

# Overview

For the countries of the Middle East and North Africa (MENA), trade and private investment are needed to provide new engines of growth and dynamism. With more trade and investment, countries in the region will be able to achieve faster growth, reduce poverty, create more jobs, and improve the knowledge, skills, and productivity of their work force.

The most important development challenge in the coming decade is to create enough jobs for the rapidly growing work force. During 2000–10 the number of new entrants to the labor force will average 4.2 million a year, twice the number for the previous two decades. The best and most sustainable way for all countries in the region to address this challenge is to accelerate their trade and investment integration, with the help of their partners.

Implicit in this is a transition—from an old model of economic organization and activity to a new one. The old model—driven by the public sector, supported by oil, aid, and workers’ remittances—cannot any longer generate faster growth or jobs, as the performance of the past two decades attests. A new model, which is much more reliant on trade and private investment, promises to support faster growth and jobs needed in the region.

Most governments in the region have already started to undertake this shift, and the region is in a state of transition. Early reformers include Jordan and Tunisia, which have opened to trade and created a more hospitable investment climate, with encouraging outcomes. Egypt and Morocco have also been taking greater steps at trade and investment reform. Among the resource-based economies, Algeria and the Islamic Republic of Iran have started to reopen their trade regimes and encourage private investment. In the Gulf, smaller countries have accelerated reforms. The United Arab Emirates, especially Dubai, are following an impressive outward-oriented strategy with large gains. Yet, compared with the rest of the world, trade and investment climate reforms in the region have been decidedly weak.

Many countries are seeking to strengthen their trade partnerships with Europe, their largest trading partner, through the Euro-Med trade agreements, while intraregional trade is being promoted through the Pan-Arab Free Trade Area (PAFTA) and the Gulf Cooperation Council (GCC) customs union. Several other smaller regional trade groupings also have been established. A number of countries are seeking membership in the World Trade Organization (WTO). Jordan and the United States have signed a free trade agreement, and more such agreements may be forthcoming.

Yet, the results on the ground remain disappointing. The 1990s were marked by stagnant or declining trade and private investment—MENA was the only region in the world to experience a reversal. There is strong pressure to produce better results.

The pressure is needed, for the transition to a new model is never easy, given the politically powerful and better organized potential losers and the weakly organized potential winners. It is no surprise, then, that trade and investment reforms have been hesitant and cautious, and outcomes weaker still. While some structural and external political economy factors (conflict, sanctions, limited WTO membership and participation, limited market access in agriculture, exclusions of services in trade agreements, and others) help to explain some of the results, weak policies and reforms also bear a large responsibility.

The region now needs to deepen and accelerate its reform, finishing the process that it has started. It needs to make three fundamental shifts in its sources of growth: from oil to nonoil sectors; from public, state-dominated to private, market-oriented activities; and from protected, import-substitution to competitive, export-oriented activities. Intensifying trade and investment is at the core of all three shifts.

### **Why Intensify Trade Now? There's Little Choice**

Waiting is costly. Policies preserving the old model, which may have been merely inefficient and expensive, are fast becoming unsustainable—for four reasons, each pointing to the urgency of reforming trade and investment. The first is the prospective decline in oil and other sources of income derived from the rest of the world. The second is the growing competition in world markets. The third is the slowing of labor migration opportunities. But the most urgent and compelling reason of all is the enormous pressures building in domestic labor markets, from the existing and growing pool of unemployed, and from the millions of new entrants to the labor markets who are young and better educated. Alternatives for employment in the public sector or in small, protected do-

mestic markets are exhausted, and this only heightens the need for change.

Oil, aid, and workers' remittances are unlikely to be able to support enough employment and income in the coming years. Countries face a steady decline in per capita oil revenues, strategic aid inflows, and workers' remittances. Rising competition in world markets is creating more pressure, both in skill-intensive activities and in employment-intensive activities, such as garments, textiles, and light manufacturing. And countries in and outside the region are constraining the free movement of labor.

These developments will only increase the pressure on employment. Of all regions, MENA faces the greatest challenge in providing jobs. Average annual growth in the labor force is expected to be 3.4 percent a year in 2000–10, twice the growth in other developing countries. A potential demographic gift runs the risk of turning into deeper social crises in the absence of adequate growth in jobs. Already, unemployment rates, which have risen in the past two decades, are among the highest in the world. At the same time, the public sector cannot provide anymore the jobs needed by the scale of new entrants to the labor force. Queuing for public jobs no longer presents a viable option.

### **Countering Unfounded Pessimism with the Tremendous Potential for Trade, Investment, and Employment**

Pessimism about the region's trading potential is deterring many MENA countries from accelerating their trade and investment. This pessimism is pervasive, barring a few exceptions, such as in Jordan, Tunisia, and the United Arab Emirates. As a corollary, political leaders do not favor policies to make the needed transition from the safety and comfort of the old model to the uncertainty of gains from a new model. Compounding the pessimism is fear about the ability to compete in world markets. There is nothing especially unique about the MENA countries in this respect. But the pessimism is unfounded.

The region's characteristics are favorable to trade. Exports other than oil are a third of what they could be. Manufacturing imports are one-half of what would be expected. The region is small, with 2 percent of world income and 5 percent of world population. Its incomes are low, in the bottom half of the world income distribution. Wages are also fairly low, in the bottom half of world wages. And it is near a high-income region, across the Mediterranean from the European Union (EU).

MENA countries can also attract more investment from abroad and encourage more private investment at home, both of which are crucial for trade and development. If exports other than oil were higher, and

were in a better investment climate, domestic private investment in traded goods and services would be much higher. And the foreign direct investment (FDI) inflows that the region could expect would be five to six times what they are today—some 3 percent of gross domestic product (GDP), as compared with 0.5 percent.

Even if only half the region's trade and private investment potential were realized over the next 10 years, per capita GDP growth would jump from 1 percent to about 4 percent a year—half from more private investment, and half from the greater productivity that openness would encourage. Importantly, this would meet the growth in jobs required in the region in the coming decade, both to absorb the new entrants to the labor force and to address the stock of unemployed.

Expanding trade and investment holds the promise of substantial dividends in job creation, for export opportunities would add millions of jobs, many of them for women if the structural barriers to women's participation are removed. The share of nonoil merchandise exports in GDP was about 6 percent on average (compared with more than 20 percent in East Asia and the Pacific). Bridging only a small part of this gap would increase employment by more than 4 million over the next five years, equivalent to cutting the unemployment rate by 4 percentage points of the labor force.

International trade is cutting up the manufacturing production chain and permitting finer gradations of specialization within that chain, for skills and labor costs and productivity. Small, resource-poor countries in the region stand to benefit from such production chains—and given their size, the prospects are virtually unlimited in world markets. Larger countries will also benefit from such specialization. Their domestic markets and proximity to major international markets will drive a much larger range and scale of domestic manufacturing possibilities. The prospects for specialization in manufacturing thus remain immense in all MENA countries. The manufacturing sectors of most MENA countries are small by international standards—almost half the typical levels in other lower-middle-income countries. And the prospective gains from more open trade are large over time.

Services will also grow, with pronounced shifts out of low-productivity public and private services and agriculture. Complementary human resource improvements and broader improvements in governance and gender equity will be essential—to enable shifts to more knowledge-based activities.

Trade is thus likely to be a key source of growth in the MENA region in the next decade and beyond. It is also likely to be relatively skill intensive, suited to the changing characteristics of educated youth entering labor markets of this region. And it can improve female participa-

tion in labor markets, as has been the case elsewhere around the world. But these effects can come only with a better investment climate to nurture new investment and new firms, as is evident in China, India, Indonesia, Malaysia, Mexico, and Vietnam. Halfhearted attempts at trade reform in the absence of deeper domestic investment climate reforms fail to create much positive impact on jobs. They can even be devastating—with large job losses from imports, and few gains from new jobs in new industries.

## **The Road to Capturing the Gains from Deep Economic Integration**

Decisive action, and the support of the region's trading partners, is needed to capture the large gains possible from regional and global economic integration—and to take advantage of the opportunities missed for the past two decades. Policies must address not just at-the-border constraints, but also a full range of behind-the-border trade and investment constraints.

### **Making Trade Reforms Successful**

Effective trade reform rests on (1) eliciting an adequate supply of private investment response, from both domestic and foreign investors, (2) inducing technological or productivity gains from a more open economic system, and (3) minimizing output and job losses in the transition. This, in turn, requires that the content, pace, and sequencing of reforms be tailored to specific settings. Indeed, many successful countries (such as China, India, and Vietnam) have often undertaken what look at first to be incomplete (or nonorthodox) approaches to liberalizing trade and investment. But they have produced outcomes that are often better than in other cases where reforms have been more orthodox and complete (as in Argentina or Brazil).

### **Sequencing and Pacing Reforms**

The debate on sequencing and speed of reforms, intense in the 1980s for Latin America, gained even more attention for the transition countries of Eastern Europe in the 1990s. The reasons for supporting gradual reforms range from allowing the costs of reform to be spread over time (avoiding the danger of reversals), to institutional arguments for creating adequate capacity and learning, and to political economy arguments of building support for reforms. The counterarguments for faster (“big bang”)

change are to gain credibility, ensure complementarity among different parts of the reforms, reduce uncertainty, and capture opportunity.

The evidence on the pace and sequence of trade reforms from experiences around the world (including from neighboring Eastern Europe, Asia, and Latin America) suggests the following:

- First, to build momentum, programs must start boldly and then follow through with further measures. This proves more durable than an initially hesitant approach, which creates doubts about the credibility of the program. So, trade reforms must encompass broad-based liberalization and widen its domain successively and quickly—so that more individual sectors or groups are able to perceive the benefits and spread the costs more evenly. Evidence from the region suggests that accelerated trade reforms would bring fairly immediate gains in aggregate consumption of 3 to 5 percentage points, creating visible benefits for consumers and domestic support for change.
- Second, programs that decisively reduce import quotas or import licensing monopolies succeed more than those that retain such privileges. That step sends a clear signal that no rent-seeking, special enclaves deserve more protection than others. Also, such actions provide widespread benefits to consumers and others through lower prices and higher-quality goods.
- Third, there must be across-the-board cuts in tariffs, setting as little administrative discretion as possible, and progressively lower ceilings within a time-bound program. Indeed, lowering all tariffs to as uniform a rate as possible is the best way to do away with a discretionary and administrative approach.
- Fourth, reforms must go well beyond at-the-border trade policies to eliminate behind-the-border impediments in customs, standards, ports, and other barriers. Indeed, trade reform cannot work without such complementary reforms.
- Fifth, trade reforms must be accompanied by consistent and bold investment deregulation to free up new entry and allow private investment to respond. That investment response is probably the most decisive element in the success or failure of the entire program.
- Sixth, the financial sector needs to allow the shift in resources from previously protected and unproductive state enterprise-dominated sectors to the new exportable sectors.
- Seventh, a case for gradualism can nevertheless be made for sectors in which job losses are likely to be significant.

## **Reforms in Resource-Poor Countries: Egypt, Jordan, Lebanon, Morocco, and Tunisia**

Although there are differences, countries in this group are relatively advanced in their broad direction of reforms. The challenge now is for these resource-poor countries to move on to a new round of more decisive and credible trade liberalization. There is little reason for gradualism, after more than a decade of adjustment time for domestic industry, enormous pressures in domestic labor markets for new jobs, and huge potential benefits of accelerated reform.

*Exchange rate policies.* Exchange rate policies need to be supportive of an accelerated round of trade reform. Significant adjustments of real exchange rates, through nominal rate adjustments or domestic demand measures, need to precede trade reforms. Tunisia has a managed float, with a real exchange rate target. Jordan and Morocco have pegged exchange rate policies. Morocco's persistent overvaluation in the past contributed significantly to its poor export performance during the 1990s, but it has improved more recently. Egypt's recent shift to a floating exchange rate offers the opportunity to slash tariff protection across the board since the depreciation that has occurred will protect import substitution industries. In Lebanon sustainable macroeconomic reforms are needed before the country can reap benefits from trade reforms.

*Tariffs and nontariff barriers.* Countries need to accelerate tariff reductions and apply them across the board, reduce peak tariffs, and simplify a still complex tariff structure. For example, the simple average tariff rates in Morocco and Tunisia at 33 percent and 30 percent, respectively, remain more than double the average for all low- and middle-income countries, while Egypt's (21 percent) remains well above. Reforms should move to cut these rates. That includes avoiding any trade-diversion effects of regional trade agreements by providing only marginal tariff advantages—if any—to regional trade partners. Tariff peaks need to be drastically reduced. For example, tariffs in Morocco and Tunisia on agriculture remain extremely high (up to 358 percent), while taxation peaks for other products remain distorted with high protection for domestically produced items and multiple and complex rates (up to 29 rates in Egypt and 22 in Tunisia).

Although nontariff barriers have been progressively eliminated, a few remain. Tunisia replaced import licensing with administrative barriers, such as *cabiers de charge*, which still impede trade. In addition, quality standards and systematic technical controls are often used, as in Morocco, which has a multiplicity of such controls. Replacement of nontar-

iff barriers with their tariff equivalents would create transparency and reduce lobbying for import licenses and rent seeking.

Domestic standards and inspections often lack any international equivalence, and many countries enforce quality norms that provide little health or safety protection. In Egypt, testing and certification procedures are lengthy and costly (Nathan Associates cited in Kheir-El-Din, 2000). More recent measures have helped, but the standards regime still remains the most significant trade barrier. Standards and inspections ought to be aligned with WTO principles.

*Managing fiscal consequences.* Fiscal consequences of tariff reduction are often cited as one important reason by countries for not cutting tariffs faster. This is wrong. Most revenue losses can be recouped through domestic taxes, such as a value added tax (VAT) and with faster growth in aggregate. Experiences around the world and in the region itself also suggest that trade tax revenue losses are frequently overstated, and revenues may indeed increase with trade liberalization as more revenues are captured because of reduced evasion, faster growth in import volumes, and tariffs that replace nontariff barriers. For example, in Morocco, customs duties are an important source of revenues for the national budget, and accounted for 4.2 percent of GDP in 1995—just before tariffs started to be reduced under the association agreement with the EU. In 1996–2000, revenues from customs duties fell to 3.3 percent of GDP, a significant loss, but smaller than feared. Most of the decline in import tariffs was compensated for by a nearly 25 percent rise in imports, so that customs duties also continued to generate revenues. But revenues from a new VAT on imports rose in the same period to 3.3 percent of GDP, more than compensating for the decline in import tariffs.

*Euro-Med agreements.* Instead of the Euro-Med agreements' scheduled tariff reductions, which are too slow, negotiations should focus on achieving greater benefits from trade partners in return for offers of accelerated trade reform. For example, Tunisia's trade liberalization has focused on the association agreement, initially yielding significant gains in some products (capital goods and intermediates) but escalating effective protection for others. The reduction of tariffs on heavily protected items was backloaded and they are only now beginning to be implemented. And countries would also gain by extending such tariff reductions on a most-favored-nation basis.

*Customs reforms.* Customs reforms, which are proceeding well in Jordan and Morocco, need to be accelerated in Egypt and Tunisia. Customs procedures remain complex and time consuming. In recent surveys

Tunisian firms report that it can take three weeks or more to comply with administrative bottlenecks. The costs are especially large for small firms. A similar situation prevails in Egypt. Procedures are complex, inspections are excessive, and release times are long.

*Services and new businesses.* Critical service sectors need to be opened to competition, especially in telecommunications, financial services, transport, education, and health. Commitments to market access require re-examination, especially in Jordan and Tunisia. In Jordan and Morocco, port and road transport deregulation is critical in view of the high transport costs. Privatization and regulatory reform in air transport is also urgent, especially in air-freight services. Tunisia requires further telecommunications liberalization. Jordan, Egypt, and Tunisia may need to actively encourage competition from foreign banks, by opening up their banking sectors.

All countries in the MENA region need deregulation to reduce bureaucratic procedures and transaction costs for new firms. The number of steps required to open a business is excessive and costly.

### **Reforms in Labor-Abundant, Resource-Rich Countries: Algeria, the Islamic Republic of Iran, the Republic of Yemen, and Syria**

The resource-rich countries have a more complicated task in shifting from state-dominated and protectionist economic systems to open, market-led systems. Much of the core support for reform has to come from the very sectors that stand to lose initially from trade policy reforms—the dominant, protected public enterprises and private sectors.

With the current situation inherently unstable, there are significant pressures for more credible and consistent change. The largest pressure comes from labor markets. The current system is unable to generate enough jobs for a young, educated, and rapidly growing labor force. Unemployment rates are among the highest in the world, and real wages are falling. Falling per capita oil rents compound the problems. At some point reform becomes inevitable. It is encouraging that some countries are indeed beginning to start such deeper reform.

What should the countries in the group of larger, resource-rich countries do to initiate and sustain effective trade reform? They first need to achieve macroeconomic stability—as most have—at a reasonable level of oil prices. But they also need to deal with the massive distortionary effects of oil rents on traded goods and services. This means managing the booms and busts better, avoiding the stop-go cycles of structural reform and backtracking, and progressively reducing the rent-seeking effects of oil. For example, during the 1979–81 boom, more than 40 percent of In-

Indonesia's oil windfall was saved abroad, and supporting exchange rate policies allowed the nonoil sectors to grow despite the oil boom.

Specifically, these countries might:

- Establish fiscal rules that insulate government spending from windfalls and downturns, by setting up explicit rules-based mechanisms for saving or drawing down temporary oil funds.
- Set aside an increasing proportion of oil revenues as longer-term surpluses for future generations (as a provident fund for old-age pensions for the current generation or for social safety nets for job losses in the transition), the scale depending on the prospects for exhaustion of the resources.
- Adopt appropriate macroeconomic policies to reduce misaligned real exchange rates.

To be credible these measures need to be backed by constitutional-type reforms so that the rules cannot be easily changed. Many of these countries distribute a significant part of the oil rents as production subsidies or low energy prices to consumers, with the same distortionary macroeconomic effects as public spending. Energy prices need to be raised progressively to world levels. Diversification and growth of nonoil traded goods and services will be impossible without some combination of these measures.

Domestic pricing deregulation for key traded goods and services is another precondition to effective trade reform. Price controls, regulations, and subsidies, so pervasive in these economies, muffle the price signals through which trade policy reforms work. For example, manufacturing, agricultural products, and key services such as transport remain subject to extensive domestic price controls, particularly in Algeria, the Islamic Republic of Iran, and Syria.

Across-the-board cuts in tariffs spread the costs of reform across all sectors, increasing the benefits and reducing resistance. The goal should be a uniform tariff rate of about 10 percent (a target lower than in resource-poor countries because offsetting oil revenues should permit lower trade taxes).

Import duties can be replaced by a stronger nonoil tax base, boosting overall government revenue. In some countries, for example, the complexity of the VAT and other taxes and high rates of evasion result in low yields. The tariffication of extensive nontariff barriers would be more effective. Customs reforms are also vital.

All countries would benefit from deregulation of services and the introduction of competition to state-owned and -operated activities—in ports, transport, telecommunications, and finance. The waiting time for a fixed telephone land-line is 10 years in Syria and 6 years in Algeria. The

advent of cellular telephones has reduced the access problem, but is not a complete solution. Freight costs are about twice benchmark levels. Algeria, the Islamic Republic of Iran, and Syria severely limit foreign bank activity in varying degrees, with state-owned banks dominating (up to 95 percent of assets). The result is poor services, high costs, extensive lending to state enterprises, shaky balance sheets, and weak financing of new activities and trade. Financial sector reform ranks high on the agenda of services requiring critical attention.

Deregulation of domestic and foreign investment is also critical for export activities. Attracting more FDI will require deep-seated reforms and improvements in the business climate. The Republic of Yemen, as a very low-income country, represents a special case in which improvements in governance (property rights, land registration, security) with respect to the private investment climate and the supply of key public services are especially critical.

Public enterprises in manufacturing and services, which employ large sections of the labor force, are often the greatest obstacles to effective trade reform in many of these countries. They are threatened by many of the trade measures and by the change to a private-sector-led economy. They also form a natural coalition with others who stand to lose from trade reforms, especially a smaller group of rent-seeking constituencies that directly benefit from many of the current trade restrictions.

Trade policy reformers will need to isolate and break up these natural constituencies of support for the status quo. One way is to isolate them by removing the main sources of their rents in trade, typically by removing administrative discretion, setting tariff rules, and eliminating licensing and quota barriers. That would release large and visible benefits to consumers, through lower prices and greater availability of consumer goods. However, it would be important to deal carefully with state enterprises and potential job losses, by allowing some state enterprises to remain in operation with harder budget constraints. A progressive reduction in the size of state enterprises could avoid large job losses.

### **Reforms in Labor-Importing, Resource-Rich Countries: The GCC States**

The resource-rich GCC countries face two main challenges. The first is accelerating nonoil growth to generate adequate employment opportunities for the young job seekers, who constitute nearly a quarter of the population. The second is reducing vulnerability to oil price fluctuations. On both accounts, the smaller GCC countries have done well. But challenges remain. Per capita incomes in Saudi Arabia have fallen (in nominal terms) from a

high of about US\$17,000 in the early 1980s to about US\$9,000, an almost unprecedented drop.

The GCC countries have embarked on deeper reforms that promise to sustain these basic policy directions and accelerate their integration with the global economy. They have established a US\$335 billion customs union, which will allow them to forge a larger common market with lower trade barriers to the rest of the world, with a standard 5 percent external customs tariff. The goal is to form a homogeneous unit to facilitate intragroup trade and collective negotiations with the WTO and trade partners and to attract foreign investment.

Challenges in trade lie mainly in four interlinked areas. First, labor markets suffer from wage rigidities, skills mismatches, and institutional factors. Some GCC countries are replacing foreign workers with nationals by setting quotas on expatriate workers and raising employment costs for expatriates. These policies could be counterproductive in the long term because wage flexibility and skilled workers are needed for growth of the nonoil sectors. Mandatory systems are not a good substitute for wage flexibility. Education and skills training improvements are also critical.

Second, the government wage bill, defense and security spending, and subsidies and entitlements are straining government budgets. The traditional role of the government as dominant employer and wage policy setter needs reconsideration, as do subsidies for food, health, education, agriculture, and basic industries. Explicit subsidies are small by international standards (2 to 3 percent of GDP), but implicit subsidies through low energy prices and long-term loans are significantly larger. Revenue policies will also need attention, especially fees for utility services and the introduction of broad-based consumption taxes.

Third, structural policies to diversify economies will need continued attention, especially privatization since most of the larger, nonoil industries remain in public hands. New regulatory standards are needed for financial markets and to spur development of local equity markets.

Fourth, making the GCC customs union work will require establishing common customs rules and procedures, harmonizing technical and regulatory procedures (standards, security, inspection, and licensing), increasing transparency, and minimizing administrative barriers.

### **Managing Transition Costs and Job Losses**

In many MENA countries, some sectors will likely suffer significant job losses—such as agriculture, public enterprises, and capital-intensive manufacturing. Business expansion takes time, and in some cases the investment climate may not be sufficiently attractive—leaving restructured

and export-oriented companies without incentives to expand and to absorb labor released by the shrinking sectors. So job destruction may outpace job creation, because lowering trade barriers may initially hurt sheltered domestic producers and displace unskilled workers in import-competing industries.

Although import-competing industries are usually capital intensive, MENA industries—like those in many middle-income countries—are also often intensive in unskilled labor. They are also often protected disproportionately because they face potentially stiff competition from lower-cost producers. In Morocco before the trade liberalization, the nominal tariff and import license coverage in apparel and footwear was among the highest in manufacturing. And in Egypt, clothing imports are still discouraged by tariff rates set at four times the weighted average.

Whether there would be significant job losses in a particular sector depends on four factors:

- The underlying aggregate growth in the economy, with higher aggregate growth offsetting the downward pressure on these sectors.
- The ability of the trade liberalization program to insulate some sectors from overall trade liberalization measures, by providing partial time-bound protection.
- Possible compensatory measures to allow enterprises to manage the transition more smoothly—such as providing enterprises funds to restructure operations, such as in the Tunisia *mise à niveau* program and similar programs in Morocco and Egypt, although these should be used sparingly given doubts about their efficacy.
- The ability to restrain job losses in state-owned enterprises without derailing the objectives of reform (allowing losses to mount temporarily in state-owned enterprises while downsizing operations as an implicit compensation measure).

The investment response of new firms and new entry into new sectors are, however, the most critical—with quick payoffs in new activities. Mexico jumpstarted the *maquiladora* border investments to generate new jobs—while negotiating longer phase-ins of trade liberalization for employment-heavy sectors, such as automobiles, agriculture, and pharmaceuticals, and leaving the state banking and oil sectors relatively untouched.

All this highlights the need for careful design in the pace and sequencing of trade and investment climate reforms—and for close monitoring and early corrections, but without backtracking, which can be costly for the credibility of the program. In China, India, Indonesia,

Mexico, Vietnam, and elsewhere, transition issues have generally been handled well through:

- Liberalizing early in key areas and inputs, and addressing key bottlenecks (such as customs or inspections) to jump-start new export-oriented activities.
- Embarking on large-scale and upfront domestic investment deregulation to foster new entry and job growth.
- Delaying state enterprise downsizing and job losses, but exposing them to competition and reducing the scale of their operations so that losses are held in check by hard budget constraints.
- Instituting compensatory mechanisms for firms that can restructure.
- Maintaining competitive exchange rates.
- Phasing reforms in with the macroeconomic cycle.

A similar strategy is possible for all countries in the MENA region, so the political and economic fear of large job losses should not be a significant reason for deferring the reform agenda.

## Liberalizing Services

International experience suggests that better-quality and lower-cost backbone services—such as finance, transport, and information and communications—and important production inputs—such as electricity—reduce the cost of exporting and strengthen linkages with global production networks. Regulatory reforms that inject more competition in markets for services and network industries, in turn, force operators to improve efficiency and pass on the lower production costs to users. Similar outcomes can be achieved by lowering trade barriers in services and making room for increased foreign investment.

Despite recent initiatives, MENA is far from a situation in which services do much to promote trade and investment. Indeed, today's regulatory constraints and low efficiency are substantial impediments to trade and investment. Inefficient and costly services, provided mostly by the public sector, raise the cost of MENA merchandise exports and limit attractiveness to investment, while impeding trade expansion within the region.

With the right enabling environment in place, liberalization of key services—especially telecommunications and transport—could facilitate the development of export capacity in other services—especially in

tourism-related services and the information and communication technology sector. In addition to its benefits for trade, liberalization in services can create more investment opportunities for the domestic private sector and attract more job-creating foreign investment as well. Stepped up investment can offset the short-term adjustment costs from the reduction of protection for import-competing industries. Sound design of private participation schemes in infrastructure services, coupled with procompetitive regulatory regimes and strong regulatory capacity, are key.

### **Making Agriculture More Dynamic**

It is in the MENA region's interests to subscribe to an equitable, liberal, and open rules-based multilateral trading system within the WTO framework. But sustainable development requires gradual reforms in agriculture and in rural areas. It also requires much faster opening of market access in richer countries and a commitment from MENA's trading partners to mitigate the substantial welfare losses from freer global trade. Closer to home and within the context of trade relations with the EU, revitalized regional trade agreements can begin to address market access and trade reforms.

With substantially better access for its exports, and with substantial trade and domestic price reforms, MENA could have welfare and efficiency gains that are large (some US\$2 billion a year). It could also have large savings in water use, with food security achieved through trade rather than protection. Already, trade is playing a vital role with the very substantial food imports that are saving huge water resources (equivalent to the annual flows of the Nile River, by some estimates). But there is much more opportunity, for a shift out of production of the still heavily protected, costly, and water-intensive activities such as beef, dairy, sugar, rice, and wheat into more labor-intensive and less water-intensive export crops such as cotton, fruits, and vegetables. Improvements in agricultural trade should lead to faster and more sustainable growth, reducing poverty along the way.

The consequences of trade-related job losses are a serious issue in agriculture. The benefits of freer trade will go mainly to better-off farmers in irrigated areas and urban consumers. But large losses will be borne by the more vulnerable segments of the rural population—small field crop producers, subsistence farmers in rainfed areas, and poor livestock herders. Their earnings losses will have to be dealt with in ways different from those envisaged for the “average” displaced manufacturing worker. The displacement process should avoid putting the burden dis-

proportionately on women. Packaging the transition process to accommodate those constraints and designing adequate safety nets could ensure that trade reform in agriculture is politically viable.

### **Anchoring Reforms in Regional Integration Agreements**

Anchoring reforms in revitalized regional trade agreements and in multilateral forums, such as the WTO, will help lock in reforms with domestic constituencies and strengthen the credibility and commitment to reform generally. An important part of the trade and broader economic reform strategy in MENA countries will thus be to revitalize regional trade agreements. There are several ways to make these trade agreements work better.

First, trade with Europe, the natural geographic trading partner for the MENA region, falls far short of its potential. With new members expanding the size and scale of the EU market, the potential gains for a number of MENA countries are expanding as well. The Euro-Med agreements and the Barcelona Process could be strengthened by accelerated commitments by MENA countries to reduce trade barriers, liberalize services, and phase in domestic agricultural reforms. The EU could offer immediate, expanded access to its markets for agriculture, as well as increased temporary migration, funds for managing transition costs, and more efficient rules of origin.

Second, substantial expansion in regional trade is possible if the barriers to trade and investment are progressively eliminated. Intraregional trade agreements could be strengthened by mutual agreements to reduce product exclusions in agriculture and services and to harmonize customs and regulatory processes (standards, investment and other licensing processes, visa restrictions).

Third, MENA countries would do well to maintain open access to world markets, anchoring their trade and investment reforms in a multilateral framework such as the WTO, which will give them greater credibility. But first more countries in the region will have to become full members of the WTO.

### **Getting Support from MENA's Main Partners**

MENA's trading partners need to rethink the challenges in this region, including the devastating effect of persistent conflict and sanctions and the disincentives of strategic aid. There is strong evidence to suggest that the incidence of violence and conflict has had a hugely negative influence

on trade and investment integration, rivaling the influence of poor domestic policies. Persistent conflict has had large neighborhood effects throughout the region, affecting not just the conflict-ridden countries but all their neighbors.

Trade barriers compound the problems. This region has the lowest proportion of its population covered by membership in the WTO. Sanctions have created their own distortionary effects. Agricultural exports (of less water-intensive crops such as fruits and vegetables) have also faced large market access barriers and tariff escalation for processed food. Labor flows have been restricted.

The support of regional partners for faster and deeper integration will thus be important in revitalizing the incentives and effectiveness of regional trade agreements and in making trade and investment reforms work. That support will include opening their markets for the region's exports of agriculture, and permitting greater flows of temporary migration—and harmonizing trade and investment processes. Building more fences around this region is not a viable solution.

## Tackling the Broader Reform Agenda

Faster growth of output, productivity, and jobs is available if MENA countries tackle deep-seated barriers to trade and investment. Reforms need to go beyond the shallow at-the-border trade policy reforms and the signing of numerous trade agreements—the staples of the 1990s—to much deeper domestic policy reforms. Liberalizing trade in goods as well as liberalizing services will yield much bigger gains in welfare. Accelerating tariff and nontariff reforms and moving to appropriate exchange rate regimes and improving the investment climate are also critical.

But a broader agenda of reforms, elaborated in companion volumes to this report, will need to complement the reforms identified here:

- Improving governance to increase the voice of citizens and the accountability of government. Improved governance is implicit and critical to reduce the array of barriers to trade and private investment discussed here, but such reforms cannot be isolated from or be successful and sustainable without broader governance reforms.
- Putting gender issues at the center of development. Women's gains from trade and investment reforms cannot proceed without the removal of a large number of social barriers, nor will the overall gains to trade and investment reform be achievable without greater participation from half the citizens of this region.

- Tackling the unemployment and labor market issues and absorbing a growing labor force into a more dynamic economic system. Trade and private investment is one critical instrument to enlarge labor demand, and indeed the central reason for shifting to a more open system, but a larger array of labor market issues will need to be addressed.