The Euro-Mediterranean Partnership

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The EU has renewed its attention on its Mediterranean neighbors and made important progress under the trade component of the Euro-Mediterranean Partnership, its broad policy initiative with the region. To help achieve the long term goal of forming a Euro-Mediterranean free-trade area by 2010, the EU is negotiating bilateral association agreements with Mediterranean countries. Empirical research suggests that the welfare effects of the association agreements are positive, but that the benefits from the proposed Euro-Mediterranean free-trade area would be greater, especially for the Mediterranean partners.

With a revived focus on Mideast affairs and countries stemming from the events of September 11, 2001, the EU has renewed attention to its Mediterranean neighbors and made important progress under its broad policy initiative with the region. In 1995, the EU launched the Euro-Mediterranean Partnership (sometimes referred to as the Barcelona Process), a comprehensive initiative governing the EU's economic, political, and social relationship with its 12 Mediterranean neighbors. The major goals of the Partnership are to promote peace, stability, and prosperity throughout the region. To help ensure these goals are met, the Partnership aims to create a Euro-Mediterranean free-trade area (FTA) by 2010. The population of this FTA could measure over 700 million, counting countries in central and eastern Europe that are currently negotiating to join the EU, somewhat less than the approximately 800 million people that would comprise the Free-Trade Area of the Americas (FTAA), currently under negotiation among Western Hemisphere countries. In the run-up to 2010, the EU is negotiating association agreements with Mediterranean partners to expand free trade bilaterally. Currently, the EU has concluded association agreements with all but one of these Mediterranean countries.

Background

The 12 Mediterranean partner countries, with a population of about 229 million, are: Algeria, Morocco, and Tunisia–the 3 collectively known as the Maghreb–Egypt, Israel, Lebanon, Jordan, the Palestinian Authority, Syria, Turkey, Cyprus, and Malta. Cyprus and Malta have applied to join the EU and are currently negotiating accession (see *IER*, Nov.-Dec. 2001). They could become members of the EU as early as 2004. Turkey has also applied to join the EU, but is not presently negotiating to join. A customs union between Turkey and the EU entered into effect in January 1996.

With the other nine Mediterranean countries, the EU is negotiating association agreements to replace the first generation bilateral cooperation agreements that the EU negotiated with Mediterranean countries in the 1970s. In the earlier agreements, the EU generally granted unilateral duty-free treatment for industrial products, with limited concessions for agricultural products. The trade-related provisions of the new association agreements are broadly similar and can be distinguished from these past agreements by the greater degree of market access granted to EU products in the Mediterranean countries. Each of the new association agreements calls for bilateral free trade covering industrial products and the progressive liberalization of trade in agricultural products, such as the widening of tariff-rate quotas. Under the new agreements, EU concessions in agriculture remain limited; however, a review of the agricultural situation is provided for at a later time. They also call for the parties to assess the possibility of liberalizing trade in services at a future date. Depending on the agreement, the Mediterranean partner could have up to 15 years to dismantle tariffs on EU exports.

In addition to trade liberalization, the agreements cover cooperation in a range of other areas. The EU will provide technical and financial support to implement the association agreements, including for example, the restructuring of customs administrations, support for standards and technical regulatory bodies, and strengthening of the statistics system. The agreements also commit Mediterranean partners to economic liberalization, including modern legislation on competition and the protection of intellectual

[1] The views expressed in this article are those of the authors. They are not the views of the U.S. International Trade Commission (USITC) as a whole or of any individual Commissioner.

property rights. New institutional structures will be set up to facilitate cooperation on a host of other issues, ranging from education and culture to the fight against crime and terrorism. The European Union established a financial instrument in 1996, known as "MEDA," to provide technical and financial support for economic and social reforms in the Mediterranean partners.[2]

Status of the Association Agreements

Such association agreements with three of the nine Mediterranean countries have been ratified and have entered into force: Tunisia (March 1998), Morocco (March 2000), and Israel (June 2000). The agreement with Jordan was ratified in March and is scheduled to enter into force on May 1, 2002. An interim agreement with the Palestinian Authority has been in effect since July 1997, but implementation to date has been limited. According to the European Commission, Israeli impediments to Palestinian trade and insufficient capacity of the Palestinian economy have constrained progress. Also, the sensitive political situation has prevented the negotiation of a full Association Agreement.[3]

Cooperation agreements continue to govern EU trade with Algeria, Egypt, Lebanon, and Syria. Negotiations with these four countries are at different stages. The agreement with Egypt was signed in June 2001 and awaits ratification. Ratification is required by the European Parliament and the parliaments of each of the 15 EU member states as well as the Mediterranean partner.

The agreement with Algeria was initialed on December 19, 2001, and is expected to be signed later in 2002. The association agreement with Lebanon was initialed on January 10, 2002. Because ratification is often a long process, the EU and Lebanon agreed to conclude an Interim Agreement that would implement the trade aspects of the association agreement, probably in mid-2002. Syria was the last of the Mediterranean partners to begin negotiations for an association agreement with the EU in 1997. Negotiations to dismantle tariffs are underway, but progressing slowly. Syria's economy is highly protected and reforms of the industrial sector are far less advanced than in the other Mediterranean partners.

In May 2001, Euro-Mediterranean trade ministers met for the first time since the Barcelona Process began in 1995. Ministers noted that in the Mediterranean region "the increase in trade and the attraction of investments in the last five years has been insufficient, compared to other areas such as Central and Eastern Europe and Latin America, where trade and investment by the EU has grown faster."[4] To achieve the full potential of a Euro-Mediterranean area, the ministers stressed the importance of concluding association agreements as well as the importance of developing trade between the Mediterranean partners. In 1999, about 52 percent of Mediterranean trade was with the EU, and only 5 percent was among Mediterranean countries.[5] The ministers also noted that although foreign direct investment remains stable in the region, it is low compared to other developing countries. EU officials have pointed out that investors believe the Mediterranean is too "fragmented, split into tiny, separate markets with conflicting standards and rules,"[6] and often has a poor business environment (e.g., inadequate infrastructure and services).[7] To help remedy this situation, the trade ministers set up two working groups. One group aims to improve the efficiency of the service sector by exchanging information and building capacity in Mediterranean partners to prepare them to negotiate liberalization of services trade. The other working group is to harmonize rules of origin with the aim of extending the pan-European system of cumulation to the Mediterranean. Work on rules of origin is likely to first focus on the textiles and apparel sector, an important sector in trade. The ministers also agreed to identify additional areas where a convergence of legislation could help spur trade and investment. In particular, they referred to norms and industrial standards, sanitary and phytosanitary legislation, intellectual and industrial property rights, competition policy, and customs legislation.[8]

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[2] Council Regulation (EC) No. 1488/96 of 23 July 1996 on financial and technical measures to accompany (MEDA) the reform of economic and social structures in the framework of the Euro-Mediterranean partnership.

[3] European Commission, "The EU and Gaza West Bank," found at Internet address *http://europa.eu.int/comm/external_relations/gaza/intro/index.htm*, retrieved Nov. 14, 2001.

[4] *Euro-Mediterranean Ministerial Meeting on Trade, Presidency Conclusions*, Brussels, May 29, 2001.

[5] European Commission, *Euromed Special Feature*, Issue No. 22, June 7, 2001, found at Internet address *http://europa.eu.int/comm/external_relations*, retrieved Dec. 6, 2001.

[6] "EU Welcomes Moroccan Economic Reforms," *European Report*, No. 2626, Oct. 13, 2001, p. V-4.

[7] For a good discussion on foreign direct investment in the Mediterranean, see *The Euro-Mediterranean Partnership in the Year 2000, Second FEMISE Report on the Euro-Mediterranean Partnership*, Heba Handoussa, Economic Research Forum, Egypt, and Jean-Louis Reiffers, Institut de la Méditerranée, France, Coordinators, July 2000.

[8] *Euro-Mediterranean Ministerial Meeting on Trade, Presidency Conclusions*, Brussels, May 29, 2001; and European Commission, *Euromed Special Feature*, Issue No. 22, June 7, 2001, found at Internet address *http://europa.eu.int/comm/external_relations*, retrieved Dec. 6, 2001.

On March 19, 2002, in the second ministerial meeting on trade, Euro-Mediterranean trade ministers noted that progress toward the FTA requires substantial efforts to improve "South-South" integration (that is, between the Mediterranean countries themselves) and that "in terms of regional integration, the experience of the past years clearly showed that tariff dismantling alone was not enough to ensure rapid development of trade and a significant rise in direct investment."[9] Therefore, the ministers agreed to establish a Working Group on Trade Measures Relevant for Regional Integration. The working group is charged with developing an Action Plan on Trade and Investment Facilitation, which will address customs procedures, standardization issues and conformity assessment, the regulatory framework for investment, and the protection of intellectual property rights.

EU-Mediterranean Trade

In 2000, the Mediterranean partners together accounted for 6 percent of the EU's imports and 9 percent of its exports, or about 8 percent of extra-EU trade, ahead of EU trade with Japan and China. This percentage was about the same as in 1991. Turkey, Israel, and Algeria were the EU's top three partners among the twelve and accounted for almost two-thirds of EU-Mediterranean trade.[10] The EU has traditionally registered a trade surplus with the region, despite a significant deficit in the energy sector.

The composition of EU-Mediterranean trade has changed little over the past decade. Over 80 percent of total trade consists of energy, miscellaneous manufactured products (for example, clothing, footwear, and furniture), and machinery and transport equipment. The energy sector accounted for almost 30 percent of EU imports from the region in 2000. In particular, petroleum products accounted for over 20 percent of EU imports. Algeria, Syria, and Egypt accounted for 94 percent of Mediterranean energy exports to the EU in 2000, with Algeria accounting for nearly 70 percent of this amount. The second largest EU import from the region was clothing, which accounted for nearly 18 percent of EU imports from the region in 2000. The largest category of EU exports to the Mediterranean was the machinery and transport sector, which accounted for about 45 percent of EU exports to the region. This trade pattern is typical of trade between industrialized and developing countries. Road vehicles were the largest export, accounting for over 11 percent of EU exports to the area. In general, EU exports to the Mediterranean countries in the machinery and transport sector were capital-intensive goods. Turkey and Israel were the largest traders among the Mediterranean partners in this sector, reflecting Turkey's developing automobile industry and Israel's strong telecommunications equipment exports to the EU.[11]

Potential Effects in Theory and Practice

Empirical research suggests that trade, whether interregional or international, raises income.[12] Larger countries tend to have more interregional trade and thus higher incomes than countries with small domestic markets and closed economies. Recent research supports the hypothesis of exports as a potential engine of growth for small developing countries. For the Mediterranean partners of the European Union–Mediterranean Association Agreements (EU-MAAs), accessing the larger EU market should result in net welfare gains for all members. Under the theory of comparative advantage, when a nation reduces barriers to a trading partner, national resources adjust through specialization toward areas of comparative advantage relative to the trading partner. Theoretically, EU-MAA partners attain higher levels of welfare from specializing in their areas of comparative advantage and exporting to their trade partners. The net welfare position will include losses to factors in those sectors which are declining, especially returns to specialized labor and capital in the industries in decline. For the Mediterranean partners, these would include inefficient state-owned enterprises and protected domestic industries with high levels of inefficiency due to import-substitution policies. Wages to labor and rents to capital will fall in these declining sectors and increase in the growth sectors as the economy adjusts in response to changes in relative prices brought about by the EU-MAAs. Because EU trade with the Mediterranean countries is small relative to total EU trade, individual Mediterranean partners are too small to influence the terms of trade for their export commodities to the EU. This implies the small country model for the Mediterranean partners. Under the small country model, unilateral trade liberalization is superior to regional or multilateral (reciprocal) trade liberalization at improving the welfare of the small

[9] European Commission, "Conclusions of the Presidency–Euro-Mediterranean Ministerial Conference on Trade, Toledo, 19 March 2002," press release IP/02/437, Mar. 19, 2002.

[10] Eurostat, "EU-15 and the 12 Mediterranean Partners: Solid Trade Links," *Statistics in Focus*, External Trade, 7/2001.

[11] Eurostat, "EU-15 and the 12 Mediterranean Partners: Solid Trade Links," *Statistics in Focus*, External Trade, 7/200; and European Commission, "World Trade Organization Ministerial Conference, The EU Figures for the Doha Conference," Nov. 8, 2001.

[12] Frankel, Jeffrey A. and David Romer, "Does Trade Cause Growth?" *The American Economic Review,* 1999, Vol. 89(3), pp. 379-399.

country.[13] All Mediterranean partners suffer from asymmetry relative to the EU trade bloc, as their economies are significantly smaller and less-developed.

The EU-MAAs have been nick-named the hub-and-spoke agreements. This system represents a free-trade arrangement between Europe and the Mediterranean partners that indirectly links the Mediterranean economies. The EU acts as the hub for the Mediterranean spokes. Although a Euro-Mediterranean free-trade area is a goal of the Barcelona Declaration establishing the Euro-Mediterranean Partnership, the bilateral hub-and-spoke agreements may slow Mediterranean regional economic integration as the small Mediterranean countries have limited government resources to negotiate agreements. Nonetheless, implementation of the bilateral association agreements will encourage regional integration by improving harmonization of standards and technical efficiency in the Mediterranean countries. Four of the Mediterranean partners–Egypt, Jordan, Morocco, and Tunisia–and initiated negotiations for regional trade liberalization in 2001.

What are the possible consequences of forming a bilateral hub-and-spoke system with the EU as the hub? With a hub-and-spoke system, the hub enjoys free trade with all the participants, while the spokes do not liberalize with respect to one another. Thus, the hub enjoys the maximum benefits of this free-trade system. This means the EU hub has significantly more to gain from the EU-MAAs than the Mediterranean partners. The hub will get a larger share of the welfare gains at the expense of the spokes.[14] For example, under the EU-MAA, EU firms will be able to access markets for exports and obtain least cost inputs from any of the Mediterranean partners, whereas firms in each of the Mediterranean partners will only see trade liberalization relative to the EU. Firms in the Mediterranean partners will lose competitiveness relative to the EU under the hub-and-spoke system. Under the hub-and-spoke system, the EU gains a competitive advantage in each market, not enjoyed by the Mediterranean partners. Some industrial trade that normally takes place directly between Mediterranean partners may be diverted through the EU to take advantage of the EU's preferential position in the system. This can cause trade diversion that reduces the net welfare gains from trade liberalization under the EU-MAAs. This kind of trade diversion would increase demand in the EU services sector (transport, insurance, banking) at the expense of service sectors in the Mediterranean partners. Besides the preferential benefits to EU firms of the special hub status, the EU has concern with slowing the immigration flow from the region. Improved investment and employment opportunities in the Mediterranean partners would improve employment in the growth sectors, with the potential for net reductions in unemployment and reduced pressure for migration to the EU.

The EU is the biggest investor in the Mediterranean partner countries. The EU-MAAs are likely to increase confidence in these economies, encouraging investment from the EU, especially repatriation of capital and remittances from Mediterranean workers in the EU. Although market access under the EU-MAAs is expected to attract investment to the Mediterranean partners, the biggest investment flows may be into the EU. Given the EU's preferential treatment in all the EU-MAA member markets, firms would prefer to locate at the hub. A Mediterranean member would be less attractive because there are no tariff reductions relative to other Mediterranean partners. Production growth would be centered at the hub in this type of trading system. Gains from economies of scale and clustering of industry are more likely for the EU than the Mediterranean partners. EU industrial clusters that might form under the hub-and-spoke EU-MAAs are unlikely to shift to Mediterranean partners upon completion of an EU-Mediterranean FTA proposed for 2010.[15] The Mediterranean partners would have greater opportunities for FDI under a free-trade area than the EU-MAAs, because of the market distortions caused by the hub-and-spoke system.

Nevertheless, the Mediterranean partners face numerous potential gains from the EU-MAAs. First, they will immediately enjoy increased access to the EU market, other than for agricultural products. Second, they will have improved domestic efficiencies from elimination of their tariff barriers over the 12-15 year phase-in periods. Developing countries have the potential for more efficiency gains from implementing free-trade agreements than their industrialized partners due to the high level of trade barriers observed in most developing countries. Gains from trade liberalization include improved efficiency in sectors previously protected by trade barriers and increased transparency for doing business. Reduced tariff and nontariff barriers lower domestic prices and price distortions. For the EU-MAAs, this will only be true in the manufacturing and some service sectors. Agricultural prices will remain high and may even increase in the food importing Mediterranean countries. As a result of improved market access under the EU-MAAs, the Mediterranean partners are expected to attract some

[13] Bernard Hoekman and Simeon Djankov, "Catching up with Eastern Europe? The European Union's Mediterranean free trade initiative," in *Opening Doors to the World*, Raed Safadi (editor), The American University in Cairo Press, 1998.

[14] For a theoretical discussion of the hub-and-spoke system versus free-trade areas, with references to NAFTA, see Ronald Wonnacott, "Trade and Investment in a Hub-and-Spoke System Versus a Free Trade Area," *The World Economy*, 1996, Vol. 19 (3), pp. 237-252.

[15] Ronald Wonnacott, "Trade and Investment in a Hub-and-Spoke System," op. cit.

foreign direct investment, resulting in improved economic growth and industrialization. Management practices, productivity, and technology should improve in the Mediterranean countries as a result of greater association with the higher income, industrialized EU. Trade agreements in general have been shown to stimulate domestic economic reforms in developing countries. This is especially relevant for the Mediterranean partners, who lag behind Latin America and Eastern Europe in reforming their economic policies. However, a stable macro-economy, public institutions, privatization of state monopolies, efficient services sectors, private savings and investment cannot be imported through a free-trade agreement.[16]

It should be noted that the potential welfare gains to the Mediterranean partners would be greater under the proposed EU-Mediterranean FTA than the EU-MAA hub-and-spoke system. Under an FTA, trade barriers are reduced among all members, not just between the EU hub and each of the Mediterranean spokes. Morocco, Tunisia, Egypt, and Jordan agreed in 2001 to move forward in liberalizing regional trade. A free-trade area would have lower overall tariffs and thus greater welfare gains for all members. This should encourage the Mediterranean partners to eliminate regional trade barriers. An FTA would also remove any preferential income gains enjoyed by the EU as the hub of the EU-MAAs. However, the EU would be receiving a smaller share of a much larger income pie. Under an FTA, the Mediterranean partners would have more opportunities to benefit from economies of scale, improved competition, and regional bargaining power. The Mediterranean partners have less bargaining power under the EU-MAAs than they would have had under a free-trade agreement where they could have combined resources in negotiating with the EU in areas of common interest. It is unlikely that the individual Mediterranean partners, which are all small developing countries, were able to exert much negotiating power on the EU. A free-trade area would allow Mediterranean partner firms to have equal access to Mediterranean markets and low-cost inputs, putting them on equal footing with EU firms. If the Mediterranean partners successfully form a regional free-trade area in 2010 that directly eliminates barriers between Mediterranean partners, any trade diversion created by the EU-MAAs would be eliminated. At that time, the EU firms would lose their temporary preferential access to Mediterranean markets under the EU-MAAs.

The EU-MAAs relative to an FTA create more administrative work because the EU agreements with each Mediterranean partner are negotiated separately and contain different features. Firms must comply with rules of origin that would not be as pervasive under a free-trade agreement. Firms will need to familiarize themselves with each separate agreement to conduct business within the hub-and-spoke system. The Mediterranean partners stand to lose a substantial amount of customs revenue under the EU-MAAs, which explains the long phase-in periods allowed for the Mediterranean partners. It is estimated that Morocco will lose approximately two-thirds of its customs revenue under the latest version of its EU-MAA. This negative effect on public finances will reduce the net welfare gains from bilateral trade liberalization with the EU. However, the EU-MAAs include provisions for technical and financial aid from the European Union to assist the Mediterranean countries during the transition from protectionism to liberalized trade. The MEDA program provides for grants to the Mediterranean partners to help reduce the financial pain of lost domestic industry competitiveness and lost tariff revenues.[17]

Conclusions

The newest round of bilateral association agreements between the European Union and Mediterranean countries is an important step at moving the Mediterranean partners toward free trade. Although the EU-MAAs will result in greater welfare gains for the EU hub than the Mediterranean spokes, the goal of eventually forming a Euro-Mediterranean FTA by 2010 will remove any temporary advantages caused by the EU-MAAs. Because the Mediterranean partners will benefit more from regional integration under a Euro-Mediterranean FTA than bilateral arrangements under the EU-MAAs, they should move forward as quickly as possible with negotiations aimed at such a regional FTA.

[16] Bernard Hoekman and Simeon Djankov, “Catching up with Eastern Europe?,” op. cit.

[17] *Khaleej Times*, “Lebanon to Sign Euro-Med Deal,” found at Internet address *http://www.khaleejtimes.com*, retrieved Dec. 17, 2002.