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Global Challenges and Opportunities Facing MENA Countries at the Dawn of the Twenty First Century

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Abstract

The premise of the paper is that when the forces driving the globalization of the world economy are fully appreciated, the need for a new program of action in the MENA countries becomes very clear. We are going through a period of rapid and fundamental change that requires major adjustments in the way economic policy-making has been practiced so far. Decisions to trade and invest are increasingly an integral part of broader business strategies relating to the efficient organization and location of production and marketing activities. With international competition becoming increasingly intense, the ability of newly-developed and incorporated technology to enhance competitiveness provides incentives for firms to form strategic alliances or joint ventures and to seek economies of scale in production and marketing, thus reducing transaction costs, spreading the high cost of research and development and influencing trade and investment flows world-wide. What is then needed is a multi-policy, comprehensive approach that will promote the openness of markets to global competition in order to create truly internationally contestable markets in the MENA region. This can only be achieved by tackling the implications for international competition arising from government and private actions in the different policy fields. The strategy should lead to further market-openings and a deepening and broadening of rules affecting the conditions under which trade and investment will take place in the future.

ملخص

تنطلق هذه الورقة من الفرض القائل بأن التقييم الكامل للقوى الدافعة إلى عالمية الاقتصاد يوضح بجلاء الحاجة إلى برنامج عمل جديد في دول الشرق الأوسط وشمال افريقيا. إننا نمر بمرحلة تغيير متسارع وجذري يتطلب اجراء تعديلات كبرى على الاسلوب الذي يتم به إلى الآن وضع السياسات الاقتصادية. وقد أصبحت قرارات قطاع الأعمال بشأن التجارة والاستثمار بشكل متزايد جزءاً لا يتجزأ من استراتيجيات أعمال أوسع نطاقاً تتعلق بالتنظيم وتحديد مواقع الإنتاج وأنشطة التسويق بشكل فعال. ومع ازدياد حدة المنافسة الدولية تصبح مقدرة التكنولوجيات حديثة الابتكار والتطبيق على دفع القدرة التنافسية بمثابة حافز للشركات على اقامة تحالفات استراتيجية أو مشروعات مشتركة، وعلى السعي وراء وفورات الحجم الكبير في الإنتاج والتسويق، مما يقلل من تكاليف المعاملات، ويوزع التكاليف المرتفعة للبحث والتنمية، ويؤثر على التجارة وتدفق الاستثمار على مستوى العالم. إذن فهناك حاجة إلى نهج شامل ومتعدد السياسات، يشجع انفتاح الأسواق على المنافسة العالمية بحيث يتم خلق أسواق ذات قدرة تنافسية عالمية بحق في منطقة الشرق الأوسط وشمال أفريقيا. ولن يتسنى تحقيق هذا الهدف إلا بمعالجة التغيرات الطارئة على المنافسة العالمية من جراء الإجراءات الحكومية والخاصة في مجال السياسات المختلفة. ومن شأن هذه الاستراتيجية أن تؤدي إلى المزيد من الانفتاح في الأسواق وإلى تعميق وتوسيع القواعد المؤثرة على الظروف التي سوف يتم في ظلها التجارة والاستثمار في المستقبل.

INTRODUCTION

It is difficult to have watched the course of events during the last decade without recognizing that something fundamental has happened to the international economy. Virtually in every dimension of economic life we have experienced an increase in international economic activity, both in absolute terms and relative to the level of national activity. This is the phenomenon economists refer to as "globalization," or the forging of closer links between different markets and production structures. It captures a process involving the intensification of economic ties among national economies through cross-border flows of goods, services, investment and factors of production. Perhaps equally importantly, globalization describes the challenges of governing an increasingly borderless world with complex patterns of cross-border linkages.

In addition, technological innovations are fashioning the world economy from the bottom up. Whereas countries can devise ways to limit or stop the movement of goods across their borders, they have far less control over the trans-border movement of information and know-how. The free and rapid flow of technological innovations coupled with the shortening of product cycles have made many domestic regulations appear obsolete and costly. The resulting pressure for regulatory reform presents a unique opportunity for shaping national systems in a way that will enhance the openness of markets and reduce the degree to which regulations create obstacles to international competition. Moreover, new technologies and regulatory innovations have made it possible to supply many infrastructure services on a competitive basis and have opened up possibilities for international trade in such services.

Technological change has contributed to a decline in transaction costs for individual firms. As a result, the range of enterprises for which global operations are commercially viable has grown wider. Competition between global firms is increasingly being conducted in the area of new technologies and production processes. At the same time, research and development costs and the economies of scale involved are fostering new strategic alliances between firms. Significantly, this process has made the nationality of firms and even of individual products largely irrelevant.

With the dispersal of production and of marketing processes worldwide, the competitiveness of firms has been enhanced by greater efficiency in the use of factors of production and in the design of customized products in close contact with end-users. Simultaneously, globalization has blurred the identity of firms and products, which has presented new challenges to governments in managing their economies and produced a growing sense of economic uncertainty among economic actors as they face strong international competition and the need for adjustment. All of these factors are undermining the traditional separation between the domains of domestic and international policies.

In addition to the emergence of new products and innovative patterns of production and corporate organization, an increasing number of countries are becoming important actors in the world economy. Many developing countries played an important role in the Uruguay Round negotiations and through this single undertaking committed themselves to implementing the entire package. With rapid growth, many of these countries see their stake growing in a well-functioning world economy, and hence should prepare themselves to engage substantively in the discussion of how and when to open markets further and to deepen and broaden international rule-making or understandings that affect trade. One important consequence of the globalization of production and markets is that economies at vastly different levels of development are being drawn together through more extensive trade and investment flows.

Against the background of these developments, many countries have felt the need to strengthen regional cooperation. Regional trade agreements have become a permanent fixture of the global trading system for economic as well as political reasons. The political reasons often relate to the search for a stable international political order. The economic reasons are related to the fact that in many industries market opening and the internationalization of production have been easiest to achieve on a continental basis. The momentum associated with regional trade initiatives in recent years reflects the attempts by governments to come to grips with the realities of deeper economic interdependence through a drive for greater and more quickly realizable liberalization.

While all countries need to prepare to deal effectively with emerging issues affecting trade, new actors in the world economy in particular must become fully engaged in both the process and the results of the evolving international system. In the area of trade, some countries in the Middle East and North Africa (MENA) region will need to continue to bring their trade practices fully into conformity with World Trade Organization (WTO) obligations, resisting protectionist pressures by domestic industries and foreign investors alike. Others will need to contribute as full partners to the universal set of rules and practices. In this respect, accession negotiations to the WTO are a particularly important opportunity to establish a firm understanding and acceptance of international disciplines and of how domestic reform elements in these economies can most profitably and predictably intersect with international disciplines to the benefit of all.

Countries in the MENA region should recognize that in the absence of major reversal of policies, it will not be possible to stop the process of globalization which is increasingly becoming a critical parameter of national economic development. In other words, it will not be possible to stop what has become an inexorable movement towards an ever more deeply integrated world economy, not least because deeper integration brings tremendous economic and broader political and social benefits. It creates ever-expanding market opportunities while providing the basis for greater stability in a country's international relations. It also exposes political and other elites – and ultimately the wider public – to international values and the balance of rights and obligations that flow from being a member

of the international community. Not for a long time have circumstances been so favorable as they are now for there to be almost universal participation in the creation and benefit of wealth. The emerging deeply integrated global economy offers a real chance for the first time in world history for virtually all participants to share in the benefits of sustainable global economic growth.

The premise of this paper is that when the forces driving the globalization of the world economy are fully appreciated, the need for a new program of action in MENA countries will become very clear. We are going through a period of rapid and fundamental change that requires major adjustments in the way economic policy-making has been practiced so far. What is needed is a multi-policy, comprehensive (versus piecemeal) approach that will promote the openness of markets to global competition in order to create truly internationally contestable markets in the MENA region. This can only be achieved by tackling the implications for international competition arising from government and private actions in the different policy fields. The strategy should lead to further market openings and the deepening and broadening of rules affecting the conditions under which trade and investment will take place in the future.

I. THE NEW WORLD ECONOMY: THE PROMISE

Globalization

It is no exaggeration to characterize increased globalization as the most dominant feature of the new world economy. In its turn, globalization has underpinned the continued expansion of trade and foreign direct investment (FDI), including intra-industry trade. However, it must also be noted that decisions to trade are increasingly an integral part of broader business strategies relating to the efficient organization and location of production and marketing activities. With international competition becoming increasingly intense, the ability of newly-developed and incorporated technology to enhance competitiveness provides incentives for firms to form strategic alliances or joint ventures and to seek economies of scale in production and marketing, thus reducing transaction costs, spreading the high cost of research and development, and influencing trade and investment flows worldwide.

International Trade

International trade in both goods and services has continued to grow faster than national incomes throughout the post-war period (see Table 1). In addition to liberalization at the regional level as well as autonomous liberalization, eight rounds of multilateral trade negotiations (MTNs) under the auspices of the General Agreement on Tariffs and Trade (GATT) have been the major factor behind the freeing of markets and the increased cross-border flows of goods and services to where the returns are higher. The eight rounds of

MTNs have succeeded in lowering the average trade-weighted most-favored-nation (MFN) tariffs on industrial goods from a high of 40 percent at the end of World War II to less than four percent at the end of the Uruguay Round (1986-1993).

Liberalization in multilateral, regional and autonomous settings has removed to a large extent other traditional barriers to trade which have been the basis of almost all post-war commercial diplomacy on which the existing multilateral architecture has been built. Examples of such barriers are the trade bias originating from the practice of tariff escalation and the practice of voluntary export restraints (VERs) or any similar measure, thus implying a significant relaxation of non-tariff barriers (NTBs). But why has there been such clamor for more liberal trade regimes? A simple answer is that liberalization is a very good idea.

Considerable evidence now indicates a positive association between liberal trade regimes and economic growth. This association is supported by actual experiences as well as analytical studies in this field, from World Bank (1987) to Edwards (1989) to OECD (1993). The economies that have adopted an open trade regime were able to create competitive industries; stimulate domestic and foreign investment; exploit economies of scale; and facilitate technology transfer and the adoption of best-practice techniques, all of which gained the most from buoyant international trade. Further, a comprehensive study by the World Bank found that higher shares of exports in GDP have a close relationship with higher productivity (Papageorgiou, et. al. 1991).

Moreover, casual empiricism suggests that the growth of world trade and output has coincided with periods of trade liberalization through a combination of multilateral and regional arrangements and unilateral measures. Whereas in the past the share in world GDP of exports of goods and services represented only six percent of the total, that share reached 21 percent in 1992. Thus, it is not surprising to see that the completion of the Uruguay Round as the most comprehensive package of trade liberalization to date is anticipated to further enhance economic growth. The growth in world output in 1994 is now expected to register 3.1 percent, against 1.7 and 2.3 percent in 1992 and 1993, respectively. Behind this resurgence in output growth lies a 7.2 percent surge in the volume of world trade in 1994, against growth rates of 4.7 and 4.0 percent, respectively, in 1992 and 1993. Of course, while it would be stretching the point to attribute all the higher pace of economic growth to the liberalization package of the Uruguay Round, one cannot neglect its substantial contribution nevertheless. To put things into perspective, if the Uruguay Round had managed to raise the rate of growth of the world economy by a mere 1/10 of a percentage point in 1994 – say, from 3.0 to 3.1 percent – then the annual income gain for the world would be US$274 billion after seven years (OECD 1993a), and US$510 billion thereafter (Francois, et. al. 1994).

By contrast, the economies that have resisted the movement towards a liberal trading regime have witnessed a deterioration in both their internal and external balances with

sometimes devastating effects on economic growth and its prospects. Their experience has consistently demonstrated that structural adjustment finally had to take place, generally at higher social and economic costs. The main problem with trade policy interventions is that there is no direct linkage between the instruments and broad policy objectives – namely, increased private sector investment, higher output, higher productivity and enhanced competitiveness. Protection is in effect a punitive tax on efficient exporters and efficient import-competing sectors, and a regressive tax on consumers. A recent report by the GATT Secretariat found that Japanese VERs on automobiles shipped to the EC raised the price of Japanese cars to EC consumers by 33 percent (GATT 1993). Similarly, textiles and clothing protection in the United States and Canada cost every household US$310 and US$220, respectively, per annum. For agricultural commodities, the same situation prevails. OECD estimates for 1991 showed that agricultural protection and assistance in OECD countries resulted in significant differences between domestic and world market prices (OECD 1993b). Consumers paid the difference in terms of higher prices and taxes which totaled US$354 billion in 1991. This represented an annual transfer from consumers to producers equal to US$440 per household. Moreover, assistance in the form of public subsidies is a burden on public finances. The benefits of trade-distorting interventions usually go to the politically influential, improving the welfare of interest groups at the expense of general welfare. Furthermore, interventions are prone to lead to serious conflict with trading partners.

To be sure, trade liberalization does involve short-term costs associated with structural adjustment. In the short run, jobs may be lost. In this respect, it must be emphasized that protectionism has never proven to be an efficient means of sustaining employment. Quite to the contrary. Careful examination of the factors affecting employment shows that more jobs are created from a stronger export effort than are lost to imports (OECD 1992). An earlier OECD study also concluded that "jobs saved in industries protected are often offset by viable jobs forgone elsewhere in the economy. On its own, protection is a poor alternative to positive adjustment policies" (OECD 1985). This will be even more so in a globalizing economy. A country which attempts to cut itself off from the stream of world development forgoes the advantages of dynamism abroad, which is a sure way of locking itself into relative decline.

In order to help put things in perspective, it would be instructive to review some of the studies that have attempted to estimate empirically the economic impact of the Uruguay Round. The results of the models discussed here are estimations of the potential net welfare gains from trade liberalization. These are calculated from estimated net efficiency gains and net terms of trade effects, net of the effects of induced changes in tariff revenues. The calculations attempt to capture both the aggregate gains and losses from structural adjustment which would follow from liberalization. They are not forecasts of what to expect by way of changes in welfare, but rather estimates of the net results of trade liberalization compared with what would have obtained in its absence.

The Uruguay Round creates major difficulties for economic modeling. This is because it goes well beyond cutting protection on trade in goods to include services, investment and intellectual property, and because many of its effects will operate through an improved system of multilateral rules and disciplines. All modeling exercises use simplifying assumptions to make quantification more tractable. Some assumptions result in underestimation of the positive effects of trade liberalization. In particular, the dynamic gains from trade are inadequately captured in these calculations. These include scale economies,[1] specialization and the positive effect on confidence that the conclusion of the Uruguay Round has brought. The calculations also omit the benefits from liberalization in services and investment, protection of intellectual property, and the strengthening of rules governing trade remedies such as anti-dumping and countervailing duties. The addition of services alone under the GATT/WTO umbrella is expected to lead to substantial benefits, as the service sector is now the largest sector in most economies, developed and developing alike. The calculations also do not capture the positive contribution to trade liberalization made by the increasing application of multilateral disciplines by developing countries or by their unilateral liberalization in the context of accession to the GATT/WTO.

With these caveats in mind, Table 4 presents a summary of the results of seven recent studies (Panel A) as well as the model type and assumptions used in each of these (Panel B). The impact on world welfare is estimated to range from US$212 billion (Nguyen, et. al. 1993) to US$510 billion (Francois, et. al. 1994). That on developing countries ranges from US$86 billion (OECD 1993) to US$122 billion (Francois, et. al. 1994). As expected, all the various studies find that welfare gains are to a great degree proportionate to each country's own liberalization efforts. The net benefits estimated by Francois, McDonald and Nordstrom (1994) are the highest because they include gains derived from scale economies. The gains reported in the OECD study (1993) are higher than those obtained by the World Bank/OECD (1993) study because the former study added cuts in non-tariff barriers on industrial products. The larger net benefits reported in the studies by Stoekel (1990) and DRI (1993) derive, respectively, from a higher reduction in tariffs and NTBs (50 percent) than in the OECD (1993) study, and from the inclusion of an exogenous increase in productivity. Finally, the results reported by Nguyen, Peroni and Wigle (1993) are based on a relatively smaller number of countries. While the overall results are sensitive to the various methods and assumptions used, all the studies show that by cutting just tariffs, agricultural subsidies and NTBs, the net benefits are expected to be substantial.

Foreign Direct Investment (FDI)

Aside from its explosion in the mid-1980s onwards, the most important trend affecting FDI in the 1990s is the drive to liberalize policies affecting its flows as part of a broad-based strategy to attract foreign investors. While investment inflows averaged US$67

[1] One recent study (Francois, McDonald and Nordstrom 1994) has introduced scale economies in its estimation.

billion per annum in the 1982-87 period, they more than doubled to US$158 billion in 1992 (Table 2). However, the growth of FDI flows to developing countries is unevenly distributed among them. Most FDI inflows are still concentrated in 10 to 15 countries overwhelmingly in Asia and Latin America (Table 3), with China taking the lion's share after emerging as the largest host country in the developing world.

MENA countries' shares in total FDI inflows appear to have remained constant between one and two percent during the period 1982-92. However, their share in FDI flowing to developing countries alone is clearly on a downward trend. Whereas in 1989 that share peaked at ten percent, subsequent years witnessed a continuous decline, and in 1992 – the latest year for which comprehensive data are available – the share registered half of its highest level.

A cross-country review of experiences with FDI liberalization policies reveals that such undertakings were most successful when they were associated with a broader liberalization movement that covered international trade in goods and (more recently) services, international financial transactions, and technology transfer. The aim of this broader movement is to enhance economic efficiency through the phasing out of discriminatory or distortionary government policies. Just as markets are becoming more interdependent, so are policies: outward-oriented trade policies emhasize the need to compete in world markets on the basis of productive efficiency, which in turn requires new investment in modern plants and the upgrading of human skills. Modern technology, especially in transport and communications, has given a fillip to globalized production structures, blurring the old distinctions between trade and investment as alternative means of securing access to markets. This is the most important factor that explains why many governments that used to show an inclination toward rationing and conditioning the entry of FDI into their markets now go to some length to encourage these flows (Low 1995).

Many countries, especially the developing economies in Asia and Latin America, sought the contribution of FDI to achieve their long-term development goals because of a desire not so much for financial resources but, perhaps more importantly, for technology transfer, know-how and organizational and managerial skill development, better access to foreign markets and employment creation. The trend of the destination of FDI clearly shows that even when free of restrictions, FDI became substantial only when successful industries were founded, when economic growth accelerated, and when policies to encourage exports were adopted. Hence, the experience suggests that FDI cannot be the only stimulus for economic development, the important precondition being the existence of a stable political and economic environment.

Only a few developing economies (such as Hong Kong and, to a large extent, Singapore) have virtually no restrictions on the entry and operation of foreign companies. In most MENA countries, FDI is governed by a variety of laws and regulations. During the 1980s new laws or modifications of existing ones were enacted to attract FDI. Nonetheless, in

many industries FDI remains either completely restricted – mainly in the service sector – or regulated by ownership and performance requirements. Simultaneously, special incentives are often granted to exports or to high-technology industries. In some cases, these incentives discriminate against domestic enterprises and do not seem to improve the overall investment climate of the host economies. During the first half of the 1980s, rapid economic growth and a location advantage have constituted the major initial attraction of FDI. The location advantage included, inter alia, the use of local low-cost and skilled labor and a higher profitability of FDI relative to other locations. Furthermore, emphasis on human resource development and the creation of an efficient infrastructure favored both foreign and domestic entrepreneurs. The development of equity markets and improved and continuous access to international capital markets also were some of the characteristics that helped attract FDI. The above characteristics encouraged labor-intensive FDI initially in assembly and low-technology activities, and progressively in more sophisticated advanced technology industries. This made resource-based, labor-intensive export-oriented activities the predominant areas of involvement of foreign-owned enterprises.

During the second part of the 1980s, while export-oriented activities remained popular, the growth of indigenous consumer purchasing power has led to increasing number of investments to service domestic markets. With the region that was enjoying the highest GDP growth in the world, South and Southeast Asia have emerged as the largest recipients of FDI among developing countries, accounting for more than half of all flows to LDCs (Table 3). China, Malaysia and Thailand emerged as the fastest-growing recipients. In fact, of the 18 largest recipients of FDI among all LDCs, nine economies are from South and Southeast Asia. Only two countries from the MENA region made the list of the top 18 host countries: Egypt and Tunisia, with ranks of 9th and 18th , respectively.

Regional Integration

Between 1948 and 1994, over 100 regional trading arrangements were notified to the GATT. However, in recent years the trend to formal regionalization has accelerated markedly, with 34 different regional trading arrangements having been notified to the GATT during the period 1990-1994 (WTO 1995). The extension of the EU, the formation of NAFTA, CEFTA and MERCOSUR, major developments in APEC, calls for a "Free Trade Area of the Americas" and a "Trans-Atlantic Free Trade Area," as well as a range of other initiatives elsewhere all suggest that the euphoria surrounding the formation of regional trading arrangements during the first part of the 1990s will not abate.

Regional trading arrangements are an exception to the MFN principle of the GATT (Article I). Article XXIV of the GATT allows the establishment of free-trade areas (FTAs) and customs unions (CUs) under certain conditions. The provisions are designed to ensure that any such arrangements will encourage the creation of new trading opportunities amongst the parties involved, as opposed to diverting trade away from third parties. Four basic rules are supposed to ensure this result. First, substantially all trade must be covered by

the arrangements, so that they do not simply promote a few trade-diverting sectoral deals. Second, trade barriers must be eliminated, not merely reduced on a preferential basis. Third, external trade barriers toward third parties must be no higher on average after the establishment of an FTA or CU than they were before. Finally, recognizing that these kinds of arrangements will be phased in over time, Article XXIV requires that interim agreements include a plan and schedule for the formation of an FTA or CU "within a reasonable period of time". This transitional period should not exceed ten years.

Regional trading arrangements amongst developing countries are covered in separate provisions. In the early 1970s, a group of developing countries established a protocol under which they exchanged tariff preferences among themselves. This arrangement did not envisage the creation of a CU or FTA, and no other provisions in the GATT system offered legal cover. A waiver under Article XXV was therefore granted for ten years in November 1971. Subsequently, the Enabling Clause – one of the instruments that emerged from the Tokyo Round – provided general legal cover for these kinds of regional arrangements. It provided that such arrangements should aim to facilitate trade, should not create obstacles to the trade of third countries, and should not impede MFN-based trade liberalization. However, the Enabling Clause only covers regional arrangements amongst developing countries in respect of tariffs: the preferential removal of NTBs is subject to criteria or conditions which may be prescribed by the Contracting Parties.[2] Finally, the Enabling Clause does not provide legal cover for arrangements between industrial and developing countries such as the Caribbean Basin Initiative of the United States. As with arrangements among developing countries involving NTBs, Contracting Parties prescribe the criteria.

The formation of a regional trading arrangement alters tariffs and trade preferences and thereby changes relative prices and patterns of production and consumption. There are two main "static" effects of such an arrangement. Trade creation is a shift away from high-cost domestically produced goods to lower-cost imports from regional partner countries. Other things being equal, the trade creation effect combined with greater opportunities to exploit economies of scale implies a regional expansion in real income. Analogously, trade diversion involves the substitution of inefficient regional suppliers for efficient suppliers in third countries on account of the tariff preference, and as such tends to reduce regional national income. Therefore, the real income of the regional grouping rises when trade creation dominates trade diversion.

The relative size of trade-creating and trade-diverting effects depends on a number of factors. Opportunities for trade creation are enhanced and those for trade diversion are minimized in cases where a regional arrangement groups together countries that are already major trading partners. This is because prior to the introduction of preferences, trade flows

[2] Decision on "Differential and More Favorable Treatment Reciprocity and Fuller Participation of Developing Countries". Decision of November 28, 1979 (L/4903), para. 2(c).

are consistent with least-cost sourcing so that the removal of trade barriers will reduce the likelihood that a large number of items will be diverted from third countries' least-cost suppliers to higher-cost suppliers within the regional arrangement. Furthermore, the higher the pre-arrangement MFN tariffs, the higher the pressure for trade diversion following the formation of a regional trading arrangement. Alternatively, when the external barriers of a regional arrangement are low, the potential for trade diversion is low because lower external tariffs offer less scope for the displacement of imports from third countries.

Regional trading arrangements may also give rise to other dynamic effects. These effects originate from the way regional trading arrangements evolve over time. Regardless of trade creation/trade diversion effects, the dynamic effects could be positive or negative depending on whether regionalism will lead to multilateral free trade by merging regional blocs into a single world bloc.

Regional economic integration has generally been induced by a combination of market and economic as well as non-economic policy factors. Economic motivations generally include: the prospect of enhanced economic growth originating from the opportunity to exploit scale economies; regional specialization and learning by doing; and attracting foreign investment. Locking in domestic policy reforms at the regional level and thus enhancing the credibility and sustainability of economic reforms – including trade liberalization – has also been identified as providing a momentum for the formation of regional trading arrangements. Other economic reasons include: the "domino effect" which stipulates that the opportunity cost of remaining outside a regional arrangement rises as new ones are formed or as existing ones are expanded or deepened; the "infant industry" argument that has promoted the pursuit of regionalism under the premise that it would broaden and deepen domestic regional markets as a precursor to exposing regional industries to the full rigors of extra-regional competition; and the prolonged process of multilateral negotiations during the Uruguay Round. Non-economic objectives such as the promotion of regional cohesion and security and various foreign policy considerations have also provided additional impetus for going regional.

II. THE CHALLENGES

One of the most important consequences of increased globalization is that many countries are becoming fairly close locational substitutes in the eyes of multinational corporations (MNCs). Such an environment creates low tolerance for policy mistakes in the sense that relatively small differences in institutional set-ups and practices may have a large impact on trade and investment flows.

Together with globalization, the march of liberalization will increasingly shift the focus of international commercial diplomacy beyond countries' borders and into an ever-increasing number of areas that have traditionally been considered to belong solely in the domestic

policy domain. The notion that varying regulatory environments among countries are a source of unfair competition seems to be gaining popularity, and demands on governments to "countervail" these differences through trade restrictions are increasing. Thus, such differences will increasingly become the source of new trade friction. Accordingly, this has introduced new and potential areas of tension within the multilateral trading system.

One of the clearest manifestations of current (and future) threats to the trading system has been the attempts to replace the objectives of "free" or "freer" trade with demands for "fair" trade. The politically appealing notion of "fair" trade is increasingly being employed to justify government actions aimed at protecting domestic industry or pressing for foreign trade liberalization. Demands for fair trade have the attraction of appealing to a notion of natural justice, where governments may be ready to act in order to "level the playing field." Hence, whereas unfair trade practices were confined to foreign subsidies and dumping practices, they now bespeak the need for greater intervention in the domestic policies of other countries. The most prominent of these concern environmental policies and policies related to labor standards, although differences in standards in other areas such as competition policies are also important.

The presumption today in some circles is that doing different things about the environment and/or labor standards – or doing the same things in different ways – is sufficient to justify complaints about "unfair" competition. What this means in practice is that governments will increasingly become answerable to one another in the way they conduct domestic economic policy-making. It is quite reasonable to expect that demands for intergovernmental actions may well extend beyond the purview of policy-making in the environment and labor standards fields and into any other area that may affect the cost and production structures of individual firms. Thus, nothing will prevent such issues as varying tax rules among countries or differing investment incentives or funding for research and development or welfare or pension schemes from becoming entangled with issues of "unfair" competition.

It is important to note that trade policies become involved here not because trade itself is creating the underlying problem, but rather because a denial of market access is seen as an effective threat or enticement for a government to change its behavior. Moreover, economic theory has established that trade policies are inefficient instruments for correcting domestic distortions. They are second-best instruments, and may affect domestic policies only indirectly. Finally, the willingness of governments to change some economic variables (instruments) in order to change or stabilize other economic variables (such as environmental and labor standards) presupposes a clear distinction of the welfare effects of the former as compared with the latter. The lessons of the 1960s and 1970s are that this distinction may, after all, not be clear. Indeed, there may well be a point beyond which the manipulation of instruments may be more costly in terms of welfare than the welfare gain that could be derived from greater stability of what are traditionally considered target variables (such as income policy, fiscal policy, structural policy, monetary policy, and

trade and exchange rate policies).

Issues arising from the interplay of trade and environment policies and trade and labor standards are similar insofar as they raise the same broad policy challenges. These are related to: (i) the effects of trade policy on environmental quality and on labor standards; (ii) concern over the differential costs between countries of meeting environmental or labor standards; (iii) the use of trade policy to attain environmental or labor-related objectives; and (iv) the appropriate institutions that should be entrusted with developing multilateral rules and disciplines in these two areas.

There has been a frequently voiced fear that as open trade leads to specialization and growth, it results in more pollution and more resource degradation. This view rests on the belief that moving towards more liberal trading regimes induces, on the one hand, a shift in the production structure towards the tradable sector, thus implying faster depletion of environmental resources; and, on the other, it promotes changes in the patterns of production that result in adverse environmental effects downstream in the form of industrial pollution. However, neither of these two effects is clear-cut in terms of implying an unambiguous worsening of environmental well-being. Moreover, even if these effects do exist, they must be weighed against the improved use of environmental resources that stems from greater efficiency in input use as a result of liberal trade policies.

The problem of environmental degradation cannot be convincingly linked to specialization through trade. On the contrary, open trade may be beneficial to the environment through its effects on resource allocation and income levels. Environmental degradation may be a problem at any level of trade and international specialization – it depends on other policies. Nevertheless, it must be recognized that trade liberalization might, through its effects on relative prices, accelerate environmental degradation. Whether or not this will indeed happen is an empirical issue, though environmental degradation should be addressed through appropriate environmental policies and not through growth-inhibiting interventions such as trade protection.

The other concern about open trade is that it will generate pressures for competitive deregulation and thereby compromise environmental quality and high labor standards. Once again, trade restrictions are not appropriate either as an environmental policy or as a policy to safeguard high labor standards. Differences are bound to exist among countries in relation to environmental quality and labor standards, reflecting differing environmental absorptive capacities, labor demand and supply conditions, and social priorities. In economics, the "state of the environment" as well as labor are treated as factors of production or as country-specific resource endowments and as part of what determines comparative advantage. Competitive deregulation occurs if governments allow it to happen, not because opening up to trade forces a defined set of standards (environmental or labor) upon a country. If a country has a comparative advantage over another on environmental grounds or labor cost grounds, it will tend to specialize accordingly.

The second category of issues is two-faceted. On the one hand, industries faced with the costs of environmental and labor regulations complain that imports produced under looser environmental and labor standards are a source of unfair competition. On the other hand, there is the frequently voiced fear that the threatened migration of polluting industries or of industries seeking lower labor standards will undermine the political will to impose necessary environmental and labor controls and standards on domestic industry. This would, in turn, lead to competitive deregulation among countries. Whether this happens is, once again, an empirical question.

Numerous studies have attempted to estimate the impact of environmental control costs (ECCs) on industry price, output and the trade balance. Common findings of most studies are: (i) estimates of total ECC by industry tend to be very low, that is, abatement costs are a small portion of industry costs (for example, the weighted average of such costs to output in the US in 1988 ranged from 0.54 percent to just over three percent for one of the most polluting industries – cement); (ii) reductions in output caused by ECCs are also small and insignificant on average; and (iii) there is little evidence of any significant impact of ECCs on the pattern of trade.

A growing body of research has also analyzed possible relationships between trade patterns and "core" labor standards.[3] This analysis has led to several results. First, cross-country differences in core standards will have no influence on external competitiveness in general. These differences are likely to be largely offset by differences in either productivity levels or exchange rates. Moreover, cross-country differences in core standards are likely to shape comparative advantages. The patterns of specialization will therefore be affected by changes in core standards. In addition, upgrading core standards could improve the terms of trade in low-standard countries. It is also conceivable that better core standards could improve economic efficiency, thereby stimulating output and trade over the long-run. Finally, it is worth noting that from an environmental and/or labor standpoint, the focus on competitive considerations – rather than environmental quality and labor standards as such – could easily lead to situations in which trade intervention in the name of environment or labor does nothing, or even does harm, to environmental quality and labor standards.

The third category of issues relating to the use of trade policy to achieve environmental or labor standards objectives is largely about enforcement. Trade policies may be harnessed as a means of encouraging countries to participate in an international agreement. They can also be used to induce countries to become a party in an international agreement that they would otherwise abstain from. Alternatively, trade policies may be applied by one

[3] Core labor standards are defined as the rules and regulations that establish freedom of association, the right to organize and bargain collectively, restrictions on child labor and prohibition of forced labor. These are the standards that the International Labor Office (ILO) itself is proposing to be included in what is termed the social dimension of trade liberalization.

country to impose its own environmental and/or labor standards upon others.

Most international agreements require convincing enforcement provisions, involving a retaliatory or punishment mechanism. This becomes more important the greater the influence of an international commitment is on the policy of governments, and the greater the incentives that exist to be less than fully cooperative under the terms of an agreement. The question of interest here is whether trade restrictions offer an efficient retaliatory mechanism. Here the theory is not very helpful, because it is assumed that a credible threat does not need to be exercised. If an international agreement is properly structured and stable, non-compliance by a party to the agreement would be irrational, in the face of the severity of the retaliatory consequences of such action. Countries are assumed to have entered into an agreement because they consider it to be in their interest to do so. In this framework, the withdrawal of market access – in other words, the imposition of trade restrictions – may be an effective threat.

The case for trade restrictions as an enforcement mechanism under an international agreement must be distinguished clearly from the case of the use of trade policy to induce cooperation in the absence of international agreements as discussed above. The use of trade policies to influence outsider behavior, in the sense of encouraging a commitment by a country to particular environmental or labor policies or to an agreement, is more likely to involve punishment than rewards. In general, the more remote international consensus is on an issue, the more disruptive this particular use of trade policy will become.

An even less straightforward use of trade policies, however justified on environmental or labor standard grounds, arises when a country uses the threat of trade restrictions to impose its own acceptable environmental or labor standards on another country. It is easy to see how anti-competitive such an approach would prove to be. Where trade policy is turned to environmental or labor standard ends in this fashion, it becomes disruptive while skirting due multilateral process. The fourth and last category of issues that arise from the interplay of trade and environment policies and trade and labor standards concerns the appropriate institutions that should be entrusted with developing multilateral rules and disciplines in these two areas.

In conclusion, demands on governments to do something about the environment and about labor standards via trade policy are increasing, in both multilateral and regional contexts. A judicious and non-protectionist response to these demands will be one of the major trade policy challenges of the decade ahead.

Turning our attention to the proliferation of inherently preferential trading arrangements, the concerns they raise are whether these arrangements will expand and whether the process of such coagulation of subsets of regional groupings will lead to eventual multilateral free trade among all or to a fragmentation of the world trading system. From a systemic perspective that seeks to defend multilateralism, regional trading arrangements

might be considered acceptable if they: (i) create new trading opportunities; (ii) do not unduly distort trade; and (iii) do not create unassailable vested interest groups that would block the extension of liberalized trading arrangements on a non-discriminatory basis. In other words, there would be less to worry about if regional agreements were regarded as interim measures, aimed at providing momentum for non-discriminatory trade liberalization efforts.

The proliferation of regional integration arrangements may affect the balance between existing regional integration and the multilateral trading system. The latter could lose a good deal of its significance if MFN treatment were to cover a decreasing share of world trade, and if members of agreements were to have their responsibilities and interests divided between regional and multilateral objectives and rules. The risk would be greater if there were to be a proliferation of "hub-and-spoke" agreements. A global, multilateral trading system would, however, remain essential to address inter-regional relations and disputes, protect the interests of third countries, and work towards strengthened and expanded multilateral rules.

That regional trading arrangements and the multilateral trading system have generally been complementary is not sheer coincidence, but rather the result of deliberate policy choices. One challenge facing policy-makers will be to ensure that this continues. Much will depend on the credibility of the WTO and on its capacity to accommodate and discipline regional trading arrangements. This also requires the multilateral trading system to be able to respond quickly to the evolving requirements of international commerce and keep pace with progress in the regulatory frameworks of regional trading arrangements. If these conditions are fulfilled, they should restrain outside countries from forming defensive agreements or from seeking preferential agreements with regional entities in order to secure access to their market.

General multilateral discipline on regional trading arrangements – mainly in the form of Article XXIV of the GATT – has helped ensure that regional agreements per se do not lead, on balance, to deterioration in the conditions of trade and market access for third countries. It has not, however, provided indisputable criteria by which to assess the effects of regional integration agreements on trade and investment flows or the compatibility of regional agreements with the GATT. The slightly tighter interpretation of Article XXIV embodied in the Final Act of the Uruguay Round will make the conditions for the creation of FTAs and CUs somewhat more constraining, but it is unlikely to result in more definitive rulings than in the past.

The improved multilateral dispute settlement procedures adopted as an outcome of the Uruguay Round should help to exert greater discipline on regional trading arrangements through the challenging of such arrangements, rules or measures which conflict with other existing GATT/WTO provisions. But the stronger dispute regime will not help much when the common rules are still weak. Together with divergence among regional

arrangements, this would seem to limit the scope for the development of a multilateral "case law" on regional trading arrangements.

To say that regional trading arrangements and the multilateral trading system are not alternatives, but rather complementary approaches to problems of international commercial diplomacy, is not sufficient. The key issue is what policy choices and decisions could be made to ensure that regional trading arrangements remain supportive of the multilateral trading system in a way that strengthens its credibility for third countries. The need and advisability of further expansion of the disciplines in Article XXIV (and the Understanding on it) is debatable and may not be a realistic option at this point.

III. THE VISION

Economic prosperity in the MENA region is critically dependent on a well-functioning international economy. Therefore, it is incumbent upon countries in the MENA region to ensure that the international system develops in ways that will benefit them. This necessitates looking beyond the immediate future with the aim of anticipating events rather than reacting to them.

As the 20th century draws to a close, the policy challenges of globalization and regionalization that have been identified in the preceding section present policy-makers with three options. They may choose to rely on the historical policies of reducing at-the-border trade barriers, thus continuing the adoption of what is referred to as the agenda of "shallow integration". Alternatively, they may search for new policy instruments, or even choose instruments that capitalize on the increased interdependence and mobility. This may involve the harmonization and reconciliation of national differences, thus going the route of "deep integration". The third and last route would involve steps towards de-linking to reduce the interdependence and restore some freedom of action to national policy-makers.

New barriers to foreign trade and the international movement of capital are examples of de-linking, that is, of efforts to reduce interdependence by providing for increased separation between national markets. We witnessed some of that during the early 1980s when highly-indebted countries, faced with a mounting debt crisis, increased trade barriers to save foreign exchange, then eventually reversed course. Adopting such a strategy is a very bad idea, and it constitutes the most pessimistic scenario as it will eventually lead countries that adopt this strategy either to complete marginalization or, in case the practice is widespread, the result will be global fragmentation and the forgoing of opportunities for economies of scale and growth through specialization. Under such a scenario one thing is certain: global fragmentation (and at times shallow integration) do not favor the interests of small countries. Quite to the contrary, a fragmented world economy would tempt large countries to use their domestic policies to exploit their monopoly power. One way to

counter that is to ensure that markets are indeed competitive and remain open to foreign trade and investment.

Assuming that markets operate efficiently when the invisible hand is left un-fettered, then the freeing of trade and capital flows among countries would ensure that market pressures encourage a certain harmonization of policies while permitting national diversity. However, if one recognizes that markets may fail – and they do – then the case for going the route of deeper integration is strengthened. This is all the more so if one recognizes that in the absence of international governance, opportunistic national behavior could be expected. Nonetheless, the benefits of closer relations, be it between countries or between marriage partners, can be obtained only at the expense of giving up a certain amount of autonomy or independence.

The institutions and policies of the past – both domestic and international – need to be modernized further and in some countries redesigned in anticipation of the tools, rules and techniques that will be required for international commerce in the first decade of the next century. MENA countries will need to respond to the challenges with a sense of urgency, as failure to do so will see increased conflict within the international system and the realization of the potential benefits of a highly-interdependent system slips away.

The principal policy challenge facing MENA countries is to respond flexibly with domestic institutional arrangements that kick off the process of liberalization in some countries while sustaining it in others. Flexibility is needed in order to accommodate the pulls and strains from at times quite different interests, whether domestic or international. But this represents only the first step in the quest for creating truly international markets in the region.

In the area of FDI, the creation of efficient international markets necessitates providing foreign companies with access and the ability to operate as easily as their domestic competitors. But national treatment in and of itself is only a necessary condition for the creation of a truly contestable international market. Thus, when domestic regulatory reforms remain restrictive for both domestic and foreign firms (such as in cases where governments monopolize public utilities), national treatment means little. Also, national treatment by itself may not produce the desired results in cases where regulations have adverse effects on the operation of MNCs. Examples include local content requirements, rules of origin and restrictions on international financial transfers.

Hence, the creation of truly international markets in the MENA region requires a comprehensive approach that should not be confined to policies affecting trade and investment only. The reach of reforms should also encompass competition policies, government regulations, procurement practices, technology policies and corporate governance.

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Table 1: Growth of world trade and output, 1870-1990
(Average annual growth rates, percentage)

Year	Trade	GDP	Difference
1870-1913	3.9	2.5	1.4
1950-1960	6.5	4.2	2.3
1960-1970	8.3	5.3	3.0
1970-1980	5.2	3.6	1.6
1980-1990	3.7	2.8	0.9
1991-1993	3.9	1.1	2.8
1994-1996	7.3	3.0	4.3
1997-2004	6.0	3.3	2.7

Source: World Investment Report, 1994; UNCTAD, New York and Geneva. Data for 1991 onward are projections by the world Bank (1995), Global Economic Prospects and the Developing Countries, Washington, D.C.

Table 2: Foreign direct investment inflows, 1982-92
(Millions of US Dollars)

Host region/ economy	1982-87 Annual Average	1988	1989	1990	1991	1992
All countries	67,526	159,101	196,132	207,912	162,124	158,413
Developed Countries	52,757	131,313	168,488	176,346	120,616	102,401
Developing countries	14,752	27,772	27,376	31,266	39,060	51,485
MENA	1,344	2,575	2,614	2,095	2,066	2,720
MENA/Total (%)	2%	2%	1%	1%	1%	2%
MENA/developing (%)	9%	9%	10%	7%	5%	5%
Algeria	-7	13	12		12	10
Bahrain	45	222	181	-4	-7	-9
Egypt	809	1,190	1,250	734	253	459
Iran	-105	61	-19	-362	23	18
Iraq	3		3		-3	8
Israel	110	230	125	101	253	235
Jordan	43	24	-1	38	-12	41
Kuwait	-3	16	4	-6	1	-35
Lebanon	4		2	7	2	19
Libya	-152	98	125	159	190	150
Oman	139	92	112	141	149	59
Qatar	-2	-21	-2	5	43	5
Saudi Arabia	149	-83	-20	554	128	385
Syria	18	121	47	72	62	18
Tunisia	150	61	79	75	125	379
Turkey	92	354	663	684	810	844
UAE	41	189	39	-116	26	122
Yemen	10	8	14	13	11	12

Source: World Investment Report, 1994; UNCTAD, New York and Geneva.

Table 3: The largest host developing economies to FDI flows, 1981-92, US$ millions.

Host	1981-85	1986	1987	1988	1989	1990	1991	1992	Total, 81-92
China	3983	1875	2314	3194	3393	3487	4366	11156	33768
Singapore	6745	1710	2836	3655	2773	5263	4395	5635	33012
Mexico	5832	1523	3246	2594	3037	2632	4762	5366	28992
Malaysia	5415	489	423		1668	2332	3998	4469	18794
Brazil	9936		1225	2969	1267	901		1454	17752
Hong Kong	3022	996	3298	2627	1076	1728		1918	14665
Argentina	2024	574		1147		1836	2439	4179	12199
Thailand	751			1105	1775	2444	2014	2116	10205
Egypt	3150	1217	948	1190	1250				7755
Taiwan	340	326	715	959	1604	1330	1271		6545
Nigeria	1801		603		1882			897	5183
Indonesia	0					1093	1482	1774	4349
Colombia	2591	674							3265
Korea	0	435	601				1116		2152
Venezuela	0						1916		1916
Philippines	0			936					936
Chile	784								784
Tunisia	633								633
Total above (a)	47007	9819	16209	20376	19725	23046	27759	38964	202905
All LDCs (b)	65528	14095	23953	27772	27376	31266	39060	51485	280534
All OECD (c)	185430	67307	111145	130845	162599	163825	118129	94817	1,034,097
LDCs + OECD (d)	250958	81402	135098	158617	189975	195091	157189	146302	1314631
a/b	72%	70%	68%	73%	72%	74%	71%	76%	72%
a/d	19%	12%	12%	13%	10%	12%	18%	27%	15%

Source: World Investment Report, 1994; UNCTAD, New York and Geneva.

Table 4: Global General Equilibrium Studies of Multilateral trade liberalization

a) Impact on world welfare

Study	Global welfare effects
Francois, McDonald and Nordstrom (1994)	$510 billion (1992 dollars, measured in 2005)
OECD (1993)	$274 billion (1992 dollars, measured in 2002)
World Bank/OECD (1993)	$213 billion (1992 dollars, measured in 2002)
Nguyen, Perroni and Wigle (1993)	$212 billion
DRI (1993)	increase of 4.5% in world income
Stoeckel (1990)	increase of 5.0% in world income
Peterson (1992)	increase of 1.0% in world income

b) Summary of approaches

Study	Model type & main assumptions
Francois, McDonald and Nordstrom (1994)	Scale economies; imperfect competition. Calculations based on the final offer data.
OECD (1993)	Constant returns to scale in production; perfect competion. Calculations based on the DFA, manufacturing tariffs and NTBs cut by 36%; agricultural subsidies by 36% & agricultural support cut by 20%
World Bank/OECD (1993)	Constant returns to scale in production; perfect competition. Elimination of agriculral subsidies & support & elimination of import tariffs on non-agricultural goods.
Nguyen, Perroni and Wigle (1993)	Constant returns to scale in production; perfect competion. Partial MFA liberalization; cut in both agricultural subsidies & support by 70%; reduction of import tariffs on industrial goods by 50%.
DRI (1993)	Macro-econometric, partial equilibrium model of the G7 with efficiency gains from trade liberalization exogenously determined.
Stoeckel (1990)	Constant returns to scale in production; perfect competition. Tariff & NTBs reduced by half.
Peterson (1992)	Global macro-econometric, partial equilibrium model with product differentiation & constant returns to scale in production. .

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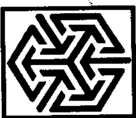

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