

# 3

## Regional and Global Integration<sup>1</sup>

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### 3.1 Introduction

In the past 50 years, the MENA region has been integrated to the world economy through two main channels: the sale of oil, and labor migration. Labor migration, in retrospect, acted as the main way to redistribute oil revenues from the oil exporting to the importing countries, especially those in the Mashrek region, greatly benefitting millions of households. The migration of mostly unskilled workers from the Maghreb to Europe, during its period of fast growth, played a similar role. But migration will almost certainly never again boom as it did in the past.

During the same period, MENA countries' attempts to integrate in the global system of trade in goods and services have yielded modest results. Exports have not been a dynamic source of growth. While Import Substitutions Strategies can be blamed for these failures in the distant past, the more recent culprits have to be found in local and global conditions. Local conditions were clearly not favorable to competitiveness, as the dynamism of the private sector was taxed by the emergence of a crony form of capitalism since the market liberalization of the 1980s (see Chapter 2).

In considering its external engagement with the global economy, the challenge of youth and skilled employment must be considered as the absolute priority for the MENA region. We argue in this chapter that a successful strategy for the region must rest on new arrangements on trade and investment with the EU and the GCC in particular that can foster FDI focused on activities that generate technological externalities and allow the developing countries of the MENA region to move up the quality ladder and generate more skilled jobs. The increased competition from Asia and Eastern Europe means that an export-led strategy is more challenging now compared to the 1980s when

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<sup>1</sup> The chapter draws in part from Cammett et al, a Political Economy of the Middle East (2015).

Asian exports boomed. Nevertheless, the rise of FDI in the context of the rise of global value chains and the central role played by services offer good opportunities for the MENA countries to benefit from regional and global integration in ways that creates good jobs for skilled youth, including in the manufacturing and agricultural sectors. The vision would require domestic and regional policies to promote the expansion of an efficient regional service platform. But it would also require commensurate complementary actions by Europe and the GCC, the two main trade bloc with large potential for the region, that are adapted to the historical political window in which the region finds itself.

In other parts of the world, regional and global economic integration have been complementary affairs – regional integration supporting global integration, and vice-versa. An important reason for this is the neutralization of hub and spoke biases that reduce the attractiveness of FDI to the region, including from Europe and the GCC. The “flying geese” phenomenon in East Asia, where investment and trade originating first from Japan rolled down the peninsula over time to expand the “Asia Factory”, is the quintessential example of this complementarity. Europe too became more competitive globally by expanding its own market and unleashing capital and labor movement, inter-industry trade, and the forces of innovation and competition.

There have also been dreams and visions of an integrated Middle East region in the past, but they have ended up in failure. The constitution of a large regional market in the future depends in large measure on the role of the GCC, whose economy has now become the more dynamic part of the regional economy. The GCC has a large market for goods and services for which the region possesses a cultural advantage. It has access to large amounts of public and private investable capital. And it is the place of residence of a large share of the region’s skills. Policies can be devised along all these dimensions that foster economic dynamism in the MENA countries. This should in time include policies that make it more attractive for production for the GCC market to take place in the developing MENA countries rather than in the GCC, which would require lower subsidies to energy, capital, and labor in the GCC countries themselves.

The Euro-Med initiative, started in 1995, was meant to connect the region to European markets but it has essentially failed to make a difference. These agreements were superseded by EU enlargement, which brought Eastern European countries that compete with MENA exports into the heart of Europe. These agreements need to be substantially improved. More balanced Euro-med agreements would be more similar to those signed with Eastern Europe – they would lower effective tariffs and NTBs further, support the MENA countries in meeting quality standards, propose deeper rules that need to be adhered to (eg anti-monopoly, public procurement), and most important, implement pro-active policies to upgrade skills in the MENA countries. The main goal should be to encourage FDI originating in the EU to move beyond the search for low-pay jobs and towards more sophisticated activities, and especially those that can serve the larger Arab market.

The rest of the chapter explores the possibility that a new perspective on MENA's regional and global integration can lead to better economic growth. It analyzes recent developments along each of the dimensions of trade in labor, goods and services, and capital, highlighting the inter-linkages across these dimensions and proposing in each case innovative solutions that together, can form a new architecture of relations with the global economy that would be more promising for MENA's development.

### **3.2 Labor migration**

In retrospect, labor migration has transformed the political economy of the region further, at least so far, than trade in goods or capital flows. Broadly speaking, there were somewhere close to 20 million Arabs working outside their country of origin around 2010 (ESCWA 2013). About half of them worked in Arab countries around 2010, mostly in the GCC. The number of economic migrants in GCC states in 2010 has been estimated at about 12 million (compared to about 4 million national workers). While workers in the Gulf were predominantly from Arab countries in the 1970s, the share of Arabs has fallen to less than 50% currently. Lebanon and Jordan, and a few years ago Libya and Iraq, have also been destination countries. A whole range of skills are utilized, but, in general, unskilled work and domestic service in the Gulf today is largely performed by Asians, while Arabs have increasingly moved into the semi-skilled and skilled tasks. The interaction of people from different parts of the region in the Gulf has shaped a renewed sense of a regional culture and fostered its dynamism, including with the spread of satellite TV.

Equally, the large influx of Maghrebis in Europe also had profound effects on society in the Maghreb. Migrants who arrived to Europe before the 1990s were less-educated migrants seeking economic opportunities, while the more-recent migration waves included a larger share of more educated migrants motivated by more personal and strategic reasons.

International migration to Europe and the GCC creates opportunities for larger remittances, but it can rob countries of their best skills. Brain drain has been exceedingly costly for the region, as their expatriation rates for qualified workforce are abnormally high compared to other countries with similar per capita income (Docquier and Rapoport, 2012).<sup>2</sup> The main flows associated with migration of highly skilled workers come from countries of North Africa, specifically Algeria, Morocco and Tunisia to France and Belgium and more recently to Spain and Italy, but also of Jordanians and Lebanese

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<sup>2</sup> For example, 45% of Arab students who study abroad do not return to their home countries, 34% of skilled doctors in Britain are Arabs, and the Arab world has contributed 31% of the skilled migration from developing states to the West, including 50% of doctors, 23% of engineers, and 15% of scientists (Zahlan, 2014).

to the EU and the GCC. In more recent times, there has been massive exit of skilled labor from Syria and Iraq. Highly qualified women are over-represented in international migration in general and from MENA countries in particular, because of the added cultural and social costs to migration, which can more easily be lowered through investment in education (Miotti et al 2012).

North America is increasingly attracting the most qualified. Migration to the US and Canada are recent and self-selected due to both high emigration costs and to immigration policies that favor qualified immigration. As a result, in recent years, there is a relative decrease in the number of migrants to Europe and an increase in migration towards the US (Mouhoud 2015). This notable change also reflects the excessively restrictive immigration policies in the EU. In France for example, migrants with a temporary status move in a Kafkaesque universe where foreigners need to constantly worry about the renewal of their status, with all the administrative overhead that this process entails, thereby placing them in a permanent state of stress and mistrust towards public authorities and negatively affecting their professional and social integration strategies. Furthermore, these migrants often experience a drop in status, at least at the beginning. Compared to the situation in the US, in the EU, the migrants tend to be unemployed at much higher rates than the natives. In Canada and the US, the first residence permit granted to migrants can be a springboard for quick access to citizenship, a natural step after a few years of residence. Among the potential emigration candidates, those who can meet the selection criteria in terms of skill and education levels prefer to emigrate to Canada and to the US, while those who rely on family networks to reduce their costs of emigration continue to go to Europe (Miottiet al 2012).

### **Remittances**

Estimates of the magnitude of remittances are shown in Table 3.1. Remittances remain a crucial source of foreign exchange in the region. Indeed, remittances, estimated at some \$13 billion in 2010 just from the GCC and perhaps up to \$20 billion from all sources still dwarf both foreign direct investment and official development assistance for the region. For Yemen and Egypt the value of remittances exceeded that of any commodity exports. Remittances often paid for a substantial fraction of imports, especially in Egypt, Jordan, Morocco, and Yemen. Remittances to Tunisia, for example, represented 4.5% of GDP on average during 2003–12, and 7.5% in Morocco.<sup>3</sup> Official figures for remittances

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<sup>3</sup> At particular moments in time, remittances played a crucial role. On the eve of the Gulf War of 1990–91, remittances to Egypt were the equivalent of 10% of that country's GDP, and in Yemen, remittances were at near one-third of GDP. Lebanese remaining in their country at the end of the civil war subsisted primarily on remittances, which were the equivalent of two-thirds of Lebanon's GDP.

Table 3.1 Workers' remittances (% of GDP)

Countries	1961–1970	1971–1980	1981–1990	1991–2000	2001–2010
Labor Abundant Resource Rich	4.34	3.14	7.99	5.54	2.91
Algeria	4.34	2.07	0.72	2.33	0.92
Iran, Islamic Rep.				1.09	0.54
Iraq					0.61
Sudan		1.59	1.96	3.00	4.88
Syrian Arab Republic		5.77	2.78	2.52	2.45
Yemen, Rep.			26.50	18.78	8.05
Labor Abundant Resource Poor		8.63	9.96	11.62	13.65
Egypt, Arab Rep.		10.56	9.89	6.99	4.53
Jordan		14.71	18.75	19.76	19.21
Lebanon					21.88
Morocco		5.72	6.94	6.14	7.71
Tunisia		3.54	4.27	3.57	4.47
West Bank and Gaza				21.62	24.10
Israel	1.34	1.55	1.39	1.04	0.34
Turkey		2.42	2.63	1.90	0.38
Overall MENA	2.84	4.88	6.94	6.36	5.90

Source: World Bank Indicators

represent only the tip of the iceberg. Much money enters labor-exporting countries through unofficial channels.<sup>4</sup>

A number of factors may reverse this trend (Docquier and Rapoport 2012). One reason is the changing composition of the migrant stock. In Algeria, the new migration of the 1990s and 2000s includes young men and women called “Harragas”<sup>5</sup>, who are characterized by weak attachments to their country of origin and who declare a lack of desire to return (Mouhoud 2015). Using individual data from a specific survey conducted in France, Miotti et al (2012) have shown that transfers were lower for migrants from the Maghreb and Turkey than for those from sub-Saharan Africa, which suggests particular links between the need to remit and the incentive to emigrate. Migrants from North Africa who arrived before the 1990s were more likely to remit than are those who arrived more recently. The earlier less-educated migrants had stronger ties to their home country, which accounts, after controlling

<sup>4</sup> According to some estimates, informal remittances received in Algeria for example are two to three times higher than official remittances received, because the conversion of remittances at the black market exchange rate increases their purchasing power by up to 50% (Charmes 2010).

<sup>5</sup> The word in Maghreban Arabic could be translated by “who burn” referring to identify papers.

for a number of other explanatory variables, for their greater tendency to remit compared to more-recently arrived migrants whose emigration was linked to aversion towards the home country and/or insecurity-related factors (Mouhoud and Odinet 2010). There is a concern in the Maghreb countries about the risk of a reduction in transfer income in the future (Margolis et al 2015).

In recent years, the movement of people has accelerated as a result of the political instability in the region, and especially in Syria, Iraq, Yemen, and Libya. Over 10 million Syrians have fled their homes since March 2011, with 3.7 million Syrian refugees in neighboring countries (Lebanon and Turkey have nearly 2 million refugees each, and Jordan nearly 1 million), and 6.5 million are internally displaced within Syria. Refugees present massive humanitarian, social, and economic challenges. The catastrophic rush across the Mediterranean of people from the region and from Africa, fueled by wars and poverty, is creating a human disaster, which has so far been remedied in Europe only through security tools, which is insufficient to deal with the unfolding human drama of sunk boats and shattered lives.<sup>6</sup>

### **Policy challenges**

Most migrants do keep a contact with the home country: the large majority comes back at least temporarily for major holidays and for important family events such as weddings; others come back seeking investment opportunities, or opportunities to use their specialized skills for the national interest; and the vast majority of migrants to the GCC want to return home. Beyond important humanitarian concerns, how to better take advantage of diasporas in the West and in the GCC to improve development prospects must be at the centers of regional concerns. These diasporas can be tapped for finance, entrepreneurship, and technical skills. Such an initiative would help speed up the region technological catch-up along three possible tracks.

A first track would be to encourage improved interaction of highly skilled migrants with their home countries. Involving them in specialized functions in their countries of origin, such as in academia, research and innovation, or the financial sector would yield valuable gains. This would not be aimed at a definite return, but rather, at creating a framework of incentives that can tap into their emotional attachment to the home country. There are successful

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<sup>6</sup> It must be noted also that as part of their Euro-med agreements, the Maghreb countries had agreed to play a role in the repressive European anti-immigration policy against would-be-migrants from their countries and of those from sub-Saharan Africa transiting through their territories, such as agreeing to re-admit their nationals expelled from Europe.

examples of many countries in Latin America and Asia, which have implemented strategies to tap into the global stock of expatriate skills for their highly specialized development needs.<sup>7</sup>

A second track would aim at promoting the free movement of students and qualified staff within the MENA region. Such a process is already at work in the GCC countries where monetary incentives and better conditions act like pull factors towards the GCC, while geographical and cultural proximity facilitates movement back and forth in a process of accumulation of skills and financial resources that continuously searches for new opportunities between the home and destination countries. This sort of rapid mobility of human capital creates forces for deep regional integration.

A third track can focus on actions that can be undertaken by the receiving (EU, USA, Canada, GCC) areas to encourage exchanges between diaspora communities and their native countries by promoting mobility of individuals. This does not mean completely opening borders to international migration, but ensuring that those who are legally resident have a stable and secure status. This pre-supposes that migrants could return to invest and work in their native countries without losing their entitlements and the right to come and go. Improved security would encourage migrants to take investment risks in both their host and native countries.

### **3.3 Trade in goods and services**

The Arab region focused on producing for its own market in the 1960s and 1970s when it followed state-led, import-substitution growth strategies, and only shifted to private sector and export led growth later in the 1990s and 2000s. The transition has not been wholly successful however, principally because institutions and policies were not adequate to the task. As a result, the region as a whole has not seen its export revenues driving its economic growth, in spite of good endowments of labor (in the labor rich countries), capital (in the oil exporters), and energy, and its closeness to the large European and GCC markets. Global and regional conditions have also not been favorable, especially with the rise in competition from East Asia and from Central and Eastern Europe connected to the rise of the WTO and EU enlargement, and the rise of a highly subsidized economy in the GCC.

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<sup>7</sup> Examples include programs such as Red Caldas de Colciencias (Colombia), Talven (Talentos para Venezuela), SANSa (South African Network of Skills Abroad), and Philippines Brain Gain Network. The case of China and India are also considered exemplary in their mobilization of skilled diasporas companies.

### **Performance in non-oil trade**

The region now represents about 4% of the world economy (up from 3% in the 1990s). Its share of global exports of goods and services was about 5% in 2010. But over 80% of this is accounted by oil. The region's share of non-oil global exports of goods and services was only about 1.2%, up from 1% in the 1990s, which much of the improvement coming from service export, including tourism (World Bank 2013b). While these outcomes suggest that the region is not as poorly integrated in the global economy as it is sometimes suggested, it is also clear that it has not been able to take advantage of global markets to grow as East Asia has done.

Exports increased in most countries over time, but performance was unequal and overall modest at best. Petroleum exports still dominate trade, and indeed the economy of much of the region. Compared to East Asia, which exported 41.1% of its GDP during the 2000s, the developing countries in the sub-region do seem to compare too unfavorable, exporting 34.7% of its GDP in goods and services in the 2000s. There are however two reasons why for many countries, this is not a good performance. First, the share of manufacturing goods in total exports remains considerably smaller than in East Asia, with 22.7% GDP in manufactured exports, against 31.8 in East Asia. As important, most of the regional economies are small, and as such, they would be expected to trade more with the outside world. Taking into consideration population size, GDP per capita, and distance to market, Behar and Freund (2011) estimate that the oil importing countries of the region export about 30% less than their potential. By their measure, only Morocco, Tunisia, and Jordan over-perform. Indeed, these countries increased their manufacturing exports most in the last decade (Table 3.2). Others, and especially Egypt, did not however. Among the oil producers, a small share of exports is constituted by manufacturing goods. Nevertheless, one can note the remarkable success of Saudi Arabia's expansion of manufacturing export (and also Bahrain and the UAE), but also, that this was largely dependent on the enormous energy subsidies provided to the industrial sector.

A more detailed analysis of Arab countries' export performance reveals that the main constraint has not been to find new products to export. Indeed, the region seems no less capable than other regions at discovering new market niches where it may have comparative advantages (Chauffour 2011). Instead, and in contrast to East Asian exporters, the main constraint has been to expand the production of these market niches, or to exploit the "intensive margin". Even the more successful exporters such as Morocco and Tunisia have not been able to penetrate large shares of their export markets – for example, their share of the EU's garment sector could not rise above 3–4% of the market, and even went down under pressure from other more competitive exporters in recent years. As a result, exports from the region had been made up largely

Table 3.2 Export performance

	Exports of goods and services (% of GDP)			Manufactures exports (% of GDP)		
	1971–1990	1991–2000	2001–2010	1971–1990	1991–2000	2001–2010
Labor Poor	65.5	48.3	63.3	17.3	7.7	4.7
Resource Rich						
Bahrain	107.3	81.6	89.8	39.8	22.7	8.5
Kuwait	64.5	46.0	58.4	14.7	4.3	2.5
Libya	39.7	28.3	59.6		1.3	2.2
Oman	57.3	46.8	54.6	2.6	6.9	4.2
Qatar		51.4	59.8		7.3	4.6
Saudi Arabia	51.4	37.2	54.8	1.1	3.2	4.8
United Arab Emirates			65.8			2.2
Labor Abundant	18.7	22.0	31.9	1.4	1.0	2.5
Resource Rich						
Algeria	25.9	27.6	39.9	0.4	0.9	0.7
Iran, Islamic Rep.	21.5	20.5	28.7	0.8	1.6	2.6
Iraq						
Sudan	9.4	6.6	17.9	0.0	0.3	0.1
Syrian Arab Republic	18.2	30.5	36.7	3.1	3.1	7.3
Yemen, Rep.	12.2	24.6	36.0		0.1	0.5
Labor Abundant	27.6	28.4	33.3	9.7	18.8	22.7
Resource Poor						
Egypt, Arab Rep.	21.0	21.4	25.6	4.6	7.8	7.9
Jordan	39.9	49.2	50.0	16.4	25.4	35.6
Lebanon	18.2	12.2	20.1		9.8	13.9
Morocco	21.2	26.1	31.9	6.6	14.8	21.2
Tunisia	34.2	40.7	46.0	14.2	31.3	34.8
West Bank and Gaza		16.1	14.9			
Israel	38.3	31.3	38.5	30.8	28.1	32.8
Turkey	9.6	19.0	23.5	4.6	14.2	19.2
Overall MENA	34.7	32.5	42.6	10.0	10.2	10.8

Source: World Bank Indicators

of traditional products, with services making up most of the growth. The evidence, using various measures of the technological sophistication of products exported, suggests that the skills and knowledge content of Arab exports has only increased slowly and moderately since 1990 (Chauffour 2011). The great bulk of MENA country exports concentrate on low value-added products, such as textile and clothing, fuel products, basic chemicals, or agriculture. Low quality products account for about half of total manufacturing products exports, whereas high quality products generally do not exceed 25% of exports.

Although there has been a recent improvement in the technical contents of the products, progress towards upgrading has been slow (Peridy and Roux 2012). The countries of the MENA region did not manage to develop comparative advantages in the specialized high-technology sectors, and more generally, in products high up on the quality ladder that require specialized skills.

### **Trade in services**

Access to efficient services – banking, insurance, telecom, transport, retailing services – is crucial for productivity and global competitiveness. Services represent a large share of the value of industrial production – an average of 20%, and much more for the more sophisticated products that tend to be produced in global value chains that combine inputs from many destinations, and thus include large R&D and travel inputs. Services offer other advantages too. They can grow fast through technological catch-up, employ skilled youth and more women than in traditional sectors; and they offer a comparative advantage to Arab speakers given the need to conduct much of the work in Arabic.

As in the rest of the world, there has been a rapid rise in the export of services from the region, and most of it has gone into regional trade – the sector has doubled in size between 1990 and 2010, yet its share in global service trade has remained flat at 2.8%. Some countries of the region did however do better than this: today, 80% of Lebanon's and 40% of Jordan's exports are made of services, and the figure while lower, is also high at 20% for Egypt, Tunisia, and Morocco (World Bank 2013b).

There is large under-exploited potential in many of these areas. Services industries are notorious for depending heavily on effective regulatory regimes in order to balance their growth with their social value (anti-monopoly, banking supervision, telecom rules). However, regulatory agencies have considerable degrees of discretion, and services have been a core area for cronyism in the past (Malik and Awadallah 2013). Compared to other exporting region, MENA thus ranks relatively low in terms of the quality of its service trade restrictiveness index (World Bank 2013b). As a result, the development of a regional services platform, a crucial ingredient for a more dynamic regional investment and trade strategy, has been lacking.

### **Regional trade**

Ideally, the MENA region could count on at least two complementary trade blocs to pull its growth through trade and investment – the GCC and Europe. In practice however, the role that Japan played in Asia, the US for Mexico, or Europe for the Eastern European countries after they moved away from communism has not been filled by these two entities to date. The constitution of a large Mediterranean market, going from Southern Europe to the GCC, would have been ideal to pull up growth, with the Mediterranean Sea acting as the

“Mare Nostra” – the sea that connects – a role steeped in the history of the region, from the Phoenician to the Venitian and Maghrebi traders (Braudel 1966).

Many countries of the region have not been able to export more within the region, despite the comparative advantage provided by culture and individual connections. There are several factors that underlie this relative failure, besides a general lack of competitiveness. First, costs associated with administrative red tape and weaknesses in regional transport related infrastructure services are ranked as the most important constraints to intra-regional trade (Hoekman and Zarrouk 2009, Dennis 2006). Second, outside of production meant for the GCC market, countries from the region tend to produce similar products, and they consequently tend to experience more pressure from their domestic producers to impede regional trade (Galal and Hoekman 2003). Finally, the various conflicts between the countries of the region have not helped – for example, disputes between Morocco and Algeria over the Western Sahara have undermined the development of trade within the Maghreb region.

Using exports to the region as a share of total export as a measure of trade integration, MENA trade integration has not improved since the 1970s – from 6.0% of total exports in 1970 to 10.8% in 1990, and 5.2% in 2010. These fluctuations largely represent changes in the value of oil exports (while regional trade is mainly in non-oil goods and services). A more precise estimate of regional trade would thus exclude oil. In 2010, non-oil export of goods to the region was 18% of total non-oil exports of the region (ESCWA 2013). By way of comparison, 25% of Asean trade, 49% of NAFTA’s trade, and 65% of European trade is within their region.

Is 18% too little or too much? After all, if trade destination was completely random, the region should only sell 4% of its exports within the region, since the region only represents 4% of the world economy. To evaluate performance, we need to keep in mind that overall trade in non-oil goods and services is small. Moreover, we need to factor into this calculation the drivers that normally foster regional trade. Studies that use a standard “gravity model” of international trade theory to ask whether inter-regional trade flows are lower than what could be expected given levels of GDP, geography, culture, and trade agreements yield ambiguous answers. While earlier studies were somewhat negative (Hoekman and Sekkat 2010), the more recent studies suggest that inter-regional trade is now larger than what standard gravity models would predict (Abedini and Peridy, 2008). Still much more progress could be made if goods and services could flow more easily within the region, and many have argue that the creation of an effective regional free-trade association (or custom union) could raise intraregional trade significantly, perhaps even doubling it (ESCWA 2013).

At only 4.3% of regional to total exports, the Maghreb countries had the lowest share of inter-regional trade as their economies are more turned towards

Europe.<sup>8</sup> The GCC is just a bit more trade-integrated – only 5% of its exports go to the region – but this represents 20% of its non-oil export revenues. Some countries of the Mashrek however, building on historical ties with neighboring countries and with the GCC (see Owen 1999 for a history), have expanded their regional exports significantly. On average 19.1% of Mashrek's exports went to the region in 2010 and regional markets represented more than 50% of the (small) exports of Syria and Yemen, 35–40% of the exports of Lebanon, Bahrain, and Oman, and 25% of the exports of Jordan and Egypt.

### **Unfavorable Euro-Med trade agreements**

The most significant trade treaties are those negotiated with the World Trade Organization, the European Union,<sup>9</sup> and to a lesser extent, the US,<sup>10</sup> and within the region. Thirteen countries in MENA have joined the WTO; seven others are in various stages of application.<sup>11</sup> States in the region have all signed agreements to liberalize trade with the European Union. EU trade policy towards the MENA countries is covered under the general framework of the EU regional trade agreements (RTAs) as well as the EU free trade agreements (FTAs)<sup>12</sup>. The association agreements with the European Union are highly significant for Algeria, Morocco, and Tunisia, while the national project to join the European Union seems to be receding in importance in the political economy of Turkey.

There is a marked contrast between the ex-ante studies, which concluded as to the existence of significant potential gains of the Euro-Med agreements, and the ex-post analyses, which show small gains for the region. Peridy and Roux (2012) compared the results of 24 CGE models, which assess the effects of trade liberalization in the Euro-Med area. Almost all studies highlight important

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<sup>8</sup> According to recent estimates, the Maghreb countries are trading very much below than what their characteristics should allow (Bhattacharya and Wolde 2010).

<sup>9</sup> The Euro-Med association members are, as of 2014: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine, and Tunisia.

<sup>10</sup> Various types of FTA signed by the US with Bahrain, Jordan, Israel, Lebanon, Morocco, Oman.

<sup>11</sup> Turkey is a charter member of the WTO. Other MENA members (and date of accession) are Bahrain (1995), Egypt (1995), Israel (1995) Jordan (2000), Kuwait (1995), Morocco (1995), Oman (2000), Qatar (1996), Saudi Arabia (2005), Tunisia (1995), the UAE (1995), and Yemen (2014). Countries in various stages of application are Algeria, Iran, Iraq, Lebanon, Libya, Sudan, Syria, and Yemen.

<sup>12</sup> The European Union's trade policy instruments consist of both bilateral cooperation (e.g. The European Neighborhood Policy (ENP), Association Agreements (AA), Partnership and Cooperation Agreements (PCAs)) and multilateral (e.g. Eastern Partnership (launched in Prague in May 2009), the Union for the Mediterranean (the Euro-Mediterranean Partnership, formerly known as the Barcelona Process, re-launched in Paris in July 2008), and the Black Sea Synergy (launched in Kiev in February 2008). For an overview of ENP policy, see Wesselink and Boschma (2012).

effects on GDP and trade growth in the region, with growth rates of more than 5% in most of the studies.<sup>13</sup> But the ex-post studies of the result of these agreements show very limited impact. While the measured impact is positive on the region's imports, it is insignificant or negative on its exports (Michalek 2007; Cieslik and Hagemeyer 2009).

It is now clear that the Euro-Med agreements were not favorable to the MENA countries. Autocratic rulers in the region rushed to sign them as a way to foster their international legitimacy, more than to secure economic gains.<sup>14</sup> These agreements were made in a bilateral and non-cooperative fashion and they neither included agriculture nor trade in services. Instead, they were limited to manufactured goods for which countries of the region had few advantages.<sup>15</sup> The EU protection on agricultural products has remained high, considerably constraining EU market access to MENA products, so much so that the share of its agricultural exports to the EU is below the overall share of agriculture in MENA's total exports. In 2009, the EU received a third of MENA agricultural export, and these represent only 7% of the region's total exports. During 1995–2009, the MENA region had increased the relative share of manufacturing exports in its exports to the EU, but this was largely due to the performance of Turkey and Israel, who exported respectively 42% and 11% of the MENA region's exports to the EU. Within this, the rise of more sophisticated manufacturing remained limited (FEMISE, 2010). As a result, while MENA imports from the EU have increased rapidly since the Barcelona process was begun, exports from MENA to the EU have stagnated. The decline in net trade in manufactured goods, and the maintenance of barriers to the exporting of agricultural products, could only be compensated by tourism, remittances of migrants, and foreign direct investment, which ended up too low to make the difference.

The Euro-Med agreements were built on what seems like a workable vision of an "Arab Factory". Beyond the problems noted above, its failure can also be attributed to an acute hub-and-spoke problem (Puga and Venables 1997). The Euro-med agreements have done little to attract new investments in

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<sup>13</sup> Using the framework of the new trade theory (Helpman and Krugman 1989), and the new theory of regional integration (Pomfret 2003), these studies include traditional gains (factor reallocation and comparative advantages) and gains due to the non-tariff barriers liberalization and the evolution of terms of trade.

<sup>14</sup> In the case of the expansion agreements with the countries of Central Europe (Peco) the advantage was clearly in favor of Peco that held a number of barriers against EU countries while the latter undertook from the outset to fully open their borders to the former.

<sup>15</sup> The liberalization in the low-skills manufacturing sector in which the Mediterranean countries had comparative advantages was not complete until recently because of Voluntary Export Restrictions that remained in place until the middle of the 2000s.

manufacturing exports and to increase intra-regional MENA trade (Ülgen 2011). Decision-makers were aware of the hub-and-spoke problem when the EU-Med agreements were being negotiated, and efforts were deployed to avoid it by broadening the regional space. The agreements foresaw that the creation of a regional market would proceed at the same time as the region would open up to the EU market, in order to foster positive dynamics in the regional economy as a result of the association with Europe.<sup>16</sup> But among other difficulties (see next section), the challenge of negotiating separate agreements with the EU and each MENA nation in parallel turned out to be a huge logistical challenge.<sup>17</sup>

### **A fragmented Arab market**

The main attempt at opening up a region-wide unified market is the 1997 agreement to establish the Greater Arab Free Trade Area (GAFTA), an effort that was initiated by the Arab League as early as 1953. GAFTA has by now been ratified by 18 countries. It focuses on gradually reducing tariffs between Arab countries. Studies have found that the effect of the agreement has so far remained modest, increasing regional trade by about 20% (Abedini and Peridy 2008). There are two main factors that have reduced the effectiveness of the agreement. First, it only concerns goods with a sufficiently large share of Arab origin – i.e. at least 40% of the value of the product needs to be produced by the exporting country to benefit from the lower protection afforded by the agreement. There are however very few goods, besides food or natural resources, that satisfy this requirement – for example, garments typically use imported textile, and the labor content tends to be only about 10% of the value of the final goods. Second, importing countries were allowed to develop a negative list of goods that would be excluded from free trade. Moreover, the negative list grew to be quite long, as local producers feared competition by similar producers in neighboring countries and lobbied for protection (World Bank 2013b).

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<sup>16</sup> In addition, these agreements included in most countries support for industrial upgrading to help domestic firms improve their competitiveness and withstand competition by European firms.

<sup>17</sup> Still, many new regional FTAs were signed, but only to complicate further the “spaghetti bowl” of overlapping trade agreements in effect in the region. One important impediment to regional trade was, here too, the “rules of origin” issue. Each (small) country cannot produce alone a large share of the value of exported products. Yet, effective “cumulation” of right of origin is not allowed. Only the “deeper” integration Agadir Agreement, signed between Egypt, Jordan, Morocco, and Tunisia (implemented in 2007), has started to allow these countries to “cumulate” rights of origin. It is too early to tell if this new agreement will manage to advance the cause of intra-regional trade more than its predecessors (Cieřlik and Hagemeyer 2009). It should be noted that the US rules for FTAs don’t allow cumulation and this has hampered US-MENA trade like it had hampered the Euro-Med FTA agreements.

Negotiations on free trade in services was initiated in 2003, but has not been completed, owing to differences in interest again. More recently, a decision was taken to establish an Arab custom union by 2020.<sup>18,19</sup>

The most important constraint to regional integration has increasingly shifted towards the unfair competition by GCC producers for the Arab market. The extraordinary rise of the GCC in recent decades meant that by 2010 its GDP was about equal to that of the rest of the Arab world. Unlike the poorer MENA countries, the GCC has managed to grow its private sector immensely in the last two decades, in areas such as real estate and services, but also in tourism, manufacturing, and energy intensive industries. Manufacturing activities have expanded rapidly and so have exports. In 2011, manufacturing as a share of non-oil GDP stood at 22% in Saudi Arabia and Qatar, 19% in Bahrain, and 13% in UAE, in all cases well above these ratios in the 1990s.<sup>20</sup> While most exports are dominated by oil and gas (which accounts for over 90% of exports in Saudi Arabia, Qatar, and Kuwait, and 75% in Bahrain and Oman), non-oil exports have been growing too. While 50 to 60% of non-oil exports are constituted by petrochemicals and high-energy products, other exports include agro industries, base metals, electrical machinery, and services, especially transport and tourism.

But this performance is unsustainable, and it has been boosted artificially by enormous subsidies for home production. Energy subsidies are huge: in 2011, they stood at \$44 billion in Saudi Arabia, \$8 billion in Kuwait, \$18 billion in the UAE, and \$4 billion in Qatar (Espinoza et al 2013).<sup>21</sup> In addition, about 20% of the budgets of Qatar, Bahrain, and Kuwait are now spent subsidizing businesses in other ways. Equally, the GCC region is unique in the world for the scope of its labor import. It is ranked third (after the US and the EU) as an immigration region in 2010. Around 2010, it was estimated that there were about 12 million migrant workers in the GCC, constituting 80% of its

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<sup>18</sup> But given that many Arab countries have their own FTA with non-Arab countries, this project will have difficulty progressing. Establishing a custom union between the Arab countries would require that either all FTAs with non-Arab countries be abolished, or that all Arab countries join in the same FTAs.

<sup>19</sup> The GCC countries have already moved to a customs union (meaning they have free trade among themselves and similar tariffs to the rest of the world), with a possible monetary union on the horizon. But the level of the GCC intra-trade has not changed significantly over the recent years and had probably reached its full potential during the first decade of the GCC creation (Boughanmi 2008), with little change in production structure directly connected with the agreement, except possibly for the United Arab Emirates (Insel and Mahmut 2011).

<sup>20</sup> Saudi Arabia is today the largest exporter of industrial products in the region: \$20 billion compared to Egypt's \$5 billion.

<sup>21</sup> These amounts represent the quantity sold to the private sector, times the difference between international price, and the price energy was sold at to local producers.

workforce (ranging from 62% in Saudi Arabia to over 90% in UAE and Qatar) and about 35% of its population. This dependence had grown over time, and the source of the demand is now much more from the private sector than from governments: the private sector is a sector for expatriates who constitute over 90% of its labor force.

In effect, the GCC is the only region of the world where wages in its private sector are set by a global labor market, ensuring that it gets the cheapest wage for every level of skill in the world. But equally, there is no other region in the world where national labor accepts such competition by foreign labor – normally, labor may feel, and rightly so, to be entitled to benefit from oil booms. This policy benefits mainly rich private entrepreneurs, and is accepted by national labor only because (and as long as) they get their share of the pie in the form of state patronage, free social services, cheap energy and water, subsidized housing, and importantly, by being massively hired by their governments at very high wages.<sup>22</sup> This quid-pro-quo – open labor imports to satisfy the private sector against generous patronage to satisfy national labor – is at the heart of the social contract in the Gulf between the rulers, the private sector, and the national middle class engaged in the labor market. Private sector development has mostly benefitted entrepreneurs, who have become richer, but it has so far not affected positively the GCC middle class.

This growth model is clearly unsustainable, in addition to it indirectly harming the private sector in the rest of the region where production for the GCC market, or at least for its culture specific goods, could be undertaken on a more efficient and sustainable manner. The sustainability problem of the Gulf States is not (yet) how to live in a world without oil, but rather, how to employ effectively a fast growing national labor force. The current strategy of public sector employment will reach its limits sooner or later, given the high rate of growth of its national labor force, now at about 4%. Already 40 to 60% of state budgets are going into wages and social programs. At the same time, the current rates of national employment in the private sector in the various GCC countries range are miniscule, ranging from 1% to 4% (in Qatar Kuwait, and the UAE), to about 10 to 15% (in Saudi Arabia, Bahrain, and Oman). In effect, unless the gap between private and public compensation narrows dramatically, nationals are simply not employable in the private sector. Reversing this situation entails reducing labor migration as well as subsidies to the private sector, and accepting to live with a smaller and more efficient private sector, supplemented by more efficient and smaller transfers per capita to the population.

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<sup>22</sup> Most Gulf state nationals not only work for the state, but the wages they earn tend to be multiples of what is offered in the unregulated private sector labor market: 2 to 4 times in Saudi Arabia (4 for lowest skills), and about 2 times in Bahrain for example (Espinoza et al 2013).

The political problem with this transition is that it pits the interests of labor (the rising middle class) and those of the elite in the private sector, which explains why the policies to constrain foreign labor migration, which have been implemented since the early 2000s, have been unsuccessful. The political dilemma is all the more important given the rising income and education levels of the population, which makes it more demanding of freedoms and autonomy. As such, such a transformation will in the best of cases be slow and gradual, although it is bound to happen.

In recent years, the GCC regimes have reacted to the Arab Spring with a dramatic rise in patronage commitments and a reversal of economic reforms.<sup>23</sup> They have also become the main international financiers of the transition countries, and especially of Egypt (see further below).

### **The effect of domestic policies**

Trade policy has been an active area for reforms, in both its regional and global aspects, but there remains however a lot of unfinished business, much of it related to the agenda of “behind-the-border” trade facilitation. Investment risk and cronyism have continued to tax the economies of the region up to the present. As a result, domestic jobs were lost in the face of increased foreign competition, the supposed gains from trade liberalization tended to have difficulty materializing (except in the more attractive GCC market). For example, after they entered the WTO, the influx of cheap Asian textiles in Tunisia and Egypt hurt domestic manufacturers (in both cases public sector enterprises), who lost out to Asian manufacturers in local markets and could not compete in the global market (Henry and Springborg 2010, 48). The high tax and regulatory barriers affecting the trade of services, such as in the heavily regulated airline, transportation, and communication industries impeded competitiveness in both countries. Still, Tunisia’s supply response was more dynamic than Egypt’s as many firms, especially those in the off-shore sector, took advantage of new market opportunities abroad to expand production in new sectors such as electrical goods and food processing. Overall, some studies have calculated that trade liberation resulted in small net gain of jobs in Tunisia, while Egypt, which was more “structurally impeded” from expanding new exports, ended up losing jobs on a net basis (Konan and Kim 2004).

In spite of trade agreements, the region remains more protected than other regions, especially in services, which taxes its competitiveness. While tariffs were

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<sup>23</sup> In Saudi Arabia, the cost of the package announced in February and March 2011 to mollify popular grievances – which included public employment, housing, and welfare measures – was costed at \$130 billion. In 2012, nearly 300,000 young Saudis were hired in the public sector – as much as during the previous decade. Similarly, public sector salaries were raised by 70% in the UAE.

reduced everywhere, over time, other type of impediments, Non-Tariff-Measures (NTBs), rose in parallel. Examples range from slow clearance and inspection processes, to complex signatures needed to process trade, to license or registration requirements for importers, packaging requirements, regulations on production or distribution processes, traceability, sanitary restrictions, and product-quality requirements. Such regulations can be useful when their goal is to protect the national interest, but they can also be pushed by local producers to defend their interests, as often happens in Europe, for example in the case of agricultural imports. The recent studies of cronyism in Tunisia (Rijkers et al 2014) and Egypt (Diwan et al 2014) show that restrictions were driven by lobbying activities of politically connected large firms, trying to defend their domestic market interests in the face of rising global competition. For example, tariff rates were reduced in Egypt by the end of the 1990s (from an average tariff rate of 16.5% in 1995 to 8.7% in 2009) but Egypt responded by increasing the use of non-tariff technical import barriers. By 2009, there were 53 different types of regulations that could be construed as instruments of protection. Of the NTBs in place in Egypt in 2009, almost half (24) were introduced or amended around 2000. Diwan et al (2014) find that the politically connected firms were much more likely to be in sectors protected by NTBs than other firms. In particular, they find that 82% of connected firms but only 27% of all firms sell products that are protected by at least two types of NTBs, while 71% of politically connected firms but only 4% of all firms are in sectors that have at least three types of NTBs.

### **New perspective on global integration**

Past choices to promote outsourced assembly activities in sectors that are intensive in labor (textile, leather, clothing, electrical equipment, toys) were failures. They did not encourage a move up the chain towards industrial segments with more added value, and the incentives to increase the level of training and qualification remained low. In recent years however, imitating the last generation of products has become more difficult because of the widespread use of intellectual property rights, and thus for high technology products, barriers to entry have become extremely high. As a result, new strategies are needed to improve the technological content of MENA exports.

At the end, the main question confronting the region remains that of the way in which it would participate in the emerging global distribution of labor. So far, a private sector that lacks dynamism and poor regional arrangements have prevented it from becoming the “big factory” that it could have become. The countries of the MENA region should take advantage of recent transformations in global production to achieve a better integration into global value chains, as well as increase its export to GCC markets.

The rise in transport costs and rising labor costs in emerging countries have led to a reconfiguration of the location of the different segments of the

productive process on a regional basis, particularly in Europe. Global production is expanding not only in industry but also in services via global value chains (GVC) with countries and firms specializing in certain segments or activities rather than in whole sectors. While it has been increasingly harder to decentralize industrial activities out of industrial countries due to the acceleration of production automation and the higher transportation costs, which affect the bulkier industrial goods, in contrast the service sectors has become easier to outsource. Indeed, there is close to zero outsourcing cost in the provision of intangible services given the widespread use of new information and communication technologies (ICT). In high-income countries, manufacturing production actually has a significant share of its added value coming from services and the competitiveness of industrial production of formerly industrialized countries depends increasingly on the competitiveness of their business service sector. In Interacting with GVCs, firms have developed global innovation networks that organize their R&D activities, and services have become key elements of an efficient GCV strategy. The countries that manage to specialize in these segments will experience faster catching up.

New strategies need to take account of these recent global developments. An opportunity exists for the MENA countries to participate in this regional reconfiguration, principally by attracting FDI and outsourcing operations in business service activities both upstream (fundamental research and development, consulting, design) and downstream (logistics, brands, personalization, publicity). Services can create jobs for qualified personnel, and catch-up with industrialized countries is possible given the relatively low fixed investment costs needed in intangible activities. Moreover, services influence the capacity of adaptation and innovation of industrial and tertiary/service firms. Indeed, recent studies show that the preferred environment for innovation is now in services, albeit still in response to demand coming from industry (Gallouj and Djellal 2010). Innovations in many other sectors, such as health and education, the environment, tourism, and the financial sector also find their origins in services. But while service activities can promote technological catch-up and a more extensive employment of graduates, not all service activities are equal in this respect. It is thus important to figure out which activities are most conducive to the development of an economy of knowledge and the extensive use of graduates. Priorities are likely to include services related to knowledge and intangible investments such as basic research and development, higher education, consulting, and marketing, followed by intermediation services (logistics, postal sorting, railways triage center, and transport). Collective services with high economies of scale, public or private (health, hospital, legal services) are geographically anchored activities and they are complementary to specializations in other sectors (Gaugris and Mouhoud 2013).

### 3.4 Capital movement

FDI inflows can supplement domestic investment by bringing in much needed finance to the struggling private sector of the region. But more important, it has the potential to expand the manufacturing sector, which can be a major source of new jobs, by bringing in much needed transfer of technology and management know-how to boost productivity and allow countries to catch up with the technology frontier. Foreign manufacturing MNCs tend to have better access to external markets than domestic firms, and so, by developing linkages with domestic firms as producers of intermediary products and services, they can create spillover benefits to the whole economy, beyond their sector of activity.

As discussed above, an important impediment for a good performance of the Euro-Med agreements is the fragmentation of the regional market. Indeed, one important goal of regional trade integration is to increase the region's attractiveness to global FDI – foreign companies moving their production to the region in order to lower their costs of serving regional as well as neighboring markets more effectively. Indeed, the vision of an Arab factory, that would grow initially by selling to the large Arab market, before expanding over time to integrate globally into profitable global supply chains, relies centrally on the development of a large internal market (Chauffour 2011, ESCWA 2013). In a fragmented regional market, the development of free trade with Europe or the US can actually *hurt* the cause of the regional market further by encouraging investment (and especially FDI) to move out of the region and locate instead in the EU (or Eastern Europe), or in the US, the so-called *hub-and-spoke* problem. Indeed, it is now accepted that FDI can boost growth only under favorable circumstances. Not only is a minimum level of capital stock necessary to benefit from FDI spillover effects, but in addition, the market for the output must be large enough to justify the type of FDI that can upgrade the receiving country's skill level. Bouoiyour et al. (2009) have looked at the relation between FDI, human capital, and productivity in 63 developing countries over the period 1960–2004. While in general, FDI was found to improve growth globally, in the MENA region, FDI had no impact on productivity and had little spillover effects. Instead, FDI has tended to build islands of quality that increase growth directly but with little indirect effects on the rest of the economy.

FDI flows to developing countries rose substantially in the 2000s, more than quadrupling relative to their level during the 1990s. By 2012, FDI flows to developing countries were as large as those going to rich countries (at about \$800 billion), a historical premiere, which was connected to rising commodity prices, increased global liquidity, and excess production capacity in much of the developed world. This wave of rising FDI flows did not bypass the Middle East. Starting from a relatively low base in the 1990s, they rose dramatically in

many parts of the region. From less than 0.5% of total FDI flows in the 1990s, flows to the region rose to nearly 6% of total flows by 2010. Given that Arab economies oscillate between 3 and 4% of global GDP, this seems then to be a solid performance, the region getting “more than its share” of global FDI. In some countries, FDI supplemented domestic private investment in important ways, especially in the smaller economies of Lebanon, Jordan, and Bahrain. Indeed, they became in many countries a major source of foreign exchange competing with remittances and exports.

During 2001–10, most of the FDI flows went to the GCC, and especially to Saudi Arabia and the UAE, which received more than 20% of total FDI flows to the region each. This is in contrast to the earlier period where most of the funds went to the non-oil producing MENA countries, and it can be explained by the rising oil prices, which made oil exploration more attractive. The GCC received on average about 3.4% of its GDP in FDI flows. The non-oil countries received about 30% of total FDI flowing to the region, constituting on average 4.9% their GDP. Flows were especially large in Lebanon and Jordan (12% and 10.1% GDP respectively), followed by Tunisia and Palestine (5%), and then Egypt (4%) and Morocco (about 2.5% GDP). Finally, the third category of medium oil countries started the decade with low flows but by the end of the decade, these rose. For the decade as a whole, they received on average, 1.5% of GDP annually. This went predominantly to Algeria, Iraq, and Syria, and to the natural resource sectors.

FDI global flows collapsed during the global financial crisis of 2008, but they quickly recovered by the early 2010s. However, they continued to retreat in the MENA region, with the most marked retreat in the developing countries of the region, many of which were most affected by political instability after the uprisings of 2011. Using a unique data-set for new greenfield investment from the FDI Markets database, several important characteristics of these investments can be noted – see Table 3.3.<sup>24</sup>

First, FDI inflows were concentrated in non-tradables (mostly real estate) and mining, each receiving about one third of total FDI. Services (mainly transport and tourism) received a bit less – so registering a solid performance, but manufacturing got much less (16% of total FDI). In the GCC, real estate, mining, and manufacturing attracted about one fourth of FDI each. In the poorer oil exporting countries, more than half of FDI moved into mining, and the rest mainly into real estate. In the LARP countries, non-tradables and services received about a third of the inflows each, but manufacturing only got 13%. In many Arab capitals, from Cairo to Beirut, Amman, and Casablanca, GCC companies now dominate the high-end real estate market.

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<sup>24</sup> The data are from the World Bank and it is collected on the basis of formal announcements. The data cover FDI in 17 Arab countries between January 2003 and December 2012. Overall, this represents 7,426 projects by over 4,500 multinationals corporations.

*Table 3.3* FDI into the Arab countries, 1991 to 2012, share of GDP

Into	1991–2000	2001–10	2011–12
LPRR	0.3	3.4	2.9
LARP	1.8	4.9	2.1
LARR	0.2	1.5	1.0

*Source:* UNTAD data, aggregated from data presented in World Bank 2013. See Chapter 2 for a definition of the three country groups.

Second, the largest share of these investments, more than 50%, came from MNCs from the rich West (first panel of the table). MNCs tend to have high research and development capacity and could have done much to support the development of manufacturing in MENA countries. However, more than 60% of their investments went into oil and non-tradables – such as real estate and construction (third panel).

Third, the rest of Western FDI went into labor-intensive sectors seeking low wage labor to re-export to the MNC local market. Thus, there was a large missed opportunity here to grow the type of sectors than can create a large number of skilled jobs. Indeed, the majority of investment was of the vertical type with very weak spillover effects instead of dynamic horizontal FDI of the *market* seeking type, motivated by access to markets and decentralization. Horizontal FDI tends to lock in receiving countries into specialization in low value-added activities, compared to horizontal FDI that creates new comparative advantage in upscale activities with higher level of technological sophistication. The hub-and-spoke problem has thus been fully operational here.

Fourth, GCC investment was large and more than a third of it was directed at the poorer non-oil countries. The share of FDI provided by the GCC was 60% in Egypt, 70% in Tunisia and Jordan, and 50% in Libya. Indeed, in these countries, this was the largest source of FDI. But here too, the main sectors of investment did not include manufacturing – instead, real estate and tourism projects, and investments in services, came first (Hertog 2008, Baaboub 2009).<sup>25</sup>

Fifth, because of their concentration in mining and construction, FDI inflows have not generated many jobs – close to a trillion dollars of investment generated “only” about 1 million jobs – implying that it took nearly \$1 million to generate one job! The smaller FDI in manufacturing (16% of total FDI), by way of contrast, created 55% of total jobs. The sectors that benefited include food-processing, consumer products, textile industries, and petro-chemicals. The countries that gained most of the jobs were Saudi Arabia and the UAE, countries that rely largely on migrant workers. Among the investors, Arab investment was highest in terms of its labor intensity (as a larger part went into construction activity).

<sup>25</sup> The GCC countries were not just a major investor, but also the largest destination of FDI to the region, principally by western MNCs seeking to develop oil reserves.

Table 3.4 Characteristics of FDI in MENA: cumulative FDI, 2003–12. In US\$ billion.

1. FDI, from:					Jobs created (1000s jobs)
FDI to:	DCs	Arab	LDCs	Total	
LPRR	293	89	64	446	
LARP	100	128	12	240	
LARR	109	99	41	249	
Total	502	316	117	937	
2. Sector destination of FDI					
FDI to:	Oil	Manufacturing	Services	Non-tradables	
LPRR	137	87	115	106	582
LARP	50	31	74	88	482
LARR	97	35	52	66	278
3. Sector destination of FDI					
FDI from:	Oil	Manufacturing	Services	Non-tradables	
DCs	200	90	102	109	716
Mena	23	29	125	139	452
LDCs	59	33	13	12	136
Total	283	153	241	260	1340
% of total FDI in sector	30%	16%	26%	28%	
% of total jobs created	7%	55%	19%	19%	

Source: computed from data in WB 2013. DCs stands for developed countries, LDCs for less developed countries. LPRR, LARP, LARR as defined in chapter 2.

The FDI recent surge is surprising given the high degree of political instability, and of cronyism and corruption, which have characterized the region and impeded the growth of its private sector. What then explains the high level of (pre-2011) FDI to the region? There are two types of explanations. First, GCC investors seem to be “over-investing” in the region, from a profitability and diversification perspective. This suggests that their cultural affinity gives them special incentives to work in the region, and that they are for example perhaps less affected by corruption or political instability as their inside knowledge allows them to navigate the regional waters better than western MNCs (Sekkat 2012, World Bank 2013a). A second finding is that political instability and corruption affect mainly investment in the manufacturing sector. However, political instability or high levels of corruption do not affect investment levels in the oil sector, which tends to operate as an enclave. In effect, MNCs in manufacturing have a choice of location and tend to select sites with stability and high levels of skills, while those in oil tend to have less choice (Burger et al 2013). As a consequence the region receives more vertical FDI than horizontal FDI (Bouoiyour et al 2009).

In addition to greater investment by and greater market access to the GCC, the promotion of market expanding FDI requires public action by the EU to prevent the current system of race-to-the-bottom that characterizes contracts between MNCs and regional sub-contractors. The form taken by the types of contracts offered by European companies to businesses in the Maghreb countries involves short-term profit maximization, and thus, specifications that are unfavorable to the South, as they encourage competitive bidding by subcontractors that do not internalize growth prospects brought about by investments in skill and quality upgrading.<sup>26</sup>

### **Other capital flows**

Outside of FDI, the region continued to receive more than its fair share of external official assistance – GCC, EU, and US bilateral aid, and IFIs' regional and multilateral support, but these flows became more concentrated over time (see Table 3.5). Countries undergoing post-war reconstruction received the largest share – during the 2000s, official assistance went mainly to Palestine (30.2% of its GDP a year on average during the decade), Iraq (16% of GDP per year), and to a lesser extent to Sudan (4% of GDP per year, mostly to South Sudan). Among the other countries of the region, and until the Uprisings of 2011, levels remained relatively large only in Jordan at 5.5% GDP per year during the 2000s – a level largely below what the county received in the 1970s (22.7% of GDP a year) and the 1980s (13.4% GDP). ODA has remained low and flat in Morocco, Tunisia, and Lebanon (at between 1 and 2% of GDP per year) in the last decade. And it went down dramatically in Syria – it stood at 0.6% GDP in the 2000s, compared to 9.9% in 1970s and 4.9% in 1980s), and in Yemen (1.5% in recent years, down from 6.9% in the 1980s). So on the eve of the uprisings of 2011, MENA was largely getting weeded out of official assistance, after being the most assisted region historically (Malik and Awadallah 2013), a reflection of the fall in strategic rents in the region between the second Gulf war and the 2011 uprisings.

The region did not take advantage of the huge expansion of the international credit markets, which took off in the 1990s and 2000s, until the global crisis in 2008 put a stop to that expansion. While Lebanon continued with heavy borrowings (which has resulted in one of the largest external debt ratios in the world), most other countries now have comfortably low external debts, after the large deleveraging of the 1990s. All countries have external debt to GDP ratios below the 50% dangerous limit, with only Tunisia in addition to Lebanon approaching the red-zone. Jordan and Tunisia continued to retain

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<sup>26</sup> Such practices are damaging both for the subcontractor countries and for the outsourcing countries in the long run, and need to be corrected by policies that set standards in ways that promote industrial upgrading.

a small access, borrowing moderately about 2–3% of GDP per year (on a net basis) during the 2000s – for Jordan this was a very large change compared to its heavy borrowings in the past (6% of GDP per year in the 1990s). Egypt and Morocco too did not borrow any substantial amounts, and relied instead on domestic debt to finance government deficits.

The major oil-exporting countries increased their support to oil-importing countries after the first oil shock of 1973 —direct, bilateral, and contributions to regional and multilateral agencies all rose.<sup>27</sup> Moreover, a notable attempt to use capital as an instrument of economic integration has been the region's various development funds.<sup>28</sup> More recently, the surge in oil prices during the 2000s have transformed the countries of the GCC into major players on the world financial stage, with the rapid growth of Sovereign Funds invested in OECD financial markets (De Boer et al 2008). The recent slump in oil prices will reduce these reserves, but they remain very large. As the economies of countries that experienced political upheaval after 2011 weakened, GCC countries (except Bahrain) have mobilized to provide financing. Egypt, Jordan, Morocco, Tunisia, and Yemen have been so far the principal beneficiaries of this increased support. Given the reduced access of these countries to capital markets, and the relatively low level of support from the West under the umbrella of the Deauville agreements, such support has allowed transition countries to continue providing economic stimulus longer than they could have otherwise. By the end of 2014, total pledges by GCC countries amounted to about \$100 billion, mainly in the form of soft loans and commodity aid. Much of the financing is for budget and balance of payment support. A large share of these pledges is for Egypt, followed by Jordan, Morocco, and Lebanon, and Saudi Arabia accounts for more than half of the pledges. It remains to be seen if these massive investments will end up financing consumption and delaying reforms, or at the opposite end, encourage reforms and investing in a better future.

### **3.5 Conclusions: new perspectives for integrating MENA countries in the global economy**

The low diversification of the MENA countries is partly explained by the lack of commitment to building a truly regional market, including through active policy by the GCC, despite the implementation of the free trade agreement between

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<sup>27</sup> Saudi largesse continued even during the long period of low oil prices. In 2003, the Saudis gave away about 1% of their GNI compared with a rich country average of only 0.25%.

<sup>28</sup> Among these funds, the Arab Fund has had the most self-consciously political agenda, focusing on expanding regional infrastructure in ways that enhance regional cooperation.

Table 3.5 International capital flows

Countries	Net flows on external debt (% of GDP)					Grants, including technical cooperation (% of GDP)				
	1961-1970	1971-1980	1981-1990	1991-2000	2001-2010	1961-1970	1971-1980	1981-1990	1991-2000	2001-2010
Labor Abundant	0.0	3.8	3.3	0.7	-0.1	0.7	2.7	2.9	1.5	3.7
Resource Rich										
Algeria	0.0	8.0	0.8	-0.2	-2.5	-	0.8	0.2	0.4	0.3
Iran, Islamic Rep.	0.0	0.0	0.0	-0.3	0.7	-	0.1	0.1	0.2	0.1
Iraq	0.0	0.0	0.0	0.0	3.1	-	0.1	0.1	1.0	16.0
Sudan	0.0	7.2	3.4	0.7	0.7	-	2.5	5.1	3.1	4.0
Syrian Arab Republic	0.0	3.6	8.8	2.7	-2.7	-	9.9	4.9	1.1	0.6
Yemen, Rep.	0.0		6.8	1.1	0.2	-		6.9	3.1	1.5
Labor Abundant	-0.1	7.0	7.2	2.9	2.2	4.9	8.1	5.4	4.9	6.8
Resource Poor										
Egypt, Arab Rep.	-0.1	9.7	5.9	-0.1	-0.3	-	6.3	4.1	4.1	1.2
Jordan	0.0	6.5	11.1	6.3	2.0	-	22.7	13.4	5.6	5.5
Lebanon	0.0		9.2	5.4	6.8	-		6.0	1.5	1.7
Morocco	0.0	7.0	6.1	0.2	0.0	-	1.3	1.8	1.7	1.2
Tunisia	-0.2	5.0	3.6	2.4	2.7	-	2.1	1.4	1.1	0.8
West Bank and Gaza						-			15.5	30.6
Israel						-		4.3	1.6	0.5
Turkey	-0.2	1.6	-0.4	0.0	1.8	-	0.1	0.3	0.3	0.1
MENA w/o LPRR	0.0	4.9	4.6	1.5	1.0	2.2	4.4	3.7	2.9	4.6

Source: World Bank Indicators.

Arab countries. We have pointed out the potential detrimental effects of such a vertical “hub-and-spoke” trade liberalization between the EU and the MENA countries if not completed by genuine horizontal trade liberalization within the region. A renewed drive towards regional integration between the developing countries in MENA should also be the basis for a reassessment of the association agreements with the EU in the framework of the European neighborhood policy.

The MENA countries should renegotiate with the EU the content of their free trade agreement on a multilateral and not on a bilateral basis. Indeed they must complete their tariff removal with regard to EU products. Besides Israel and Turkey, the other MENA countries still exhibit significant average tariffs which need to be reduced ideally through a multilateral negotiation against new and more favorable arrangements such as the free movement of skills, liberalization of trade in services and the inclusion of agriculture. The adoption of a more favorable system for rules of origin should also be a priority as a means of reducing trade costs between the EU and its partners. This should also include provisions for the participation of countries of the the MENA region in European research and innovation programs and tenders.

The regional opportunity is to meld the labor and capital present in the region in a successful partnership. Both capital (in the Gulf) and skilled labor (in the LA countries) are in excess supply in the region. The second oil boom has transformed the GCC into the main growth center of the region and a large market for the region’s goods, services, and skills. While this will not lead to new growth in migration, there has been a steep rise in capital flows from the GCC into the labor-intensive countries, both in the form of direct investments, and aid to transition governments. It is imperative that these massive flows of funds be shifted in the future towards sectors that create good jobs in a more sustainable manner. The challenge then is to improve the effectiveness of the emerging partnership between Arab capital and labor. The countries of the Gulf have become in recent years the main financiers of the countries in transition. For the first time, the GCC and transition countries sit at a same table and discuss macro plans for the future. The current creditor-debtor relation should shift into a broader win-win opportunity for mutual gains. The GCC could encourage investment and trade, and thus help itself as a creditor, by opening wider its own market. Part of the bargain could include preferential treatment for regional FDI in the region, or partnerships with western MNCs to invest in more skill intensive sectors, or even granting special favors to regional exports in the GCC. The new geopolitical space opened up by the “crowding out” of Turkey, an economy of more than half of the size of the GCC, from the prospect of integration into the EU also presents opportunities.

At the end however, while the external environment can make it easier for the region to integrate into valuable global interactions, the political will to allow for the development of a more dynamic private sector will remain central.

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