The Political Economy of Governance in the Euro-Mediterranean Partnership

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Working Package 8
New Challenges: Regional Integration

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New Challenges: Regional Integration

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1. Introduction

Since the 1950s, initiatives to foster regional integration within the Middle East and North Africa (MENA) have repeatedly failed. This working package considers regional integration from a number of perspectives. It examines the reasons for the failure of initiatives aiming to foster regional integration with a view to identifying how best to foster regional integration in the future.

Because the political project of MENA economic integration has historically focused on intra-regional merchandise trade, the first working paper in this series examines integration from the standpoint of merchandise trade. The paper analyses trade flows between Mediterranean Partner Countries (MPCs) and finds that when the low absorptive capacity of MPC markets is taken into account, levels of intra-regional trade are comparable with those in other regions. Little evidence is found to support the widespread notion that levels of intra-trade are disproportionately low.

Moreover, it is emphasised that there are a number of major structural constraints to intra-regional trade. These include the small absorptive capacity of MPC markets, similarities in factor endowments which limit the potential for inter-industry trade and a lack of a diversified export base which limits the potential for intra-industry trade. It is argued that in such a context, countries outside the region are likely to continue to play an important role as trade partners with MPCs. It is concluded that there is little scope for increasing integration between MPCs through increased merchandise trade.

The second working paper looks at intra-MENA integration from the perspective of factor movements. It is argued that factor movements of labour and capital are the most important factors in shaping economic integration and relations between MENA countries. Importantly, the high levels of factor movements within the region may act as a substitute for trade and undermine the basis of trade flows.

This paper points out that MENA can be divided into 2 sub-regions from the perspective of factor endowments. The first region is comprised of the Levant and North Africa and is rich in labour and poor in capital. The second is the Gulf, which is rich in capital and poor in labour. Capital flows from the Gulf to the Levant/North Africa and labour flows from the Levant/North Africa to the Gulf have led to a high degree of economic integration between oil-producing MENA countries and non-oil producing MENA countries. Thus, one can speak of integration between MENA economies if the oil-producing nations of the Gulf are incorporated into the analysis.

Finally, the third paper in this series seeks to draw attention to the role that cross-national common economic infrastructure projects can play in fostering MENA and EMP economic integration. It looks at the potential of energy cooperation for fostering regional integration in the Euro-Mediterranean Partnership by identifying regional energy dependencies, the key actors in both sides of the Mediterranean, their preferences, the existing institutional cooperation framework and their restrictions.

The paper applies the *Markets & Institutions (M&I)* approach from the Clingeandel International Energy Programme (CIEP), which positions states according to their behaviour on an axis ranging from political state-driven extreme ("*regions and empires*") to an economic, market-driven extreme ("*markets and institutions*"). The core hypothesis is that energy producers and consumers on both sides of the Mediterranean basin have similar preferences and that therefore there should be a strong likelihood for integration.

2. Major Findings of Individual Reports

Paper 1, Lebanon: "The Particularity of MENA Integration"

The fact that the MENA region has historically had low levels of intra-regional merchandise trade in comparison to other regions is often cited in the literature on intra-Arab trade. Nassar and Ghoneim (2002), for example, compare the scale of MENA intra-regional merchandise trade in the late 1990s (7-8%) unfavourably to that of the EU (over 60%), Asia (over 30%) and the Western Hemisphere (around 20%). This consistently low proportion of intra-regional trade has perpetuated the idea that there is a lack of intra-regional trade among Arab countries. However, several authors have challenged the widespread notion that there is a lack of intra-regional trade. For example, Dervis et al (1998) found that when oil is excluded from the trade figures the level of intra-regional trade is comparable to intra-regional exports in Mercosur and ASEAN.

Moreover, it has been argued that the structural features of Middle Eastern economies preclude the high levels of regional integration achieved in other regions. These features include: the negligible absorption capacity of Southern Mediterranean markets; similar factor endowments resulting in a concurrent (rather than complementary) supply structure among these countries; and the Maghreb's proximity to the EU (Escribano & Jordan, 1999). Fischer (1993) argues that because Arab countries have similar endowments in terms of natural resources and factors of production, they share the same comparative advantages. According to traditional trade theory, this limits the potential for inter-industry trade. Moreover, because these countries lack a diversified export base of manufactured goods, there is also limited scope for intra-industry trade.

Others have been more optimistic about the future prospects for increased intra-regional trade. Several authors point out that previous attempts at trade liberalization in the region were bound to fail given the dominance of import-substitution industrialization (ISI) strategies until the late 1980s/early 1990s (Dervis et al, 1998; Zarrouk, 1998). Some authors are optimistic that the region’s increasing adherence to a market and export-oriented growth model is promising for regional trade expansion and integration (Dervis et al, 1998; Zarrouk, 1998). Indeed, there has been a gradual lowering of intra-regional tariffs culminating in the establishment of the Arab Free Trade Zone in January 2005 whereby all Arab products moving among member states have been awarded the status of national goods. This FTA encompasses all 8 of the Arab MPCs.

While work on intra-regional MENA trade published in the late 1990s often expressed optimism about the prospects for increased intra-regional trade, more recent literature on intra-regional trade often notes that economic liberalization has failed to produce a major increase in intra-regional trade. This literature has often focused on the persistence of non-tariff barriers (NTBs) and restrictive behind-the-border policies. Despite the significant lowering of tariff barriers, many of these countries have retained considerable import restrictiveness through NTBs and restrictive behind-the-border policies.

This paper’s analysis of the IMF’s Direction of Trade Statistics found that over the past five years intra-MPC trade has been increasing at a much faster rate than MPC trade with the EU, or MPC trade with the world as a whole. This suggests a trend towards increased regional trade integration which is especially striking when Israel and Turkey are excluded from the calculations. However, it is important to note that the very high levels of growth partly reflect the fact that trade between these countries started from a low base. The paper also finds that MPCs do trade more with each other than would be expected on the basis of their weight in world trade and that there are two distinct trading blocs among Arab MPCs corresponding to the Maghreb and Eastern Mediterranean regions.

Finally, one of the most noticeable trends in intra-MPC trade since 2000 is the significant decline in Jordan’s export intensity to the region which results from the huge volume of trade *creation* with the US during this period. This finding points to the importance of extra-regional markets for export-growth among MPCs. Escribano and Jordan (1998) have noted what they describe as an “obsession” with regional integration among MPCs which distracts from the potential importance of extra-regional export markets to these countries. Indeed, the US looks set to become an increasingly important trading partner for a number of MPCs with the Morocco-US Free Trade Agreement having entered into force at the beginning of 2006 and an impending Egyptian free trade agreement with the US.

Paper 2, Jordan: "Trade and Regional Integration between Mediterranean Partner Countries"

This paper demonstrates that integration between countries in the MENA region is more about factors of production than about trade or final goods and services. In particular, labour and capital are the most important factors in shaping economic integration and relations between MENA countries. Factor movements of both labour and capital are rather high among countries of the region, and as factor movements can substitute for trade, some feel that such flows undermine the basis of trade within the region. This paper argues that the promotion of factor movements is a better way of achieving regional integration than trade.

Importantly, in discussing the role of factor movements in fostering intra-MENA integration, one cannot consider the MPCs separately from their oil-rich neighbours in the Gulf. The large amount of oil in the Gulf countries of the MENA region shapes the social, economic and political development both in the oil producing and non-oil producing nations and differentiates this region from others in the world. The paper points out that the MENA region can be divided into 2 sub-regions. The first is comprised of the Levant and North Africa, which are rich in Labour and poor in capital whereas the second, the Gulf, is rich in capital, mainly oil revenues, and poor in labour. According to general economic theories, capital will move to the region with higher margin productivity of capital and labour will move to the region with higher margin productivity of labour. In other words, labour will move to the gulf and capital will move to the Levant and North Africa.

With regard to the movement of capital, the current oil price boom is a major factor driving integration between MENA states because of the investment of oil revenues by oil-producing countries in non-oil producing countries. The paper notes the high levels of investment from the Gulf in various non-oil producing countries such as Jordan, Lebanon, Morocco and Sudan.

Labour mobility also plays an important role in driving intra-MENA integration. Because of the high rates of unemployment in the region and the rapid growth of the labour forces, migration in MENA plays an important role in shaping the MENA labour mobility. Most labour migration in the region has mainly been driven by economics – specifically, the huge gap in wages between sending (non-oil) and receiving (oil-producing) economies. Labour force interdependence creates a complex pattern among countries in the Middle East. Oil-rich countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) must import two-thirds of their labour force, including 80% of their professional and technical workers. These migrant workers come from Egypt (60%), Jordan, Yemen, Sudan, and South Asia, and the money they send home is a major factor in the economies of their native lands (Keller & Nabli, 2002). Indeed, Egypt, Morocco, Lebanon, Jordan and Yemen are among the main beneficiaries of worker remittances flows in the world. High levels of labour migration and movements between MENA states can act as a clear factor for integration.

This particular type of regional integration has profound ramifications for economic stability in the region. Gulf economies are dependent on oil prices which are set by international markets and those MENA countries which are poor in capital will end up being dependent on the capital of the Gulf countries. This double dependency makes the MENA region vulnerable to international shocks, affects the political and economic decisions made by the regimes and might even lead to instability in the region. Indeed, Jihadist forms of Islamism in the Arabian Peninsula were strengthened by the economic recession that Saudi Arabia and other Gulf countries suffered from after the Desert Storm campaign and the decrease in oil prices which affected the ability of many governments to provide the same quality of social services in the Gulf and other countries. Moreover, this particular form of integration leads to a situation whereby countries importing labour will end up having political leverage on countries exporting labour.

The paper concludes that economic integration in the MENA has never been about trade of final goods and services in the traditional sense of integration (such as in the EU) but rather has been about factor movement. Whereas the lack of a diversified merchandise export base in MENA limits opportunities for integration through trade, complementary differences in factor endowments between oil producing and non-oil producing economies facilitates integration through factor movements. Thus, although the application of traditional integration theories leads to the conclusion that the MENA region is not integrated, an analysis based on factor movements suggests the opposite.

Paper 3, Germany: "The Role of Energy for Regional Integration in the EMP: Strengthening Institutions"

This paper seeks to draw attention to the role that cross-national common economic infrastructure projects can play in fostering MENA and EMP economic integration. It looks at the potential of energy cooperation for fostering regional integration in the Euro-Mediterranean Partnership by identifying regional energy dependencies, the key actors in both sides of the Mediterranean, their preferences, the existing institutional cooperation framework and their restrictions. The paper's core hypothesis is that energy producers and consumers on both sides of the Mediterranean basin have similar preferences and that therefore there should be a strong likelihood for integration.

The pivotal role of energy for fostering regional cooperation and integration in the Euro-Mediterranean Partnership is mentioned in the Barcelona declaration of 1995. In contrast to trading sectors like agriculture, where both sides of the Mediterranean compete, the energy matrix of the Euro-Mediterranean space is - in net terms - complementary. Today the European Union's member states import, as a group, 13% of their oil and 20% of their gas consumption from the MPCs. Some MPCs play a major role as transit countries for energy coming from the gulf and Caspian region. In particular, Algeria, Libya and Egypt have the potential to become main suppliers of both gas and oil to Europe, based on their transport advantage. As Kagiannas et al have noted (2003:2668), there are two main reasons for developing a close collaboration between the EU and MPs in the energy sector from the EU's perspective. Firstly, geographical proximity to Europe's southern flank is a crucial factor, given the importance of transit of energy sources from other neighbouring regions, such as the Gulf and Caucasus. Secondly, the cumulative volume of oil and gas reserves in the MPs is an important guarantee of supplies to the EU.

The paper notes that the Mediterranean region presents unique conditions for economic benefit with regard to the proximity between energy producers and energy consumers. However, producing (exporting), consuming (importing) and transit countries might have different interests. As the IEA notes (2005:51), "*Mainly, concerns among consuming countries about security of supply are matched by those among producing countries about security of demand. Together, consumer and producer governments can improve the mechanisms by which they seek to reconcile their interests and achieve mutually beneficial outcomes*". Against this backdrop, the Energy Charter Treaty was developed as the international instrument for better coordination, but until October 2007 Turkey was the only MPC which had signed it.

Compared with the ambitious goals of the Barcelona Declaration and of the following Energy Ministers declarations, progress in achieving EuroMed energy market integration has remained low. A mapping of the interests and preferences within the EU and the MPCs shows that countries have diverse positions leading some countries to pursue a bilateral approach on energy despite the existing EuroMed framework. The paper concludes that there are three main obstacles which hinder integration: heterogeneous preferences within the European Union itself, an insufficient institutional framework and the negative investment field in the MPCs.

It is hypothesized that a) Euro-Mediterranean states whose energy sector is primarily state dominated are pushing for energy cooperation in the Euro-Mediterranean Partnership, and b) due to current political and economic conditions, there is a window of opportunity for the European Commission for exploiting agency slippage and fostering regional energy integration. However, the Commission's chosen "*market & institutions*" approach might not address the demands of both European member states and Mediterranean Partner Countries, causing bilateral actions from both sides which undermine the coherence and efficiency of EuroMed energy integration.