

TRADE ARRANGEMENTS IN THE
MIDDLE EAST & NORTH AFRICA

REPORT OF
THE MIDDLE EAST
ECONOMIC STRATEGY GROUP

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A Project of
THE U.S./MIDDLE EAST PROJECT of the
COUNCIL ON FOREIGN RELATIONS

November 12, 1996

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PREFACE

The Middle East Economic Strategy Group [the "Group"] was established in late 1994 as an outgrowth of the consultations at the Casablanca Economic Summit. Meeting under the auspices of the *U.S./Middle East Project of the Council on Foreign Relations*, the Group submitted a Report to the Amman Summit in 1995 dealing largely with financial and institutional arrangements to support economic development in the region. The Group thereafter was asked to continue its collaboration for an additional year, complementing its earlier work by more closely focusing on trading arrangements.

To facilitate its work, the Group enlisted the assistance of a number of experts familiar both with the region and with trade policy more generally. A list of those experts and the subject of their papers appear as an appendix to this Report. Drawing upon the work and views of those experts, the Group reached several

broad conclusions and a number of recommendations that it agreed to bring to the attention of the MENA Economic Summit in Cairo. That is the basis for this Report, which members of the Group listed on the back cover have approved.

Contrary to hopes a year ago, economic conditions in Gaza and the West Bank have sharply deteriorated. Those difficult conditions constitute a clear and present danger to the success of the entire peace process. Consequently the Group decided to add to the broader Report an Addendum addressed to that critical problem.

The Group met for over two days in Washington, D.C., to prepare its conclusions and recommendations amid evidence of renewed tension and conflict between Israel and the Palestinian Authority. These events lend special urgency and relevance to our conclusion.

REPORT OF THE MIDDLE EAST ECONOMIC STRATEGY GROUP

Conclusions and Recommendations with Respect to Trade Arrangements in the Middle East and North Africa

The point is often made that a secure and lasting peace in the Middle East must rest upon satisfying the hopes and aspirations of its people for a better life. Economic development — a growing standard of living, widely dispersed — must surely be a principal ingredient of that “better life.” It is that basic insight that gave rise to the formation of this Group and that has animated its work.

In the light of recent developments in the region, we feel compelled to emphasize the complementary point: Economic development, broadly shared, cannot proceed without a reasonably stable and open political environment.

Satisfactory economic development will require a greater degree of interdependence among the regional nations. There must be a willingness to adjust to change. Economic activity in particular sectors will need to be reoriented in the interest of greater gains for nations as a whole and the region at large. Conceptually, it can be demonstrated that shedding isolationist and protective economic policies and opening borders will have strongly beneficial economic consequences. In practice, progress necessarily requires a

leap of faith. There must be confidence that Government policies and agreements will be maintained, that contracts can be enforced, that transnational ventures will be respected and maintained, that benefits will be broadly shared.

Building that confidence inevitably must be a step-by-step process. Success can breed success, and no doubt reinforce political ties and peace. But the process will be strangled in its infancy — with grave risk for all — in the absence of a shared commitment to peace.

The Basic Approach

The Group wishes to reiterate its strong conviction that economic development must rest on a solid foundation of financial stability, disciplined budgets, high savings, and a flourishing private economy within the individual countries of the region. The growing intellectual consensus and evidence of progress in those areas in most of those countries is welcome. But it is also clear in several countries of the region the process is in its infancy.

In that context, we emphasize the essential role that a more open trading

system within the region and with the outside world must play over time. We emphasize liberal trade not simply, or even primarily, because of its direct benefits in reducing costs and increasing consumer choice and welfare. The simple fact is that an open trading order is an indispensable part of any effort to increase competition and to encourage investment, domestic and foreign — the driving forces for efficiency and growth. At the same time, adherence to an open trading order is among the best guarantees that can be provided for the maintenance of a market system internally as well as externally, with governmental control and intervention limited and appropriately funded.

In pointing to the benefits — direct and indirect — of more open trade, the Group notes that natural trading patterns for countries within the region will likely remain heavily directed toward non-regional countries and areas. That is only partly a residue of history. The economic fact is that, broadly speaking, countries of the region share sunshine and potentially low labor costs. With exceptions, populations are relatively small and poor.

They are all dependent on technology, manufactured goods and sophisticated services from industrialized countries. The large populations and industries of the industrialized world in turn provide markets for foodstuffs, minerals, and labor intensive goods. Consequently, attention needs to be given to trading arrangements between the region and the rest of the world as well as within the region.

Intra-Regional Trade Agreements

Broad and comprehensive regional trade agreements — e.g., the European Union, NAFTA, Mercosur — have become common. Contrary to the fears of many, those agreements appear to have been broadly consistent with a more liberal multilateral trading order, mainly because they have been accompanied by a general reduction in tariffs and other trade barriers and a strengthening and broadening of international trading rules. Consequently, the concept of a broad Middle Eastern/North African “free trade” area has been raised. One benefit would be to avoid inconsistencies and distortions among and between a proliferation of bilateral or more limited regional agreements which would work against efficiency and reduce incentives to investment.

Upon reflection, however, *the Group finds that a broad regional free trade agreement would not be practical for the foreseeable future and would produce few benefits at the present stage of development of most countries in the region.*

The political barriers are obvious, pending much more progress toward peace and mutual confidence. On economic grounds alone, the pronounced differences in levels of development and the degree of openness of the various economies would imply a need for large, rapid and uneven adjustment. The resulting tensions could well be counterproductive to the overall goal. Moreover, as suggested, the predominant natural trading patterns — inter-regional with the industrialized countries rather than intra-regional — limit the potential gains.

While a comprehensive area-wide trade agreement may be beyond reach, ***there are strong and valid reasons for proceeding with more limited liberalization among neighboring countries and with the rest of the world.***

There are natural complementarities between Israel and Jordan and the Palestinian areas. Israel uniquely in the region is economically developed and technologically strong, but crowded and isolated. Its neighbors have ample cheap labor and urgent need for investment and markets.

The mutual economic interest in reducing barriers and developing trade is, of course, dependent on the peace process, now thwarted by inaction and tension. Potentially, however, the benefits of trade, particularly for the Palestinians, would provide a practical reinforcement of more friendly political relations. As politics permit, Lebanon and Syria — and more importantly, Egypt — would be logical partners in a broader regional grouping.

Similarly, the Arab Maghreb states have incentives to liberalize trade among themselves. Egypt with a foot in both groups could provide a natural bridge. Then, the kind of broad regional agreement, even including the Gulf states, that we rule out for now could emerge.

In approaching these agreements, we wish to emphasize one practical matter. Broad conceptual approaches and so-called framework or protocol agreements are not enough, far from it. What is necessary, and what has been often lacking, are specific tariff schedules, detailed and realistic timetables, reformed customs procedures, and workable rules of origin. ***Without the political will and technical assistance necessary to translate broad concepts into reality, agreements will be empty shells.***

Conversely, practical and urgently needed progress can be made — e.g., in easing border procedures — without awaiting comprehensive agreements.

All that provides the work of years. What is important is that ***these sub-regional initiatives should take place within the context of membership in and cooperation with multilateral trading organizations and policies.*** The region has nothing to gain, and much to lose, from a world of disconnected, inward looking, protectionist regional blocs. Its dependence on trade external to the region, and the limited complementarities within, underscore the point.

Trade Arrangements with Third Countries

Israel has for some time had free trade agreements with the United States and with Europe. Similar, if more limited agreements have been or are being negotiated between the Maghreb countries and the European Union. ***We believe these arrangements with countries outside the region can reach their full potential for fostering trade and development for the region generally only within a framework of the kind of intra-regional liberalization described above.***

- The advantage of the arrangements with third countries lies primarily in the ability of such arrangements to anchor and sustain internal reform within the regional countries, as well as in their contribution to opening markets in industrialized economies.
- The danger lies in building bilateral relations at the expense of more efficient economic arrangements and in discouraging regional political ties.

In particular, a series of narrow bilateral agreements will not maximize the new investment, whether from at home or abroad, essential to sustained growth because of the small size of regional national markets.

To maximize the potential and to reduce the dangers, several approaches are important.

1. Arrangements with third countries should encompass the intra-regional groupings proposed earlier.
2. "Concessions" extended as part of Euromed or other third country agreements should be extended to partners within the region.
3. Agreements negotiated with Europe should be extended to NAFTA and, if interested, to Japan.

Sectoral Agreements

A promising approach for early and meaningful progress in developing regional cooperation is sectoral agreements covering key areas of mutual dependence. Tourism and power generation and distribution are illustrations with obvious and important economic potential.

Efficient communication and transportation links inherently require regional cooperation and can proceed promptly. A fair and reasonable distribution of water is part and parcel of ultimate peace. Joint agricultural and industrial projects are possible.

We are fully conscious of the fact that emphasizing the potential of such sectoral agreements is to emphasize as well the indissoluble links between politics and economics.

Reciprocal Benefits

The general approaches and trade agreements we urge are clearly in the overall regional interest, and the individual nations should individually benefit.

But it is also true that particular sectors in particular countries will be faced with the need for "adjustment" — an abstract phrase that means at least transitional loss of jobs or income for some enterprises and industries. A common approach in trade negotiations has been to try to identify particular gains and losses and demand "reciprocity."

It is our sense that demands for reciprocity, narrowly defined, will doom rapid progress toward more open trade. The fact is some of the countries involved are particularly poor, handicapped by small resources and past protectionist policies. The necessary adjustments for those countries may be particularly harsh and difficult. Consequently, *we believe trade agreements within the region should benefit from the example of earlier agreements between strong and weak — as reflected, for example, in the Euromed initiative — in providing asymmetric concessions.* Such concessions could simply be a matter of timing in speed of liberalization; in specific instances, other imbalances should be accepted.

There are precedents for this approach in Israeli agreements with Jordan. We feel it entirely appropriate — in fact, imperative — that Israel, with income per

capita a large multiple of its neighbors and with a far more flexible and competitive economy, continue and expand an asymmetric approach in future agreements. Egypt, while much poorer than Israel, nonetheless has a far larger and more diversified economy than its Palestinian neighbors; that asymmetry in strength can reasonably be reflected in Trade Agreements.

Institutional Arrangements

In our Report last year to the Amman Economic Summit, we emphasized the need, as a matter of priority, to create a

forum to facilitate cooperation and coordination. We continue to believe such a regional forum should be formed with broad membership among the regional nations and appropriate participation by potential donor countries and international institutions. Formation of such a group should not await establishment and financing of the proposed Middle East Development Bank, which has not so far commanded the full financial support of a critical mass of regional and extra-regional nations.

ADDENDUM

RECOMMENDATIONS OF THE MIDDLE EAST ECONOMIC STRATEGY GROUP ON THE PALESTINIAN ECONOMY

We wish to call special attention to the state of the Palestinian economy and the urgent need for special measures for early improvement. The already weak economy has suffered severe damage from border restrictions on the movement of goods and people imposed by the Israeli authorities, and the related near absence of private investment has sharply depressed economic activity and increased large-scale unemployment. The marked deterioration in economic conditions since the Oslo Agreements

seriously undermined support for the peace process even before the recent civil disturbances. Prompt resumption of the peace process will provide the only solid basis for economic improvement and progress toward regional integration.

We are convinced, however, that near term measures to stabilize and improve the Palestinian economy cannot wait. Action is required now in areas not dependent upon political settlement and consistent with perceived Israeli security concerns.

The Economic Setting

1. Prior to the Oslo Agreements the Palestinian economy had been almost totally dependent on trade with Israel and employment of its workers in Israel, with these relations largely serving Israeli interests.

2. The Oslo Agreements were meant to rectify part of the imbalance in the relationship by making the existing Customs Union more symmetrical in taking into account some Palestinian concerns.

3. However, partly because of border closures, the economic situation of the West Bank and Gaza has deteriorated sharply since these agreements were signed.

- There have been more than 300 days of border closures since September 1993. Employment of Palestinian workers in Israel has fallen from a peak of 150,000 workers to the current level of 35,000 permits for Palestinian workers. (Even this smaller group cannot work in Israel with any regularity because of frequent border closures.)
- This has contributed to a decline in income per capita of about one third since September 1993.
- While Israeli exports to the West Bank and Gaza have been virtually unimpeded, Palestinian exports to Israel and to the rest of the world have declined sharply under various restrictions.

- The economic relationship between Gaza, the West Bank and East Jerusalem has been fragmented as these territories remain cut off from one another through border restrictions on movements of goods and people. As a result, they have become less economically integrated today than they were prior to the Oslo Agreements. Even within the West Bank itself, communities are isolated from one another during periods of closure.
- The uncertainties associated with the border closures and the stop and go movement of labor and goods have virtually dried up direct foreign private investment.

What Needs To Be Done

The Middle East Economic Strategy Group is in no position to make judgments about the security justification for the closings imposed on Gaza and the West Bank or their continuing need. If Israel believes they are necessary, it clearly has an obligation to cooperate in measures to develop other avenues for Palestinian trade.

We urge prompt action in four areas to provide a basis for investment and renewed economic growth:

1. The dependence of the Palestinian economy on Israel must be reduced. This can be done by (i) securing unimpeded access to more distant markets by establishing a seaport in Gaza and allowing airport operations in both Gaza and the West Bank; and

(ii) strengthening transportation and trade links with Jordan and Egypt.

2. The Palestinian economy needs to be integrated by facilitating normal trade relations and movements of people within the territories. This would require: (i) establishing free passage between Gaza and the West Bank which takes into account Israeli security concerns (e.g., by building a service through road); and (ii) restoring the economic links between the West Bank and East Jerusalem.

3. A well-defined legal framework governing land and water resources needs to be established to provide a more secure base for domestic and foreign investment.

4. An international free trade zone should be developed in Gaza to absorb part of the currently unemployed Palestinian labor force and to encourage investment and technology transfer.

Related Measures

The proposed policies do not depend on near-term progress toward a definitive final settlement and they respect Israeli security concerns. Success is, however, dependent upon action by Israel, the international community and Palestinians themselves. Specifically:

- Israel should immediately transfer to the Palestinian Authority customs duties on goods imported through Israel and relax restrictions on the movement of goods and workers from the West Bank and Gaza.

- Donors should take steps to start the disbursement of funds pledged at the Paris Conference on Assistance to the Palestinian People of January 1996, and to help both in filling the recurrent budgetary gaps caused by border closures and in accelerating the implementation of the core investment program. They should also continue the provision of emergency assistance for employment-generation programs.
- Chairman Arafat's failure to delegate responsibility for economic management to appropriate institutions and experts has damaged those institutions and the possibility for more rapid development. The Palestinian Authority should build up the institutional base of the Palestinian economy so as to create an enabling environment for investment and provide the underpinnings of growth by harmonizing the judicial systems between the West Bank and Gaza, and having a more transparent budgetary process.

Due to the difficulties experienced with the implementation of the Customs Union and tax collection, cartel arrangements were made between the Palestinian Authority and the private sector to import some basic commodities at lower prices and to levy taxes on their sales. However, as soon as these difficulties are resolved, the Palestinian Authority should disengage itself from trading and production activities, which are better left to the private sector, while concentrating on building up appropriate education and health services and establishing the underpinnings of a civil society.

APPENDIX

The Middle East Economic Strategy Group, chaired by Paul Volcker, asked several regional economists to prepare papers on trade liberalization in the Middle East/ North Africa (#1-8) and on the Palestinian economy (#9-11). The authors and titles of the papers are listed below:

1. Concept Paper on Intra-Regional Trade in the Middle East/North Africa, prepared by Albert Fishlow, Senior Economist, Council on Foreign Relations, lays out the parameters of the trade study for the participating economists.
2. "Some Points on Regional Interaction in the Middle East and North Africa," prepared by Said El-Naggar of Cairo University and the New Civic Forum in Cairo and Mohamed El-Erian, Deputy Director, Middle Eastern Department at the IMF, explains the factors behind current limited regional economic interaction and suggests an "open regionalism" based on outward-oriented multilateral development strategies, supported by targeted measures aimed at addressing impediments to regional interaction.
3. "Prospects for Economic Integration in the Maghreb," prepared by Mohamed El Hedi Lahouel of the Faculte de Sciences Economiques in Tunisia, studies economic integration within the Maghreb, viewing trade liberalization as a means of attracting foreign direct investment.
4. "Incentives for Economic Integration in the Middle East: An Egyptian Perspective," prepared by Ahmed Galal, Director of the Egyptian Center for Economic Studies in Cairo, probes the economic and political incentives for Egypt to enter into new regional arrangements with the triad and other neighboring countries.
5. "Syria's Regional Trade Potential in a Changing Environment," prepared by Nabil Sukkar, Director of The Syrian Consulting Bureau for Development & Investment, discusses Syria's regional integration through the Euro-Mediterranean initiative and a cooperation agreement with Lebanon, and suggests other initiatives that Syria might undertake to achieve wider regional integration and attract foreign investment.
6. "Trade Prospects in the Triad," prepared by Nadav Halevi from Hebrew University, Israel, and now teaching at the Economics Dept. of the Stern School of Business, New York University, studies trade integration within the triad of Jordan, Israel and the Palestinian territories.

7. "Jordan's Development and Trade Policy in the Context of the Peace Process," prepared by Taher Kanaan, former Minister of Planning, Jordan, discusses the renewed potential for regional integration from Jordan's perspective.
8. "Trade Choices for the Palestinian Economy," prepared by Ishac Diwan, Middle East/North Africa head of the Economic Development Institute of the World Bank, outlines the trade issues facing the Palestinians.
9. "Toward a Better Economic Performance in the West Bank and Gaza-Discussion Notes," prepared by Noman Kanafani, a Palestinian economist teaching in Copenhagen, offers recommendations for breaking out of the constraints operating on the West Bank and Gaza.
10. "Policy Priorities for the West Bank and Gaza," prepared by Karim Nashashibi, Assistant Director, Middle East Department at the IMF, suggests specific policy areas on which the Palestinian Authority might focus.
11. "The Palestinian Economy: Policies for a Better Future (ideas for discussion)," prepared by Ishac Diwan, outlines a pathway toward institutional development for the Palestinian economy.

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