

**Euro-Mediterranean versus Arab Integration:  
Are They Compatible?**

**Gonzalo Escribano**

# Euro-Mediterranean versus Arab Integration: Are They Compatible?<sup>(1)</sup>

Gonzalo Escribano\*

## Abstract

Whilst globalization and regionalism have gained momentum all over the world during the last two decades, this is a new phenomenon in the Arab region. Mainstream economic analysis has abstracted from the political factors underlying regionalism and its political and security implications. This article deals with Mediterranean regionalism considering its political, security and cultural dimensions. In order to clarify the political dimension of economic regionalism in the Mediterranean, a review of the literature on regionalism linking economics and politics is presented. Thereafter, conceptual tools reviewed in the first section to the analysis of regionalism in the Mediterranean are applied. Finally, perspectives faced by the different integration initiatives in the region are discussed and analyzed.

## الأوروبية المتوسطة مقابل التكامل العربي : هل من توافق ؟

جوزالو إسكريبانو

### ملخص

بينما اكتسبت العولمة والإقليمية زخما شديدا في جميع أرجاء المعمورة في العقد الماضي، فإن هذه الظاهرة قد بدت حديثة العهد في المنطقة العربية. إن التحليل الاقتصادي السائد قد استبعد العوامل السياسية ولم يعط اهتماما خاصا بالإقليمية ومضامينها السياسية والأمنية. وعلى عكس ذلك، تبحث هذه الورقة الإقليمية المتوسطة مع الأخذ بالاعتبار الأبعاد السياسية والأمنية والثقافية. ومن أجل توضيح البعد السياسي للإقليمية الاقتصادية في دول المتوسط، فقد تم استعراض الأدبيات عن الإقليمية التي تربط بين الاقتصاد والسياسة. ثم تم استخدام الأدوات المفاهيمية التي استعرضت في الجزء الأول في تحليل الإقليمية في الدول المتوسطة. وفي الختام تمت مناقشة وتحليل وجهات نظر مقابل مبادرات تكاملية مختلفة.

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## **Introduction**

In recent years, multilateral trade liberalization and regional economic integration have gained momentum in the Arab World. The latter is a new phenomenon in the Arab region, where previous attempts to achieve regional integration have not succeeded, mainly due to political reasons. However, four main options are open for Arab countries in the Mediterranean: (a) to achieve regional integration within the All Arab Free Trade Area; (b) to achieve deeper sub-regional integration within a Maghreb, Mashrek or Gulf basis; (c) to conclude agreements with the European Union in the Euro-Mediterranean Free Trade Area (EMFTA) framework; or (d) to try to combine all three strategies.

Some authors conceive Euro-Mediterranean agreements as incompatible with Arab integration, while others look at them as a challenge that can foster further Arab integration. However, the analysis tends to rely on narrow economic arguments, instead of dealing with political factors. In this paper, an international political economy approach is adopted, linking economics and politics to analyze the likelihood of Arab countries integrating within a Euro-Mediterranean or an Arab scope, or both. The paper will first review the literature that explores the conceptual links between economics and politics when dealing with regionalism. Thereafter, these tools will be applied to the analysis of Euro-Mediterranean and Arab regionalism. Finally, the policy and strategic implications of regionalism for the Arab world concentrating on the Euro-Mediterranean initiative will be discussed.

One of the shortcomings of the EMFTA is its regional coverage, in as far as the Persian Gulf countries are not included. This seems to introduce significant economic and political problems for Arab integration itself. On the other hand, the EMFTA presents its own problems, perceived in a different manner from the European Union (EU) and from the Arab Mediterranean countries. In addition, political fragmentation and differences in the economic structures and policies of the Arab world introduce significant obstacles to Arab integration. In this paper, some policy implications will be addressed for both the Arab countries and the EU to reconcile Arab and Euro-Arab economic integration and political cooperation.

### **The International Political Economy of Regionalism**

During the last two decades, globalization and regionalism have gained momentum all over the world. As far as the challenge of regionalism is subordinate to the challenge of globalization, many countries have chosen regionalism as a way to further integrate themselves into the world economy (Fischer, 1998). The rise of regionalism defies the conventional economic theory, which defines it as second best when compared with multilateral free trade. However, the economic analysis has, for long, underestimated the political factors underlying regionalism and its political and security consequences. On the other hand, the literature on international relations has often omitted the economic pre-conditions for regional integration to proceed successfully. Even the growing literature on regionalism in the international political

economy field, mainly concentrates on the domestic political factors rather than on the connections between foreign policy and economics.<sup>(2)</sup>

When dealing with regionalism in the Mediterranean, abstracting from political, security and cultural dimensions is a misleading exercise. The Mediterranean region is far from being homogeneous in economic, cultural or political terms. To begin with, the geographical unity of the Mediterranean is more convention than reality (Kayser, 1996). Instead of being considered as a homogeneous body, the Mediterranean should be analyzed as space of interaction between different economic and political systems, cultures and levels of development.<sup>(3)</sup> Without such a multidisciplinary approach, the subject of study may be ill defined and, henceforth, the analysis may lead to ambiguous policy recommendations. To clarify the political dimension of economic regionalism in the Mediterranean, the literature that explores the conceptual links between economics and politics is reviewed. The emphasis is placed on the issues related to regionalism.

## **Review of Literature**

The idea of political externalities stemming from international trade, dates back to Kant (1795) and the writings of the classical economists.<sup>(4)</sup> Smith, Ricardo and Mill strongly reject the mercantilist policies both in international economics (protectionism) and in international relations (power politics). Following their misunderstanding of the economic process, the mercantilist closely associates the concepts of ‘balance of trade’ and ‘balance of power’ (Viner, 1946). The mercantilist’s main concern is the relative gains that a State can obtain in the international arena. In a ‘zero-sum’ or even ‘negative-sum’ game, the aim is to lose less than the adversaries, disregarding the domestic cost of protection or war. Mercantilist policies have proven to be extremely resilient, as far as they are incorporated in almost all the modern arguments for protection (what Johnson [1976] has called sophisticated mercantilism) and, to some extent, in the realist theories of international relations.

Nowadays, there is growing consensus regarding the beneficial effects of international trade on international relations. In addition, some recent empirical works have shown that trade is more intense between political allies (Boyer, 1993; Morrow, Siverson and Tabares, 1998). These results may be extended to other categories of economic relations, such as foreign investment, external aid or even labor migration. However, the direction of causality is unclear. Does trade foster good political relations, or on the other hand, do political alliances foster trade? In the first case, conflict may be solved by increasing economic relations. In the second case, conflict solving remains a political matter. Anyhow, a prudent approach should retain the bi-directionality of causality between economic and political relations. The policy implication of such an approach is to pursue good political and economic relations simultaneously, in order to attain a virtuous circle on which the two variables reinforce each other. Cautious conclusions are often deceptive.

Kindleberger (1986) has argued that leadership is needed if international public goods are to be provided, while in the absence of leadership, these goods will be under-

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<sup>(2)</sup> See Mansfield and Milner (1999) for a recent and exhaustive survey on this literature.

<sup>(3)</sup> See, for instance, Lorca and Escribano (1997) and Escribano (1999).

<sup>(4)</sup> See Doyle (1986) for an analysis of liberalism in world politics.

produced, due to the free-rider problem. Therefore, in a multi-polar system, international public goods should be provided by international institutions. Nevertheless, other possibilities arise when collective goods are supplied at a regional level by regional hegemons. In this framework, countries willing to further integrate in the global markets may seek regional integration as a strategy for doing so. The problem appears when a single political and military hegemon is considered, coexisting with, for example, three economic powers. This picture is by far closer to the contemporary world. It will be obvious in the forthcoming discussion how it introduces inconsistencies into the Mediterranean region.

In addition to the traditional economic gains from regional FTAs, e.g. trade creation, positive terms of trade effects, economies of scale, increased competition and growth of foreign investment to name a few, Fernández and Portes (1998) point out some non-traditional benefits. These include increased time consistency of economic policies and of political reforms signalling that certain economic and political conditions do already prevail; insurance against future political or economic developments; increased bargaining power in economic and political issues with respect to third countries or other regional groupings; and finally, to serve as a catalyst for those who expect to gain from trade liberalization or political reforms. It should be noted that the political dimension in the last four categories listed by Fernández and Portes have been introduced. Indeed, one may ask if the political motivations outweigh the economic ones when dealing with developing countries' efforts to adhere to regional groupings formerly composed of developed countries.

Turning to the security dimension, Schiff and Winters (1998) have stated that, when accounting for security externalities, a regional economic agreement may be first-best in terms of static welfare theory. Assuming that trade between neighbors reduces the likelihood of conflict, Schiff and Winters distinguish three cases for regionalism. Symptomatically, it is noteworthy that in all three categories, they make use of examples from the Euro-Mediterranean region. Firstly, regionalism can improve protection against civil strife or even civil war. For instance, Morocco, Tunisia and Egypt's commitment to achieve an FTA with the EU, may be related to fears about the fundamentalist threat.<sup>(5)</sup> Secondly, regionalism may be the countries' response to threats stemming from regional powers. The example here draws on the creation of the Gulf Cooperation Council (GCC) to face the menaces represented by Iran and Iraq. Thirdly, a historical background of deadly conflicts between neighboring countries may lead them to achieve economic integration to inhibit future wars. The obvious example here is the creation of the European Economic Council (EEC) as a mechanism to discourage new conflicts between France and Germany after WWII. Needless to say, this argument is not useful when the antagonists are still in open conflict, as it is nearly impossible for them to be willing to join the same regional initiative. In such a case, political initiative like conflict-reducing (or confidence-building) measures or pressure by a regional or global power is needed for these countries to join the same regional grouping.

From a political perspective, the debate on integration has been led by three main theoretical approaches heavily relying on the EU experience: (a) functionalism, (b) neo-

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<sup>(5)</sup> Note that Egypt has not yet signed an FTA with the EU, as Morocco and Tunisia have already done.

functionalism, and (c) intergovernmentalism.<sup>(6)</sup> Functionalism consists of adopting the physiological process by which the function creates the organ, or, in political terms, the institution. Functional integration should start in the domains of 'low politics', instead of adopting a big design that can be politically unsuitable, and is pursued as a means to reduce conflicts among nations through economic prosperity. Neo-functionalism stresses the role of political actors at a sub-national level and its goal is to maximize welfare through regional integration. Intergovernmentalism, on the contrary, highlights the role of government heads, who try to increase welfare to maintain power. All three assume that regional integration increases economic welfare, and the focus is on how a set of regional institutions is created and what the conditions for success are.

In a recent work, Mattli (1999) points to the interaction of markets and political institutions to explain regionalism. Two pre-conditions are needed if regionalism is to succeed. The first is the so-called demand conditions of economic nature. There must be a strong potential for economic gain derived from economic integration, so that societies demand it. The second is the supply condition of a political nature - the political willingness to match the integration demands, which depends on the expected outcome of regionalism. As far as economic welfare increases after integration, governments maximize their possibilities of being re-elected. In addition, following the regional 'hegemon' argument, the coordination problem, i.e. the need to match eventual divergences in national interest, asks for a regional leader acting as a catalyst, or even as a 'paymaster', if integration is to proceed. Nevertheless, Mattli abstracts from security and foreign policy objectives, which can constitute a rationale for regionalism.<sup>(7)</sup> Furthermore, the political dimension of his argument underscores, as most new political economy studies do, the fact that many developing countries are non-democratic states (Meier, 1990). If so, governments do not necessarily see welfare maximization as the only, or even the main way to stay in power. In this concern, when dealing with the Mediterranean, the regional leadership issue could be more relevant. In any case, the two pre-conditions may be useful insofar as they let political and economic considerations interact. Moreover, it may be applied to foresee the likelihood of a regional initiative succeeding.

Additionally, as Mansfield and Milner (1999) have pointed out, regional initiatives may be instrumental in stimulating political reforms. However, this argument clashes with the functionalist and neo-functionalist approach. This is as far as it means entering into the 'high-politics' arena instead of letting low-profile measures act as confidence-building measures. If a strong commitment towards liberal political reforms already exists, regionalism may be time-consistency improving and so becomes an incentive to enter the regional bloc. However, when political reforms are strongly opposed by the candidate country's government, the 'low-politics' functionalist methodology may be preferred. Also, turning to foreign policy and security issues, adversaries will not easily form a regional bloc among themselves and will strongly oppose an enemy entering a bloc which they are already in. In such a case, prior political measures are to be taken to erode antagonism among adversaries.

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<sup>(6)</sup> See Mattli (1999), chapter 2, for a resume of the three approaches.

<sup>(7)</sup> On the role of trade policy as foreign policy, see Baldwin (1985, 129-130) on trade policy political economy, Tsoukalis (1997) for the EU case, and Cooper (1987) for the US case. The political dimension of NAFTA has been stressed by Krugman (1993).

## The International Political Economy of the Mediterranean

The Mediterranean is a complex reality made up of the interactions among different economic, political and cultural systems. As such, the asymmetries between the northern and southern shores are numerous. In this section, these asymmetries are briefly reviewed to clarify the discussion on regionalism in the region.

For the purpose of this paper, the countries of France, Greece, Italy, Portugal and Spain are classified as EU Mediterranean countries; the Maghreb countries made up of Algeria, Morocco and Tunisia (Libya having been excluded due to lack of data); the Mashrek countries of Egypt, Lebanon, Jordan, Palestine and Syria; Israel and Turkey. Looking at the GDP, EU Mediterranean countries account for 86% of the total; Maghreb for 3.2%, Mashrek for 2.7%, Israel for 2.5%, and Turkey accounts for 5.0%. The sum of the Maghreb, Mashrek, Turkey and Israel GDP's all together was less than the Spanish GDP and a third of the French GDP in 1997 (Eurostat, 1998). Furthermore, in terms of human development, the EU Mediterranean countries and Israel rank within the second (France) and the 33rd (Portugal), while the Southern riparian countries rank within the 64th (Libya) and the 125th (Morocco) out of 174 (UNDP, 1998). The GDP per capita of the northern shore lies between 20,891 Euros (France) and 8,998 Euros (Portugal), while in the southern shore, GDP lies between 3,561 Euros (Libya) and 948 Euros (Jordan); Israel has a per capita GDP of 14,724 Euros. On the population side, the EU Mediterranean countries had 175 million inhabitants in 1995, while the southern Mediterranean countries had 221 million. The projection for the year 2015 is 173 million in the north and 308 million in the south (Eurostat, 1998).

In addition, the economic structure of the two shores differs widely. The southern shore is an agricultural or energy based economy, with the only exception of Turkey and Israel. The northern shore is a post-industrial society. Within the southern shore, the degree of industrialization varies among countries like Turkey, Algeria, Morocco, Tunisia and Israel, where industry contributes considerably to GDP and countries in which the role of manufacturing is small, e.g. Syria, Egypt, Lebanon and Palestine, the latter being an aid-dependent economy. On the other hand, agriculture still contributes strongly to economic activity in many southern Mediterranean countries like Morocco, Tunisia, Egypt, Syria and Turkey, where it represents between 14% to 27% of GDP. On the northern shore, with the only exception of Greece, agriculture represents on the average 3% of GDP, a similar percentage of the weight of Israel's agricultural sector.

The economic strategies and policies also differ throughout the region. The EU Mediterranean countries are open and liberal market economies. Israel, and to a lesser extent Turkey, are relatively open economies too, where the private sector is the main economic agent. Morocco, Tunisia, Jordan and Egypt are countries that, after having applied import substitution strategies through the public sector in the last two decades, have committed to *infitah* (opening) and are trying to transit towards more liberal, export-oriented and private sector-led economic systems. Countries like Syria, Libya and Algeria are state-led economies with a strong protectionist background, although Algeria is trying to reform its economic system following IMF and World Bank adjustment programs (Richards and Waterbury, 1990; Economic Research Forum, 1998; Lorca and Escribano, 1998).

These economic differences are a potential source of conflict (Marçın, 1998). However, there are also serious political divergences between north and south and, within the latter, among countries that are trying to implement political reforms and countries whose *elites* resist any political opening. Liberal democracy prevails in the EU Mediterranean and Israel, as it does in Turkey, even in the presence of human rights and minorities problems. In Morocco, the coupling of a new government democratically elected and the accession of Mohamed VI to the throne, has generated great expectations about an acceleration of political reforms. In Algeria, and in spite of the opposition presidential candidates' last-minute refusal to run for the presidency, the newly elected president is committed to national reconciliation and a more open regime. However, many countries are still being governed with the support of the army by charismatic, authoritarian leaders. How promising the recent initiatives to open some of these autocratic regimes are, is a question that remains to be answered and depends to a great extent, on generation change.

Concerning foreign policy and security, the Mediterranean is one of the EU's priorities. However, the absence of an effective Common Security and Foreign Policy is a serious handicap for the EU.<sup>(8)</sup> It is therefore forced to resort to economic instruments, e.g. aid and preferential trade, to tackle foreign policy issues. Making virtue out of necessity, this economic approach is said to conform to a new 'civilian' model of international relations (Tsoukalis, 1997). As far as the stalled Palestinian-Israeli Peace Process has become an obstacle to the political and security dimension development of the Barcelona Declaration, the EU continues to be dependent on the US' central role in this process. The fact that the EU is Palestine's main contributor is not of great help, as it raises some doubts about the effectiveness of the so-called 'civilian' powers. The EU is the regional economic power, but has little influence on political and/or security issues, which are led by the US. This dichotomy is particularly evident in the security field, with both the EU and NATO conducting a Mediterranean dialogue with southern riparian countries which is a source of mutual inconsistency (Lesser *et al.*, 1999).

In addition, there is discrepancy between foreign policy and security priorities of the northern and southern countries. For the EU, the main concern is about 'soft threats' coming from the south, e.g. terrorism, drug-trafficking and illegal immigration, etc. On the other hand, for many southern countries, it is a 'hard threat' issue coming from its southern neighbors. The southern shore of the Mediterranean is a high-conflict region, e.g., the Cyprus struggle between Greece and Turkey, the Arab-Israeli confrontation, the Lebanon conflict, frictions between Algeria and Morocco and the Western Sahara issue. From a political standpoint, and avoiding topics, the Arab world is fragmented and there is room for sub-regional powers to enforce 'power politics' (Aarts, 1999). The same is true in relation to Israel. This, in turn, is the main obstacle to regional cooperation, not to mention regional integration (Vasconcelos, 1999). As previously mentioned, there is a critical level of mutual trust that should be attained through political action, if economic integration is to proceed. Only then may the region benefit from the externalities of such integration.

Another factor of fragmentation consists of cultural differences. Given the divergences between western European and southern Mediterranean, religious values in

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<sup>(8)</sup> On this issue, see the debate between Cameron, Gillespie, Neuhold and Hill in Donoghue and Keating (1999).



both cultures are bound to clash (Huntington, 1993). However, Huntington's thesis has been widely criticized on the grounds of being a self-fulfilling prophecy. In economic terms, the culture differences are supposed to increase transaction costs. The approach adopted at the Declaration of Barcelona is to foster cultural dialogue to prevent such civilizations clashing and lowering transaction costs. The interaction of different cultures is deeply rooted in Mediterranean history and cannot be set apart from the discussion. In fact, it has been an engine of creativity, innovation and diffusion of knowledge. By recognizing the rights of other people to live under different cultural systems and through a better knowledge of these cultures, confidence may grow between them. The problem here is the opposite perceptions between the societies in the north and the south of the Mediterranean basin. The rise of Islamic fundamentalism and the increased cultural euro-centrism built upon the European integration process, impedes such a task. The European bureaucracy at Brussels is not used to dealing with cultural issues and the same can be said about southern countries. This may explain why cultural dialogue has not really caught on yet (Lorca and Escribano, 1998).

On the whole, the perspectives of regionalism in the Mediterranean region are quite complex. On one hand, the divergences in economic, political, security and cultural issues may be seen as an obstacle. On the other hand, the political will to implement regional initiatives to diminish such differences through increased economic integration, varies from one country to another. Some pre-conditions pointed out by literature previously reviewed, are matched by some initiatives, but are barely met by others. It seems clear that some political measures are needed to fulfil the supply conditions of regionalism, mainly by some southern Mediterranean countries. Giving pre-eminence to economic issues, awaiting 'low-politics' to automatically build confidence and mutual trust in 'high-politics' matters, is a misleading approach considering the geopolitical complexity of the Mediterranean region.

### **Regionalism Options for the Mediterranean**

The wave of regionalism in the Mediterranean is a relatively recent trend. Vasconcelos (1999) distinguishes between three categories of regionalism: (a) deep integration; (b) open regionalism; and (c) virtual integration. All three exist in the Mediterranean. The EU is the most successful integration process in the whole world. Later integration efforts have to some extent, tried to imitate this model. What is relevant, for the purpose of this paper, is that traditionally, the EU has chosen regionalism as the path to integrating in the world economy. As Helmut Kohl once put it, for the EU, "the answer to globalization is Europeanization". This background has to be considered when analyzing Euro-Mediterranean regionalism. Out of the EU, the farthest reaching initiative is the proposal of the EMFTA. Nevertheless, within the southern shore of the Mediterranean basin, other initiatives have been launched. Abstracting from past efforts that have never been fully implemented<sup>(9)</sup> (virtual integration), the main initiatives are the Arab Maghreb Union (AMU), the Arab Free Trade Area (AFTA) and a potential FTA within the eastern Mediterranean, integrating Mashrek countries with Turkey and, eventually, Israel.

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<sup>(9)</sup> These efforts, led by Nasser and the Arab League, were of political, Pan-Arab, nature.

**Vertical Integration: The EMFTA.** The EMFTA was launched at the Conference of Barcelona in November 1995. It should be placed as a pillar of a comprehensive approach dealing with security and political issues, as well as cultural dialogue. Without entering into the contents of the Declaration of Barcelona<sup>(10)</sup>, the main factors that led to it were: (a) former EU-Mediterranean agreements based upon preferential access to EU markets had been insufficient to promote the development of the Mediterranean countries; (b) fears coming from southern EU members of the neglect of the Mediterranean, the latter being displaced by the Central European Free Trade Area and by future enlargement towards Eastern Europe; and (c) the reaction from southern Mediterranean countries to the deepening of integration within the EU and its enlargement. It is important to highlight that EMFTA was just the economic dimension, while political and cultural dialogue were seen as complementary to the commercial and financial support measures.

*Commercial Issues.* Firstly, the question is posed as to whether the economic pre-conditions fulfilled for an FTA to be built between the two shores of the Mediterranean are met. Both parties maintain a sizeable percentage of their foreign trade with each other. However, the asymmetry stems from the fact that the EU is the main commercial partner for most southern Mediterranean countries, especially for the Maghreb countries, whilst the importance of southern Mediterranean countries as trade partners is smaller for the EU, especially for non-Mediterranean EU members. In addition, the EU's role as donor, investor and destination of migration flows from the region is also of great importance. Therefore, the economic conditions for commercial and even further economic integration, seem to be matched. However, as Escribano and Trigo (1999) have argued, intra-industry trade between the EU and the southern Mediterranean, interpreted as a proxy for economic integration, lags behind that which is between the US and the Latin American countries.

Secondly, given that southern Mediterranean countries' manufactures already enter freely, with minor exceptions, in the EU markets, the EMFTA offers few benefits from the demand side to these countries.<sup>(11)</sup> On the other hand, the EMFTA looks to foster structural, supply-side reforms in the southern Mediterranean countries. Following the statement that some countries trade whilst others sign preferential agreements, the emphasis is placed on improving industrial productivity and competitiveness in the southern Mediterranean countries. Given the mediocre results obtained by the demand-side preferential treatment granted to Mediterranean countries, this is to be done through trade liberalization and *mise à niveau*, upgrading measures, partially financed by the EU. This argument assumes that trade liberalization will have beneficial effects on these economies. However, the studies conducted to date, point to small, or even negative, static effects to be expected in terms of GDP.<sup>(12)</sup> Why, then, should southern Mediterranean countries be interested in entering an FTA with the EU? The answer may lie in the non-traditional, non-static, beneficial effects of regionalism previously identified.

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<sup>(10)</sup> On this issue, see, for instance Lorca and Escribano (1998, ch. 8 and 10).

<sup>(11)</sup> A similar asymmetry was experienced by Spain when entering the EEC.

<sup>(12)</sup> Rutheford, Rutstrm and Tarr (1994), Kebabjian (1994 and 1995), Jaidi, (1994), Hoekman and Djankov (1996), Cogneau and Tapinos (1995) and Tovias (1999).

From an economic perspective, the main issue about the EMFTA is its sustainability. There are doubts related to the risk of reversal in the trade liberalization process at the Euro-Mediterranean level for political reasons, which in turn, heavily depends on the economic results of the strategy. The fears arising from the EMFTA are mainly related to: (a) misallocation of resources and trade diversion; (b) fiscal unsustainability of tariff cuts; (c) rising unemployment associated with eventual de-industrialization in the short run; and (d) rising external imbalance.

International trade theory warns about the risks of trade diversion when entering a regional trade arrangement. Therefore, open regionalism has been advocated to prevent trade diversion. Tariff reductions should be extended to third countries to keep commercial preferences at a low level. This means that regional liberalization should be accompanied by a certain degree of multilateral liberalization if trade diversion, and consequently, resource misallocation, is to be avoided. The question to be answered is: How open should “open regionalism” be to avoid resource misallocation? Open regionalism implies an additional decrease of tariff revenue. The difficulties arising in the financing of existing budget deficits, is another controversial issue. The optimal measure may be to substitute taxes on international trade by VAT, personal income and corporate taxes. Otherwise, fiscal imbalance may endanger the sustainability of the FTA. Financing such imbalance through EU funds may solve the problem in the short term. However, this may, in turn, perpetuate the regressive nature of the tax structure, instead of fostering its modernization. So, why not finance and technically assist the tax reform? If not, there may be a premium for late tax reformers and support for the *status quo*, which, from the author’s perspective, is not desirable.<sup>(13)</sup>

The adjustment costs of trade liberalization need to be considered as well. International trade theories consider that in the long run, labor, as well as capital, will be reallocated towards sectors enjoying comparative advantages. Again, a political problem is detected that can not be dismissed by technical jargon. How long is long term? Perhaps longer than most people can bear without being paid and far more than politicians are willing to admit. Most industries in the southern shore of the Mediterranean are not competitive and are not prepared to face EU competition. For this reason, the final good sectors will be liberalized at the end of the transition period. However, this is only a way to postpone the problem, not a means to solve it. On the other hand, the *mise à niveau* program seems insufficient to turn unproductive industries into competitive ones. Some selection is needed, namely the sectors on which the countries already have a comparative advantage and those where a comparative advantage can be built during the transition period. Here, other problems emerge. Which are these sectors? How are they selected? What are the criteria? And who makes the selection? This leads to another political economy problem. The *elites* will invariably defend that the sectors to be supported are theirs. On the other hand, the criteria to make the selection will be difficult to identify by economists. Furthermore, it is necessary to consider the economic interests of the donor. Will the European Commission select agriculture and agro-food industries as sectors deserving increased financial funds from the EU?

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<sup>(13)</sup> For a political critique of EU aid re-orientation towards industrial restructuring and trade promotion, see Youngs (1999).

Moving on to macroeconomics, the risk is present on the rising external imbalance as trade liberalization proceeds. Ideally, the removal of import barriers will change the microeconomic incentives, increasing exports relative profitability. Domestic producers will then start to produce for the European market and its exports will compensate for the rising import bill. However, the experience of Spain and Portugal with accession to the EEC is a reminder that external imbalance was exacerbated and that only foreign investment and EEC funds keep their external accounts viable in the short run. But this will not be the case, unfortunately. Access to European agricultural markets will be, once again and from an economic perspective, preferable to EU financing of the southern Mediterranean countries' current account imbalance. Increased immigration flows could also compensate for increased imports through workers remittances. Nevertheless, both doors remain closed at this point, due to high political costs in the EU.

*Political Considerations.* On the political front, the political costs of the previous economic problems should first be tackled. If short run costs are too high (or not so short), social pressures can arise and trade liberalization *vis à vis* the EU, may be reversed or become too costly from a political point of view. In other words, the transition has to be eased making it sustainable in the ways previously pointed out. Political economy considerations become of great importance. Governments should keep a balance between winners and losers of the process, while preserving social stability. This is a difficult exercise, since the *elite* might be threatened by the tax reform, foreign competition for import substituting industries and, dealing with public sector officials, processes like privatization and reform of the administration, both of them present in the adjustment programs followed by some southern Mediterranean countries. Workers from import-substituting sectors and the governmental sector should be compensated through other mechanisms. If agricultural and final basic goods were to be included in the agreements at an early stage of the transition period, it would entail cheaper first necessity goods and could possibly reduce social unrest.

Mediterranean countries willing to enter the EMFTA should adapt their laws to the *acquis communautaire*. This implies the modernization of bureaucracies and of the whole state structure. This is a difficult task, as it means a change in mentality, a process that can proceed slowly, perhaps only with generation changes. It also means changes in the structure of power and its subsequent conflicts. For the EMFTA to work, laws and administrative procedures within the trade area have to be harmonized. How far the political will is able to go to stand for the costs of such harmonization, is a difficult question to answer. It will depend on the countries and their particular circumstances over time. The author stresses that this modernization of bureaucracy and State structures and institutions, is one of the main benefits stemming from the EMFTA for the southern Mediterranean countries. It gives them an external alibi to carry out the reforms that they want to implement, but are subjected to internal controversy. Implying market liberalization, disappearance of bureaucratic controls, reduction in corruption levels and the mitigation of its restraint effects on economic activity, trade liberalization will have beneficial consequences on economic growth through state modernization. Likewise, the reform of the state may influence foreign investment absorption capacity, which is closely related not only to the preceding issue, but also to cultural aspects. In the capital market circles, it is often said that investing in the southern shore of the Mediterranean

needs time and patience, due to high transaction costs. The modernization of bureaucracy will help in solving this problem.

*Cultural Issues.* The background of corruption and bad governance in some countries of the region is associated with the westernized *elite*. In addition, recent historical events, from colonization to the Gulf War, have generated among many Moslems a confidence deficit concerning European goodwill. On the northern shore, the cultural differences represent an important obstacle for potential investors. The Conference of Barcelona faces the problem by fostering a cultural dialogue that however, has not really caught on yet. In doing business, mutual trust is necessary. In signing agreements between sovereign nations, mutual respect is essential. If the EMFTA is perceived in the southern Mediterranean countries as a new form of colonialism (economic one), in which the EU threatens to impose its own values, southern societies will most likely, reject the deal. For many people from the Mediterranean, the EMFTA is a European *diktat* backed by the local westernized *elite*. When the problem stands on the clash of civilizations, cultural dialogue is the best solution, backed with a credible effort to support development and modernization, instead of conceiving it as just a new way to assure economic control and security.

Another problem, one barely treated by the literature, is the absence of an entrepreneurial mentality due to the cultural influences of the region. This issue requires some differentiation. From a historical point of view, the Mediterranean is a commercial space. Notwithstanding, the economic agents differentiate such activity from entrepreneurial activity (producing goods and services). The main difference is that commercial activity is mainly sporadic and temporary, whilst entrepreneurship is continuous and permanent. The latter is based on the long run, so that eventually short-run benefits should be sacrificed by long-run ones. The mentality for building on a long-run basis is needed to establish relations and consolidate it in solid and mutual trust. The entrepreneurial partner is needed to absorb foreign investment. He knows the domestic markets, its habits and preferences, as well as the laws and administrative practices and channels. His strategy differs from the trader whose activity is based on the short run.

These political and cultural aspects are extremely important, given the EU's disregard towards the cultural, economic and political context of the Third Mediterranean countries. This ignorance is an obstacle to the growth of capital flows towards the region, one of the smallest in the world. The reason is the high-risk perception by the foreign investor, due to the failure to notice the realities of its markets and culture. The EU should take them into account, adopting proactive and urgent measures to increase the mutual cultural knowledge and foster entrepreneurial spirit in the Mediterranean.

*Other Considerations.* Security and foreign policy considerations are also significant.<sup>(14)</sup> However, the priorities and perceptions diverge again between the northern and the southern Mediterranean shores. With regard to priorities, the EU's concerns are of a defensive type, while in the southern Mediterranean the main goal is economic development. Unlike Central and Eastern Europe where security issues pertain to strong threats, the security threats perceived by the EU respecting the southern Mediterranean, are of a soft type. The perceptions of southern Mediterranean countries

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<sup>(14)</sup> On this issue, see Soltan (1999) and Calleya (1999a, 1999b and 1998).

are nurtured with its colonial past and fears of western cultural hegemony. In order to face political instability in the southern shore of the Mediterranean, the EU is divided between two approaches. The first is a strategy of stabilization that seeks to reduce instability manifestations. Therefore, it is a *status quo*-oriented strategy. The second one consists of introducing western European liberal values and democratic procedures to modernize the southern Mediterranean countries and break the *status quo*. As already seen, instead of promoting such conflictive measures, the EMFTA may foster gradual political changes through the adoption of the *acquis communautaire*.

The EU has adopted a functionalist approach when dealing with political and security issues in the Mediterranean. The European Commission is proceeding on the economic, low politics dimension of the Declaration of Barcelona. Nevertheless, in the author's view, neglecting the high politics dimension, at least the security issues, is a mistake. For instance, the stalemate of the Arab-Israeli Peace Process blocks the Barcelona initiative, but the EU finds itself unable to intervene in a process monopolized by the US. The setting of a credible and coherent Common Security and Foreign Policy (CSFP) by the EU is a pre-condition to make Barcelona work. In addition, the security dialogue between the EU and its southern partners is being distorted by NATO's Mediterranean Dialogue. Cultural differences also play an important role in this respect. However, given the end of the Cold War, the US may rely less on Israel, Morocco, Turkey and Egypt as strategic partners. This in turn, could imply the political re-orientation of these countries towards the EU (Tovias, 1999a).

In summary, the EMFTA can foster economic stability and political reforms. The economic pre-conditions for EMFTA to be built are met albeit, the political pre-conditions are not. The FTA cannot be considered as a panacea, as far as stronger political action is needed for southern Mediterranean countries to undergo political reforms. In addition, the Arab-Israeli conflict impedes the spillovers of increased trade acting as a trust-generating measure. The need for the Barcelona Process to be conceived as open regionalism, both in economic and political terms, cannot be overemphasized. If not, there is the risk of the EU's initiative furthering fragmentation of the Mediterranean's southern shore on economic and political matters through a political and economic "hub-and-spoke" mechanism.

### **Vertical Integration: South-South Regional Integration in the Mediterranean**

Three regional initiatives within the southern shore of the Mediterranean may be distinguished: the Arab Maghreb Union (AMU), the Arab Free Trade Area (AFTA) and the FTA between Turkey and Israel. Some authors (e.g. Tovias, 1997) have also stressed the potentially beneficial effects of Mashrek-Israeli regionalism. As has been shown by the literature, intra-regional trade is very low within the southern Mediterranean area. However, the trade potential of intra-MENA (Middle East and North Africa) countries is a controversial issue, with some authors thinking about high trade potential while others are more sceptical.<sup>(15)</sup>

The best developed effort in subregional integration is the AMU. In the Maghreb, the question is whether EMFTA causes conflict with AMU. Firstly, the paralysis of

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<sup>(15)</sup> See Escribano and Jordàn (1999) for a survey on the literature and an approach based on gravity equations and trade intensity indices.

AMU is mainly a political issue. The Algerian-Moroccan bilateral relations have been very difficult due to the Western Sahara problem. Once this problem has been set apart from regional integration in the Maghreb, the AMU started to be more credible, even if the economic differences among countries proved too large. The whole design of AMU has been very ambitious and quite unrealistic. In the commercial area, the Maghreb countries negotiated tariff reductions on a product-by-product basis, following the practice of many developing countries' integration efforts. This system has a poor record and intra-Maghreb trade represents a small part of the countries' trade, as may be seen in Table 1. The political difficulties increase with the closing of the Moroccan-Algerian frontier and Morocco's refusal to take over the presidency of AMU.

**Table 1. Direction of Maghreb Countries Trade, 1998**

EXPORTS (%)												
	Algeria	Libya	Mauritania	Morocco	Tunisia	AMU	Mashrek	GCC	Turkey	MENA	EU	
Algeria	-	0.07	0.20	0.64	0.36	1.27	0.05	0.01	5.35	6.68	62.72	
Libya	0.07	-	0.01	0.33	2.17	2.51	1.67	0.01	4.42	8.62	81.81	
Mauritania	0.00	0.00	-	0.20	0.20	0.40	0.80	0.00	0.20	1.40	62.73	
Morocco	0.24	2.20	0.22	-	0.88	3.54	1.42	1.60	0.71	7.90	58.63	
Tunisia	0.42	3.51	0.03	0.64	-	4.61	0.71	0.78	0.90	8.32	79.78	
IMPORTS (%)												
	Algeria	Libya	Mauritania	Morocco	Tunisia	AMU	Mashrek	GCC	Turkey	MENA	EU	
Algeria	-	0.06	0.00	0.12	0.26	0.44	1.14	0.12	5.35	7.05	64.66	
Libya	0.18	-	0.00	2.27	4.49	6.94	2.65	0.06	2.13	11.88	64.83	
Mauritania	4.30	0.17	-	1.89	0.34	6.71	0.69	0.52	0.17	8.09	60.24	
Morocco	0.91	0.30	0.01	-	0.45	1.67	0.62	4.22	1.35	10.18	55.00	
Tunisia	0.49	1.88	0.01	0.59	-	2.97	0.00	0.78	1.75	5.53	69.28	

Source: IMF, *Direction of Trade Statistics, 1999*. Washington D.C.

N.B. MENA is comprised of Maghreb, Mashrek, Israel, Turkey, GCC, Iran and Iraq.

Therefore, the failure of AMU does not have a great deal to do with the EMFTA. Moreover, the rules of origin's cumulation within AMU is by far more generous than for eastern Mediterranean countries, so that intra-regional trade is not penalized by the EMFTA in this concern. However, the "hub-and-spoke" mechanism still represents a risk towards the strengthening of AMU, as far as AMU countries have not yet reached a comprehensive FTA among them, even if some bilateral agreements have recently been concluded between Tunisia and Morocco, the two countries involved in the EMFTA. The AMU can be further fragmented by the fact that Morocco and Tunisia belong to the EMFTA, whereas Algeria, Libya and Mauritania do not. This risk calls for a new push to AMU integration efforts (Oualalou, 1996). Two strategies should be followed to overcome such a risk. Firstly, the negotiations with Algeria for the establishment of an FTA with the EU need new impetus. Secondly, the AMU should be strengthened to compensate for the possible trade diversion, but also the political diversion effects of the agreements signed by Morocco and Tunisia.

From a security and foreign policy perspective, both Morocco and Algeria still dispute hegemony in its regional context. Some degree of political tension also exists between Tunisia and Libya. This is another element of the fragmented nature of the Maghreb. Moreover, while Tunisia, Morocco and Mauritania pertain to NATO's

Mediterranean Dialogue, Algeria and Libya do not, albeit Algeria has become an observer. Furthermore, the Algerian situation is not of great help, as far as Morocco fears the contagious effect that Islamic fundamentalism may have. As stressed by Vasconcelos (1999), the reconciliation between Morocco and Algeria may have the same significance for AMU that German-French or Argentine-Brazil rapprochement for EU or Mercosur, respectively. The problem is that political systems considerably diverge within AMU, with Morocco pursuing political reforms at a faster pace, especially after Mohammed VI's accession to the throne. On the other hand, Algerian political reforms stagnates in spite of Butleflika's efforts.

In this context, a moderate trade potential seems to be likely among Maghreb neighbors, as shown by gravity equations (Ekholm, Torstensson and Torstensson, 1996) and trade intensity indices (Escribano and Jordan, 1999), which is more important for Algerian-Moroccan trade. The potential for economic relations would be higher if labor could freely circulate across frontiers and if transport infrastructures were made ready to withstand intra-regional trade. Therefore, the economic pre-conditions for regional integration to succeed have been to some extent, fulfilled. Nevertheless, the political pre-conditions are barely matched. If AMU is to be strengthened, the Algerian-Moroccan rivalry should first be solved through political means.

If regionalism is only barely succeeding in the western Mediterranean, the situation is much worse in political terms when moving eastwards. The Eastern Mediterranean holds the two major economic and political powers of the Mediterranean's southern shore, i.e. Israel and Turkey. As previously pointed out, Turkey's GDP almost equals Mashrek plus Maghreb's GDP, while Israel's GDP equals Mashrek's, and is slightly smaller than Maghreb's GDP. From a foreign policy perspective, both countries maintain strong relationships with Western Europe and the US. Turkey is a NATO member and it maintains good political relations with the US. It is a candidate country to join the EU with which it has already created a custom union. Israel is the main ally of the US in the region, with which it has an FTA, and it is a partner of the EU. In the security field, both countries possess the most powerful armies within the region. Moreover, Israel and Turkey agreed on a bilateral FTA recently.

There is no room in this paper to tackle such complex realities as those which prevail in Israel and Turkey. Suffice it to say that in relation to regionalism, both countries have asked to enter the EU. Both of them have been rejected. Unlike Israel, which is not a European country and therefore not qualified to join the EU following the Treaty of Rome, Turkey has not qualified for accession on political grounds. The Turkish issue is of great importance. There are fears that the Euro-Mediterranean Partnership may discriminate against Turkey, given the high level of EU-Turkey bilateral relations.

The Israeli situation is unique from a regional perspective. Its economy has been isolated from its regional context due to the Arab boycott, therefore impeding Israel from fully profiting from its high level of industrial development. Political and security factors prevent Israel attaining FTAs with its neighbors, in spite of these being considered as its "natural trade partners" on economic grounds. As Tovias (1997 and



1999a) has argued, and from an economic perspective (high Arab-Israeli trade potential as measured by gravity equations and trade intensity indices), a Mashrek-Israel FTA will reap major gains for its participants. However, given the political and security context, Tovias has proposed the normalization of Arab-Israeli trade relations as a first step. The point to be stressed is that political costs for Arab countries may outweigh economic gains when fostering trade with Israel. Moreover, such an initiative may plausibly imply economic costs for Mashrek countries, as far as non-Mashrek Arab countries may decide to somehow retaliate against Mashrek countries breaking the boycott. In addition, many Mashrek countries host significant Palestinian populations, receive important investment flows from Arab countries in the Persian Gulf and are the origin of significant migration flows to these countries.

When dealing with regionalism among Mashrek countries and Israel, economic pre-conditions are matched (high trade potential), but that foreign policy and security pre-conditions are not. Whatever economic benefits may be drawn from increased trade within the region, either by normalization of trade or by further integration, these will remain on the hypothetical domain without a previous political spur on the peace process. It is difficult to envisage Syria, or even Egypt, trading freely with Israel without any significant advance in the peace process. Therefore, it is doubtful that any progress based on economic, low-politics instruments will be effective in building confidence among participants in the peace process. The political circumstances simply block the mere normalization of trade relations posed by Tovias (1997 and 1999a).

If some Moroccan-Algerian political rapprochement is needed in the Maghreb to permit AMU to proceed with sub-regional integration, for Mashrek Arab countries to dismantle the boycott on Israel, substantial concessions on the part of the latter should be granted in the peace process. In fact, the pre-requisite to attain sub-regional integration in the southern shore of the Mediterranean is the rejection towards conducting 'power politics' and pursuing regional hegemony. Without such a political will, mercantilist trade policies are bound to prevail. This political will is far more probable to emerge in the Maghreb than in the eastern Mediterranean, as far as the security threats and the political animosity are greater in the latter, due to past open conflicts. In addition, cultural and religious differences play an important role in impeding rapprochement between Israel and Mashrek Arab countries. When considering the political (negative) externalities of conducting free trade with Israel by Arab countries, Tovias' argument is not so straightforward. To put it in a well-known formula, the trade-off is something like trade-for-territories. If a political threshold is not attained, trade will not occur. Only trade stemming from prior political normalization may further act as a confidence-building measure.

The last initiative to be considered is the Arab Free Trade Area (AFTA), that may be thought of as a response to both the Euro-Mediterranean and Turkey-Israel FTAs. The AFTA is led by the Arab League, with 18 out of its 22 members signing an agreement that provides for a reciprocal elimination of tariffs by year 2008. However, little progress seems to be occurring, as happened with former attempts at an Arab level. The problem with AFTA is of both economic and political nature. Due to low trade potential (Ekholm, Torstensson and Torstensson, 1996; Escibano and Jordan, 1999) among many Arab countries, integration may lie mainly in non-trade issues, like labor migration. However, some authors have expressed a different perspective, being more

optimistic about Arab trade prospects (Bolbol, 1999; Hadhri, 2000). Historical and political factors also seem to prevent AFTA succeeding, so that the political pre-conditions are not met either (Kalaycioglu, 1996). In this respect, some authors have proposed that countries from the GCC form an FTA with Mediterranean Arab countries that have already signed association agreements with the EU in order to set up a more realistic and modest initiative (Calleya, 1999a). At present, AFTA remains in the wishful thinking, 'virtual regionalism' domain.

However, an AFTA may be built gradually by establishing bilateral FTAs between different southern Mediterranean countries, e.g. FTAs signed between Israel and Turkey, Tunisia and Morocco, Tunisia and Egypt or Tunisia and Jordan. As happened with the rise of free trade in the nineteenth century with the Cobden-Chevallier Treaty, the cumulation of bilateral FTAs may lead to a future multilateralization of these agreements in the southern shore of the Mediterranean. Hadhri (2000) has stressed that Moroccan-Tunisian and Egyptian-Tunisian bilateral trade has grown significantly after reaching the FTAs. This is a more realistic approach than the negative lists adopted by the All AFTA, from both the political and the economic perspective. Many authors, like Sideri (2000), have pointed out how the inadequacy of regional infrastructures and institutions, as well as the differences within the Arab countries' social and economic systems, jeopardize its economic integration. Sideri has also called for new vigor in Arab regional integration as a counterweight to the asymmetry of EU-Mediterranean relations. Again, the political variable is crucial if Arab economic integration is to be developed.

### **Compatibility Between Vertical and Horizontal Integration in the Mediterranean**

Some authors, both from the northern (e.g. Sideri, 2000) and southern shore of the Mediterranean (e.g. Bolbol, 1999) have stressed that southern Mediterranean countries should pursue vertical integration to alleviate their dependency on EU markets. To a certain extent, these approaches seem to advise a strengthening of intra-regional trade in the south at the expense of EU-Mediterranean trade relations. In the author's view, both strategies are not mutually inconsistent, but rather complementary.

When dealing with the alleged incompatibility between EU-Mediterranean and Arab integration, some clarification is needed. Firstly, if the recent wave of regional integration in the southern shore of the Mediterranean is considered as a way to be further integrated in the world economy, an FTA with the EU will integrate about 60% of Mediterranean trade. On the other hand, an AFTA will affect only 10% of it. In the absence of political will towards south-south integration, the relevant question is not whether the Euro-Mediterranean initiative is compatible or not with Arab integration. In this situation, vertical integration is the only realistic option, as far as multilateral or unilateral trade liberalization has proven to be very difficult. Furthermore, one may wonder if the Euro-Mediterranean initiative may foster economic integration within the southern shore of the Mediterranean basin. A more pragmatic approach is to analyze by which means vertical integration may support a horizontal one (and not just impeding EMFTA harming AFTAs). In fact, the EMFTA provides for a multilateralization of the bilateral agreements in the year 2010. The Barcelona Declaration explicitly assumes the need to foster sub-regional integration in the southern shore of the Mediterranean.

In this concern, the Spanish and Portuguese experience with regional integration may be recalled. Before entering the EEC in 1986, and in spite of geographical proximity, trade flows between the two countries were very low. In 1985, Spanish exports to Portugal represented 2.2% of total exports, while Spanish imports from Portugal represented 0.8% of total imports. In 1998, the respective figures were 9.3% and 2.8% throughout this period. Spanish exports to Portugal rose from \$542 million to \$10,021 million and Spanish imports from Portugal rose from \$237 to \$3,615 million (IMF, DOTS). Political differences and historical rooted mistrust have impeded the development of Spanish-Portuguese bilateral trade. However, as soon as both countries were subjected to the EEC *acquis*, not only trade, but full economic relations, started to develop very quickly. Attempts to achieve prior economic integration between the two Iberian countries to compensate for asymmetric trade *vis à vis* the EEC were unsuccessful due to these political and historical difficulties. As soon as the two economies overcame these non-economic obstacles, trade relations prospered.

The circumstances are not the same for the Mediterranean as they were for the Spanish and Portuguese cases, since for these countries, entering the EEC meant the automatic liberalization of bilateral trade. However, EMFTAs may act as a catalyst for AFTAs. In economic terms, EMFTA may have externalities in the horizontal integration dimension. For EMFTA to be functional, it is necessary to set up modern, transparent customs rules, the implementation of best practices in harbors and airports, the introduction of efficient administrative procedures, etc. From a political economy perspective, once the bulk of the trade liberalization occurs (and this is with the EU), few economic reasons will remain to continue opposing intra-regional trade liberalization. For the political climate towards Arab integration to evolve, these developments will spill over the whole trade flow, including intra-regional ones.

As has been previously argued, regional integration may pursue broader political objectives as support for modern, democratic socio-political market economic systems by linking onto a market economy and democratic space like the EU (as happened with the Central and Eastern Europe countries). These kinds of externalities will hardly stem from south-south integration and may have important benefits in the economic sphere. Neither will the southern countries complement FTAs with financial assistance or with generous debt exoneration. Moreover, Euro-Mediterranean relations as conceived in the Barcelona Declaration, assume the need to establish a cultural dialogue to foster trust and mutual respect across the Mediterranean. This is an important issue when related to migration or to investment flows, i.e. the rise of xenophobia in many European countries or the rise of fundamentalism in the southern Mediterranean countries. Cultural differences may act as higher transaction costs. European investors usually say that investing in the Arab World needs a lot of time and a good knowledge of Arab cultural peculiarities. Cultural dialogue may also inhibit the surge of xenophobia in Europe, which is an important obstacle to higher immigration flows from the south. So, when other economic dimensions are included, e.g. financial cooperation, migration and investment, the Conference of Barcelona seems to be instrumental in the development of the southern Mediterranean region.

One of the shortcomings of the Barcelona Conference is the absence of Gulf countries. A clear European policy towards the Gulf does not exist to date. The Gulf region is perceived by the EU as being a political, security and economic US monopoly.

Diplomatic initiatives are taken only at a member country level. The differences between the US and, say, France towards Iran or Iraq, are a controversial issue in transatlantic relations. The setting of a framework for economic and political cooperation between the EU and the Gulf countries could facilitate further integration at the Arab level. But this is difficult and long range task.

The strengthening of regionalism in the Mediterranean presents some economic problems as already pointed out. These problems have been treated extensively in economic literature, but are still insufficiently related with political issues. This relationship between trade and political liberalization has yet to be analyzed properly. Furthermore, in the Mediterranean, the political dimension is the crucial one. When including political considerations into the analysis of regionalism in the Mediterranean, policy implications differ widely. In doing so, the author wishes to highlight some critical issues necessary for EMFTA to foster Arab integration.

Firstly, concerning EU's Mediterranean initiative as has been formulated in the Barcelona Declaration, the EU is mainly interested in stabilizing its southern border. The democratic syllogism is as follows: promote economic development; then, democracy will arise from spontaneous generation. This causal relationship between development and democracy is uncertain in the Mediterranean. The author, being Spanish, cannot approve of waiting 45 years for democracy to come about, as happens with EEC low profile policies towards Franco's Spain. On the contrary, it is the author's belief that democracy promotes development, equality in income distribution, education, institution building and therefore increased social stability (Sen, 1999). Instead of thinking in a causal way, it is perhaps better to pursue a virtuous circle on which democracy and development are mutually reinforcing. For the EU's Mediterranean policy, this means looking further into the political reforms, perhaps by setting a premium for fast reformers. However, EMFTA implies a certain degree of modernization for southern societies, as far as it means adopting the *acquis communautaire* and liberal trade policies. This in turn, may foster both the state reform and add additional pressure to introduce progressive fiscal systems. The pace at which political reforms will proceed, remains an open question. However, this author thinks that the EU should adopt a closer compromise regarding democracy and human rights, a declaration of the authors' support of the liberal view of international relations. All these developments, being related mainly with EU-Mediterranean integration, may also foster intra-regional integration.

Secondly, the political and security circumstances in the southern shore of the Mediterranean are rather unfavorable for south-south regionalism to emerge. These countries still apply 'power politics' based on a realist conception of international relations. The logical consequence of this in the economic arena is the implementation of mercantilist, protectionist policies. For regionalism to appear in the southern shore of the Mediterranean, hegemonic regionalism should be abandoned. Furthermore, this fact makes the armies more powerful, impeding the political reforms from proceeding and diverting resources towards defence spending, thus increasing the social cost of hegemonic regionalism. Therefore, regionalism in the Mediterranean's southern shore, even if virtual, has positive externalities as far as it maintains the channels of dialogue open. In this respect, it is very important to shape the Euro-Mediterranean initiative so that it fosters southern regionalism, or at the very least, does not damage it.

Thirdly and closely related with the previous point, open conflict inhibits any externality coming from trade or economic integration. The Arab-Israeli Peace Process is the crucial point for regionalism to succeed in the Middle East. In a similar way AMU's future depends on Algerian-Moroccan reconciliation. Peace is a pre-condition that cannot be replaced by any economic instrument. In the Middle Eastern Peace Process, the EU is unable to do anything, as it is dependent on US decisions, as well as in other security issues, e.g. former Yugoslavia, Kosovo and Iraq. The stage of civilian power has to be surpassed in order for the EU to become a military and political power. Thus, it may be able to play a more active role in a subject such as the Middle Eastern Peace Process, which holds significant geostrategic challenges for Europe.

Last, but not least, the EU's economic role has to be reconsidered. The Common Agricultural Policy (CAP) remains the main obstacle towards wider access by southern Mediterranean countries to European agricultural markets, where they are competitive. However, the answer is not just a matter of liberalizing, since the CAP is a strong element for EU's internal political cohesion. The Euro-Mediterranean initiative's main defendants within the EU, are precisely the European Mediterranean countries, which are the most likely to be hurt by agricultural liberalization. Some kind of Mediterranean agricultural pact should be attained if this problem is to be solved. If southern regionalism is to be fostered, the 'hub-and-spoke' mechanism should be prevented through generous cumulation rules of origin. Funds regarding regional integration should be increased. Only 10% of MEDA aid by the EU is directed towards regional projects.<sup>(16)</sup> The whole MEDA funds should be expanded to impede further discrimination between the generous funds given to eastern and central Europe and the small aid flows directed towards the Mediterranean. This argument is also valid for the EU member country policies towards the Mediterranean. EU countries tend to think of development assistance and political cooperation on a country-by-country basis. For instance, Spain is mainly devoted to cooperation with Morocco, France with Algeria and Morocco, Italy with Libya, UK with Egypt, and Germany with Turkey. The scope of development and political cooperation is national, not regional. These attitudes have to change and start to favor regional projects and regional political, scientific, social and academic networks.

The author does not find any logical contradiction between Arab and EU-Mediterranean integration. Indeed, the two processes are rather complementary. If one of them appears to be blocked, then the parties may go on with the other. Each integration process has different political implications. The EU-Mediterranean process may help modernize political, social and economic systems. The All AFTA may help build larger markets and to inhibit power politics in the region. The Barcelona Declaration has opened the floor for discussion on Arab integration. If, as a result of the challenge of the EMFTA, Arab countries are pushed to develop a pragmatic approach towards Arab integration, this may well be one of the main benefits of the Barcelona Process.

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<sup>(16)</sup> MEDA is the EU aid program towards the Mediterranean countries.

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**Readers Forum**

# On the Optimum Investment Duration: Comments on Onyeiwu's Article<sup>(1)</sup>

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## Introduction

In a recent article in this journal, Onyeiwu (2000) presented a set of results on foreign direct investment and capital outflows in the Arab world. The paper has three applied sections: a descriptive section on “foreign direct investment, capital formation and economic growth (pp. 29-36); another descriptive section on “the dynamics of capital outflows from the Arab world” (pp.41-45); and an empirical section on “macroeconomic fundamentals and capital outflows from the Arab world” (pp.45-53). All three sections provided useful information and results on issues relating to foreign direct investment and capital outflows in the Arab region.

In a section entitled “determinants of capital flows in the Arab world: a theoretical discourse” (pp.36-41), Onyeiwu notes that “the stock of FDI in a country depends on the dynamics of inflows and outflows. Therefore, it is crucial to understand the nature of these dynamics, if one is to offer appropriate policies for boosting FDI in the Arab world”. This we believe is a sensible formulation. To address the issue of the dynamics of capital inflows and outflows, he proceeds to develop a model of what he calls the “optimum investment duration”. The model is presented in equations (5)-(12) of his paper.

The objective of this comment is to show that the so called model of optimum investment duration, as presented by the author, is flawed. Section (2) comments on the definition of capital flows adopted by the author, while section (3) discusses the model.

## II. On Capital Flows:

Onyeiwu launches his “theoretical discourse” by providing definitions for the components of capital inflows (denoted as CI, and defined by equation 5) and capital outflows (denoted CO, and defined by equation 6). A correct reading of the text shows that equations (5) and (6), which are formulated in functional forms, are, as they should be, definitional and hence are summations of components, rather functions of the components. Indeed, the functional notation itself is confusing since the author writes  $CI = f(\sum \text{of CI components})$  and  $CO = f(\sum \text{of CO components})$ ! The author is also not very clear about the level to aggregation on which the components are defined: the foreign investor or the country. This is true from the definition of the symbols used for the

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<sup>(1)</sup> Onyeiwu, S., (2000), “Foreign Direct Investment, Capital Outflows and Economic Development in the Arab World”; Journal of Development and Economic Policies; vol. 2, no. 2

various components of capital flows as well as for the specification of the functional forms for the capital inflows and capital outflows. Despite this problem, we note that the components of capital inflow are specified as export earnings (of the foreign investor), conserved foreign exchange (as a result of reduction in imports at the country level), equity capital (of the foreign investor), and foreign aid (the country level). Similarly, we also note that the components of capital outflow are specified as including imported capital goods, imported raw material, imported technical skills and repatriated profits. According to the author, FDI will be said to have contributed positively to capital formation if net FDI (defined as CI minus CO) is positive.

This would not have been an important observation to make had it not been for the fact that the author uses these definitions on p. 38 to specify the behavior of capital outflows and capital inflows over time, presumably to study the dynamics involved. In the perusal of the definitions of the components, and the specification of the functional forms, the author is clearly talking about the “foreign investor”. In this case, however, it is not clear how would foreign aid be considered as part of capital inflows.

### **III. On the Model of Optimum Investment Duration:**

Following the definition of CI and CO the author proceeds to develop his model of optimum investment duration. In equations (7) and (8) the author formulates an optimization problem for an Arab country (!) that wishes “to maximize the present value of net FDI, subject to the condition that its cumulative utility during the life-time of the investment remains at a given level”. One obvious requirement for such optimization problems is for the author to tell the reader about the choice variables available to the “Arab country”. Another obvious expectation is to explain the structure that links the constraint set (in this case the utility function) and the capital inflow and outflow variables that appear in the objective function to be maximized. The author does not do this and for good reason. He does not use the formulated problem any further. So any reader can forget about equations (7) and (8) without losing anything.

Immediately following the abandoned optimization problem the author launches a sensible discussion about the likely time behavior of capital inflows and capital outflows by invoking reasonable stories about the likely behavior of the underlying components. The ultimate objective is to formulate a downward sloping function for the capital inflows and a quadratic function of the capital outflows function. We hasten to note that this could have been done immediately following the definitions provided by the author without going through the so-called optimization problem of the “Arab country”. The two functions that appear as equations (9) and (10) in the author’s paper are reproduced below:

$$(9) \text{ CI}(t) = a + b t ; \text{ where } b < 0;$$

$$(10) \text{ CO}(t) = a^* + b^* t + c^* t^2$$

In his equation (11) the author incorrectly argues that he requires  $\{b^* + 2 c^*\}$  to be positive. This is incorrect because it will not allow his CO(t) to “take the shape of an inverted U” (p.39). Indeed a better way of formulating the behavior of the two functions over time would be as follows where the starred equations are our alternatives to those appearing in the original.

$$(9^*) \quad CI(t) = a - b t,$$

$$(10^*) \quad CO(t) = - a^* + b^* t - c^* t^2$$

with the reasonable restrictions that all the coefficients are positive (a, a\*, b, b\* and c\*). Had he done so, he would have saved himself the trouble of searching for the conditions under which his optimum investment period would be positive (p.40).

The author then proceeds to his ultimate result of the “optimum investment period”, which we believe is also an ultimate mistake. He argues, rather mistakenly, that at the intersection point of equations (9) and (10) “the slope of a tangent to the capital outflow function is exactly equal to the slope of the capital inflow function.. Setting the slopes of the capital inflow and capital outflow functions to each other, it is straightforward to show that  $t^* = \{b - b^*\} / 2c$  “ (p.40). This is what we mean by the ultimate mistake. The intersection point is defined by the equality of (9) and (10) and not by their slopes. Indeed at the intersection point in the author’s figure (1) the slope of the CO(t) function is negative while that of CI(t) is positive!

Using our reformulated equations (9\*) and (10\*), the correct solution for the time period during which capital inflows will equal capital outflows, call it  $t^*$  as does the author, is given by:

$$(11^*) \quad a - bt = - a^* + b^* t - c^* t^2$$

This is a quadratic in t that can be written in regular format as:

$$(12^*) \quad c^* t^2 - \{b + b^*\} t + \{a + a^*\} = 0$$

As is well known the general solution of this quadratic is given as:

$$(13^*) \quad t^* = \{(b + b^*) \pm \sqrt{[(b + b^*)^2 - 4 (a + a^*) c^*]}\} / 2 c^*$$

This is what the author calls the “optimum investment period”. However, in view of the author’s abandoning the optimization problem, it is not very clear why this is an optimum. The agent in question, the foreign investor, does not seem to be assigned any optimization function!

Similarly, the author talks about a number of equilibrium points, presumably  $t^*$  is among them. It is not clear what concept of equilibrium does he use. Both in the formulation of this “theoretical discourse” and in the analysis, no equilibrium concept was defined.

#### **IV. Conclusion:**

In this comment we offered a reading of Onyeiwu's paper on foreign direct investment in the Arab world which agreed with the descriptive and empirical sections of the paper. We argued, however, that the theoretical section of the paper is flawed in a major way. A careful re-reading of the correct solution to the original problem would not, however, make a difference to the empirical exercise undertaken by the author. It is not clear, however, if the author needed the theoretical discourse anyway.

#### **Reference:**

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