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Incentives for Economic Integration in the Middle East: An Egyptian Perspective

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Abstract

This paper examines the economic and political incentives for regional integration, focusing, from an Egyptian perspective, on whether the preferential trade agreements with the EU will stimulate trade liberalization in the Middle East and North Africa and serve to promote trade within the region itself, particularly with the Israeli/Palestinian/Jordanian triad. It also assesses current incentives and future prospects for regional integration.

The paper concludes that, in the short run, Egypt has limited economic and political incentives to integrate with the triad, or with the region. In the medium run, however, the prospects for regional integration are brighter. Egypt is about to sign a partnership agreement with the EU, and there is keen interest in attracting FDI. Both factors are expected to bring about deeper reforms at home and create pressure for regional integration to allow firms secure access to larger markets, to optimize locations across borders, and to capitalize on economies of scale.

ملخص

تحلل هذه الدراسة الحوافز السياسية والإقتصادية للإندماج الإقليمى، مركزة فى ذلك، من وجهة نظر مصر، على مدى تأثير إتفاقيات المشاركة التى أبرمها، أو سيبرمها، الإتحاد الأوروبى مع دول المنطقة على تحرير التجارة الخارجية بشكل عام، وعلى تحسين التجارة البينية فى المنطقة بشكل خاص.

وتذهب الدراسة إلى أن مصر، فى الأجل القصير، قد لا تتوفر لديها الحوافز السياسية والإقتصادية التى تشجعها على الإندماج الإقليمى، إلا أن إحتمالات الإندماج الإقليمى ستتزايد فى الأجلين المتوسط والطويل، وذلك لأن مصر سوف توقع إتفاقية المشاركة مع الإتحاد الأوروبى، كما أنها تسعى جاهدة لجذب الإستثمارات الأجنبية المباشرة. وهذين العاملين من شأنهما أن يدفعا إلى مزيد من الإصلاح الإقتصادى على النطاق المحلى وكذلك إلى توليد دوافع جديدة للإندماج الإقليمى حتى تتمكن المشاريع الإقتصادية فى مصر من الإستفادة من أسواق أرحب وتعظيم الفائدة من موقع مصر الجغرافى المتميز ومن إقتصاديات الحجم.

Summary

While the road to peace is long and far from easy, the remarkable achievements so far suggest that peace is inevitable, because the alternatives are too costly to all parties. The key question now and in the future is: What kind of economic cooperation, if any, will peace permit? In answering this question, the paper documents the degree of intra-regional trade and factor movements in the last few years, assesses the current economic and political incentives to integrate in the region, focusing on Egypt and the Israeli/Palestinian/Jordanian triad, and explores the prospects of regional integration in the medium run.

The paper makes and evaluates a very simple proposition: Regional integration becomes a reality when the parties involved have sufficient economic and political incentives. When such incentives are lacking, regional integration does not occur, no matter how many times politicians declare their intentions to the contrary. Economic incentives go beyond trade creation and diversion to cover the dynamic gains associated with investment and deeper integration reforms. They increase with: *geographic proximity,* which reduces transportation costs, thus encouraging trade; *openness*, because PTAs under heavy protection promote trade diversion by encouraging specialization among relatively inefficient producers; *investment friendly economies*, because PTAs can offer investors large markets, various sources of inputs, and the potential for specialization and economies of scale; and *the need to anchor reforms,* because PTAs with large economies (such as the US or Europe) can provide safeguards against policy reversal.

While political incentives are not independent of economic incentives, a regional agreement must be politically *desirable, feasible and credible*, in order to take place. *Political desirability* will be met when the benefits of the agreement to the leaders and their supporters outweigh the costs. *Feasibility* will be met when the leaders are able to secure support for the agreement's implementation. *Credibility* will be met when the winners and losers believe that the promises to deliver the gains and compensations are credible.

These criteria are applied in the paper to explore, from an Egyptian perspective, whether or not Egypt has sufficient economic incentives to integrate with the triad, in both the short and medium runs. The paper concludes that, in the short run, Egypt's economic incentives are too limited to warrant integration. Geographical proximity is compromised by the lack of infrastructure and lack of peace. The level of protection is high and may encourage trade diversion. The business environment is in need of improvement to permit FDI to take advantage of location and larger markets. A similar conclusion is reached with respect to political incentives. While the government could pass an agreement through the legislature if deemed politically desirable by virtue of its majority in the parliament, political desirability appears to be

lacking because the Egyptian private sector may be more interested in trading with larger markets than the triad, especially with the EU and the US, and because some may oppose such an agreement because they believe in comprehensive peace as a pre condition for full cooperation. Finally, even
if the desirability and feasibility conditions were met, the durability of the promises in the agreement may not be sustainable. Egypt has lived up to its commitments in the peace accord with Israel, but it cannot guarantee the actions of other parties. Therefore, credibility may be weak without full peace and external guarantees of tranquillity, for example, by the US or the other members of the international community.

In the medium run, the prospects for regional integration are brighter. Egypt is about to sign a partnership agreement with the EU and there is keen interest in attracting FDI. Both factors are expected to bring about deeper domestic reforms and create pressure for regional integration to allow firms secure access to larger markets, optimize locations across borders, and capitalize on economies of scale. With similar reforms in the triad and other neighboring countries, the prospects for regional integration will increase. Needless to say, peace is critical for all this to happen.

In the interim period, the countries of the triad may have strong economic and political incentives to integrate in an appropriate form. At the same time, effort should be focused on taking incremental steps that will bring about beneficial integration to all parties in the future. Reforms of national policies to make them hospitable to investment–domestic and foreign–and greater liberalization are key. These efforts can be supported and coordinated regionally, say, through the Middle East Bank. Simultaneously, it may be possible to work on joint regional projects, especially in infrastructure.

In sum, future regional trade is a big challenge, given that the recent data continue to show that the region is remarkably unintegrated, accounting for less than 10 percent of total regional trade. To make progress towards regional integration, the parties must have both the economic and political incentives to move in that direction.

1. Introduction

Notwithstanding the recent stalled progress of the Middle East peace talks, what has been accomplished to date was unimaginable a few years earlier. In 1993—14 years after the peace agreement between Egypt and Israel was signed—the first stage of a peace agreement between the Palestinians and Israel was reached, and in 1994 another was concluded with Jordan. Much is still to evolve on the Palestinian front, with Syria, and with Lebanon. The rest of the Arab countries will eventually follow suit.

While the road to peace is long and far from easy, the remarkable achievements so far suggest that peace is inevitable. The alternatives are costly to all parties. The key question now and in the future is: What kind of economic cooperation, if any, will peace permit? This question raises a set of subsidiary questions. For example, will the preferential trade liberalization prompted by the agreements with the EU serve to stimulate further trade liberalization in the Middle East and North African countries? Will these agreements serve to promote trade and other forms of cooperation within the region and with the Israeli/Palestinian/Jordanian triad? What are the prospects for extending the incipient steps toward integration within the triad to Egypt and other countries?

This paper makes and evaluates a very simple proposition: Regional integration becomes a reality when the parties involved have sufficient economic and political incentives. When such incentives are lacking, regional integration does not occur, no matter how many times politicians declare their intentions to the contrary. The limited integration in the region, despite repeated attempts at an Arab common market, is a prime example of this. Arab nationalism was not enough–nor will the peace euphoria necessarily be sufficient–to bring about economic cooperation in the region. Any serious consideration of the prospects of regional integration must therefore be grounded in the economic and political incentives to integrate.

The next section documents the degree of intra-regional trade and factor movements in the last few years. Section 3 assesses the current economic and political incentives to integrate in the region, focusing on Egypt and the triad. Section 4 explores the prospects of regional integration in the medium run. Section 5 offers concluding remarks.

2. Intra-regional trade and factor movements

Peace was viewed by many as a turning point towards political reconciliation and economic opportunities. However, significant regional integration has yet to be seen. The data on regional trade in goods and services, capital movements and labor mobility show limited progress. Similarly, the data for Egypt suggest limited progress on integrating with the triad of Israel, the Palestinian National Authority (PNA), and Jordan.

2.1 Trade in goods

Intra-regional trade in merchandise averaged only 9 percent of total exports over the period 1989-95 (Table 1). This average compares to over 60 percent for the EU, and over 35 percent for

Asia. In addition, intra-regional trade is in fact shrinking, down from 11 percent in 1989 to 7 percent in 1995.

Egypt's exports to the region (relative to its total exports) are also modest (Table 2). While the EU countries absorb close to 50 percent of Egypt's exports, Jordan and the PNA import less than 2 percent from Egypt. Although Israel imports a notable fraction of Egypt's exports, its share declined from a peak of 10 percent in 1991 to less than 1 percent in 1995. Arab countries, other than Jordan and the PNA, account for a little over 10 percent. This pattern has not changed significantly over the period 1989-95.

Although data are not presented on traded commodities, mineral fuels account for the bulk of intra-regional trade and no category of commodities is very important (El Erian and Fischer, 1996). The Arab-Israeli conflict virtually meant no trade between Israel and its neighbors. Egypt is an important exception, although there has been a dramatic decline in Israel's share in Egypt's exports in the last few years.

Table 1: Intra-regional exports in percent of total exports

	1989	1990	1991	1992	1993	1994	1995	Average 1989-95
Industrialized Countries	76	77	76	75	73	73	72	75
EU[1]	60	61	61	61	59	59	64	61
Developing countries	36	37	38	39	39	41	42	39
Africa	7	8	8	8	9	10	10	9
Asia	33	35	37	39	38	40	40	37
Europe	28	22	20	21	22	30	30	25
Middle East[2]	11	11	8	7	7	8	7	9

١. As of 1995, the EU includes 15 countries.
٢. The Middle East includes Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, the UAE, and Rep. of Yemen.
Source: IMF, Direction of Trade Statistics, 1996.

Table 2: Egypt's Trade Pattern: Exports (in percentage of total exports)

	1989	1990	1991	1992	1993	1994	1995
EU	43.17	39.42	43.10	39.70	48.26	44.33	48.90
Jordan	1.04	0.62	0.98	1.11	0.74	0.61	0.78
Palestinian National Authority	NA	NA	NA	NA	0.00	0.02	0.05
Israel	6.25	6.50	10.08	9.51	0.29	5.45	0.64

Other Arab countries	9.05	9.83	10.44	16.07	11.67	13.66	10.80
Others	40.49	43.64	35.39	33.61	39.03	35.93	38.84
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Sources: IMF, *Directory of Trade Statistics* 1996. For the PNA: Ministry of Economy and External Trade, Egypt.

2.2 Capital mobility

Although the region includes relatively capital-abundant countries (oil exporters) and relatively capital-scarce countries (such as Egypt), intra-regional capital transactions have also been limited. The exception was the large official flows from the oil exporters to other Arab countries, especially in the wake of the 1973-74 and 1979-80 oil price increases (Van den Boogaerde, 1991). The information available for the inflows of FDI into the region (North Africa and West Asia) indicates that the FDI share of the total inflows is less than 1 percent. Egypt and Israel receive more FDI than Jordan, and the trend is favorable for both countries. (See Table 3.)

2.3 Labor mobility

While capital movements are generally assumed to be easier than labor movements, labor mobility in the region has been relatively more significant than capital transactions or intra-regional trade. Table 4 shows the magnitude of labor remittances in absolute terms and as a percentage of GDP for the main suppliers of labor among Arab countries. The numbers are relatively stable, but their relative importance is greatest for Yemen, Jordan and Egypt. The flows of remittances originate primarily in the oil-exporting economies. Although the region does not have the labor mobility enjoyed by Europeans, millions of workers, e.g., from Egypt, work in the neighboring countries, and Palestinians rely heavily on employment in Israel.

3. Regional integration and economic and political incentives

The limited integration between Egypt and the region, including the triad, can arguably be attributed to the lack of adequate economic and political incentives to integrate. This argument may seem apparent and undeserving of further elaboration. However, most of the previous attempts at explaining the limited integration in the region have focused on the economic *or* political incentives, rather than on both simultaneously. Second, most attempts dealing with the economic incentives emphasized the issue of trade creation and diversion, with limited emphasis on the dynamic gains from integration. Finally, most attempts dealing with the political incentives to integrate tended to focus on the nature of governance, culture, religion and historical events, rather than on the factors which create the political dynamics for integration. This section explores the role of economic and political incentives in explaining the limited regional integration so far.

Table 3: Inflows of Foreign Direct Investment (millions of dollars)

	1989	1990	1991	1992	1993	1994[4]
Total inflows	200162	211425	158428	170398	208388	226513
European Union	81134	100862	72827	76634	68203	59910
Percent	40.5	47.7	46.0	45.0	32.7	26.5
North America	72754	55768	24751	22062	46089	55480
Percent	36.3	26.4	15.6	12.9	22.1	24.6
North Africa[1]	1642	1103	995	1396	1459	2105
Percent	0.8	0.5	0.6	0.8	0.7	0.9
of which Egypt	1250	734	352	459	493	1256
Percent	0.6	0.3	0.2	0.3	0.2	0.6
West Asia[2]	-233	2013	434	451	419	435
Percent	-0.1	1.0	0.3	0.3	0.2	0.2
of which Jordan	-1	38	-12	41	-34	-2
Percent	0.0	0.0	0.0	0.0	0.0	0.0
Israel[3]	125	101	350	539	555	406
%	0.1	0.0	0.2	0.3	0.3	0.2
Others (percent)	22.4	24.4	37.5	41.0	44.3	48.1
Total (percent)	100	100	100	100	100	100

1. North Africa includes: Algeria, Egypt, Morocco, Sudan and Tunisia.
2. West Asia includes: Bahrain, Iraq, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Syria, United Arab Emirates, Yemen.
3. Israel's exports in 1995 amounted to $1,637 million dollars.
4. Estimated.
Sources: UN, *World Investment Report*, 1995. For 1995: IMF, International Financial Statistics, July 1996.

Table 4: Workers Remittances (millions of dollars)

Labor exporting countries	1989	1990	1991	1992	1993	1994
Algeria	345	352	233	0	0	0
Egypt	3532	3743	3751	5478	4960	5073
Jordan	623	500	450	800	1040	1093
Morocco	1337	1347	1512	2165	2169	2061

Sudan	297	188	62	124	0	0
Syria	430	385	350	550	600	NIA
Tunisia	488	526	570	578	597	664
Rep. of Yemen	1035	1498	998	1018	1039	1059

Percent of GNP

Country	1989	1990	1991	1992	1993	1994
Algeria	1	1	1	0	0	0
Egypt	11	11	12	16	13	12
Jordan	17	14	12	17	20	19
Morocco	6	5	6	8	9	7
Sudan	3	2	1	2	0	0
Syria	4	3	2	NA	NA	NA
Tunisia	5	4	5	4	4	4
Rep. of Yemen	NA	24	23	28	33	29

Source: The World Bank, World Debt Tables, 1996.

3.1 Economic Incentives

The economic incentives to integrate preferentially have evolved over time. In the period following World War II until a couple of decades ago, regional arrangements were initiated when developing countries were following import-substitution strategies, with the twin features of heavy protection and state, rather than market, allocation of resources. Under these conditions, preferential trade agreements (PTAs) can lead to significant trade diversion, albeit with some trade creation. As elaborated by Viner (1950), trade creation results from lowering trade barriers among the members of the PTA. Trade diversion occurs when members of the PTA import from other members whose products are produced less efficiently than in other parts of the world. Where the gains from trade creation outweigh the cost of trade diversion, there are economic incentives to integrate.

New regional arrangements, in contrast, are taking place among countries characterized by keen interest in participating in the world market (Lawrence, 1996). These countries are more open, export and market-oriented, and private sector dominated (see Table 5 for details). The consequence of this development for the incentives to integrate regionally is increasing emphasis on the potential dynamic, rather than static, welfare gains from integration. The dynamic gains are associated with the flow of new investment, improved productivity, and low transaction costs. These benefits can outweigh the net loss in static welfare, provided that investors do not locate in the hub (rich countries) rather than the spoke (developing countries), productivity improves as competition increases and services are liberalized, and transaction costs are reduced following the adoption of more efficient regulatory schemes, for example, with respect to harmonization of procedures, standards, and certification. When countries are in the process of moving away from import substitution strategies towards more open economies, PTAs with large economies (e.g., the US) can serve as anchors that make the associated reforms more credible (Francois, 1996).

Whether "traditional" or "new", the verdict on regionalism, with respect to the welfare implications for the trading partners, is ambiguous. Accordingly, the economic incentives to integrate have to be tested empirically on a case-by-case basis. This empirical analysis can be undertaken using sophisticated models (e.g., gravity models) or by drawing on anecdotes. The shortcoming of sophisticated models is that they do not capture important effects of integration, especially those arising from investment and institutional changes. On the other hand, anecdotes do not permit generalizations. For both reasons, the approach followed here is somewhat eclectic. It is based on contrasting a number of insights drawn from both theories with some factual data for Egypt and the triad. Conclusions are then made as to whether or not Egypt has sufficient economic incentives to join the triad.

Table 5. Regionalism: Old & New

Old	New
Import substitution, withdraw from world economy	Export orientation, integrate into world economy
Planned and political allocation of resources	Market allocation of resources
Led by governments	Led by private firms
Mainly industrial products	All goods, services and investment
Deal with border barriers	Deeper integration
Preferential treatment for less developed	Equal rules (different adjustment periods)

Source: Lawrence, 1996.

What then are the main insights that create economic incentives to integrate? The key ones can be articulated as follows:

- *geographic proximity,* because proximity reduces transportation costs, therefore encourages trade;

- *openness*, because PTAs under heavy protection promote self-sufficiency and specialization among relatively inefficient producers, thus, promote trade diversion;
- *investment friendly economies*, because such economies can use PTAs to offer location advantages to multinationals in the form of larger markets for output and various sources of inputs. They also allow domestic investors to specialize and take advantage of economies of scale in production and marketing.
- *need for reform anchor*, because PTAs with large economies (such as the US or Europe) can provide safeguards against policy reversal (Francois, 1996).

The question is whether Egypt has sufficient economic incentives along these lines to join the triad in a customs union or a free trade area. The answer appears to be "no" in the short run. The possibilities for limited trade and specific projects are probably more appropriate at this stage. As Egypt and other neighboring countries move further in the direction of liberalization, as they conclude PTAs with the EU, and as they undertake more economic reforms domestically, the economic incentives to integrate with the triad and other neighboring countries will be higher.[1]

To elaborate the basis for this conclusion, clearly geographical proximity is an advantage. Yet transportation costs do not necessarily correlate with distance. The lack of adequate infrastructure and the sense of insecurity arising from the Arab-Israeli conflict are significant geographical barriers. These barriers are exacerbated where the goods being transported are bulky or perishable. Equally important, Egypt's economic incentives to join the triad at this time are limited because of the high level of protection accorded to several industries in the three countries and the PNA (Table 6). Although the Israeli economy is relatively more open, some commodities enjoy high effective rates of protection (e.g., food, chemicals and products, and rubber and plastic products). In Egypt and Jordan, the rates of effective protection are even more significant.[2] Under these conditions, attempts to integrate with the triad may amount to integration of industries which are relatively inefficient and highly protected from competition.

Table 6. Average Nominal Tariff Protection and Effective Rate of Protection for selected sectors

Sectors	Egypt		Jordan		Israel	
	Nominal	ERP	Nominal	ERP	Nominal	ERP
Mining	9.0	7.0	22.7	8.5	33.7	13.9
Food	36.0	72.0	41.1	22.5	9.5	114.3
Clothing	68.0	162.0	41.0	146.0	11.0	8.2

[1] The prospects of regional integration in the medium run are discussed in Section 4.

[2] This statement still holds although Egypt, under the reform program carried out in the 1990s, has unified and devalued its exchange rate, opened up the capital account, and reduced the maximum and dispersion of tariff rates.

Leather	35.0	28.0	47.0	54.0	10.0	2.9
Wood and cork products	33.0	66.0	51.0	92.0	13.7	13.7
Paper and printing material	31.0	90.0	12.0	48.0		
Chemicals and products, excl. petroleum	15.0	21.0	26.7	20.1	7.4	43.8
Petroleum refineries	13.0	83.0	6.0	-3.0	NA	NA
Metal products	28.0	14.0	17.0	14.0	27.9	14.8
Machinery	27.0	38.0	16.0	5.0	8.1	5.9
Transport equipment	40.0	90.0	31.0	102.0	-3.4	0.8
Rubber & plastic products	24.0	33.0	29.0	65.0	11.9	18.3
Average	29.9	58.7	28.4	47.8	10.8	19.7

Sources : For Egypt, Hoekman and Djankov (1996); For Jordan, Hoekman (forthcoming); and for Israel: Halevi (1996).

Members of the agreement may give each other access to their markets, but only in those products they import from the rest of the world. This will maximize trade diversion.[٣]

Beside the need for further liberalization, especially in Egypt and Jordan, the limited inflow of FDI to the triad countries and Egypt relative to such fast-growing economies as Malaysia and Thailand suggests that more reforms are needed to make the business environment more hospitable to investment. Until such reforms are adopted, the merits of joining the triad to attract FDI are limited, in part because the size of the economies of the triad is relatively small. Finally, while Egypt can in fact use PTAs to anchor its ongoing structural reforms and gain investors' confidence, it can achieve this objective more credibly by joining the EU or the US in a PTA.[٤] Of course joining the EU and the triad are not mutually exclusive—Israel has a free trade agreement with the EU and the US. But trade diversion and investment issues seem to suggest that Egypt may be better off waiting rather than joining the triad now.

3.2 Political incentives

Even if countries have sufficient economic incentives to integrate with a few countries, they may not follow through because the leaders do not have the political incentives to do so. PTAs can strengthen or erode the position of political leaders, therefore PTAs are pursued only where their political benefits outweigh their political costs. The leaders must consider PTAs politically *desirable, feasible* and *credible* to sign them.[٥]

[٣] Trade diversion will also be higher, the greater the share of imports from outside the PTA (Lipsey, 1960), and the less similar the production structure of the members of the PTA (Viner, 1950). The latter has been shown to hold in the case of Egypt and Israel (Fawzy, 1994).

[٤] The evidence suggests that Mexico benefited from NAFTA as an anchor for its economic reform (Francois, 1996).

[٥] These conditions were used in a recent World Bank study (1995) to explain why some countries reform their state-owned enterprises, while others lag behind.

Political desirability is met when the benefits of the agreement to the leaders and their supporters outweigh the costs. It could come about if the current leadership and its constituencies face an external shock (e.g., war) that changes the political calculations of the costs and benefits in favor of a PTA. Alternatively, desirability may come about if a country has a new leadership with new constituencies whose interest is more in line with a free trade agreement.

Political feasibility is met when the leaders are able to secure the approval of and support for carrying out the agreement. It requires that the leadership is able to secure the consent of other parts of government–legislatures, bureaucracies, and the state or provincial governments. This is more difficult under democratic regimes, especially where the leaders govern by minority in the legislature. Second, the leadership must be able to compensate the losers, at least partially, especially if they are a vocal minority prepared to destabilize weak coalitions and engage in civil disobedience.

Political credibility is met when the winners and losers believe that the promises to deliver the gains and compensations in the future are credible. In the present context, credibility depends in large part on the perception as to whether the agreement will be respected by all parties in the future, and whether the relationship between the parties is based on trust and irreversible peace. The leadership of the members of the PTA must be able to convince the losers that they will be compensated, and the winners that they will not be affected adversely.

Does a PTA encompassing the triad-plus Egypt meet the conditions of desirability, feasibility and credibility? In my view, it does not. Even if some countries meet all three conditions, the successful conclusion of the agreement requires that *all* political leaders involved find the agreement desirable, feasible and credible. The foundations of this conclusion are elaborated below, with a particular focus on Egypt.

Consider *desirability*. For Egypt, the constituencies of the leadership are varied, as may be suggested by the government majority in parliament. The bureaucracy does not have a stake in an agreement with the triad. The private sector is more interested in trading in larger markets, especially the EU and the US. There is a general sentiment, particularly among some in the intellectual community, that comprehensive peace is a pre-condition for full cooperation. Besides, Egypt is playing the role of a catalyst for peace in the region, and joining the triad may diminish its capacity to play that role. Overall, then, it does not appear that Egypt would consider joining the triad in a PTA desirable at this time.[٦]

With respect to *feasibility*, Egypt is in a position to pass an agreement through the legislature if deemed politically desirable by the leadership. As already indicated, the government has a majority in parliament. The potential losers from such an agreement are likely to be too few and disbursed. The opposition of some intellectuals could not be stronger than when President Sadat signed a peace treaty with Israel. Therefore, Egypt meets the feasibility condition.[٧]

Finally, even if the desirability and feasibility conditions are met, the credibility of the promises to be made in such an agreement may not be believable without external guarantees. Egypt has lived up to its commitments in the peace accord with Israel, but it cannot guarantee the actions of Israel and other parties. Reneging on previous commitments every time a new government is elected, or a disruptive act by opponents of the peace process, would not attract investors to the region who need to be assured that tranquillity and free trade will be the order of the day. Therefore, that condition may not be attained without full peace and external guarantees of tranquillity, for example, by the US and other members of the international community.

3.3 Interaction between economic and political incentives

The economic and political incentives in favor of regional integration are not independent of each other. Moreover, the interaction between the two sets of incentives can be positive or negative. For example, the economic gains from regional integration may make a PTA politically desirable if the benefits accrue to the groups supporting the governing regime. Here the economic and political incentives work in the same direction. Conversely, where regional integration benefits the opponents of the ruling regime, it would be politically undesirable. In this case, the economic and political incentives are not aligned, and the agreement is not likely to come to fruition. This point may help explain, for example, why the EU is reluctant to liberalize its agriculture sector with Tunisia, Morocco and now Egypt.

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[٦] Although it is difficult to ascertain for other countries, the Palestinians may be the key party in favor of an agreement. Mr. Arafat has just been elected, and he enjoys a broad-based support in favor of prosperity. Given that the Palestinian economy is dependent on Israel, not only for trade but also for employment, it seems reasonable to suggest that an agreement is desirable from a Palestinian perspective. On the Israeli front, it is more difficult to say. A new government has been elected, whose interest seems to lie more in security than in peace, trading in goods or allowing labor movement. On the other hand, the government won by a very small margin, suggesting somewhat the contrary.

[٧] As for the members of the triad, the feasibility condition may not be fully satisfied. The Israeli government may not be able to push the agreement through parliament, because its constituency seems to favor security over peace. The gap in per capita income may also cause some opposition, given that Israeli's per capita income in 1994 was $11,363, compared with $1,521 for Jordan and $885 for Egypt. The Palestinians will also find it difficult to push for a trade agreement under limited progress on the peace front. Jordan seems to meet the feasibility condition.

With respect to feasibility, comprehensive peace in the Middle East makes regional integration politically feasible, given that not all leaders can necessarily afford domestic or foreign opposition and stay in power. This opposition may diminish, however, if the economic incentives to integrate become strong enough for the supporters of the leaders to exert corresponding pressure on them to make peace. With respect to credibility, a peace guarantee by strong external forces will obviously reduce the risk facing investors. As a result, FDI may increase, contributing positively to the economic incentives to integrate.

In sum, Egypt does not seem to have sufficient economic or political incentives to join the triad in the short run. This should not necessarily be the case in the medium run.

4. Prospect of integration in the medium run

The prospects for regional integration in the medium run depend on the changes in economic and political incentives the future brings. While the future is uncertain, it is not divorced from current and past events. Beside peace, two factors currently on the horizon seem to have the potential of influencing the prospects of regional integration in a significant way: PTAs with the EU, and FDI. This section explores the role of these two factors on the economic and political incentives to liberalize and integrate in the medium run.

4.1 The role of PTAs with the EU

Egypt is a full member of the WTO, and is soon to sign a partnership agreement with the EU. The government has also undertaken a series of economic reforms in the 1990s, the effect of which is to open the economy to foreign trade and investment. But Egypt is not the only country in the region moving in this direction. Israel has gone further. Beside liberalizing the economy and acceding to the GATT, Israel has PTAs with the EU and the US. Jordan started a process of opening up its economy and is now in the process of joining the GATT and also negotiating a PTA with the EU. The question is whether these agreements will speed or impede regional integration and further liberalization.[^]

The literature offers a number of reasons as to why the answer could be in favor of further liberalization and regional integration and a number of reasons to the contrary (Frankel, 1995). On the one hand, major trading partners outside the PTA may demand accession or liberalization in the countries concluding a PTA, especially where the trade barriers facing them are relatively high. This will put pressure toward further liberalization. Operating in the same direction is the

[^] Openness is key in helping countries begin a process of converging or catching up with richer countries, as shown by Sachs and Warner, 1996.

gradual phasing out of protection in the context of a PTA, as this gradualism diminishes domestic resistance to liberalization. Where the phasing out of protection is accompanied by some compensation and technical assistance, the resistance to liberalization is reduced even further. A final related point concerns the precedent that liberalization in the context of a PTA sets in motion. Subsequent to the agreement, domestic producers will understand that their government cannot easily provide them with protection, which may help further liberalization later.

PTAs may also promote regional integration through their potential influence on firm competitiveness. As indicated above, emerging arrangements are not only about trade but also about competition and investment. To the extent that PTAs remove tariffs and bring about reconciliation of divergent national practices with common rules and policies (e.g., bringing standards up to mutual recognition), they pave the way for further trade with outsiders. While PTAs may divert trade, they could stimulate reforms that improve the business environment. Not only would this help domestic producers, but it may also make the country a more attractive location for foreign producers. All this will make firms more efficient, and therefore more open to further liberalization.

On the other hand, PTAs could make further liberalization and integration more difficult. They could entail new forms of protection by implementing rules of origin and administering anti-dumping and countervailing duties which have protectionist effects. Kreuger (1993) and Hoekman (1992) argue that the new arrangements may include, for example, intricate rules of origin that represent a retreat from freer trade.

PTAs could also make further liberalization more difficult if the leaders invest much of their political capital into them rather than in multilateralism (Bhagwati, 1992). Firms may, in addition, exert influence in designing new systems of rules that help insiders and hurt outsiders. For example, tariffs may be designed in such a way as to increase protection for certain interest groups, thereby diminishing the political support for multilateral and regional liberalization. Similarly, the way the gradual phasing out of protection is designed can also impede further liberalization, especially where tariffs are removed first on capital and intermediate goods (Galal and Hoekman, 1996). This is because this pattern of tariff reduction will increase effective rates of protection in the interim period, which makes liberalization of final goods more difficult.

All told then, it is an empirical question whether PTAs promote or reduce the possibility of further integration and liberalization. Liberalization in Europe coincided with the formation of the European Community and the European Free Trade Area. In other regions, however, regional arrangements were associated with fragmentation of world markets and eventual failure of such arrangements.

The EU initiative in the Mediterranean region carries some promise in favor of liberalization in the future, but also some risks. The agreement Egypt is soon to conclude with the EU is expected to resemble those of Tunisia and Morocco. If so, it will require liberalization of manufactured imports from the EU over a 12-year period, and immediate duty free access to the EU markets for Egyptian manufactured exports. It will require the adoption of competition policies as they relate to trade with the EU. In return, the EU will provide financial and technical assistance to help industries adjust to the new regime. The main shortcomings of the agreement are that it will provide little in improved access for agricultural products, require no liberalization of government procurement, does not ensure free movement of capital, and makes no commitments to liberalize services.

Because the PTA is fundamentally a move toward partial liberalization with a few trading partners, it can be beneficial if it boosts the sectors which are competitive and shrinks the sectors which are not. The danger is that while the agreement may succeed in reducing the size of the import-competing sector, it may do little to stimulate exports and FDI. In other words, it may contribute towards improving standards and policies, but with no significant impact on FDI. This is why Galal and Hoekman (1996) argue, in the case of the agreement under negotiation between Egypt and the EU, that Egypt should use the agreement to advance a growth strategy with liberalization as a critical component.[9] Otherwise, the agreement may generate small static welfare gains from trade creation over trade diversion, but leave the EU as the hub and Egypt as the spoke. This will be at the expense of further regional integration, given that countries like Egypt and Israel will prefer exporting to Europe rather than to countries in the region.

4.2 The role of foreign direct investment

The triad countries and Egypt are not capital-abundant countries. All of them are keen to attract FDI to grow rapidly and raise the standard of living of their populations. In Egypt, a sustained growth of 7 percent per year requires investment approximately equal to 27 percent of GDP, compared with national savings of 18 percent. This leaves a gap of about 10 percentage points of GDP, or about $12 billion dollars. FDI can undoubtedly help, given the limited room for borrowing and the gestation period it takes to stimulate domestic private investment. The

[9] Galal and Hoekman (1996) detail that growth strategy for Egypt. The key reform areas emphasized are reforms to reduce the size of government (to promote domestic savings) and encourage investment; open the economy to trade and investment; and increase competition, mainly through privatization.

advantages of FDI go beyond providing capital, to include bringing knowledge about the latest technologies and access to major markets. Will this need for FDI promote regional integration and further liberalization in the future?

The answer depends in part on what policies Egypt—and other countries for that matter—adopt. FDI initially moved to developing countries to gain access to raw materials. It then moved to take advantage of import-substitution strategies by selling in internal markets behind high protection. Currently, many multinationals and governments pursue FDI to service external markets. To the extent that countries follow appropriate policies to promote exports, FDI can foster regional integration. Conversely, to the extent that FDI is attracted to produce for domestic markets under high protection, it may in fact discourage regional integration.

Another FDI-related factor in favor of improving the prospects of regional integration is the recent emphasis on privatization, deregulation and financial liberalization. As these reforms intensify in the region, they will attract FDI, especially in such sectors as banking, communications, utilities and transportation. As a result, domestic services will be produced more efficiently, capital movement will be easier, and the cost of conducting business will be smaller. All these factors will make the countries of the region more attractive locations for FDI, which will enhance the prospects of regional integration. Further reinforcing this is the possibility that countries will also undertake other reforms to attract FDI, including making credible commitments not to expropriate assets in the future, predictable and transparent rules of game, simplified regulatory regimes with respect to establishment and operation, and easy access to large foreign markets without complicated customs procedures.

On their part, multinational firms can also influence the tendency toward regional integration in the future. Because they are increasingly interested in producing complex products across borders, they often find it advantageous to source raw materials in one country, and to process labor-intensive components in a second and technologically-intensive processes in a third. They consider limited markets to be depriving them of the benefits of economies of scale in production. Accordingly, they can be expected to push for regional integration, to the extent that these arrangements make the movements of goods easier across locations. This is indeed what happened with respect to the regional trading blocks in Europe, North America and Asia (Fishlow and Haggard, 1992). The same can be expected to happen in the Middle East.

All told, the prospects of integration in the region are likely to be higher in the future, as countries adopt more investment friendly environments, liberalize their economies, and harmonize their regulatory systems (standards and the like). These measures will attract FDI and multinationals and promote domestic investment as well. Investors will in turn attempt to persuade politicians to integrate with other countries in the region to secure larger markets, capitalize on economies of scale and optimize production across locations.

5. Concluding Remarks

This paper dealt with the economic and political incentives of regional integration, focusing, from an Egyptian perspective, on whether the PTAs with the EU will serve to promote trade within the region and with the Israeli/Palestinian/Jordanian triad, and the prospects for extending the incipient steps toward integration within the triad to Egypt. The key points can be summarized as follows:

- Future regional trade is a big challenge. The data on intra-regional trade and factor movements continue to show that the region is remarkably unintegrated, accounting for less than 10 percent of total regional trade.
- The poor integration record can be attributed to the limited economic and political incentives to integrate. Economic incentives go beyond trade creation and diversion to cover the dynamic gains associated with investment and deeper integration reforms. Political incentives are not independent of economic incentives, but a regional agreement has to be politically desirable, feasible and credible to take place.
- In the short run, Egypt has limited economic and political incentives to integrate with the triad. Geographical proximity is compromised with the lack of infrastructure and lack of peace. The level of protection is high and may encourage trade diversion. The business environment is in need of improvement to permit FDI to take advantage of location and larger markets. And dynamic gains from regional integration will only come with investment, which is a medium run phenomenon.
- In the medium run, the prospects for regional integration are brighter. Egypt is about to sign a partnership agreement with the EU and there is a keen interest in attracting FDI. Both factors are expected to bring about deeper reforms at home and create pressure for regional integration to allow firms secure access to larger markets, optimize locations across borders, and capitalize on economies of scale. With similar reforms in the triad and other neighboring countries, the prospects for regional integration will increase. Needless to say, peace is critical for all this to happen.

Before concluding, one question is in order: What could be done in the interim period until the prospects for deeper integration are present? Assuming satisfactory progress on the peace front, the countries of the triad may have strong economic and political incentives to integrate in an appropriate form. At the same time, effort should be focused on taking incremental steps that will bring about beneficial integration to all parties in the future. Reforms of national policies to make them hospitable to investment—domestic and foreign—and greater liberalization are key. These efforts can be supported and coordinated regionally, say, through the Middle East Bank. Simultaneously, it may be possible to work on joint regional projects, especially in infrastructure.

In short, regional integration, like other policy issues, can be beneficial, provided certain conditions are met. Perhaps the most important condition is that the parties to the exchange have both the economic and political incentives to carry it out. When both ingredients are present, a mutually beneficial integration will be forthcoming, otherwise the promise of integration will remain just that—a promise.

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