 1=fully committed; -- =non-member

Source: Valckx (2002).

86 The Economist (12 October 2002) and Financial Times (12 December 2002).
87 The figures in the diagram were taken from Valckx (2002). They were adapted from the methodology developed in Mattoo (1999). The liberalization index ranges from 0 (no commitment) to 1 (fully committed).
and 100 percent in Syria (World Bank 2000b). In Egypt, the four largest commercial banks are state-owned, and on top of this they also own shares in other banks (Ersel 2000). This contrasts with Jordan and Lebanon, where state-ownership is almost absent, or Morocco, where privatization has brought the level down to 27 percent (Grais and Kantur 2003). Another widespread problem are low levels of competition—as illustrated by concentration indices. In the average MENA country, “70 percent of bank assets are owned by the largest five banks, compared to 60 percent in Latin America and 52 percent in Asia” (World Bank 2003d). These figures partly reflect the small size of most domestic markets and highlight the need for greater regional integration. Another indicator for the competitive dynamics and strength of the banking sector is the availability of funding for the private sector. Again, the situation in several Arab MPs is unsatisfactory (see table 3.3). While domestic credit to the private sector in Algeria and Syria is negligible (8 percent of GDP), countries like Morocco or Lebanon have high interest rate spreads (8.2 and 6.3 percent respectively). These problems are due to a crowding out by government debt, low levels of competition, or poor bank management (e.g. an inability to offer attractive products or to assess client risk). Foreign ownership has recently increased in some MPs, but remains low: it is nonexistent or close to zero in Algeria, Egypt, and Syria; 12 percent in Tunisia, 18 percent in Morocco, and 30 percent in Lebanon (Lee 2002).

Table 3.3 Financial Market Indicators (2001)

<table>
<thead>
<tr>
<th>Country</th>
<th>Market Capitalization</th>
<th>Listed Domestic Companies</th>
<th>Domestic Credit to Private Sector (% of GDP)</th>
<th>Interest Rate Spread (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>($ m)</td>
<td>(% GDP)</td>
<td>(% traded)</td>
<td>(%)</td>
</tr>
<tr>
<td>Algeria</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Egypt</td>
<td>26,094</td>
<td>25</td>
<td>16</td>
<td>1,148</td>
</tr>
<tr>
<td>Jordan</td>
<td>7,087</td>
<td>72</td>
<td>15</td>
<td>158</td>
</tr>
<tr>
<td>Lebanon</td>
<td>1,401</td>
<td>7</td>
<td>5</td>
<td>13</td>
</tr>
<tr>
<td>Morocco</td>
<td>8,591</td>
<td>27</td>
<td>11</td>
<td>55</td>
</tr>
<tr>
<td>Syria</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Tunisia</td>
<td>2,131</td>
<td>12</td>
<td>14</td>
<td>47</td>
</tr>
<tr>
<td>WB&amp;G</td>
<td>723</td>
<td>18</td>
<td>10</td>
<td>24</td>
</tr>
<tr>
<td>Total/Av.</td>
<td>46,027</td>
<td>23</td>
<td>10</td>
<td>206</td>
</tr>
<tr>
<td>Israel</td>
<td>45,371</td>
<td>53</td>
<td>52</td>
<td>615</td>
</tr>
<tr>
<td>Turkey</td>
<td>33,958</td>
<td>32</td>
<td>163</td>
<td>288</td>
</tr>
</tbody>
</table>


The development of capital markets is another major reform challenge, that the MPs are confronted with. Most southern Mediterranean stock markets are small and total stock market capitalization of the eight Arab MPs with their 164 million inhabitants is about as high as that of Israel, with a population of 6 million (see diagram 3.5). In most Arab MPs, the stock market turnover ratio, an indicator for trading dynamics and liquidity, is between 5 to 16 percent, compared to 30 to 40 percent in most Eastern European countries. One of the most promising strategies to develop stock markets are large privatization programs, as the examples of Jordan and Morocco have shown. The market cap of the Casablanca exchange, for instance, rose from 7 percent of GDP at the beginning of the privatization process to 26 percent by 2002 (Grais and Kantur 2003). Foreign investors provided more than a quarter of privatization proceeds (putting the country on the map of international investors) and a range of modern financial services institutions developed in the process (investment banks, independent stock brokers, financial services enterprises with research capacity). By international standards, however, MP stock markets remain small and cross-border mergers or alliances between them would be desirable. Such forms of deeper integration are increasingly
monopolies require some degree of cross-border regulation to achieve regional integration. In financial markets, prudential regulation at the national level is needed to prepare the sector for cross-border integration. But there is less need for regulatory convergence. For the time being, much of the EU acquis in this sector does not seem appropriate for less developed neighboring countries. As MP economies develop and capital markets mature, however, increased regulatory harmonization with the EU should be considered.

In financial markets, more than in many other sectors, there seems to be significant potential for South-South integration. One reason is the small size of most financial institutions. "The assets of the leading international banks such as Citigroup or HSBC exceed those of all Arab banks combined" (Wilson 2002). A larger regional market could also help in the development of more diverse capital markets. Dubai, for instance, wants to become the corporate bond center of the Arab world, with the creation of the Dubai International Financial Center. Another argument for South-South integration are potential synergies between the oil-rich Gulf countries, major exporters of capital, and between the Arab MPs. To date, most funds from the Gulf countries flow to industrialized countries (Arab investments in the EU have been estimated at $365 billion and in all OECD countries together at $1.3 billion). The development and integration of financial markets among the Arab countries could help redirect some of these investments to the southern Mediterranean countries. For that, however, the MPs will not only need more developed financial markets, but also a more conducive business environment.

3.3 Telecommunications

The significance of telecommunication for the development of a modern economy—in which services, information, and speed play a critical role—is widely acknowledged. On the one hand, the telecom sector is important in its own right—thanks to its contribution to GDP, employment, foreign direct investment, and stock market capitalization. On the other hand, it serves as an input into most other economic activities and as an important connector to the global economy.95 The telecom revolution of the 1990s, which transformed the sector in developed and developing countries alike, was driven by technological progress, regulatory reform, private investments, and rapidly increasing demand. The best practice in sector policy that emerged over the past decade includes: the separation of regulatory from operational functions and the creation of independent regulators; the privatization of the incumbent and the gradual opening of the fixed-wire network to competition; the tendering of competing GSM licenses; and the full liberalization of value-added services (e.g. data, internet).96 An analysis of links between the policy framework and sector performance in 86 developing countries for the period 1985 to 1999 yielded some important conclusions (Fink et al. 2002). It found that the effects of policy reforms on sector performance outweighed those of technological progress; that comprehensive reforms increased performance much more than partial reforms; that the positive effects of private participation are reinforced through competition; and that the sequencing of reforms matters, especially introducing competition prior to privatization.

Europe has been at the forefront of global telecom reforms. In 1998, an extensive package of EU legislation came into force. This "big bang" was the culmination of a decade-long process, which

95 Fink et al. (2002). The paper finds the correlation between communication costs and bilateral trade to be significant, especially for non-homogenous products. For these, "connections between buyers and sellers are made through a search process." This increases the "importance of proximity and preexisting ties"; it results in transactions to be conducted through "trading networks rather than markets"; and it makes international trade more sensitive to communication costs.

96 An extensive overview over best policy practice can be found in the Telecommunications Regulation Handbook of the Information for Development Program (Infodev): (www.infodev.org/projects/314regulationhandbook/).
included the liberalization of data and satellite services. The 1998 package comprised the abolition of all exclusivity rights; Europe-wide licensing rules (e.g. transparency, non-discrimination, unlimited number of licenses); rules for interconnection (e.g. interoperability, obligation to grant access to competitors at cost-related rates); guidelines for universal services; a directive on number portability (important for retail competition); and an obligation to member states to establish independent telecom regulators. In the mobile phone sector, most national governments licensed three or four GSM operators. In 2001, the local loop was liberalized as the last sub-sector, even though competition was slow to gather pace. The impact of these various policies exceeded even optimistic forecasts. Within two years, prices for many services fell by 20 to 50 percent. Across the EU, the sector has witnessed a wave of privatizations, extensive restructuring of formerly state-owned companies, explosive traffic growth, unprecedented investments in infrastructure, cross-border consolidation, and the creation of hundreds of new firms. Despite the difficulties the sector experienced since the bursting of the New Economy bubble, the reforms implemented during the 1990s brought enormous benefits to consumers.

To consolidate liberalization measures for the €160 billion EU telecom market, the Commission issued streamlined regulations, which became effective in mid-2003. One reason was that a maze of legislation had developed during a decade of reforms. Another was the convergence of technologies (e.g. voice and data, broadcasting and telecommunication), which called for more technology-neutral rules. Moreover, the development of market competition and regulatory capacity allowed for a lighter regulatory regime (mainly general principles to be applied by national regulators). Now, to what extent is the EU acquis in the telecom sector a model for the southern Mediterranean countries? For a number of reasons, it seems of relatively limited relevance in the short term. In most MPs the level of independence and institutional capacity of regulators remains low; the enforcement of regulatory decisions through the legal system tends to be difficult; competition in fixed-wire services is virtually nonexistent and incumbents remain entrenched. Moreover, low penetration rates of fixed-wire and the fixed-to-mobile substitution effect create very specific policy challenges. In other words, the general principles enshrined in the EU acquis and many of the regulatory instruments developed in the Single Market could well be replicated, but given the different levels of development, full regulatory harmonization seem less of a short-term priority.

Morocco, the Arab MP where telecom reforms are most advanced, shows that a combination of domestic policy measures and foreign investment can lead to impressive results. Supported by the World Bank through policy advice, technical assistance, and a sequence of adjustment operations, the country successfully implemented a broad reform program (Wellnius and Rossotto 1999). The telecom sector law, which entered into force in June 1997, lay the foundations for private participation and competition. Inter alia, it defined licensing principles, established the independent regulator ANRT, and provided for the privatization of the incumbent operator. Several implementation decrees, such as interconnection rules or the legal regime for leased lines, fine-tuned the legislative framework. In August 1999, a second mobile phone license was awarded to a consortium led by Telefónica of Spain and Portugal Telecom. Thanks to a transparent and competitive tender, the winning bidder paid $1.1 billion in license fees—equivalent to 6 percent of the country’s foreign debt or two years of capital inflows. The prospect of imminent competition induced the incumbent to lower tariffs (by around 50 percent within a year) and to aggressively expand its subscriber-base (a doubling in less than two years). Two years after the issuing of the

97 In fixed-wire services, for instance, the number of providers offering long-distance calls within the EU increased by 90 percent to 475 between 1999 and 2000. In the same period, mobile phone penetration increased from 36 to 55 percent (to 194 million subscribers). Average prices for leased lines fell by a third between 1997 and 2000. (European Commission website: http://europa.eu.int/comm/trade/services/nspw03.htm).
second license, there were more than 5 million mobile phone users in Morocco. The license specifications were designed to also stimulate competition in other market segments (it granted rights to provide fixed wireless services and to build long-distance networks as well as an international gateway). In December 2001, the Government sold 35 percent of Maroc Telecom to a strategic investor, Vivendi Universal of France, for $2.1 billion. Vivendi has an option to acquire a further 16 percent from the government in 2004. Both the GSM license fee and the privatization receipts considerably exceeded the figures of comparator countries.

The Moroccan success story not only illustrates the benefits of well-sequenced reforms, but also highlights the importance of a credible regulatory framework and a transparent tender process. ANRT was given a strong mandate, sufficient autonomy, and adequate institutional resources. This provided bidders with an independent and competent interlocutor early on in the reform process. Technical assistance, including from the World Bank and the European Commission, helped it build technical and institutional capacity. As regards the tender process, clearly defined interconnection rules and licensing principles facilitated the calculation of bids. The separation between financial offers and technical offers (e.g. targets for service quality and coverage) channeled competitive dynamics as to maximize economic benefits. Keeping the process on schedule and publishing bid evaluation reports on the ANRT website further enhanced the credibility of the tender. While ANRT was one of the first successful sector regulators in the region, a recent benchmarking exercise showed that further improvements were possible (Mohammad 2002). ANRT’s independence remains limited (the prime minister chairs the board and some other members also sit on the board of the incumbent) and its financial autonomy is incomplete. Moreover, government attempts to interfere with the operation of the regulator have threatened to undermine the country’s hard-won reputation in the investor community.

Across the southern Mediterranean region, mobile telephony is the sub-sector where competition and private participation are most advanced. Jordan, Egypt, and Lebanon have had two competing operators for years. Algeria tendered a second license in 2001 (for $737 million) and Tunisia in 2002 (for $450 m). In the latter case, however, observers criticized the tender process for being insufficiently transparent. While Lebanon managed to use a private duopoly (both licenses are privately owned) to quickly restart telecom services after the civil war, a high degree of regulatory uncertainty and political interference have severely damaged the country’s standing among investors. The reform process in

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99 MEED (1 December 2001).
100 Reuters Business Briefings (2 October and 14 December 2001).
101 Reuters Business Briefings (29 March 2002).
102 The private GSM companies started operating without a clear regulatory framework. Efforts by politicians to change the rules of the game or to levy various fees or taxes on these companies have dragged on for several years.
private mobile operators were negotiating to pay Telecom Egypt $170 million each, so it would not use a third GSM license it had obtained—a form of collusion that would be illegal under EU competition law. License conditions differ across the region. All three Maghreb countries, for instance, granted international gateway rights, while Tunisia and Algeria also offered extended license duration. Most countries have collected the entire license fees upfront, whereas Egypt emphasized revenue sharing over the licensing period. Despite some teething problems in the reform process, most MPs now have two GSM providers and rapidly growing mobile penetration rates—which in several cases already exceed fixed-wire penetration (see diagram 3.6).

**Box 3.6 Regional Consolidation between Mobile Phone Operators in Latin America**

Both Latin America and the southern Mediterranean region consist of a number of mostly small economies in geographical and cultural proximity (e.g. same language and religion). With most Latin American countries having embraced similar models of economic reforms since the late 1980s, the region is increasingly being treated as one entity by international investors. Especially in services sectors such as financial markets, retail distribution, electricity, media, air transport, or telecommunication there has been a clear trend towards cross-border consolidation at the company level—often driven by foreign investors seeking economies of scale. In mobile telephony, America Movil—subsidiary of the privatized Mexican telecom operator Telmex—is leading this type of deeper regional integration. Following an acquisition spree and healthy organic growth, it was serving 31 million subscribers across the sub-continent by mid-2003—an increase by 37 percent over 2002. Besides 20 million customers in its home market, it is a major provider in Argentina, Brazil, Columbia, Brazil, Ecuador, and Guatemala. In some countries, growth was driven by aggressive distribution (large networks of points of sales) and innovative services (e.g. pre-paid cards). In others, takeovers of existing providers led the expansion. A third means of increasing the company’s regional footprint has been the acquisition of new wireless licenses—for instance in Nicaragua in September 2002. America Movil’s predominance in Latin America is being contested by Telefonica Moviles. The subsidiary of the Spanish phone company Telefónica serves 10 million customers in the region. In late 2002 it bought Mexico’s second largest wireless provider and in March 2004 it acquired stakes in 10 Latin American mobile operators from BellSouth of the United States for a total of $6 billion. Luxemburg-based Millicom, a subsidiary of Sweden’s Tele2, has established mobile phone operations in Bolivia, Colombia, Guatemala, El Salvador, Honduras, and Paraguay. Such activities of foreign investors foster deeper regional integration through investments in cross-border infrastructure, the provision of cross-border services (roaming), technology diffusion, and the creation of regional consumer brands—one of the most visible effects of regional integration for the general public.

One interesting feature of the mobile phone market, which could provide lessons for other services sectors, is the role that foreign investors are playing in market development. In 1999, Telefónica of Spain and Portugal Telecom acquired Morocco’s second GSM license. In 2001, France Telecom, with its mobile subsidiary Orange, acquired a majority stake in Egypt’s MobiNil. The company also holds 40 percent in Jordan Telecom, which operates one of the country’s two GSM networks. France Telecom has declared the Arab countries its main target for investments in emerging markets and the company plans to use Jordan as a regional hub for its activities. The second provider in Egypt is owned by Britain’s Vodafone—the world’s largest mobile company, which also has a footprint across the European continent. Both Telecom Italia (which already owns a Turkish mobile operator) and Telefónica participated in the bid for Tunisia’s second license. The winner, however, was private Egyptian company Orascom—a conglomerate that is not only a main shareholder in MobiNil, but also won the second license in Algeria. More recently, in a drive to focus its participation on 12 main GSM operators, Orascom decided to shed nine of its sub-Saharan licenses and sold its majority stake.

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103 FAC/Reuters News (21 April and 18 May 2003).
104 Reuters Business Briefings (29 March 2003).
106 Financial Times (9 March 2004).
107 Financial Times Abstracts (3 January 2001) and MEED (24 July 2002).
in the Jordanian provider Fastlink to Kuwait's MTC in 2002.\textsuperscript{108} "The success of Tunisia Orascom as an Arab-Arab venture funded by Arab money and run and managed mostly by Arab skills could set an example for more Arab investments in Tunisia and elsewhere in the Arab world."\textsuperscript{109} As the mobile phone market in the southern Mediterranean matures, the consolidation towards a few large regional providers is likely—similar to trends in Europe or Latin America.

<table>
<thead>
<tr>
<th>Table 3.4 Status of Selected Telecom Reforms in the Arab MPs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Competition in fixed telephony</strong></td>
</tr>
<tr>
<td>No</td>
</tr>
<tr>
<td><strong>Number of mobile operators</strong></td>
</tr>
<tr>
<td><strong>Competition in leased lines</strong></td>
</tr>
<tr>
<td><strong>Internet service providers</strong></td>
</tr>
<tr>
<td><strong>Independence of regulator</strong></td>
</tr>
<tr>
<td><strong>State-ownership in incumbent</strong></td>
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</table>


In spite of significant progress in the mobile segment, the Arab MPs still lag global reform trends in telecommunications. Especially the liberalization of fixed-wire (e.g. long distance and international telephony, leased lines, data services) and the privatization of state-owned telecom companies needs to be accelerated. So far, competition is confined to the "margins" of the sector, such as mobile telephony or internet service providers (see table 3.4; World Bank 2003a). None of the southern Mediterranean countries has effectively introduced competition in fixed-wire and only a few of them have partially privatized their incumbents (e.g. Jordan, Morocco, Israel). The lopsidedness of reforms is illustrated by the fact that the number of mobile phones in several MPs already outnumbers fixed-wire connections (fixed-to-mobile substitution). Expanding the scope of private participation and competition will also require a further strengthening of regulatory frameworks. While most MPs have established sector regulators, their autonomy and institutional capacity needs to be strengthened. All these domestic reforms should then be anchored by extended GATS commitments in the sector. In telecommunications, there seems relatively little value added in regional integration measures at the policy level, except for the exchange of best practice between policymakers and regulators. With telecom an important "backbone" service, however, sector reforms could act as a general catalyst for deeper regional integration. Among other things, it could foster trade in IT-enabled services and the cross-border provision of content (e.g. internet portals for the Arab world or audio-visual services).\textsuperscript{110}

As far as multilateral liberalization is concerned, telecommunication is one of the services where the GATS negotiations have progressed furthest. In the Uruguay Round, most commitments for the sector concerned value-added services (e.g. electronic and voice mail, online information and database retrieval), but few related to basic services (e.g. voice telephony, leased lines). Separate negotiations on basic telecommunications were launched and in 1997 the GATS Fourth Protocol entered into force. This covers all sub-sectors and it is technology-neutral (e.g. a bound service may

\textsuperscript{108} Reuters Business Briefings (29 March 2002), FAC/Reuters News (27 December 2002).
\textsuperscript{109} Tunisia Orascom chairman Mohamed Fethi Houidi quoted in FAC/Reuters News (28 January 2003).
\textsuperscript{110} Unfortunately, Orascom's participation in several GSM tenders has been tainted by accusations of corruption.
\textsuperscript{110} Information and communication technology (ICT) is not only a connector between countries in its own right, but also an important input into other backbone services, notably transport and financial markets.
be provided via cable, wireless, or satellite). 69 members, accounting for 93 percent of global turnover in the sector, made commitments as part of those negotiations. Ten additional countries (mostly new WTO members) bound the sector since then. Especially for market access, extensive use was made of precommitments. Morocco and Tunisia were among the 27 developing countries that used this important mechanism. Another noteworthy feature of sector negotiations was the inclusion of regulatory principles in the Reference Paper (see box 3.7). Sixty-six members made additional commitments in this regard—including the EU, which adopted the entire paper. One reason for the significant GATS progress made on telecommunication was the global reform momentum in this sector (i.e. multilateral commitments reflected unilateral reforms). Unfortunately, the commitments of most MPs were limited. Especially the core of the sector, fixed-wire services, was barely covered. In other cases, commitments were insufficiently implemented. Egypt for instance, subscribed to the Reference Paper, but the Minister chairs the board of the regulatory authority and also sits on the board of the incumbent. Morocco has formally abolished exclusivity rights in fixed-wire, but the requirement to build an alternative network instead of regulating the conditions for network access, has deterred new entry into the market.

Box 3.7 Domestic Regulation and Multilateral Disciplines: The Telecom “Reference Paper”

In the network services, pro-competitive regulation at the national level is needed to address incidences of market failure (natural monopoly elements, vertical integration, anticompetitive behavior by entrenched incumbents) and to ensure market access. The “Reference Paper” that accompanied the 1997 GATS Agreement on Basic Telecommunications was the first time that multilateral disciplines included explicit provisions on domestic regulatory principles. 60 of the 69 members that made commitments in this sector also subscribed to the Reference Paper (in part or in full). The paper could serve as a precedent for WTO agreements on other sectors and themes where effective regulation is critical (e.g. electricity, transport, competition policy). The Reference Paper covers several major areas of sector policy: the provisions on competitive safeguards, for instance, require governments to prevent major telecom companies from anti-competitive practices, such as cross-subsidization or an abuse of information (critical for many regulatory issues). With respect to network interconnection, key regulatory principles codified in the agreement are nondiscrimination, transparency, and the cost-relatedness of charges. Such interconnection is critical in addressing market failure arising from natural monopolies or vertical integration. Regarding rules on regulatory independence, the Reference Paper stipulates impartiality, as well as full institutional separation between regulator and service providers. The agreement also includes rules on the publication of licensing criteria and the fair allocation of scarce resources (e.g. frequencies, interconnection capacity). A more limited example for GATS commitments on regulation are the “Disciplines on Domestic Regulation in the Accountancy Sector.” They contain a binding provision to ensure that licensing requirements are not being abused to create “unnecessary barriers to trade” (the principle of necessity) in these services and that “they are not more trade-restrictive than necessary to fulfill a legitimate objective” (the principle of proportionality). The GATS Reference Paper on regulation in basic telecommunications clearly has its limitations. Some of its language remains rather general and to date only two cases related to the regulatory principles it defines have been brought before the WTO dispute settlement body. Nevertheless, it provides an important precedent for multilateral agreements on regulatory issues. It should be noted that most EU directives concerning regulation also pertain to general principles to be incorporated into national policy frameworks by member states. These international agreements on regulatory principles show that it is possible for the MPs to anchor domestic services sector reforms through multilateral or regional agreements.

3.4 Electricity

Electricity is one of the sectors where deeper forms of integration and more comprehensive liberalization of trade in services can only be achieved at the regional level. To understand why this

111 Most of the information in this box was taken from Mattoo (2002).
is the case, it is useful to first discuss the fundamental transformation that electricity markets have undergone during the last decade and a half. This sector was long dominated by vertically integrated and state-owned monopolies, but is now seeing the introduction of competition, private participation and modern regulation. The objectives of these reforms has been to enhance efficiency, lower costs, mobilize private investment, and consolidate public finances. As an increasing number of countries have experimented with different policies and market structures, an international best practice for the design of the legal, regulatory, and institutional framework has emerged. This includes:

- the corporatization and restructuring of state-owned utilities (e.g. commercial management, balance sheet restructuring, more effective metering and billing);
- the rebalancing of tariffs to bring prices in line with costs and to reduce government transfers;
- the modernization of the regulatory framework to prevent an abuse of monopoly power (e.g. separation of regulatory and operational functions, the creation of independent regulators);
- the vertical unbundling of the industry into generation, transmission, distribution, and trade;
- the introduction of competition in generation and trade;
- the promotion of private sector participation through privatizations and concessions;
- the establishment of power exchanges for efficient interaction of buyers and sellers in an unbundled industry (e.g. spot markets, futures markets, power pools); and
- the pursuit of public service objectives through less distortive instruments (e.g. targeted subsidies to the poor, instead of artificially low prices across the board).

Given the long lead times for the construction of power plants (about 5 years) and the long amortization periods for infrastructure investments (10-20 years), private investors demand a stable and transparent regulatory framework. Moreover, the right sequencing of reforms is of particular importance in this sector (e.g. downstream privatizations prior to upstream policy reforms can lead to policy “lock-in”). For these reasons, governments need to develop coherent and long-term reform strategies.

In the southern Mediterranean, and especially in the eight Arab MPs, reforms are at an early stage and the sector is still largely organized according to the traditional model. Practically all electricity utilities remain state-owned and vertically integrated. Pro-competitive policies and effective competition are conspicuously absent. Few MPs have established energy regulators and those who have, rarely endowed them with the necessary mandate, autonomy, or resources. Private sector participation is confined to a few independent power plants (IPPs), which were mostly introduced into unreformed sectors. As in the other infrastructure sectors, private participation is mainly seen as a tool to mobilize investments, and less as an instrument to enhance competition and economic efficiency. The need for further reform is illustrated by various performance indicators. In Lebanon, for instance, the annual

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112 For a detailed discussion of electricity sector policies in the region see Müller-Jentsch (2001).
deficit of the state utility amounted to $464 million. Network losses are estimated at 25 percent in Syria and between 15 and 20 percent in Algeria, Egypt, and Morocco (see diagram 3.7). In Egypt, the arrears of the state-owned electricity companies (i.e. unpaid bills) stood at $2.7 billion. In Algeria, government subsidies to the utility Sonelgaz amounted to $1 billion in 1998 alone. In several MPs, prices below costs still induce wasteful over-consumption and low levels of energy efficiency.

Most governments in the region, however, have at last launched sector reforms to tackle these problems. Jordan has long had private distribution companies, has established a regulatory authority, modernized sector legislation, and is tendering its first IPP. Turkey plans to fully unbundle the sector in accordance with EU rules, privatize state-owned assets, and has established an independent regulator. Given the country's track record of past reforms, however, it remains to be seen if these plans will be fully implemented. Algeria has initiated comprehensive electricity sector reforms, with support from the World Bank. Egypt and Lebanon would like to see greater private participation but are hesitant to liberalize the sector. Egypt has unsuccessfully tried to privatize generation and distribution assets, while three IPPs left the government with significant liabilities after a severe currency devaluation. This example illustrates the dangers of introducing private participation without careful preparation through upstream policy reforms. Morocco has privatized about a third of its generation capacity and sold distribution concessions for the main cities to private operators, but the government has shown little interest to introduce broader competition in this sector. Rapidly growing electricity demand and fiscal constraints in most MPs create significant pressure for greater private participation. This makes it even more important to introduce a stable and transparent regulatory framework, which is conducive to private investments and competition.

In the European Single Market, the electricity sector was one of the last network industries in which restrictions to competition and cross-border integration were systematically removed. A 1999 directive obliged member states to gradually open the power sectors to competition (by giving customers the right to choose their supplier); to unbundle generation, transmission, and generation; to designate a transmission system operator; and to ensure non-discriminatory access to the transmission network. Even though governments were only obliged to open 33 percent of the market to competition by 2003, more than two-thirds had been liberalized by that date. In fact, the minimum standards set by the Commission triggered a process of "competitive liberalization," as governments tried to avoid falling behind in the reform process. Despite formal market opening, however, entrenched incumbents continue to delay unbundling and obstruct competition (e.g. through excessive prices for network access). Hence, national regulators had to be established to translate the general principles of the directive into detailed regulations and to ensure enforcement. All EU countries now have independent energy regulators. The ten new member states that acceded to the EU in May 2004 are also being integrated into the common electricity market. In addition, eight Balkan countries plan to integrate their markets with that of the EU.\footnote{In November 2002, a total of 12 countries in South-Eastern Europe (including EU and accession countries) signed the Athens Memorandum of Understanding to that effect (www.seerecon.org/infrastructure/sectors/energy).}

One interesting feature of EU reforms has been their dual objective. Besides the promotion of competition and more transparent regulation, the aim was to remove barriers to cross-border integration. Several institutions help to ensure the latter. The Council of European Energy Regulators (CEER) was created to facilitate regulatory cooperation and an exchange of best practice between EU countries. Equally important for the integration of national markets is the collaboration between network operators, through the European Association of Transmission System Operators (ETSO). After all, cross-border trade (and thus competition) occurs through interconnections between national transmission systems. ETSO members therefore have to work together on issues such as cross-border...
pricing or congestion management. At the technical level, the Union for the Coordination of the Transmission of Electricity (UCTE) ensures the stability of the continental European grid. At the utility level, cross-border mergers and acquisitions (worth €20 bn in 1999 and $66 bn in 2002) and cross-border sales to customers in other countries have been the driving forces of integration. The development of sub-regional power markets, such as the European Energy Exchange or the Nord Pool, has been another element in the creation of trans-national market structures.

Box 3.8 Cross-Border Cooperation between Sector Regulators

The introduction of competition in network industries (electricity, gas, telecom, water, rail) requires pro-competitive regulation to redress market failure.\textsuperscript{114} Hence, the establishment of independent regulators is an integral part of liberalization programs in those sectors. Moreover, deeper regional integration in these markets requires cooperation between regulatory authorities. The optimal degree and type of cooperation, however, varies between sectors. Generally speaking, the creation of institutional networks between regulators facilitates the spread of best practice (through information exchange and benchmarking). It thus indirectly helps to level the playing field in cross-border markets through regulatory convergence. In the electricity sector, however, deeper forms of integration (e.g. regional power pools) require much more elaborate forms of regulatory cooperation, including common rules for cross-border transactions and cross-border markets. In the railway sector, network access for private operators along transnational corridors also calls for close regulatory cooperation. In air transport, cross-border traffic rights have traditionally been awarded on the basis of bilateral air service agreements between governments, and thus their liberalization requires joint regulatory action. Whereas all these examples concern economic regulation, cross-border cooperation is also needed on technical, safety and environmental regulation—for instance with regard to aircraft or maritime safety, as well as for the technical integrity of interconnected electricity grids.

In the EU Single Market, regulatory cooperation is particularly elaborate in the electricity sector. For 50 years, UCTE has been responsible for maintaining the stability and integrity of the continental European grid. ETSO coordinates economic aspects of interconnection, such as cross-border pricing or congestion management. The CEER not only facilitates the exchange of best regulatory practice (e.g. through eight technical working groups), but it also ensures a consistent application of EU regulations and acts as an important interlocutor for the European Commission.\textsuperscript{115} All major parties involved in the regulation of European energy markets also participate in the Florence Regulatory Process. Launched in 1998 by the European Commission, the forum convenes twice a year to debate the further development of the regulatory framework. In the telecom sector, cooperation between EU regulators has also been institutionalized, but to a lesser extent. The Framework Directive for the sector obliges all member states to establish sector regulators and to guarantee their independence. Cooperation between national regulators takes place through the European Regulators Group for Electronic Communications Networks and Services.\textsuperscript{116} The main role of this forum is to advice the Commission on the implementation and revision of regulations, to spread best practice, and to ensure a consistent application of common rules across the Single Market.

The economic benefits of these policy measures have already been significant. In most countries, prices fell significantly following liberalization—in many cases by 10 to 20 percent. Since then, however, part of that decrease was reversed, due to higher fuel costs and successful entrenchment by incumbents. Throughout the EU, the dual process of cross-border integration and liberalization has led to comprehensive restructuring of utilities and widespread privatization of state-owned companies. In response to competition and new market opportunities, energy companies are restructuring, cutting costs, and offering improved services to customers. Modern power markets and

\textsuperscript{114} The main market failure in electricity are natural monopolies in transmission and distribution. Pro-competitive regulation thus includes the unbundling of network ownership from services provision (e.g. network access regulation) or restrictions to vertical integration (e.g. separation of transmission and distribution from generation).

\textsuperscript{115} For further information, see: UCTE (www.ucte.org), ETSO (www.etso-net.org), and CEER (www.ceer-eu.org).

innovative trading instruments are being developed and previously segmented national markets, with a combined annual turnover of €170 billion, are integrating rapidly. By the time the Euro-Mediterranean FTA is completed, energy markets across the EU are expected to be fully liberalized, privatized, and integrated. Companies and households should benefit from lower prices and better services, while European utilities will be internationally competitive due to cost-cutting and consolidation. To speed up this process and to overcome obstacles encountered by the 1999 Directive, the Commission introduced amending legislation in 2002. This introduces competition for all non-households by 2004 and for all households by 2007.\(^{117}\) It imposes stricter requirements on unbundling and obliges all member states to establish regulators. At the same time, a separate regulation on cross-border trade was adopted.

The economic benefits of deeper integration of electricity markets could be substantial in the southern Mediterranean. First, cross-border power transfer for emergency support and peak demand allows countries to lower expensive reserve margins (around 25 percent of generation capacity). This reduces investment needs and increases capacity utilization. Second, economies of scale, different load profiles, and complementary energy endowments can give rise to further gains from trade (e.g. countries with natural gas resources may export electricity). Third, private investors tend to be more willing to invest in large markets. Most significant, however, regional power markets could facilitate domestic reforms in the MPs, especially the introduction of competition. The reason is that most national electricity markets in the MPs lack the critical mass ("small systems") to make effective competition feasible and unbundling worthwhile. The European example shows that domestic liberalization and regional integration can become mutually reinforcing, if reforms are properly designed and coordinated between neighboring countries.

There are three basic models for cross-border power markets. Under the single buyer model, currently used in the southern Mediterranean, a central entity purchases electricity from all producers and then resells it. This model, which does not necessarily require unbundling, limits competition. The open access (third-party) model has more competitive trading mechanisms. Transmission systems are open to generators, who can sell directly to distributors or large customers. Most trades, however, continue to take place on the basis of long-term contracts. A precondition for such an arrangement is the effective regulation of network access, and preferably the unbundling of transmission. In other words, functioning cross-border power markets require complementary domestic reforms. The third and most sophisticated type of trans-national power markets are power pools, or wholesale exchanges. Requirements for the operation of a pool are a well developed regulatory framework and institutional structures (e.g. spot and future markets, power brokers), as well as a sufficiently large number of generators of similar size to permit for effective competition.

A prerequisite for trade in electricity are physical links between national grids. With several interconnection projects completed in recent years, virtually all countries in the southern Mediterranean are now hooked up to the transmission networks of their neighbors (including submarine cables between Morocco and Spain). The capacity of many interconnections is still low (permitting only emergency and peak exchanges) and grids are not as densely meshed as on the European continent. Several capacity expansions are being planned and thus the physical and technical basis for regional integration of electricity markets is being put in place. Deeper forms of market integration, however, will require reforms of the regulatory and institutional framework.

There might in particular be potential for sub-regional power markets in the southern Mediterranean (e.g. in the Maghreb and Mashrek), since transmission losses are a function of geographic distance.

\(^{117}\) Financial Times (26 November 2002) and The Economist (30 November 2002).
In that context, it is interesting to note that Spain and Portugal have agreed to fully integrate their national power markets in the coming years. Based on the rules of the EU directive, both countries are harmonizing legal frameworks and upgrading physical interconnections. The regulatory agencies of the two countries are cooperating to develop common regulations, while the two transmission system operators are defining modalities for the joint management of the interconnected grid. Morocco, which plans to upgrade its interconnector with Spain, and Algeria (which is interconnected to Spain via Morocco) are already participating on the Spanish spot market. In the medium to long term, it would be conceivable that the Maghreb countries integrate more deeply with the emerging Iberian market, just as the Baltic Republics are integrating with the Nord Pool.

Box 3.9 The Baltic Sea Electricity Ring and Power Pool

One of the most ambitious schemes for sub-regional integration in the power sector can be found around the Baltic Sea. Similar to the Mediterranean Electricity Ring, the emerging Baltic Ring will connect the grids of EU countries (Finland, Sweden, Norway, Denmark, Germany) with those of transition economies (Estonia, Latvia, Lithuania, Belarus, Poland) on the other side of a common sea. The two missing links that have to be completed are between Lithuania and Poland and between Estonia and Finland. At the country level, the Baltic states and Poland have started to liberalize and privatize their electricity sectors. At the regional level, there is consensus that physical interconnection is only a necessary condition for market integration. The region’s energy ministers therefore agreed to pursue regulatory integration of power markets.\(^\text{118}\)

To understand these dynamics, it is useful to first look at what has been happening in the Nordic countries. In 1996, Norway and Sweden created Nord Pool as the world’s first cross-border power exchange. Finland and Denmark joined soon after. The exchange is jointly owned by the TSOs of Norway and Sweden. The creation of the exchange required the transfer of the interconnectors to independent TSOs in participating countries. Nord Pool provides a number of trading instruments and services. The Nord Pool spot market determines power flows, while national system operators ensure the physical execution through the exchange of balance power. The spot market (Elspot) offers trade in hourly power contracts for physical delivery during the following 24-hour period. Elspot is open to all companies that have signed the necessary agreements and about 200 companies now trade on Nord Pool. The futures market (Eltermin) is a purely financial market for price hedging, risk management, and trade in forward and futures power contracts. The trading time horizon is divided into weeks, blocks, seasons, and years. About fifteen brokers provide services and products to the market. Nord Pool enters into all contracts and reduces counterparty risk through the clearing of contracts via the Nordic Power Exchange. About 20 percent of all electricity consumed in the region is already being traded on Nord Pool.

With Nord Pool now firmly established, regional cooperation between the Nordic countries and their Baltic counterparts is being pursued through Baltrel, whose members are power companies and utility associations from eleven countries. With financial assistance from the European Commission, Baltrel analyzed the status of networks and regulatory frameworks; it identified obstacles to the development of competitive markets; it proposed remedies to address them; and it is supposed to coordinate the implementation of agreed measures.\(^\text{119}\)

Regulatory reforms would include the harmonization of standards and regulations, the creation of a grid code, and common operating rules. As one of the first concrete steps, regulators from Estonia, Latvia, and Lithuania signed a protocol on the common Baltic energy market in November 2002. “The deal aimed to establish international electricity trading in the Baltics, provide third party access, effective pricing mechanisms and independent transmission system operators.”\(^\text{120}\) The creation of a fully-fledged power pool in the Baltic region during the next decade thus seems to be a realistic scenario and could provide interesting lessons for the MPs.

The formal definition of what constitutes trade in the electricity sector is difficult and multilateral trade negotiations have thus far played a negligible role in the liberalization of this sector. Trade in energy equipment is covered by GATT. Horizontal GATS commitments on commercial presence (rights of establishment, FDI) might become increasingly relevant for trade via mode 3. However,

\(^{118}\) Economist Intelligence Unit Country Briefing (27 January 2003).

\(^{119}\) Detailed annual reports and other information can be found on the Baltrel website (www.baltrel.com).

\(^{120}\) Reuters News (5 November 2002).
Chapter 4

Other Sectors and Themes

4.1 IT-Enabled Services
4.2 Business and Professional Services
4.3 Distribution Services
4.4 Tourism Services
4.5 Competition Policy
4.6 Public Procurement
important impediments to cross-border trade in electricity (mode 1) and market integration arise from regulatory issues such as vertical integration, conditions of network access, and state-owned monopolies. As a result of electricity sector unbundling, the distinction between energy goods and energy services is becoming increasingly important. Whereas vertically integrated utilities previously covered the entire value chain (and thus services were only implicitly embedded in energy goods), unbundling has separated goods (e.g. generation and network infrastructure) from services (e.g. transport and distribution of power). Transportation and distribution of energy are considered as services under GATS, if provided independently. However, energy services were not negotiated under the Uruguay Round and it remains unclear to what extent they will be covered in the Doha Round.

In summary, electricity sector reforms in the southern Mediterranean countries are at an early stage. Existing inefficiencies and especially rapid demand growth create an urgent need for greater private participation, but given the dangers of poor sequencing (policy “lock-in” as a result of premature privatization), the MPs should focus on upstream policy reforms first (unbundling, competition, regulation). At the same time, deeper Euro-Mediterranean integration in the electricity sector would be desirable from an economic point of view. GATS commitments regarding commercial presence can help to liberalize FDI, but since most MPs already permit foreign investment in generation, the binding constraints for greater foreign participation are government ownership in existing assets, vertical integration, and the absence of pro-competitive regulation. These policy issues are not yet sufficiently being addressed under the GATS framework. Moreover, geography matters in the electricity sector and deeper forms of integration can only be achieved between neighbors—namely trade through cross-border interconnections and the establishment of cross-border markets. For these reasons, domestic liberalization in the MPs and regional agreements (bilateral or plurilateral) appear to be the best vehicles for cross-border integration. The current scope of the GATS would allow to anchor certain reform multilaterally and future GATS negotiations might increase the scope for doing so.

**Diagram 3.8 Investments in Infrastructure Projects with Private Participation ($/capita, ‘90-‘01)**

To conclude this chapter, progress in liberalizing the main backbone services remains slow and uneven in the southern Mediterranean. This is reflected in the volume of private investments in telecoms, transport, and energy (see diagram 3.8). While the second half of the 1990s saw higher investments than the first half, the figures for most MPs still lag considerably behind other developing regions, like Latin America. Morocco, Jordan, and Turkey are most advanced, while countries like Algeria, Egypt, Syria, and Israel have very low per capita levels of private investments in infrastructure. Another problem besides the low levels are some of the patterns in investments. In electricity, for instance, they mostly came in form of independent power plants and were not...
accompanied by regulatory reform. In telecom, reforms in mobile telephony have been substantial, while fixed-wire telephony has seen little liberalization. In the transport sector, many of the investments came in the form of stand-alone build-own-operate (BOT) concessions and were insufficiently embedded in broader sector reforms.

As the MPs simultaneously pursue national economic adjustment, deeper regional integration, and multilateral liberalization, they will need to develop integrated reform strategies. The optimal mix between these objectives will differ between the backbone services reviewed in this chapter. In telecommunication and financial markets, the multilateral framework is well advanced and there seems little value added in regional integration measures—especially since the optimal type of regulation differs between developed and developing countries. In electricity and air transport, the GATS framework remains weak and EU rules seem a well-suited basis for regional integration efforts, as they are in line with international best practice and explicitly designed to address cross-border policy issues. In all of these sectors, however, regional or multilateral initiatives can only be an anchor, but not a substitute for genuine reform efforts at the national level. Given structural incidences of market failure in all main backbone services—natural monopolies in the network industries and information problems or externalities in financial markets, procompetitive regulation should be a central ingredient both for domestic adjustment and cross-border integration. The outlined policy measures will not only help the backbone services become more efficient, but also allow them to fulfill their function as catalysts for general deeper integration and economic development.
Chapter 3 was devoted to the backbone services with the greatest regulatory reform needs. This chapter will review some other important sectors and policy themes. IT-enabled services associated with business process outsourcing seems to offer a great potential for the export of services from the MPs to the EU (section 4.1). Two other backbone services, where reform needs are less pronounced (business services) and less complex (distribution services) are discussed in sections 4.2 and 4.3 respectively. The tourism industry—of vital importance for economic development and trade in services in many MPs—is subject of section 4.4. Other policy areas of relevance for the process of deeper integration in the Euro-Mediterranean include competition policy (section 4.5) and public procurement (section 4.6).

4.1 IT-Enabled Services

Analogous to the fragmentation of the production chain in manufacturing, an increasing number of back-office services are being contracted out. Outsourcing is no longer confined to services such as accounting, billing, legal advice, database and payroll management, or call centers. More specialized services like medical transcriptions, frequent flyer programs, or special effects in the film industry are also increasingly subject to business process outsourcing (BPO). The research firm Dun & Bradstreet estimates that BPO accounts for $200 billion per year worldwide and will continue to grow rapidly.121 Thanks to advances in communication technology, many “IT-enabled services” have become tradable and can be outsourced to economies with lower wages. A study of the consultancy Gartner estimates that up to 25 percent of traditional IT jobs will be relocated from developed to developing countries by 2010. “By 2005, “30 percent of leading European businesses will include outsourcing IT services to “nearshore” or offshore sites in their business and IT plans.”122

In India, the leading developing country in this respect, IT-related services exports accounted for $8 billion in 2002 (two-thirds of that to the US) and are expected to grow to $21-24 billion by 2008.123 The total turnover of the India’s IT sector is forecast to increase to $77 billion by 2008.124 The sector already employs 1 million people directly and 2.5 million indirectly.125 It thus seems instructive to take a closer look at the Indian experience. Software development has long been the main IT-enabled service export of India. Two-fifth of the Fortune 500 companies outsource software requirements to India and work related to the year-2000 problem alone earned Indian companies $2.5 billion.126 More recently, however, BPO has been the most dynamic market segment. In 2002, India’s IT industry grew 29 percent—faster than in any other country. While classical IT services, such as software development, grew by a “mere” 22 percent, IT-enabled services such as outsourcing expanded by 65 percent.127

Estimates for individual market segments confirm the potential of further BPO exports. A survey by Deloitte Consulting, for instance, found that the world’s 100 largest financial services firms plan to

121 Information from Dun & Bradstreet cited in The Economist (5 May 2001).
122 Financial Times (17 March 2004).
123 Financial Times (20 September and 22 October 2002).
124 Estimate by IT consultancy Gartner cited in Financial Times (5 February 2003).
125 Financial Times (22 October 2002).
126 Financial Times (3 July 2000).
127 Financial Times (5 February 2003).
A distinct category of services that are subsumed under the general business services heading of the GATS are "professional services." Generally speaking business-to-business services tend to be lightly regulated in most countries, and barriers to trade are few. Professional services, however, are usually governed by a much more complex regulatory regime—especially regarding the formal qualification, experience, and licensing of professionals. In most cases lawyers, accountants, auditors, architects, engineers, or doctors are not only being regulated by public authorities, but also by their own professional bodies and associations. Even though the need to safeguard professional standards and to protect consumers in the presence of information asymmetries may justify some regulation, they also constitute barriers to international trade. In fact, they are often being used explicitly or implicitly for protective purposes.\footnote{In many countries, professionals are not only well organized but also part of the domestic elite. In other words, they constitute a vested interest group with an ability to influence economic policies for rent-seeking purposes.} Examples are restrictions on the creation of local partnerships, the membership in professional associations, or the temporary movement of intra-corporate transferees.

Even if a government formally grants national treatment to foreign professionals, the need to re-qualify to obtain a national license might effectively prevent trade in these services. The best way to overcome this barrier are mutual recognition agreements, whereby a country recognizes the qualifications and licenses obtained in a partner country. In fact, the GATS framework specifically provides for an exception to the MFN principle in this regard. GATS Article VII (on recognition of qualifications, standards, and certification of suppliers) permits bilateral or regional mutual recognition agreements. During the Uruguay Round, a Working Party on Professional Services (WPPS) was established to develop disciplines for these specific markets. Accountancy services were used as a precedent to define multilateral rules. In 1998 the WTO Council adopted the "Disciplines on Domestic Regulation in the Accountancy Sector." One of the main provisions was a "necessity test" to ensure that licensing requirements "are not prepared, adopted or applied with a view to, or with the effect, of creating unnecessary barriers to trade."\footnote{These disciplines will only apply to signatories and will only enter into effect with the conclusion of the next round of negotiations.} It should be noted, however, that the WTO is not the main body for the global harmonization of rules in accounting services. The key players are the International Accounting Standards Committee (IASC), the International Federation of Accountants (IFAC), and the International Organization of Securities Commissions (IOSCO). In May 2000, the IOSCO adopted international accounting standards (IASs), which will also become mandatory for all listed companies in the EU from 2005 onwards. To enhance financial market transparency and to facilitate the flow of investments, the MPs should also adopt these standards. Accounting rules are a policy area where the adoption of global standards are the optimal basis for regional integration.\footnote{For an overview of international accounting standards, see Van Greuning and Koen (2001)}

Now, what are the policy implications of trade in business services and their role for regional integration in the Euro-Mediterranean? First, as manufacturers and other companies extend their activities across the free trade area, it is important that business service suppliers can "move" with their clients. Second, in many of these services, geographic proximity (e.g. for personal contacts between professionals) and cultural proximity (e.g. common language, similar legal systems or business culture) are important for cross-border trade. This should facilitate regional linkages, especially among the Arab MPs (i.e. South-South integration). Third, EU firms are among the world leaders in many business services (one-fifth of EU external services trade falls into this category) and can thus help the MPs to upgrade their business environment and benefit from knowledge spillovers (e.g. through the training of local staff). Fourth, much of the liberalization that would be required has to take place at the national level (unilaterally) or through the GATS (multilaterally). Only regarding...
issues such as mutual recognition, additional integration measures at the regional level seem merited. In summary, MP governments would be well-advised to gradually liberalize most business services and to anchor those domestic reforms through more far-reaching GATS commitments.

4.3 Distribution Services

Another economic activity that constitutes a “backbone” service for deeper integration between economies is distribution. Distribution services can mainly be subdivided into wholesaling and retailing, but also include activities such as mail order or franchising. As the final stage of the supply-chain, it is a horizontal activity that cuts across sectors. Without access to distribution networks, foreign companies will have difficulties to sell their wares to potential customers and thus inefficiencies in this market can constitute an important non-tariff barrier in a wide range of industries. Cross-border distribution services are mainly supplied via mode 3 (commercial presence) and to a lesser extent via mode 1 (cross-border supply). Barriers to trade include restrictions regarding the right of establishment, zoning laws for the construction of retail outlets, limitations on the acquisition of real estate by foreigners, or restrictive rules concerning the distribution of certain products (product exclusions). Besides its importance for cross-border integration, however, distribution is also a large sector in its own right. Within the EU Single Market, it accounts for about 13 percent of GDP and (being a labor-intensive industry) for 16 percent of employment (EC 1998). Inefficiencies in this industry thus have broader welfare effects. In Japan, for instance, retail sector rigidities have long been blamed for high consumer prices and difficulties encountered by foreign firms to penetrate the Japanese market.

Cross-border liberalization of distribution services brings greater competition, substantial investments, and market consolidation—all developments that enhance economic efficiency. It should be noted, however, that it also has social consequences. On the positive side, lower prices and greater choice can bring tangible benefits to large parts of the population—after all, retail margins account for a substantial part of the final price of many consumer products. There might even be positive implications for gender equality. In many countries it is not uncommon for women to spend several hours per day shopping. The technical implications for the completion of the Mediterranean Electricity Ring have been studied by a regional MEDA project for food and other necessities. Liberating them from the burden of those chores will permit them to spend more time on other activities. The flip side of such improvements, however, is that retail consolidation through large supermarkets or department stores may hurt the myriad of small shops that exist in many developing countries. Given these broad economic and social implications, reforms should be gradual and they should distinguish between market segments. There is a strong case for comprehensive liberalization in wholesale distribution, where economies of scale are large and repercussions on small shop-keepers are small. As far as retailing is concerned, stores serving the urban middle classes would be the obvious place to start (e.g. food, furniture, electronics retailing).

Due to significant scale economies, distribution tends to be highly concentrated and competitive in industrialized countries. In many developing economies, however, barriers to market access remain common and especially the retail segment tends to be highly fragmented. This pattern is reflected in the GATS negotiations on distribution services, where low and middle income countries have thus far been very reluctant to make commitments. Only 33 WTO members have bound the distribution

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141 In several markets, vertical integration between production and distribution means that an inability to open own-brand retail outlets will prevent certain producers from distributing their goods in a country. Examples are clothing companies H&M and Zara, or the furniture retailer IKEA. Therefore, commitments in this sector should not only apply to distribution companies, but also to foreign manufacturers, as regards the distribution of their own goods.
sector under the GATS—one of the lowest figures of all sectors. High income countries, where retail liberalization is well advanced and strong domestic retailers have an interest to expand abroad, are eager to see further progress. The EU, for instance, has made commitments in all sub-sectors and only a few restrictions remain. These include certain goods carve-outs (e.g. pharmaceuticals) and some limited economic needs tests for supermarkets or department stores (mainly urban planning restrictions). The criteria for these restrictions, however, are transparent and non-discriminatory.

As far as regional integration is concerned, it should be noted that EU countries are home to large global players, such as Carrefour, Metro, Safeway, Ahold, Woolworths, Marks & Spencer, IKEA, or H&M. Many of them have expanded their distribution networks across the EU and far into neighboring regions—especially into Eastern and Central Europe. In Slovakia, for instance, the six largest retailers in 2003 were from western Europe. The need to source goods from a multitude of suppliers and to maintain complex logistics networks (e.g. central warehouses, frequent replenishment of supplies) creates an economic rationale for regional integration at the company level. However, liberalization in this global industry should be multilateral and governments ought to leave the emergence of regional patterns to market forces. Given the nature of the industry, the market entry of foreign distribution companies will not only enhance competition, but also tends to be associated with significant investments into physical infrastructure (e.g. warehouses, retail outlets, truck fleets), knowledge spillovers (e.g. just-in-time logistics or modern marketing techniques), and human capital formation (training of local staff). A liberalization of the distribution sector in the MPs would most likely lead to an extension of European retail networks to the South and thus help to deepen economic integration in the Euro-Mediterranean region.

4.4 Tourism Services

Around the shores of the Mediterranean Sea, tourism is a thriving industry that brings significant value added, employment, foreign currency earnings, and investments to its host economies (see table 4.1). International arrivals in the twelve MPs total 30.5 million (18.5 million in the eight Arab MPs). “On average about 50 percent of international tourists to these countries come from the EU. For some countries, this figure is much higher (e.g. 85 percent for Malta, 72 percent for Cyprus)” (Eurostat 1999). Total tourist receipts in the twelve MPs amount to $22 billion per year (half of these from the eight Arab MPs). The exact figures were $3.8 billion for Egypt, $1.6 billion for Tunisia, and $2.5 billion for Morocco. The dynamics of this industry are reflected in high growth rates. Between 1990 and 2001, tourist revenues increased by 245 percent in Egypt, by 95 percent in Morocco, and by 70 percent in Tunisia. Starting from a low base, they tripled in Syria (World Bank 2003c). The industry is also an important source of jobs. In Morocco, for instance, 600,000 people are directly or indirectly employed in the sector. In Tunisia, tourism accounts for 7 percent of gross domestic product. It is “the principle source of foreign currency and the second largest employer, providing 80,000 jobs directly and 300,000 indirectly.”

A drawback of tourism is the seasonal and volatile nature of the industry—for instance, the wars in Iraq and the terrorist attacks of September 11 all caused substantial dips in demand.

The comparative advantage of the southern Mediterranean countries in this sector not only stems from a favorable climate and attractive coastline, but also from their geographic proximity to Europe—the main source of international tourists in the world (EC 1998). If the MPs want to maintain their market share and high growth rates in this competitive industry, they will have to offer

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142 Frankfurter Allgemeine Zeitung (26 April 2004).
high quality services at reasonable prices. They also need to build on their geographic proximity to the EU by ensuring efficient air transport connections (the key backbone service needed to for deeper integration in this industry). As mentioned in section 3.1, charter traffic in most MPs with large tourism industries is already mostly liberalized. However, more competition in scheduled passenger traffic, a privatization of key airports, and eventually the creation of a common civil aviation area between the EU and its southern neighbors would further facilitate the flow of tourists between the two sides of the Mediterranean. The success of Lebanon’s open skies policies illustrates that point. Better South-South integration of tourism infrastructure (e.g. links between historic sites in Israel, the West Bank, and Jordan) could attract additional tourists. A final point regarding the linkages between tourism and deeper integration should be mentioned: as an important conduit for the exchange of ideas and personal contacts, tourism helps economies to mesh at the micro level.

Tourism is not only an important economic sector for many MPs, but also accounts for a significant part of total services trade of these countries. In Jordan, Morocco, and Egypt for instance, tourism amounts to around 20 percent of total exports (see table 4.1). The predominant mode of delivery, a peculiar feature of this economic activity, is consumption abroad (mode 2). However, commercial presence (mode 3) also plays an important role. Especially international chains of hotels and resorts, but also car rental companies and tour operators can be an important source of foreign direct investment. Many MPs have far fewer regulatory restrictions regarding trade in tourism, than they have in other services sectors. Nonetheless, some barriers to trade continue to exist. While FDI in hotels is generally encouraged, limitations to foreign ownership and market access often exist for ancillary services, such as shuttle services between hotels and airports, excursions within the country, or the intermediary services provided by travel agencies. Often these are reserved for local companies. Given the high degree of vertical integration through package providers, such restrictions can be disruptive to the operation of foreign tour operators. In fact, the main GATS requests of the EU to the MPs in tourism services concern the removal of such restrictions. Limitations on the temporary movement of workers (mode 4)—such as staff of tour operators looking after customers during the season—can also induce frictions.

Despite the economic importance of tourism for many MPs and its large share in regional services trade, further cross-border liberalization in this sector is not necessarily a top priority. The reason is that the economic attractiveness of the sector and global competition between tourist destinations has already induced most countries, including the MPs, to reform this sector unilaterally. More than a hundred WTO member states have made commitments regarding tourism services. In recent years, many southern Mediterranean countries have privatized state-owned hotels, opened their markets to

<table>
<thead>
<tr>
<th>Inbound Tourists (m)</th>
<th>Tourism Receipts ($ m)</th>
<th>As Share of Exports (%)</th>
<th>EU share of Nights Spent (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Algeria</td>
<td>901</td>
<td>102</td>
<td>1</td>
</tr>
<tr>
<td>Egypt</td>
<td>4,357</td>
<td>3,800</td>
<td>23</td>
</tr>
<tr>
<td>Jordan</td>
<td>1,478</td>
<td>700</td>
<td>19</td>
</tr>
<tr>
<td>Lebanon</td>
<td>827</td>
<td>837</td>
<td>44</td>
</tr>
<tr>
<td>Morocco</td>
<td>4,223</td>
<td>2,460</td>
<td>22</td>
</tr>
<tr>
<td>Syria</td>
<td>1,318</td>
<td>1,082</td>
<td>16</td>
</tr>
<tr>
<td>Tunisia</td>
<td>5,387</td>
<td>1,605</td>
<td>17</td>
</tr>
<tr>
<td>Total</td>
<td>18,491</td>
<td>10,586</td>
<td>20</td>
</tr>
<tr>
<td>Israel</td>
<td>1,196</td>
<td>2,166</td>
<td>6</td>
</tr>
<tr>
<td>Turkey</td>
<td>10,783</td>
<td>8,932</td>
<td>18</td>
</tr>
</tbody>
</table>


144 The vast majority of WTO members have made commitments in tourism (over 114 countries).
FDI in hotels and resorts, and implemented other policies to upgrade their tourism industry. Morocco, for instance, launched a comprehensive tourism development strategy in 2001, with support by the World Bank. It aims at doubling the number of hotel rooms and at quadrupling the number of annual arrivals by 2010. Cornerstone of the program is the Plan Azur, which foresees the construction of six large resorts by international investors for a total of $4.3 billion. Tunisia is also pursuing an ambitious tourism development plan that is meant to double the number of overseas visitors to 10 billion per year in the decade to 2010. If they succeed, these plans will both accelerate economic development and deepen regional integration between the two sides of the Mediterranean Sea.

Box 4.1 Health Tourism and Retirement Abroad

Two developments that are still in their infancy, but could provide significant opportunities for services trade and deeper integration in the Euro-Mediterranean, are health tourism and the trend to retire abroad. Both can be regarded as specific types of tourism that are being driven by the ageing societies of developed countries. Health services account for up to 10 percent of GDP in most European economies and faced with rising costs, many of these countries are looking for cheaper ways to provide such services. Examples for health tourism driven by differences in price and service quality are Western Europeans traveling to Hungary for dental care; the renown spas of the Czech Republic; or rich individuals from Arab countries coming to Europe for high-tech surgery. The unique climate and water of the Dead Sea has led to the development of a significant health tourism industry for skin-related conditions in Jordan and Israel.

A developing nation that has systematically encouraged health tourism is Cuba. Its strong tradition of medical training and well-developed public health care system permit the country to offer even advanced treatments to foreigners. There are now efforts to actively upgrade the capacity to offer plastic surgery (packaged with convalescence holidays) and the public agency Cubanaan Turismo y Salud is opening service centers in Europe to better market health services to foreigners. In 1995-96, “25,000 patients went to Cuba for treatment and 1,500 students went there for training” (Mattoo 2002). Several MPs have the potential to build similar services industries for European or Gulf country clients. Delivered via mode 2, the main constraints to such trade is the portability of health insurance. Commitments on this issue could well be part of a trade in services agreement between the EU and MPs (health insurance portability is already possible within the EU). Other examples of liberalization measures geared at facilitating health tourism in the region are the right of establishment for foreign health clinics or temporary work permits for southern Mediterranean nurses taking care of elderly people in the EU.

Related to leisure and health tourism is the retirement of individuals from developed countries (including MP migrants retiring at home), who are attracted by a better climate and lower costs of living. Many northern Europeans have already settled on the Spanish islands, in southern France, or the Italian region of Tuscany. In the United States, Florida has become the “retirement home” for millions of people and more recently Mexico has emerged as a popular destination for pensioners. “If only 3 percent of the 100 million elderly persons living in OECD countries retired to developing countries, they would bring with them possibly $30 billion to $50 billion annually in personal consumption and $10 billion to $15 billion in medical expenditures” (Mattoo 2002). The existence of a well developed tourism infrastructure (e.g. transport connections) and the availability of services consumed by older people (e.g. health services) are a precondition for this modern form of migration. One of the main constraints remains the portability of pension entitlements.

145 MEED (20 December 2002 and 14 February 2003).
146 MEED (28 December 2001).
147 Der Spiegel Online (27 February 2003).
4.5 Competition Policy

Reflecting the central role that competition plays in dynamic market economies, all OECD countries and a large number of developing countries have adopted competition laws to protect consumers from cartels, restrictive practices, and the abuse of market power.\footnote{448 For a general overview see Organization for Economic Cooperation and Development and World Bank (1999).} Competition (or antitrust) rules complement other policies that stimulate competition, including deregulation (removing government-imposed constraints to competition); sector-specific regulation (to address incidences of market failure); trade liberalization ("import competition"); and privatization (breakup of state-owned monopolies, separation of commercial and regulatory functions). Sector-specific regulation addresses structural obstacles to competition in a sector—such as the allocation of air traffic rights, the unbundling of port services from port management, or interconnection rules for electricity grids and telecommunication networks.\footnote{449 Sector regulation and general competition policy can be substitutes or complements, depending on the circumstances.} The cross-sectoral nature of competition law, on the other hand, provides for a flexible instrument to tackle anti-competitive behavior on a case-by-case basis. While both the enforcement of sector specific regulations and general competition laws requires the establishment of sufficiently autonomous and technically competent regulators, the more general nature of competition laws tends to put an even greater demand on the limited implementation capacity of many developing countries.

Besides undermining economic efficiency at the national level, anti-competitive behavior by firms can be an important obstacle to trade. Examples are export cartels or a merger in one country that creates a dominant position in another. As government-imposed barriers to market access have been reduced significantly in recent decades, such private barriers have become more salient. In 1996, the WTO established a working group to analyze linkages between trade and competition policy and to inform the debate about possible multilateral disciplines in this policy area.\footnote{510 While the EU has long argued for WTO rules on competition policy, the preference of the United States for bilateral agreements and the reluctance of many other members to move towards multilateral disciplines on this issue, has led the EU to scale down its proposals. The EU would still like to see all its main trading partners adopt national competition laws and for the WTO to define general principles, analogous to the GATS reference paper on basic telecommunications and rules for cooperation between national competition authorities. Key principles would be nondiscrimination (between domestic and foreign companies) and transparency (of decisions and procedures), but could also include other items (e.g. sufficient autonomy and competencies of antitrust authorities). Clear rules and obligations for the exchange of information between national authorities investigating cartels, mergers, etc. would also be included into such multilateral disciplines. The WTO dispute settlement body, however, should only rule on the general consistency of national competition laws with the agreed principles, not on specific cases. So far, however, little concrete progress has been made and the Doha Ministerial Declaration made an opening of formal negotiations conditional on the ability to reach consensus on negotiation modalities.}

Given the limited role of multilateral disciplines on competition policy to date, EU rules might be of greater relevance to the MPs—both as an example for the role that competition policy can play in the process of regional integration and due to the competition provisions contained in the AAs. The EU has established the most elaborate supranational framework for competition law in the world and the strict enforcement of these competition rules by the European Commission (which acts as the EU’s competition authority) has been a driving force in the creation of the Single Market. While Articles 81, 82, 86, and 87 of the Treaty of Rome define general principles, detailed implementation
regulations and especially a large body of precedent-setting decisions have created an elaborate policy framework. This is well integrated with sector-specific regulations and other procompetitive Single Market policies. Whereas EU rules apply to the entire spectrum of anti-competitive activities (e.g. cartels, mergers, price fixing, market sharing, predatory pricing), the jurisdiction of EU institutions is confined to cases that affect cross-border competition. Purely domestic cases are being dealt with by national competition authorities, but nowadays most cases do have some cross-border implications. Another unique feature of EU rules is that they also explicitly apply to government subsidies that distort competition (Article 87). In fact, the Commission prohibits state transfers to private or public enterprises in whatever form (e.g. subsidies, guarantees, tax breaks) and strictly scrutinizes the behavior of EU governments. Extensive powers of investigation, combined with a reputation for independence and strict enforcement that it has built, deter private companies and governments from interfering with the competitive dynamics of the Single Market.

The EU example shows that competition rules can play a major role in deeper regional integration. More recently, the effects of the EU competition regime have started to radiate into neighboring regions. The EU has created a web of bilateral trade agreements with other countries, and most agreements with its neighbors include provisions on competition and state aids policies. The most comprehensive are those with EFTA countries participating in the Single Market (Norway, Iceland, Liechtenstein). These countries fall under the full jurisdiction of EU competition law. The 10 countries that acceded in May 2004, had already transposed EU rules on competition and state aids and they are receiving technical assistance to develop effective enforcement mechanisms and a “competition culture.” Upon accession, they also come under the jurisdiction of the EU regime. As part of its customs union with the EU, Turkey committed itself to a far-reaching adoption of EU competition and state aid rules. The competition and state aid provisions of the AAs with other MPs are much weaker and will only become effective upon the enactment of implementation regulations. These are to be drawn up by the bilateral Association Councils, within five years after the entry into force of the respective AA. This deadline, however, only seems to be indicative and has already lapsed in the case of Tunisia. Analogous to EU-internal rules, bilateral competition and state aids provisions with all these countries only apply to cases affecting cross-border trade.

While multilateral and regional disciplines remain weak or non-existent, national frameworks for competition policy are still rudimentary in most MPs. Exceptions are the new EU member states Cyprus and Malta, as well as Turkey and Israel. These countries have developed detailed rules and effective competition authorities. Morocco, Algeria, Tunisia, and Jordan have adopted competition rules and set up competition authorities (excluding Morocco). The main problem in the Arab MPs, however, is actual enforcement. Most competition authorities are insufficiently autonomous (e.g. regarding the right to initiate investigation or the ability to enforce decisions) and institutionally weak (few technically qualified staff, insufficient budgets). None of the Arab MPs have effective state aids policies and in many cases, competition rules do not apply to key parts of the economy (e.g. infrastructure sectors, state-owned monopolies). These weaknesses are reflected in the case-load, the economic significance of the cases investigated, as well as the fines levied.

As part of their mise-a-niveau process, the MPs will have to determine how fast and how far to move in the area of competition policy. In many of these economies, more blatant impediments to competition still exist (e.g. legal barriers to competition, state-owned monopolies, unregulated cases of market failure in key services sectors) and should be a priority for reforms. Given weak

151 For a detailed discussion of competition policies in the MPs, see Geradin (2004).
152 The deadline lapsed in 2002 without a start of negotiations or a provision of related technical assistance. This contrasts with the case of the Europe Agreement, where implementation measures were quickly adopted.
153 For a comprehensive regional and a country-specific assessment, see (1) Geradin (2004); (2) Lahouel (2003).
institutional structures and a limited implementation capacity, many southern Mediterranean countries do not yet seem ripe for elaborate competition regimes. Nonetheless, well-designed competition laws and competition authorities can play a useful role. They should initially focus on the main anti-competitive conducts (e.g. cartels, abuse of dominant position) and act as an advocate for the development of a “competition culture” (e.g. advise to governments on competition-related policies or the issuing of public opinions). Their mandate and institutional capacity could then be gradually expanded. The implementation regulations of the AAs could be used as an external anchor for such domestic reforms. As in all other policy areas, however, regulatory harmonization with the EU should not be pursued for its own sake, but only to the extent that it effectively facilitates trade or economic reform in the MPs. Flanking measures would be donor-sponsored capacity building projects, the exchange of best practice through regional networks of competition authorities, or peer reviews. Given the different stages of development across the MPs, a differentiated and gradual approach is called for.

4.6 Public Procurement

Cross-border competition for government procurement is an important building block for the creation of a comprehensive free trade area. The purchasing of goods and services by public entities can account for 10 percent of a country’s GDP and the world procurement market has been estimated to exceed $3 trillion per year (excluding compensation of state employees and military expenditure; World Bank 2000a; Evenett 2002). In developed and developing countries alike, discrimination in favor of domestic companies remains widespread. This can take the form of local content rules or residency requirements as well as more implicit forms, such as biased product specifications, non-competitive contract awards, or rigged tenders. Discrimination in public procurement not only constitutes an important non-tariff barrier, but it also reduces welfare at the national level. It creates rents that undermine incentives to increase efficiency at the company level; while increasing costs of purchases for the government and thus taxpayers. An analysis of OECD countries found the “margin of preference” (the premium paid by governments to favored domestic suppliers) to range between 13 and 50 percent. Non-transparent and uncompetitive procurement also creates a fertile breeding ground for corruption—a major impediment for economic development in many southern Mediterranean countries.

As far as multilateral disciplines are concerned, the WTO Government Procurement Agreement (GPA) entered into force in 1996. It only binds signatories and has less than 30 members. Virtually all of these are high-income countries, including Israel as the only MP. The GPA obliges countries to apply national treatment for procurement to other signatories (principle of reciprocity) and to abide by the most-favored nation principle. The rules of the GPA apply to all purchases exceeding a certain volume. It covers all goods unless exemptions have been granted (“negative list”), but it only covers those services explicitly listed in the annexes (“positive list”). In addition to its provisions on nondiscrimination, the GPA defines rules regarding the transparency of the procurement process. Key principles include open access to tenders, the use of objective technical specifications, a publication of tenders, and the notification of relevant regulations to the WTO. The third main pillar of the GPA are enforcement provisions, including the installation of domestic arbitration procedures (to avoid time-consuming court settlements) or the possibility to bring cases to the WTO dispute settlement body.

154 Local and provincial governments tend to spend about half as much again on goods and services as central governments.
As these multilateral rules increase the efficiency, transparency, and accountability of procurement, it should be in the interest of any country to unilaterally adopt them by passing appropriate laws (e.g. national procurement law, anti-corruption laws) and by setting up institutional mechanisms to enforce them (e.g. an independent public procurement agency, credible appeals procedures for bidders, auditing of procurement contracts). Both in NAFTA and especially in the EU, public procurement rules have been an integral part of regional integration efforts. As part of the EU enlargement process, many CEECs and three of the MPs (Cyprus, Turkey, Malta) are adopting the strict EU directives on public procurement. Several of the Arab MPs have started to reform their public procurement regimes, in some cases with help from the World Bank. Given the economic importance of this matter, they would be well advised to accelerate public procurement reform at the national level and to anchor those reforms through regional and multilateral commitments.
CONCLUSIONS: FROM STRATEGY TO ACTION

Eight years into the Barcelona Process, the Euro-Mediterranean Partnership has not yet led to a notable acceleration of economic reforms or an improvement of economic performance in the southern Mediterranean countries. At the same time, the Arab MPs have been marginalized in the global economy. Increasing global competition for low value-added manufactures and EU enlargement threaten to further erode their competitive position. In order to increase exports, attract FDI, and create jobs for a rapidly growing workforce, these countries need to better leverage a key source of comparative advantage they are endowed with: geographic proximity to the large European markets. The EU accounts for about a quarter of world GDP and foreign direct investment. With the right policies, geographic proximity to these markets could be turned into a powerful driver of economic development. This requires deeper forms of integration between the two shores of the Mediterranean. The main policy instruments for achieving this would be the liberalization of trade in services and the comprehensive behind-the-border reforms that this entails.

Deeper integration is not about regulatory harmonization for its own sake. The ultimate objective is the removal of a wide spectrum of non-tariff barriers that obstruct economic transactions and resource flows across borders. Regulatory harmonization is only one mechanism to achieve that. The wholesale adoption of the rules and regulations of the Single Market (the acquis communautaire) seems neither feasible nor desirable. The focus should rather be on a tailor-made type of “regulatory convergence.” As Mexico’s integration with the U.S. economy during the 1990s has shown, deeper integration can be achieved with low levels of policy harmonization. What is primarily needed are decisive domestic reforms that enhance productivity, improve the general business climate, and remove non-tariff barriers. Cross-border integration can be an important catalyst and a useful complement for such reforms.

The pursuit of deeper integration—which can also be conceptualized as the gradual or partial extension of the Single Market to the South—has a decisive practical advantage. While it formulates a “grand vision” for the region, it can be implemented incrementally and at multiple speeds. As this study has shown, deeper integration may be tackled at different policy levels (national reforms, regional integration, multilateral liberalization) and in a wide range of policy areas (individual sectors and themes). This permits each MP to move at its own pace and according to its own priorities. While the long term goal is clear, there are many ways of getting there. The modular nature of the strategy proposed makes it possible to start with implementation immediately and it allows fast reforming countries to move ahead without waiting for the laggards. At the same time, an overarching and clearly communicated vision—participation in the Single Market and integration into an “wider Europe”—should help overcome vested interests that obstruct individual reforms.

As policymakers move from strategy to action, they have a number of implementation instruments at their disposal. In most services sectors, multilateral GATS commitments would be the appropriate tool. This would require WTO accession of some of the Mediterranean Partners and a strengthening of existing commitments for the others. If the Doha Round is not concluded in the foreseeable future, such commitments should be made unilaterally. As regards bilateral instruments, the existing Association Agreements provide for further liberalization of trade in services. The establishment of such economic integration agreements, in the sense of GATS Article V, are being discussed in the Euro-Med working group on services. In addition, protocols could be added to the existing agreements. In some cases, such protocols could be substitutes for multilateral commitments (e.g. in air transport) and in others they could be add-ons (e.g. on regulatory convergence or institutional
cooperation). A more ambitious bilateral option would be to bundle various additional commitments into European Neighbourhood Agreements (or second generation AAs). Another type of instrument would be regional agreements between the EU and the MPs as a group (e.g. on a common civil aviation area). While this would require complex negotiations, it may be considered for specific areas.

The most important implementation instrument remain unilateral reforms. Most non-tariff barriers and restrictions to trade in services can best be removed through domestic policy measures. These are very similar to those reforms needed to ensure the partner countries become more efficient economies (increased competition, increased private sector participation, rights of establishment for foreign investors). While commitments (at the bilateral, regional, or multilateral level) bring additional benefits—such as reciprocal concessions or signals to investors—each MP can deepen its integration with European and global markets unilaterally. A lack of progress on the external front should not be used as an excuse to hold back with reforms at the national level. Overall, a well designed mix of instruments would help unlock the synergies between them. Whatever the exact instruments used, they will have to be credible and effective. Mere policy statements and declarations of intent will not suffice.

Moving from strategy to action not only requires the right tools, but also the appropriate incentives for MP governments. The most important incentive, of course, should be the economic gains to be reaped from deeper integration and economic reforms. Another critical incentive would be additional financial assistance to fast reforming countries—and correspondingly less assistance to slow reforming countries. One of the most powerful incentives could be reciprocal concessions by the EU on agriculture or labor mobility. This has long been demanded by the MPs and should at least be granted to fast reformers as a highly-geared incentive. In fact, the bundling of reciprocal concessions into give-and-take packages for both sides (European Neighbourhood Agreements) could be a powerful catalyst for economic reforms. Moreover, there are “soft” incentives that have been successfully used in the enlargement process and could be adapted to the region. These include benchmarking, national action plans, and annual progress reports. The EU’s new European Neighbourhood Policy (ENP) foresees most of these incentives. The challenge will be to effectively integrate them into a coherent incentive regime that will help to accelerate reforms.

A final ingredient, besides implementation instruments and incentives, is improved donor coordination. This has often been talked about, but has remained limited and ad hoc. A “grand vision” could help focus donor efforts. This is what happened in the enlargement process: The EU provided a development paradigm (“enlargement”) and an effective policy framework to achieve it. Other donors then channeled their technical expertise and funding towards the common goal. To achieve something similar in the MPs, however, all involved parties should agree on an efficient division of labor, clearly defined deliverables, and specific time-tables. One scenario for increased donor coordination, could be to translate the ENP Action Plans for fast reforming MPs into policy matrices for multi-donor operations and technical assistance.

Most importantly, implementing the ambitious reform agenda that deeper integration entails requires significant political will on behalf of governments and concerted assistance efforts by the donor community. Translating general commitments to deeper integration into tangible progress on the ground will be no easy feat. The potential payoffs, however, would make such efforts worthwhile.
ANNEXES

Annex A: NAFTA and its Lessons for Deeper Regional Integration
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ANNEX A: NAFTA and its Lessons for Deeper Regional Integration

The North American Free-Trade Agreement (NAFTA) between Mexico, the United States, and Canada was the first far-reaching case of North-South integration and can provide some useful lessons for the Euro-Mediterranean Partnership.\(^{156}\) In several respects, NAFTA's core provisions go beyond those of the Association Agreements (AAs) between the EU and the MPs. Over the ten-year period to 2003, trade in goods has been almost completely liberalized. Tariffs are being removed for 99.3 percent of imports from Mexico to the United States and for 98.1 percent of U.S. exports to Mexico. In the case of agricultural goods—thus far excluded in the Euro-Mediterranean agreements—non-tariff barriers are being tarifficated and trade is being liberalized (in some cases a 15-year phase-out period applies).\(^{157}\) With respect to public procurement, NAFTA also goes further than the AAs. It includes a positive list of sectors and purchasing entities to which national treatment applies. In a chapter on technical barriers to trade, the agreement also contains some concrete provisions regarding norms and standards, as well as on sanitary and phytosanitary measures. Twenty-four committees and working groups were established—each corresponding to a particular clause of the agreement—to ensure implementation, dispute settlement, and close working relationships between governments at the technical level.

One major difference between NAFTA and the Euro-Mediterranean AAs is their treatment of trade in services. While the Euro-Med agreements contain no specific commitments in this field, NAFTA liberalizes trade in services to a considerable extent. Except for sectors included in a negative list, the rights of national and most favored nation treatment are granted to service providers and requirements to establish a presence in the other jurisdiction are lifted (Abbott 1995). There are also very liberal provisions concerning investments (mode 3 of supply). Whereas telecommunications, air and maritime transport are largely excluded, banking, construction and engineering, as well as trucking and bus services (most transport flows in NAFTA are land-based) are gradually being opened to foreign companies. Moreover, the economic costs of remaining exemptions are considerably reduced by the fact that most of the excluded sectors have already been liberalized at the national level in all three NAFTA countries. NAFTA entered into force in 1994 and most of its provisions have by now been implemented. Compared to the AAs, NAFTA targets a broader range of economic integration issues, contains stronger provisions on most of them, and puts a clear focus on effective implementation.

Whereas NAFTA is comprehensive with regard to economic integration, it is otherwise a "no-frills" agreement. It has no external dimension such as a common external tariff or a common commercial policy vis-à-vis third countries.\(^{158}\) Its institutional structures are relatively light and it is a purely economic agreement. Besides two rather limited supplementary agreements on environmental and labor issues, NAFTA has no political, cultural, or security dimension—unlike the Euro-Mediterranean Partnership (Sbragia 2001). There is no effort to achieve regulatory convergence, but rather a pragmatic approach to the removal of non-tariff barriers. Another important difference is that

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\(^{156}\) It is sometimes argued that the first case of North-South integration was the EU accession of Greece, Portugal, and Spain. Their GDP per capita relative to that of the other EU members, however, was about five times higher than the respective ratio between Mexico and the US/Canada.

\(^{157}\) Mexico's total agricultural exports doubled from $2.4 to $5.3 billion during the 1990s and the stock of U.S. FDI in food processing reached $5.7 billion in 2000 (Financial Times, 1 July 2003).

\(^{158}\) One exceptions are strict rules of origin (ROOs). They discriminate against third countries, to ensure that most benefits of trade liberalization accrue to companies from NAFTA countries and to prevent the use of Mexico as an export platform to the US. However, ROOs are less of an obstacle for the creation of regional production networks in the case of NAFTA than in the Euro-Med FTA. First, there is no patchwork of different trade agreements. Second, among large countries cross-border value-chains are more likely to be of a bilateral nature.
NAFTA is basically a bilateral North-South agreement between the United States and Mexico, whereas the Euro-Med Partnership has more complex plurilateral structures. For instance, the sectoral policy dialogue of the Euro-Med Partnership (EMP) conducted via regional fora have yielded few tangible results. The group of participants simply seems to be too broad and heterogeneous (currently 35 countries), while political tensions in the region complicate matters further. Another problem is the fact that the MPs do not have a clear institutional counterpart, as Mexico basically does in the U.S. government. The division of power between the Commission, the Member States (represented in the Council of Ministers), and the European Parliament makes decision processes on the EU side slow and complex.

One crucial difference between these two cases of North-South integration, however, is the fact that the implementation of NAFTA was accompanied by a much more ambitious program of domestic adjustment in the southern partner. Mexico launched a far-reaching program of economic reform in 1987, which it consistently pursued for over a decade (Ruiz-Nápoles 1966; Ortiz 1996). Except for Tunisia or Jordan, none of the MPs has a comparable track-record. Despite the Peso Crisis, which occurred less than two years after NAFTA's launch, Mexico's economic performance during the 1990s has been impressive. Its trade more than tripled from $82 billion in 1990 to $279 in 1999. This translates into an average growth rate of 15 percent (twice the global average) and made Mexico the seventh largest trading nation in the world. Manufactured goods replaced petroleum products as the main export item (a sign of changes in comparative advantage) and much trade is now intra-industry (a sign of advanced economic integration). Accumulated FDI between 1994 and 2000 amounted to $85 billion. 75 percent of Mexico's exports go to the United States and 60 percent of its FDI are coming from there. The government estimates that half of the average 5 percent growth achieved in the last four years of the 1990s can be attributed to increased exports. In summary, economic integration with the vibrant U.S. economy, in conjunction with domestic reforms, has benefited Mexico greatly.

The dramatic growth rates in U.S.-Mexican trade and FDI flows were largely driven by the creation of "cross-border industrial complexes," or rather Mexico's integration into North American production networks. Outward processing trade was greatly facilitated by the fact that maquiladora assembly plants had been established on the border, long before NAFTA came into being. These factories were located on Mexican territory, but enjoyed a type of free-zone status. They imported U.S. components duty-free, under the condition that finished products were re-exported to the U.S. market. "NAFTA was introduced at a time when a particular form of trade involving industrial complexes that span the borders between the United States and its two neighbors had already evolved over a period of decades. [...] Thus NAFTA creates an opportunity to expand and extend trade relationships that are already well established" (Lakshmanan and Anderson 2001). As NAFTA came into force and did away with the tariff advantage the maquiladoras enjoyed, those well-

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159 Mexico is much larger than the MPs in terms of population and GNI. The only MP that comes close in terms of size is Turkey with a population of 66 million (Mexico: 99 million) and a per capita GNI of $5,830 (Mexico: $8,240). From World Bank (2003c).
160 The bilateral policy dialogue conducted through the Association Councils, on the other hand, tends to be of a rather general nature.
162 Not all of Mexico's increase in exports and FDI during the 1990s can be attributed to NAFTA, but there is evidence of a strong causality (Lederman et al. 2003).
163 Financial Times Deutschland (28 March 2001). Despite the downturn in the United States and in the global economy, FDI was still running at over $12 billion in 2001 and $13.6 billion in 2002 (Financial Times, 22 February 2003).
established linkages at the company level were extended deep into Mexico proper and thus acted as a catalyst for more comprehensive economic integration.

As far as economic reforms in the backbone services are concerned, vested interests have thus far preserved the state-owned monopoly in electricity and left the telecommunications sector only partially reformed. However, the comprehensive overhaul of the transport sector can be regarded as a successful example of how structural reforms have enabled the Mexican and U.S. economies to mesh at the micro level. Regardin external economic reforms, the government is pursuing further trade liberalization with other countries. In 2000, Mexico signed a far-reaching free-trade agreement with the EU, as well as with Israel and four of its Central American neighbors. In the meantime, negotiations between 34 countries of the western hemisphere are under way to create the Free Trade Area of the Americas (FTAA) by 2005. Despite Mexico’s stellar performance in the 1990s, the process of export-led growth threatens to run out of steam. Besides the cyclical downturn in the US, the main structural challenge is the fierce competition of China and other Asian countries in labor-intensive manufactures. In the two years since 2001, an estimated 540 maquiladora plants with 200,000 jobs left Mexico in search of cheaper labor. In 2002, China overtook Mexico as the second largest importer to the US. Unless Mexico implements a wave of second generation reforms to enhance productivity, it will find it increasingly difficult to compete.

A final aspect of deeper integration between the United States and its southern neighbors that needs to be mentioned is migration. Thanks to millions of (mostly illegal) immigrants from Latin America, Latinos have replaced blacks as the largest minority group in the US. An estimated 11 million Mexicans alone live north of the border. As opposed to many other waves of immigrants before them, Latinos are not simply being assimilated into the American “melting pot,” but they are also transforming their host country in return. Spanish is already the most commonly spoken second language in the US. In predominantly Hispanic cities like Miami, San Diego, or Los Angeles signs of Latin American culture have become omnipresent. At the same time, Mexicans and other Latin Americans trained at U.S. elite universities have become a driving force of social and economic modernization in their home countries. While some of these developments mirror patterns of emigration from neighboring regions into the EU, flexible labor markets and a decade of rapid economic growth during the 1990s has helped to productively integrate Latinos into the U.S. economy. Annual remittances of Mexicans working in the US, for instance, amount to a staggering $10 billion. With northward migration unabated, the process of interpenetration between the economies of Mexico and the United States is likely to continue for many years to come.

164 A source of conflict remain technical and safety requirements for Mexican trucks crossing into the United States.
165 In parallel, negotiations between the United States and Mexico’s five southern neighbors were launched for a Central American Free-Trade Agreement (US-CAFTA). (The Economist, 15 February 2003).
166 Financial Times (1 July 2003).
167 Examples for such second generation reforms would be a breakup of the oligopolistic structures in telecoms; a privatization of the electricity and oil sectors; or policies that would encourage exporters to add more value (e.g. through research and development, or design and branding) instead of merely competing on price.
ANNEX B: Rules of Origin as an Impediment to Deeper Regional Integration

In a world of preferential trade agreements, different tariff rates apply to the same category of goods, depending on the country from which they are being imported. To prevent goods from a high-tariff third country being channeled through a preferential trading partner, certificates of origin need to be provided. These certificates allow the goods to qualify for tariff exemptions. "Rules of origin" (ROOs) define conditions that a product must satisfy to be granted preferential access—i.e. to "obtain origin" from the exporting country under the provisions of a free trade agreement. These rules are spelt out in trade agreements between countries and often account for the bulk of text in such documents. ROOs usually require a minimum percentage of domestic value added; a change of tariff heading (the processing of imported materials into more advanced goods); or specific processing operations that have to be performed within the exporting country. In EU trade agreements, changes of tariff heading tend to be the default rule and annexes specify for which product categories other rules apply. Since international value chains often cross multiple borders, different ROOs are invoked depending on the sequence of trades involved. Given the administrative frictions this entails, rules of origin can significantly reduce or distort trade flows. In fact, empirical evidence shows the utilization rates for preferences in several EU agreements with developing countries to be low—apparently because the costs of proving conformity exceeds the margin of preference.\(^6\)

In regional trade blocks, simple and harmonized rules of origin are important to allow for the emergence of border-spanning production networks. Which steps of the value chain are processed in what country should be determined by comparative advantage and not by rules of origin. An example for such intraregional trade would be cotton harvested in Egypt, processed into yarn in Turkey, woven into fabrics in Italy, sewn into apparel in Tunisia, and distributed to final consumers across Europe (for the role of ROOs in this industry, see also Annex D). More important than harmonization of ROOs \emph{per se} is the possibility to "cumulate origin" within a trade block. In other words, processing steps performed in trading partner A, and incorporated in intermediate products imported into country B for further processing, should be treated as originating from country B, if the resulting goods are later exported to other members of the same trade block. However, there are different types of cumulation. In the case of "bilateral cumulation" only intermediate inputs from the country to which processed goods are re-exported qualify. An example is the import of electronic components from the EU to Tunisia and the re-export of consumer electronics to the EU, after labor-intensive assembly. "Diagonal cumulation" extends the same privilege to inputs imported from other countries within the trade block and thus permits for more complex regional supply chains. "Full cumulation" counts any processing activity from any country in a regional trade block as "qualifying content," regardless of whether it is sufficient to confer originating status to the traded components themselves.

Within the Euro-Mediterranean FTA, the current rules of origin are complex and have repeatedly been identified as a major obstacle to intraregional trade.\(^7\) The rules of origin not only vary across bilateral Association Agreements, but there are also other complications. For instance, Morocco’s free-trade agreements with Tunisia and Algeria require 40 percent of domestic value added, whereas the one between those two countries uses 50 percent as the threshold. The bilateral AAs between the EU and the three Maghreb countries use a mixture of criteria to determine origin. For automobiles and machines, for instance, they require a minimum of 60 percent of domestic or EU value added; in textiles at least two processing stages have to be carried out (spinning and weaving or weaving and


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In regards to cumulation, the AAs only permit diagonal or full cumulation in those cases, where the ROOs among the three Maghreb countries are identical with those defined in the AAs. This is not yet the case and as the rules of origin for many tariff headings differ in the three AAs, it would not even be possible to align all of them simultaneously. Additional incompatibilities arise with the provisions under the emerging Greater Arab Free-Trade Area (GAFTA)—which most of the MPs belong to—as well as with the network of bilateral trade agreements among the MPs.

This complex system of overlapping rules of origin is non-transparent and imposes significant transaction costs on businesses and traders. It also adds significantly to the work of customs authorities (certifying origin is one of their main tasks) and thus amplifies one of the main bottlenecks in regional supply-chains. Most problematic, however, are obstacles to cumulation—especially given the small size of most MP economies. Effective diagonal cumulation would encourage South-South trade and make the region more attractive for foreign investors. One way to achieve this would be to harmonize ROOs between different AAs and then to amend the ROOs in South-South agreements, in order to make them compatible with those of the AAs. Another option is to extend the “Pan-European Rules of Origin” to the MPs. These were originally introduced between the EU, the EFTA countries, and the CEE enlargement candidates in 1997. Such an extension would require a replacement of the original protocols in the AAs (and in the corresponding South-South agreements) with those used in agreements with members of the pan-European system. In 2001, Euro-Mediterranean Ministers of Trade established a working group to explore how Pan-European Rules of Origin could be extended to the MPs. This working group produced a new Protocol, which was endorsed by Euro-Mediterranean Trade Ministers in July 2003. It is to be inserted into all existing and future agreements. At the institutional level, the “Pan-European Group of experts”—which deals with technical issues of implementation—is to be opened to participation by the MPs.

Once implemented, these changes should facilitate trade across the Euro-Mediterranean free trade area, at least when compared to the status quo. However, further reforms would be desirable to address remaining constraints. First, the Pan-European rules only provide for diagonal cumulation and not for full cumulation. Second, important restrictions remain in the form of sufficient processing requirements. Examples are two-stage processing rules for textiles and apparel or 40-50 percent value added rules in some other sectors. Third, administrative costs of proving compliance need to be reduced to a minimum (e.g. the complex and very detailed product-specific ROOs in the AAs could be simplified). Such costs fall disproportionately on those companies that do not have state-of-the-art accounting systems—in other words, they represent a particularly heavy burden for small and medium sized enterprises in the southern Mediterranean countries. The most comprehensive solution to the ROOs problem would be the creation of a customs union, with all countries having the same external tariff, rules of origin are no longer needed. This, however, would entail comprehensive policy coordination and does not appear to be a realistic scenario for the foreseeable future.

171 Most MPs have a comparative advantage in labor-intensive production stages, which often account for a relatively low share of total value added. Such high thresholds can thus severely discourage outward processing trade between the two shores of the Mediterranean.
172 This makes it more difficult to perform a sufficient number of processing steps domestically.
ANNEX C: Regional versus Multilateral Liberalization of Trade in Services

What are the arguments for and against regional trade liberalization ("preferential trade"), as compared to multilateral liberalization? The answer differs for trade in goods and trade in services. Generally speaking, the gains from trade to be reaped by a liberalizing country include a more efficient division of labor (driven by comparative advantage); economies of scale; increased competition; knowledge spillovers; and an external anchoring of domestic reforms. In the case of goods, regional liberalization is generally seen as second best, as the gains from trade are only being realized vis-à-vis the preferential trading partners, but not vis-à-vis the rest of the world (as would be the case through multilateral liberalization). In addition, these more limited gains from trade are at least partially cancelled out by the negative effects arising from "trade diversion": due to a tariff bias, least-cost suppliers from the rest of the world are being crowded out by less efficient suppliers from the preferential trading partner. An additional argument against regional, as opposed to multilateral liberalization, are the greater negotiation costs and the reduced transparency associated with a patchwork of preferential trade agreements. But there are also arguments for regional integration. It may be easier to achieve due to fewer parties involved and greater interdependency resulting from geographical proximity. It can also permit for more efficient bargaining, as it reduces the risk of outsiders free-riding on a reciprocal exchange of concessions. On balance, however, there is broad consensus that multilateral liberalization of trade in goods is the first best option and should receive priority.

While many of these considerations also apply to the liberalization of trade in services, there are some important differences. Before turning to the arguments for and against preferential trade, a general feature of trade in services (as compared to goods) should be mentioned. Since trade in services tends to require the interaction between supplier and customer, it involves factor movements (labor and capital). Especially trade via mode 3 (commercial presence), the predominant mode for most services, can considerably increase the net gains from trade accruing to an economy. On the one hand, it can generate a significant influx of FDI and associated knowledge spillovers into a country opening its services sectors to foreign firms. On the other hand, the replacement of high-cost domestic suppliers by more efficient foreign competitors (one of the main conduits for efficiency improvements) leads to less displacement of domestic employees, than in the case of goods.

Besides this general benefit of services trade, there are several reasons why preferential trade liberalization might have fewer adverse effects in the case of services than in the case of goods. There are two additional determinants of gains from trade: (1) The net gains from trade for a national economy also depends on 'location effects'. As production capacity is being moved to regions where productivity is higher thanks to agglomeration or clustering dynamics, an economy might gain or loose, depending on the distribution of those location effects between countries. (2) Dynamic gains from trade often outweigh the static gains, but are harder to measure. They include accelerated growth due to an increased rate of productivity growth; faster physical and human capital formation; or an ability to attract larger investment projects, for which market size matters.

Given the institutional capacity constraints of governments in many developing countries, the issue of negotiation costs is a very relevant one. Moreover, a patchwork of preferential trade agreements—as currently exists in the southern Mediterranean—make for a much more complex policy regime. This creates considerable information and transaction costs for private companies—as well as administrative costs for governments.

Many economic models that are being used to analyze gains from trade assume fixed factor endowments. This assumption is relaxed, if dynamic effects (growth of endowment) or location effects (reallocation of endowment) are taken into account. In the case of services, however, trade via mode 3 (commercial presence) and mode 4 (movement of natural persons) involves a movement of factors of production by definition.

For a more rigorous analysis of pros and cons for preferential liberalization of trade in services, see Mattoo and Fink (2002). This paper distinguishes between protective instruments according to their effects on variable and fixed costs for foreign suppliers, as well as quantitative restrictions on final sales and on the number of providers.
• First, most barriers to trade in services are prohibitive (e.g. regulatory restrictions or exclusivity rights) instead of revenue generating (as in the case of tariffs for goods). One consequence is that welfare gains from trade for consumers and firms do not have to be netted against a loss in fiscal revenues (increasing the net benefits for the domestic economy). A second implication is the lower risk of trade diversion, because there was no trade to begin with. However, the presence of location-specific sunk costs can create problems analogous to the effects of trade diversion.179

• Second, procompetitive regulation is required to remove tariff barriers for trade in many services, and regulatory cooperation is easier to achieve at the regional level. One example is the cross-border regulation of interconnected electricity grids and power pools. Another case is the cooperation in air traffic control and joint regulatory regimes for common civil aviation areas. However, the need for a harmonization of regulations and the cooperation between regulatory authorities varies considerably between sectors and the nature of the trading partners (e.g. relative differences in the quality of regulatory regimes or levels of development).

• Third, cross-border trade (mode 1) in network services requires physical interconnection and geographic proximity—especially in electricity, but also in some transport and telecommunication services. These types of trade can only take place between neighboring countries (i.e. regionally).

• Fourth, in several important services sectors multilateral negotiations are at an early stage and little progress is expected in the foreseeable future. Electricity is a case in point. Another example is aviation, where the core of sector policy (air traffic rights) has not even been incorporated into the GATS framework, but is still governed by the 1944 Chicago Convention.180 In these cases, regional liberalization is the most promising way forward.

When assessing the pros and cons of regional services trade liberalization for the MPs, it is important to keep in mind the specific nature of their preferential trading partner: the European Union. There are several features that make the EU a well-suited counterpart for such integration. First, it is a large economic block that accounts for a quarter of world GDP; it is already the main trading partner for most MPs; and it is an economy that is very open to the rest of the world. All these features considerably reduce the risk of trade diversion.181 Second, geographic and cultural proximity make it a well-suited partners for deeper integration. Third, the supranational policy framework of the Single Market (especially in network services) facilitates regulatory cooperation. Fourth, as in other cases of North-South integration, the potential for knowledge spillovers and FDI flows towards the MPs is high. Fifth, a broader vision of deeper integration with the Single Market could help MP governments overcome the resistance of vested interest groups against individual reform measures.

179 In many services, substantial location-specific sunk costs exist (e.g. investments in telecom networks or port infrastructure, development of brand recognition or branch networks for banks). This can create a 'lock-in' effect, where regional liberalization precedes multilateral liberalization: if foreign firms from the preferential trading partner have higher cost, the sunk investments will give them a first-mover advantage vis-à-vis lower-cost suppliers from the rest of the world. The significance of this problem depends on the size of the sunk costs (a sector-specific factor) relative to the gap in costs and quality (a factor depending on the type of preferential trading partner).

180 The Chicago Convention is based on the principle of national sovereignty over airspace and a key implication is that international air traffic rights are being regulated through bilateral air service agreements between governments. In other words, the multilateral sector framework has paradoxically led to a complex patchwork of bilateral regimes.

181 The AAs permit MPs to enter into preferential trade with 25 EU countries, accounting for more than a quarter of global GDP and often more than 50 percent of their trade, through one single agreement. Moreover, the EU’s openness to the rest of the world (its weighted mean tariff for all goods is a mere 2.7 percent) implies that EU firms are exposed to global competition and thus their efficiency is close to world standards.
Despite these arguments in favor of regional liberalization among Euro-Med partners, there are also arguments to the contrary. First, in sectors where the GATS negotiations are well advanced, multilateral liberalization remains the first best alternative. In fact, the declared policy of the EU is to give priority to progress in multilateral negotiations. Second, the EMP thus far lacks well-developed enforcement instruments, if compared to the WTO dispute settlement mechanisms. Third, the technical assistance provided under the MEDA program has not yet proven to be a strong catalyst for economic reforms. Once these problems have been rectified, the balance of the argument will shift further towards regional liberalization. Fourth, a key advantage of regional trade agreements is that they facilitate mutual exchanges of preferences (more efficient bargaining), but so far there has been little indication of a political willingness to do this. If the EU were willing to offer greater concessions on trade in agricultural products or temporary movement of workers, for instance, the MPs might be willing to deepen their regional integration agreement with the EU by liberalizing trade in services or by adopting specific EU regulations.

In economic terms, the optimal mix between regional and multilateral liberalization—i.e. the desirable type of “open regionalism”—has to be determined on a sector-by-sector basis, and by mode of delivery. Generally speaking, multilateral liberalization should be the default option. Hence, WTO membership of all MPs and a strengthening of their GATS commitments should receive priority attention. Regional liberalization should be pursued in markets where regulatory cooperation is important, in policy areas where the GATS framework is poorly developed; and in sectors that are important for the overall process of deeper integration (e.g. in the backbone services). In many cases, it might be best to “top-up” multilateral commitments (e.g. on market opening) by complementary regional agreements (e.g. on cooperation between regulators). In all cases, however, regional agreements need to comply with WTO rules. The bundling of different sectors into one agreement will permit for cross-sectoral reciprocity and can facilitate negotiations. In some sectors, advantages of geographic and cultural proximity are likely to lead to the emergence of regional structures at the company level (e.g. banks or supermarkets with regional branch networks). Such patterns, however, should emerge through the interplay of market forces and not be preempted through preferential trade agreements at the policy level. When choosing between multilateral and regional (plurilateral) liberalization, MP policymakers should keep in mind that unilateral (domestic) reforms are in many cases the most beneficial of all. Additional benefits of cross-border liberalization—be it regional or multilateral—arise from access to FDI, modern technology, regulatory best practice, economies of scale, import competition, and a credible signal to investors that reforms are irreversible (external anchoring through legally binding commitments). The challenge will be to devise integrated sector reform strategies that develop linkages and synergies between services sector reforms at the national, regional, and multilateral level.

The EU has developed very successful enforcement mechanisms within the Single Market, ranging from peer reviews and benchmarking exercises to supranational institutions endowed with strong enforcement mandates. One of the main obstacles for the gradual or partial extension of the Single Market to the MPs (i.e. for deeper integration among EMP countries) is that more effective enforcement instruments are yet to be developed. One option would be to enhance the role of the bilateral Association Councils. In some cases, it might also be possible to extend the membership and mandate of EU-internal institutions to the MPs (e.g. Eurocontrol). A more complicated, but prima facie appealing alternative would be to create South-South supranational structures (e.g. regional regulators). A mutual exchange of concessions (without the risk of free-riding of outsiders benefiting from the MFN principle) can facilitate beneficial bargains between pairs or groups of countries. For instance, economies of scale and a common language might induce banks to develop regional branch networks across the Arab MPs. The same could hold for the supermarket networks of international retailers or for mobile phone operators. However, policymakers should liberalize multilaterally to maximize competition and to ensure that these networks are being created by the most suitable companies (not those enjoying preferential access).
ANNEX D: Business Trends in the Textile Industry and their Implications for the MPs

The textiles and clothing industry is of vital economic importance for many MPs in terms of trade, employment, and GDP. Apparel exports amounted to $6.9 billion for Turkey, $2.6 billion for Morocco, and $2.5 billion for Tunisia in 1999—accounting for 25 to 50 percent of total exports in these countries. The EU, which imported a total $71 billion-worth of textiles and clothing in 2000, is by far the most important client (Someya, Shunnar and Srinivasan 2002). While these trades grew considerably during the 1990s, the competitive position of the region is deteriorating. In Morocco, e.g. the textile sector “faces stiff foreign competition and thus its share in exports has declined from 37 percent in 2001 to 34 percent in 2002.” The liberalization of global textile trade, in combination with profound changes in the way that clothes are being marketed and sourced will put increasing pressure on the southern Mediterranean countries to redefine their comparative advantage in this important export industry. With the phase-out of the Multifibre Arrangement by 2005, they will find it increasingly difficult to compete with countries like India and China on costs. Instead, they will have to exploit their geographic proximity to the European market more effectively, by upgrading their transport and ICT links. It is useful to look at some key business trends in the sector to fully appreciate the importance of trade facilitation.

The fundamental problem in apparel retailing is that clothes are seasonal products and fashion items, for which demand is inherently difficult to predict. The accuracy of demand forecast, however, is a major determinant of profitability. If retailers order products which customers do not demand (referred to as “+error”), they have to maintain costly inventory and mark down unsold stock at the end of the season. If they order too few items that are in demand (“−error”), they face stockouts and lost sales. Both type of errors are widespread and costly. For each season, retailers go through a learning curve. Seven month prior to a season, they have approximately a third of the forecast information they need. By the start of the season this figure increases to about two-thirds, and three months into the season it reaches 100 percent. Such a steep learning curve creates an important trade-off with regard to the sourcing mix. While traditional up-front ordering (5-8 months prior to the selling season) allows to source in large batches from cheap suppliers in Asia, the long lead times this requires entail high forecasting errors. In-season replenishments, on the other hand, increase forecasting accuracy, but require high-cost sourcing in smaller batches close to home. A study of European retailers found that up-front orders were associated with +errors of 28 percent and −errors of 18 percent, compared to a mere 7 and 8 percent in replenishment orders.

Due to faster fashion cycles, increased competition in retailing, and growing familiarity with just-in-time production, the percentage of in-season replenishments (currently around 10 percent) is increasing dramatically. The high premium this puts on managing information and product flows through tight supply chains is a main driver of another important trend in the textile industry: vertical integration. The dramatic growth of companies like Zara, H&M and GAP—with an emphasis on tight supply-chains and quick responses to fashion trends—epitomize the transformation of the industry. For countries striving to benefit from trade in textiles, in-season replenishments are

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187 Ibid. “Largely quota-free and enjoying preferential agreements, MENA country exports of clothing thrived under the earlier MFA quota regime (1984-95) that constrained the dynamic exporters. However, in the recent period, 1995-2000, leading up to the abolition of MFA in 2005, MENA market shares have leveled off signaling a potential decline, if MFA is totally abolished as scheduled.”
188 “Changes in the retail regime influence the competitive advantage of different exporters unequally, as non-price factors become an increasingly significant influence on sourcing decisions.” These include quick response times, flexibility, and reliability (Baden 2002).
189 Prof. Heikki Mattila. (not dated). “Towards a Consumer-Driven Clothing Supply-Chain.” Tampere University, Finland.
particularly attractive. It is a market segment with high value added (fashionable items), low cost sensitivity (speed is the key variable), and rapid growth. Interestingly, in-season replenishments are also the market segment where the MPs can exploit their geographic proximity to Europe vis-à-vis Asian producers—who can only compete on speed using costly air freight (up to 10 times as expensive as land or sea transport).

This, however, will require not only the ability of southern Mediterranean companies to meet highest standards in terms of flexibility and reliability. It will also require access to state-of-the-art logistics as well as information and communication technology (ICT). Relevant ICT applications include “bar coding and point-of-sale scanning used to provide immediate and accurate information on product sales; electronic data interchange (EDI) used by the retailer for replenishment orders; and automated distribution centers to handle small replenishment orders.” At each cross-border and inter-firm interface, ICT and logistics services act as facilitators. Compressing lead times to 2-3 weeks (the highest standards in the industry) requires a comprehensive removal of frictions in information and transport flows. Trade facilitation, however, is not only needed to get southern Mediterranean products to European markets, but also for economic integration among the MPs. The reason is that textile supply-chains tend to cross borders repeatedly. Raw materials are produced in one country, turned into yarn and then fabrics (a highly automated process often performed by industrialized countries); shipped to low-wage countries for labor-intensive sewing; and then exported to final consumers (e.g. in Europe or the US). If a Tunisian apparel manufacturer, for instance, produces a collection for a European retailer, he must be able to effectively manage both the upstream supply-chain (dozens of fabrics and other materials sourced from various countries) and the downstream supply-chain (just-in-time delivery to clients). As sourcing patterns change each season, supply-chains must also be highly flexible.

Given the complexity of such supply networks, it is increasingly regions and not only countries that compete in this global industry. While large economies like China and India have the critical mass, smaller countries will increasingly be sidelined, unless they manage to become part of tightly integrated regional clusters. Especially three such clusters have emerged: (i) the United States, Mexico, and the Caribbean Basin; (ii) East and South Asia; and (iii) the EU, Eastern Europe and the southern Mediterranean. The MPs will thus have to increasingly rely on tighter regional integration with the European cluster to compete in world markets. This regional cluster, however, is still less integrated than its competitors and the European Apparel and Textile Organization (EURATEX) has called upon policymakers to accelerate the creation of a Pan-Euro-Mediterranean Zone in this sector. More efficient backbone services should be an integral part of this process.

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190 “Information technologies are also increasingly a feature of retailers’ organization of sourcing, including harmonized information systems [...] and web based supplier management systems. This trend is more prevalent in the United States than in Europe, but is likely to increase among larger EU retailers. For suppliers who do not have the capacity to absorb, or work with these systems, this probably means exclusion from direct relationships with buyers and relegation to a subcontracting role” (Baden 2002).


192 This comprises: 2 days for collection and transfer of point-of-sales information, 14 days to make the fabric, 1 day for transport to production site, 3 days for garment production, and 1 day for transport to retailer.

193 Most MENA countries specialize on labor intensive apparel manufacturing. For instance, clothes exports account for 38 percent of exports in Tunisia, while textile exports account for a mere 3 percent. The figures are 32 and 2 percent for Morocco; 10 and 14 percent for Egypt; and 11 and 3 percent for Jordan.

ANNEX E: Glossary of Selected WTO and GATS Terms

Bound: In their schedules of commitments, WTO members can inscribe self-imposed obligations, which govern their trade with other members. For services, they can select specific sectors that are bound by the disciplines of the GATS (e.g. most-favored-nation or national treatment principles), subject to certain limitations specified in the commitments. The objective of such binding is to create legal obligations, ensure transparency, and avoid backsliding in the process of progressive liberalization (a reversal of commitments is only permitted under extreme circumstances and generally subject to compensation). With unbound sectors not subject to some GATS provisions (essential market access, national treatment, etc.), however, the GATS makes for a flexible framework.

Dispute Settlement: Critical to the enforcement of a rules-based trading system are institutionalized procedures to settle disputes between members. A country that believes another party to be in violation of its commitments may invoke the WTO dispute settlement procedures. (Since trade agreements are of an intergovernmental nature, private parties do not have this right.) The first stage in the procedures is the creation of a panel of impartial experts, which has to issue a report within a six months period. To become binding, the report has to be adopted by the Dispute Settlement Body (DSB). If the concerned country fails to comply with the ruling by a given deadline, the complainant can request permission from the DSB to retaliate with a proportionate suspension of its own concessions. Credible dispute settlement mechanisms help prevent unilateral retaliation (illegal under WTO rules) and are particularly important for small countries (who lack negotiation power).

GATS: The General Agreement on Trade in Services (GATS) was concluded in 1994 as part of the Uruguay Round and brought the services sector into the realm of the multilateral trading system. Partly due to the complexity of services trade, the GATS is still less developed than the GATT, but it is one of the areas where trade liberalization is expected to progress most in the coming years.

GATT: The General Agreement on Tariffs and Trade (GATT), negotiated in 1947 among 23 countries, constituted the nucleus and remains a central pillar of the multilateral trading system. Initially confined to tariff negotiations, it increasingly expanded to other trade-related policies. Through successive rounds of multilateral trade negotiations, the GATT led to a dramatic reduction in trade barriers for goods, while expanding its membership to 148 countries by late 2003.

Market Access: Trade in services liberalization is largely concerned with effective market access (via the four modes of supply). Article XVI of the GATS defines types of measures restricting market access that are legal under WTO rules. A member may only adopt or maintain those measures if they are specified in its schedule. These include restrictions on the number of service providers, the value of transactions or assets, the quantity of services output, the number of natural persons that may be employed, the type of legal entity through which a service can be provided, and limitations on the participation of foreign equity or the absolute value of foreign investments.

Measures: This legal term refers to policy measures affecting trade in services. They can include laws, regulations, or administrative decisions taken at different levels of government. Such measures are subject to multilateral trade disciplines and the commitments listed in the schedules of members.

Modes of Supply: Four modes of trading services are recognized in Article I of the GATS: (1) cross-border supply (only the service crosses the border); (2) consumption abroad (the consumer crosses the border); (3) commercial presence (the provider crosses the border through different types of establishment, such as branches or representative offices); and (4) presence of natural persons (individuals temporarily cross the border for the sake of supplying a service). The term "supply"
comprises the production, distribution, marketing, sale and delivery of services. For every bound service, members can make commitments for each of the four modes of supply and then in turn with regard to market access and national treatment (giving rise to a matrix of commitments).

**Most-Favored-Nation (MFN) Principle:** Any foreign service or service provider has to be accorded treatment in terms of trade-related measures "no less favorable" than those from other countries. This principle, enshrined in Article II of the GATS, ensures nondiscrimination between foreign providers from different countries. While exemptions to this default rule may be invoked on a one-time basis (listed in an annex to a schedule, in principle limited to 10 years, and subject to negotiations in future trade rounds), the MFN principle is meant to ensure gradual convergence to the most liberal regime. It also reduces negotiation costs (preferences negotiated with one country are extended to all). There is a GATS Annex on MFN Exemptions and all exemptions a member wishes to maintain have to be included in its MFN Exemption list. Now that the GATS is in force, new exemptions need to be approved by three-quarters of all WTO members.

**National Treatment (NT) Principle:** Core WTO principle contained also in Article XVII of the GATS to ensure nondiscrimination between domestic and foreign services or service providers. Whereas the NT principle is a "general" commitment for goods, it is a "specific" commitment for services—i.e. it only applies to bound sectors and is subject to limitations listed in a country’s schedule. The MFN and NT principles are the key instruments for ensuring nondiscrimination within the multilateral trading system.

**New Members:** Two dozen countries joined the WTO since the end of the Uruguay Round, with close to three dozen additional countries having had applied for WTO membership. For countries that joined the WTO at its inception in 1995, commitments made under the Uruguay Round remain binding, while more stringent conditions tend to be imposed on new members. The reason is that during the accession process, existing members may demand concessions from the applicant in return for their approval. With "progressive liberalization" a key feature of the multilateral process (Article XIX of the GATS), the Doha Round should help extend the commitments of old and new members alike.

**Precommitment:** Governments can inscribe obligations to liberalize certain trades at a specified future date in their schedules. This permits them to externally anchor planned reforms (and thus resist vested interests lobbying for protection), while granting domestic companies a transition period to prepare for competition. To date, little use of this mechanism has been made under the GATS.

**Preferential Trade:** The GATS framework permits for preferential trade agreements (PTAs) among sub-groups of countries. This is done through Article V and is conditional on certain rules: All PTAs have to be notified to the WTO; they must not lead to an increase in protection vis-à-vis third countries; they need to have substantial sectoral (and modal) coverage; and they must eliminate substantially all discrimination between or among the parties to such a PTA.

**Reciprocity:** Whereas the binding of sectors is voluntary, countries have several incentives to do so. Besides the welfare gains from liberalization and the signaling effect to investors, there is the additional benefit of reciprocity. Reciprocity not only provides “payment” for concessions in terms of better access to foreign markets, but also had the political economy advantage of pitching domestic export interests against groups lobbying for import protection. Under the GATT, where tariffs allow for easy quantification of barriers and thus a calculation of equivalence, reciprocity has been the main driving force behind liberalization. Under the GATS it has so far played a lesser role.

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195 For a detailed discussion of the accession process, see Michalopoulos (2002).
Trade barriers to services, which tend to come in the form of regulations, are much more difficult to quantify and thus cross-issue linkages might be needed to achieve reciprocity (e.g. between sectors or modes of supply). One problem is that the MFN principle limits the scope for reciprocity (creating an incentive for other countries to free-ride). Another difficulty is to devise mechanisms that grand “credit” for services sector reforms unilaterally adopted between multilateral rounds of negotiations. While there is no formal credit rule, such considerations are part of the informal guidelines applied to GATS negotiations (a reference to such mechanisms is made in Article XIX.3).¹⁹⁶

**Schedule of Commitments:** For each sector that a member decides to bind (positive list of sectors), the schedule of commitments has to specify all trade restrictions that the government wishes to maintain (negative list). The entry “unbound” indicates that no commitment is made. Governments can make full commitments (by entering “none” in the respective part of the commitment) or partial commitments (by specifying restrictions to be maintained). While the GATS proposes a taxonomy of sectors (the classification list—see also Annex F—specifies around 160 sectors and sub-sectors), countries may use their own definition to delineate markets for which they make commitments. Given the signaling effect to investors of making binding GATS commitments, a country’s schedule should at least reflect the status of domestic policy reforms already unilaterally adopted.

**Transparency:** The principle of transparency is critical to the maintenance of a rules-based trading system. About 200 notification requirements are enshrined in the various WTO agreements (Hoekman 2002). It reduces uncertainty and information costs for traders, increases the legitimacy of the system, and reduces the burden on dispute settlement mechanisms. Article III of the GATS, for instance, obliges member countries to publish trade-related regulations, notify any relevant changes to the WTO, and to establish a central enquiry point. These obligations are complemented by multilateral surveillance of trade policies by the WTO through periodic, country-specific “trade policy reviews.” The WTO further facilitates the exchange of information between members through various committees, working groups, and councils that meet in Geneva on a regular basis.

**TRIPS:** The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) was signed as part of the Uruguay Round and is one of the main multilateral trade agreements.

**WTO:** The World Trade Organization (WTO) administers the trade agreements negotiated by its member states—especially the GATS, GATT, and TRIPS. Established in 1995 after the conclusion of the Uruguay Round, the WTO is a member-driven organization with rather light institutional structures. With only a few hundred staff, the Geneva-based secretariat acts as a nodal point in a complex intergovernmental network (there are 40 councils, committees, and working parties). Importantly, the WTO is a “single undertaking”—i.e. all its provisions apply to all members and countries can no longer confine their participation in the global trading system to individual agreements. By late 2003, the WTO had 147 members. The Doha Round, launched in 2001, is the latest round of multilateral negotiations is meant to significantly expand the scope of WTO disciplines.

¹⁹⁶ For more detailed discussions of the role of reciprocity in the multilateral trading system, see (1) Finger (2002) and (2) Hoekman and Messerlin (1999).
ANNEX F: Sector Classification for GATS Schedules Recommended by the WTO

Excluded below are third-level subdivisions, listed in the WTO classification for business services (46 subdivisions), communication services (21), financial services (16), and transport services (33).

1. Business Services
   (A) professional services, (B) computer and related services, (C) research and development services,
   (D) real estate services, (E) rental/leasing services without operators, (F) other business services.

2. Communication Services
   (A) postal services, (B) courier services, (C) telecommunication services, (D) audiovisual services,
   (E) other.

3. Construction and Related Engineering Services
   (A) general construction work for buildings, (B) general construction work for civil engineering, (C)
   installation and assembly work, (D) building completion and finishing work, (E) other.

4. Distribution Services
   (A) commission agents’ services, (B) wholesale trade services, (C) retailing services, (D) franchising,
   (E) other.

5. Educational Services
   (A) primary education services, (B) secondary education services, (C) higher education services, (D)
   adult education, (E) other education services.

6. Environmental Services
   (A) sewage services, (B) refuse disposal services, (C) sanitation and similar services, (D) other.

7. Financial Services
   (A) all insurance and insurance related services, (B) banking and other financial services, (C) other.

8. Health Related and Social Services
   (A) hospital services, (B) other human health services, (C) social services, (D) other.

9. Tourism and Travel Related Services
   (A) hotels and restaurants, (B) travel agencies and tour operator services, (C) tourist guides services,
   (D) other.

10. Recreational, Cultural, and Sporting Services
    (A) entertainment services, (B) news agency services, (C) libraries, archives, museums and other
cultural services, (D) sporting and other recreational services, (E) other.

11. Transport Services
    (A) maritime transport services, (B) internal waterways transport, (C) air transport services, (D)
space transport, (E) rail transport services, (F) road transport services, (G) pipeline transport, (H)
services auxiliary to all modes of transport (I) other transport services.

12. Other Services not Included Elsewhere

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