Introduction

Economic integration, both with neighbors and the world more generally, has proven to be a basic feature of all sustained high growth experiences in the post-1950 period. Economies that have grown at an average rate of 7 percent or more per year for 25 years or longer all increased their overall productivity through trade, foreign direct investment (FDI) inflows, and the acquisition of technology and knowledge through education abroad, reverse engineering, spillovers from imports of machinery, learning by doing, and exchanges of ideas more generally. These various channels of engagement with the global economy allowed firms and households to use already available knowhow and techniques to improve living standards.

All successful experiences of integration had to take their external environment, and in particular the external market access conditions they faced, as a given. Successful countries made the most of the global economy, despite numerous trade and investment barriers that restricted access to foreign markets. Trade policies in major markets helped some countries and constrained others – for example, the web of restrictions affecting exports of textiles played a role in jump starting production in some countries – but for all the dynamic developing and transition countries what drove export growth was the ability to excel at harnessing prevailing trade and investment opportunities.

Greater integration into the international economy is a key means through which MENA countries can reap the benefits of already existing market opportunities to accelerate economic growth and job creation. Excluding petroleum exports, the MENA region, with over 400 million people, exports roughly the same amount as Switzerland. The potential for improvement is therefore almost unlimited. The Arab market itself offers considerable untapped potential for intra-regional trade (Malik and Awadallah, 2011; Hoekman and Sekkat, 2010). With a population of over 500 million inhabitants, the EU represents a market estimated at 20 percent of global GDP when measured in terms of purchasing power parity.

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1 This paper draws on previous work by the authors and various co-authors and colleagues. The views expressed are personal and should not be attributed to the World Bank.
Once Turkey and the other new growth poles in Asia, Africa and Latin America are taken into account, Jordan, Lebanon, Tunisia and other countries in the MENA region with relatively small domestic markets are faced with an almost unlimited external demand.

A necessary first step to conquer international markets is to open the domestic economy. As is well known, a tax on imports is ultimately a tax on exports. The emergence of global value chains and international production networks that imply that goods cross borders a number of times before reaching the final consumer has rendered obsolete the traditional policy of using trade protection to support import-substituting industrial development (Baldwin, 2011). As is true for trade in goods, a country cannot become a major services exporter unless it is open to services imports. Opening up trade in services, if implemented in conjunction with an appropriate regulatory and competition policy environment, can help remedy supply-side constraints and increase productivity of all firms in an economy by generating more, better and cheaper services. A country not open to trade in services automatically excludes itself not only from a significant part of world services trade, but also significantly increases its trade costs to the detriment of its competitiveness and excluding itself from participating in global value chains and international production.

Integrating into global markets is not just a matter of reducing barriers to trade applied at the border. The recent experience with trade liberalization in many MENA countries illustrates that an effective economic integration strategy requires complementing reductions in trade barriers with policy reforms to ensure that markets become more competitive (contestable for new entrants) and that operating and transactions costs for firms fall. It is important to recognize that much was done to reduce barriers to trade in the MENA region in the last 15-20 years. Significant progress was made over the last two decades in many Arab countries to lower import tariffs and other explicit trade restrictions. Tariffs in Egypt for example were reduced to less than 10 percent on average, down from over 40 percent in the late 1980s, most quantitative restrictions removed and the trade regime greatly simplified. Similar reforms were implemented in other Mediterranean countries. This stimulated an increase in exports of non-traditional products and greater diversification of the export base in a number of countries. Many countries also saw an increase in trade in services. Greater inflows of FDI were one driver for the increase in trade, especially in the last decade.

However, the positive supply responses to trade reforms were limited as a result of the continued dominant role of the State in most Arab economies (World Bank, 2009). Barriers to entry for new firms
and high costs of investment in new activities resulting from a plethora of regulatory impediments and state control resulted in less job creation and economic dynamism than has been observed in other parts of the world following policy reforms to open the economy to foreign goods and services.

**Trade Performance**

In 2008, MENA’s share in world exports of nonoil goods and services was only 1.2 percent, up from 1 percent in 1998 (World Bank, 2011). During that 10 year period, the region’s share in world exports of services grew by nearly 30 percent, double that registered by other middle income countries (excluding China). The out-performance was offset by under-performance for exports of nonoil goods, which registered an increase of only 17 percent, well below the 26 percent attained by the comparator group of middle-income economies. Regional export growth was driven mostly by an expansion of existing products to new markets and new products to existing markets – that is, along the extensive margin. The dominance of the extensive margin can be explained partly by declining sales to a number of traditional export markets in Europe (Brenton, Shui and Walkenhorst, 2010), but is also an illustration of a gradual increase in participation in international production sharing arrangements in sectors such as motor vehicles (Tunisia) and chemicals (GCC oil exporters).

Behar and Freund (2010) conclude that a typical MENA country exports less than half and as little as one quarter of its potential, controlling for standard determinants of trade such as country size, income and distance to partner markets. Similarly, Bhattacharya and Wolder (2010) also find that a typical MENA country exports much less than what it should given fundamental trade determinants, although imports are much closer to what would be expected.²

The major reason for the underperformance is the cost of doing business in the region, part of which reflects trade costs. Of course, other factors also play a role. Thus, for some countries real exchange rate overvaluation as a result of Dutch disease dynamics impeded greater export dynamism (Diop et al., 2012). More generally, however, in many countries trade reforms, while significant in an absolute sense, did not go far enough to keep up with what other countries elsewhere in the world were doing in removing barriers to trade and lowering trade and other operating costs for firms. Trade potential and growth is increasingly determined by the level of the trade costs that affect supply chains. The continued prevalence of high ‘red tape’ costs associated with moving goods and services across borders in Arab

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² This is a well-established result in the literature, see e.g., Harb (2007) and Péridy (2007).
countries – especially in comparison to ‘competing’ countries in Central and Eastern Europe – and dominance of the State in the economy limited the positive effects of tariff reduction.

**Figure 1. Non-oil merchandise export growth by region, 1998-2008 (in value terms)**


It is almost a platitude that the structure of the world economy has changed dramatically in the last 20 years. Products increasingly are produced in regional or global value chains, with value being added to a product by firms located in different countries. Much if not most of the value that is embedded in products reflects services such as design, marketing and distribution, as well as labor. The geographic fragmentation of production is reflected in the increasing vertical specialization of trade, with firms in countries producing an input that is exported and used in further processing of a product in the importing country, which may then be exported to a third country, and so forth. It has been estimated that some 30 percent of all trade today is vertical in nature (Daudin et al, 2010). A large share of this trade is also intra-firm – involving exchanges between plants that are part of the same company. That in turn implies that such trade is closely linked to FDI – and that barriers to FDI will constrain the ability of a country to participate in global supply chains.
A striking feature of the MENA region as a whole is that it participates to only a very limited extent in supply chains. The composition of exports varies widely across Arab countries as a result of oil. For countries that are importers of oil, exports of manufactured and agricultural goods and services accounted for 38 percent of GDP, which is quite high compared to other developing regions. But these exports are largely for final consumption — they do not comprise of goods that are processed further in the destination market.

**Figure 2. Intra-industry Trade Index by Region**

One very crude measure of vertical specialization is intra-industry trade (IIT): imports and exports of similar products. Analysts have pointed out for many years that levels of IIT for MENA countries are very low (Havrylyshyn and Kunzel, 2000). This has continued to be the case in the recent period. IIT was rising during the 2000s, but remains far below what is observed in other regions — indeed, IIT levels are the lowest of any region (Figure 1). Tunisia has been most successful in integrating into production networks and has the highest share of IIT in the MENA region (40 percent), followed by Morocco and the UAE. The only country in the region with a significant share of components in its total exports — a key feature of vertical specialization — is Tunisia, which saw the share of parts and components in total exports expand...
from less than 4 percent in 1985 to 10 percent in 2006 (Behar and Freund, 2010).

There are many reasons for the extent to which the region lags behind on this measure of economic integration and specialization. In part it is simply a reflection of endowments – oil. But as is illustrated by the case of the UAE, natural resource dependence need not imply that there is no scope for diversification – the UAE has become a major exporter of distribution, logistics and transport services (Ianchovichina, 2011). The main reason for the lack of change in IIT is the level of trade costs in many countries. The costs are in part a result of trade policies – e.g., restrictive rules of origin (Gasior, 2008) – but the most important determinant of such costs are administrative procedures and requirements: what is often called ‘red tape’.

The major reason for lackluster trade and employment performance in comparison with other developing countries is an overall lack of competitiveness. Competitiveness is central to harnessing private sector growth for sustainable employment, poverty reduction, and, ultimately, wealth creation. Firms, especially small- and medium-sized enterprises, serving both export and domestic markets cannot exploit opportunities if they are burdened by costs outside their control that make them uncompetitive. Increasing the number and value of products produced, the number of markets served, increasing new investment and the survival rate of firms are all conditional on lowering such costs. Following the recent disruptions in economic activity and decline in export revenues, an increase in investment is urgently needed. To encourage new entry and expansion of existing firms economy-wide policies to improve the business environment and investment climate are needed.

**Priority areas for further reform**

There are arguably two overarching priority areas for trade-related reforms: (a) improve market access opportunities and related regulations; and (ii) lower trade costs and improve “connectivity” for firms.

Market access in the MENA region is quite restrictive, particularly for exporters from Latin American and Sub-Saharan African countries. Notwithstanding the progress made in the last decade in reducing tariff rates, the overall level of tariff and nontariff protection in the MENA region vis-à-vis the rest of the world remains relatively high by international standards, especially for agricultural products (Figure 3). In particular, the region compares unfavorably with its main competitors in Eastern Europe and Central
Asia, Latin America and the Caribbean, and East Asia and the Pacific—the new dynamic poles of the world economy.

Significant progress has been made in reducing tariffs on goods in MENA. Over the last decade, preferential liberalization under PAFTA and other PTAs has been complemented by reductions in MFN tariffs. As a result, the average uniform tariff equivalent of all tariffs (ad valorem and specific) for the region fell from some 15 percent to 6 percent between 2002 and 2009. Surveys of trading enterprises suggest that tariffs are no longer seen to be a major impediment to trade (Hoekman and Zarrouk, 2009). What distinguishes trade policy in a number of MENA countries from other developing and emerging markets is the prevalence of nontariff measures (NTMs) and associated enforcement and compliance costs. As a result, the overall trade restrictiveness of nonoil exporting countries in the region is higher than in most other countries (Figure 3).

**Figure 3. Overall Trade Restrictiveness index by region, 2008**

Econometric studies suggest that the gap introduced between domestic and world prices for a given product as the result of NTMs is typically large in countries for which data are available (e.g., Morocco, Tunisia), especially for agricultural goods (Augier et al, 2012). Progress has been made in streamlining NTMs over the last two decades, with the virtual abolition of instruments such as quantitative...
restrictions, prohibitions, and price controls and a great increase in the use and incidence of technical regulations and product standards. Key remaining hurdles are procedural requirements and administrative processes that result in delays and high costs of compliance.

Tackling costs associated with inefficient trade facilitation and logistics is central to further integration of Arab countries, both regionally and globally. The costs of “connectivity” are often fixed, and as a result they disproportionately affect small firms, farmers, and the poor, severely limiting their participation in trade and investment. Reducing the costs associated with moving goods along international supply chains, whether these costs are measured in terms of time, money, or reliability, is a core element of any trade and FDI agenda.

Based on the results of a survey of trading firms, Hoekman and Zarrouk (2009) conclude that tariffs have mostly been removed on intra-PAFTA trade and that customs procedures are now perceived to be much less of a problem than in the late 1990s. In 2001, tariffs were ranked as one of the most important barriers to intra-regional trade; in 2008 they were ranked last. Instead, transport-related infrastructure and real trade costs (trade facilitation) were ranked as the most important constraints. These results support recent analytical studies that conclude that the magnitude of Arab trade flows is significantly lower than it would otherwise because of high real trade costs (e.g., Behar and Freund, 2010; Bhattacharya and Wolder, 2010; Harb, 2008; Péridy, 2007; Zaki, 2010, 2011).

Bourdet and Persson (2011) estimate that improving export and import procedures to the best practice level prevailing in the region is likely to increase the value of non-EU Mediterranean exports by 34% and to increase the number of products exported by non-EU Mediterranean countries by 21%. If exporting non-EU Mediterranean countries reached the level of efficiency in export procedures that the best EU countries have, total exports from the countries analyzed would increase by 40% on average.

Computations of bilateral trade costs for MENA countries indicate that, as compared to the EU, trade costs are typically twice as high in the region, especially for trade between Arab countries (Arvis and Shepherd 20112). Maghreb countries have lower trade costs with Europe than between themselves (Table 1). Since trade in the Mediterranean region mainly takes place within single markets (e.g., EU, GCC) or through preferential arrangements (e.g., Euro-Med Association Agreements, PAFTA, Agadir agreement), the cost differentials relate mainly to distance, trade logistics, facilitation issues, and the existence of nontariff measures. Trade costs are consistently higher for agricultural products. This reflects the higher transportation costs (per unit value) and time sensitivity of perishables, but also
potentially the impact of more controls at the borders and nontariff measures. In short, MENA’s geographic advantages in terms of connectivity to major markets such as the EU are more than offset by weaknesses in trade facilitation and logistics.

Table 1. Bilateral trade costs for industrial products (%)

<table>
<thead>
<tr>
<th></th>
<th>Maghreb</th>
<th>Mashreq</th>
<th>GCC</th>
<th>Egypt</th>
<th>France/Italy/Spain</th>
<th>Greece</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maghreb</td>
<td>95</td>
<td>152</td>
<td>167</td>
<td>126</td>
<td>75</td>
<td>151</td>
</tr>
<tr>
<td>Egypt</td>
<td>126</td>
<td>112</td>
<td>111</td>
<td>119</td>
<td>149</td>
<td>185</td>
</tr>
<tr>
<td>Mashreq</td>
<td>152</td>
<td>77</td>
<td>96</td>
<td>112</td>
<td>119</td>
<td>151</td>
</tr>
<tr>
<td>France/Italy/Spain</td>
<td>75</td>
<td>149</td>
<td>132</td>
<td>119</td>
<td>50</td>
<td>96</td>
</tr>
<tr>
<td>Greece</td>
<td>151</td>
<td>185</td>
<td>169</td>
<td>163</td>
<td>96</td>
<td>169</td>
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<tr>
<td>GCC</td>
<td>167</td>
<td>96</td>
<td>69</td>
<td>111</td>
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</tr>
</tbody>
</table>

Source: Shepherd (2011).

The main trade logistics bottlenecks reflect “soft infrastructure” constraints, such as customs and other border agencies, trade and transport facilitation frameworks, and trade logistics services providers. Container dwell times in Morocco or Tunisia are about a week, which is substantially more than the OECD average (3 days) and also exceeds those of emerging economies in Asia (Malaysia has 4 days, and transit time in Shanghai is 2.5 days). Markets for logistics services, including trucking, are fragmented by country, with many small providers and few incentives for consolidation and efficiency gains. There are relatively few active corridors between MENA countries. Prior to the Arab Spring, the most active corridors were Tunisia-Libya, Turkey-Syria-Jordan, and Jordan-Iraq, as well as corridors within the GCC. Apart from the Tunisian-Libyan experiment at Raz Jair, there is no cross-border coordination between countries (a joint border post, for instance), and there is often a wide no man’s land between posts, if not an outright border closure. There are typically many controls on each side of a border, including for security purposes.

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3 The following paragraphs draw on World Bank (2012).
Countries have much to gain from improving sub-regional trade corridors and regional trade facilitation frameworks. In most trade corridors, existing or projected investment in infrastructure will not deliver benefits without effective transit systems. The efficient movement of goods and vehicles across borders and overland for long distances relies on having in place a seamless transit system at the regional level, or at the very least between neighboring countries. While various formal regional and bilateral agreements are in place, implementation is often jeopardized by poor cross-country cooperation. In larger countries such as Egypt, the performance of internal corridors is also a key priority for reducing poverty in lagging areas and addressing rising concerns about development disparities within the country. Measures to improve internal logistics performance to improve connections to international trade corridors and supply chains is just as important, if not more so, than action at the borders.

A large part of the competitiveness reform agenda revolves around improving the operation of markets for services. Trucking services are an example. Informality and relatively short distances prevent the emergence of a network of high-quality medium-size transport operators, which has implications not only for logistics but also for road safety and urban management. Intermediary professions (e.g., brokers, agents) also tend to be very fragmented, with insufficient quality control, while nationality requirements for brokers (except in Morocco) favor a small number of well-connected domestic operators. Yet reforms are possible. In 2007 Jordan implemented an innovative loading-by-appointment system at the port of Aqaba, which forced truckers to operate in formal companies. This transformed the market structure of trucking operations in the corridor serving Amman and Iraq. Morocco has also promoted the development of new logistics services for the manufacturing industry, operating in parallel to the “old” fragmented trucking and brokerage sector. The reform involved developing logistics zones (e.g., Tangier, Casablanca), opening up the sector to FDI, and installing new customs regimes suitable for logistics activities (World Bank, 2012).

More generally, services trade, whether embedded in goods or stand-alone, represents an important source of diversification and growth potential for Arab countries. As already noted services exports before 2010 were growing more rapidly than merchandise exports, which often were low-value-added industrial goods, confined to the bottom of the productivity chain as emerging countries moved up the value ladder. In the past decade the share of services trade in GDP doubled on average, and almost tripled in the case of Egypt (World Bank, 2011). Egypt, Morocco, and Tunisia rank among the world’s 30 largest net exporters of services (in value), helping to partially offset merchandise trade deficits.
However, services exports have been mainly concentrated in transport and travel, that is, tourism. Travel alone represents 50 percent or more of the services exports in Egypt, Jordan, and Morocco, and close to 50 percent in Tunisia, compared to 25 percent or less, on average, for the rest of the world. The share of exports of other types of services, such as business and communications services remains well below the world average.

Barriers to trade and investment in services sectors often are significant in the region (Bottini et al., 2011). Expanding production and exports of services will often require FDI—and thus liberalization of access to services markets for foreign firms. In MENA, FDI started increasing at a rapid pace since 1995. Indeed, net FDI inflows as a share of GDP were highest in MENA compared to other regions in the world (Table 2), illustrating how market reforms, after a time lag of two to three years, can raise the profile of an economy and bring it to the attention of investors, leading to FDI projects, new economic activities, and jobs. While the global flows of FDI tripled in the decade preceding the 2008 global financial crisis, those going to the Arab economies increased at an even higher rate, albeit from a very low level. However, except for tourism, FDI outside the energy sector was mostly directed to nontradables, with little going to export-oriented manufacturing or high-tech services (World Bank, 2011).

| Table 2. FDI has grown rapidly in MENA (% of GDP, net inflows) |
|------------------|---|---|---|---|---|
| EAP              | 1.57 | 3.9  | 2.64 | 3.46 | 3.33 |
| ECA              | ..   | 1.06 | 2.16 | 3.07 | 4.44 |
| LAC              | 0.74 | 1.73 | 3.93 | 2.74 | 3.01 |
| SAS              | 0.14 | 0.63 | 0.72 | 1.08 | 3.31 |
| SSA              | 0.41 | 1.4  | 2    | 2.94 | 3.47 |
| MIC              | 0.78 | 1.97 | 2.71 | 2.88 | 3.51 |
| World            | 0.99 | 1.13 | 4.83 | 2.55 | 3.04 |
| MENA             | 0.22 | 0.31 | 1.22 | 2.57 | 4.57 |

Source: World Bank, WDI

The pattern of FDI inflows points to a set of political economy, policy, and regulatory factors that are constraining the realization of fully benefiting from globalization. Addressing these issues is within the power of national authorities, and doing so could position Arab economies to take greater advantage of FDI for economic and social development of both their respective countries and the whole region. The manufacturing and services sectors, where most jobs are generated, have not been able to attract their shares of FDI, compared to the petroleum and real estate sectors. The limited investments received in
manufacturing and services have generated little local added value because of impediments to spillover effects on the host economy.

Looking forward, political, social, and legal stability will be a key prerequisite to attract more investment, whether of Arab or other origin, and to persuade investors to establish and expand their businesses. Equally important, investors need markets and compelling business opportunities to invest in those markets. Streamlining current restrictive investment regimes and adopting a timetable for phasing out restrictions on foreign equity participation in all economic sectors, except for a short and clearly defined negative list would create new opportunities for private investors, especially in critical economic sectors such as banking and insurance, electricity, and transport. Opening up to foreign investors would entail completion of privatization programs and establishing a level playing field in all economic sectors, including improving access to production factors (industrial land, foreign exchange, and credit). The payoffs are likely to be considerable. According to the Jordanian authorities, privatization and regulatory reforms in the telecommunications sector in the mid-2000s generated 25,000 additional jobs. Barriers to the process of “creative destruction” in Arab countries are enormous. The average firm in the MENA region is almost 10 years older than the average firm in East Asia or Eastern Europe. Croatia’s working-age population is comparable in size to Jordan’s, but the average number of newly registered firms in Croatia was almost five times higher in 2004–2009 (World Bank, 2012).

**Conclusion**

No country in the last 50 years has sustained high levels of growth and significantly increased per capita incomes without greatly expanding trade and investment. Although countries in the MENA region made significant progress in the last decade in reducing tariffs and other barriers to trade, the region’s share in world exports of nonoil products has remained flat. Excluding the oil sector, the region remains one of the least integrated in the world, both in terms of intra-regional trade and integration into global production networks. Investment has been deterred by relatively high trade and investment barriers – while governments did pursue trade reforms, these lagged behind the depth and speed of opening of markets observed in other regions of the world. Real trade costs, including the impacts of poor trade facilitation and logistics services, remain higher than elsewhere. Intra-regional trade agreements among Arab countries and with the EU did not address some of the basic drivers of high trade costs and the constraints that impeded investors from establishing or expanding production facilities.
A critical factor that explains the disappointing supply response to reforms implemented in the past decade is the lack of growth of the private sector. There are huge opportunities to harness existing trade and investment opportunities for growth and employment. The challenge is to establish conditions that will encourage entry by new enterprises and expansion of existing firms. As argued by Malik and Awadallah (2011) there is an important political dimension to addressing this challenge as a precondition is a willingness to accept the associated redistribution of economic rents and influence away from the State and entities with close ties to the State (World Bank, 2009). Completing trade and investment reforms, including regulatory simplification and reforms of NTMs is an important element of allowing such a change to occur, but it is only a part of what is needed to allow a vigorous, competitive market place to emerge in countries in the region.

The importance of deepening economic integration in the MENA region is a core element of the diagnostic and the recommendations of a recent World Bank report on trade and FDI prepared for the Deauville Partnership (World Bank 2012). The implementation of far-reaching domestic reforms in MENA countries is vital to realize the growth and associated employment opportunities offered by access to neighboring markets and those in the rest of the world. To confront and adapt to the rapidly changing global trade landscape that is driven by specialization and participation in global value chains and vertically integrated production networks, MENA countries need to improve their competitiveness across the board – including in critical areas such as innovation, business sophistication, financial development and overall economic governance. Thus, the policy reform and investment agenda goes far beyond the trade cost-related factors that were the main focus of this note. But trade integration should figure prominently in future policy-making, including a concerted focus on realizing the long-standing vision of greater regional integration of the Arab world.

References


