The European Union's New Mediterranean Strategy

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Establishing a free-trade area with the southern Mediterranean region is the centerpiece of the European Union's new Mediterranean strategy. Strong adjustment and reform efforts by the countries of the region will be essential for the strategy's success.

THE EUROPEAN countries have traditionally had close political, social, and economic relations with the countries of the southern basin of the Mediterranean region (SMR). The SMR countries are defined here to include Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, and Tunisia, although the European Union's (EU) strategy also includes Cyprus, Malta, Turkey, and the successor states of the former Yugoslavia.

The first formal attempt at establishing institutional links between the EU and the SMR countries came in the early 1960s. A number of special association and trade agreements were signed with all the countries in the region, except Algeria. These agreements dealt mostly with trade relations, were of limited duration, and lacked clearly defined regional objectives. In the second half of the 1970s, the EU launched a second initiative that envisaged a more comprehensive region-wide strategy aimed at establishing a free-trade area between the EU and the SMR countries. The strategy also foresaw actions in nontrade-related areas, such as the social sectors. New cooperation agreements of unlimited duration were signed during 1975–77. The agreements allowed for tariff-free entry to the EU for most SMR countries' manufactured goods and provided limited tariff preferences for those countries' agricultural exports. SMR countries were to gradually eliminate their own tariffs on EU exports, but the timing was not specified. The agreements also provided for financial assistance; during 1978–91, the EU and the European Investment Bank (EIB) committed ECU 3.3 billion to the SMR countries.

The new strategy

Despite the deepening economic relations between the two regions, what was initially heralded as a multilateral framework under the second initiative was reduced to a set of agreements that remained bilateral in their emphasis. Moreover, while trade between the two regions grew sharply over the last two decades, the share of trade accounted for by one region in the other's total trade remained broadly stable. Between 1970 and 1994, the EU accounted for about half of the imports and exports of the SMR countries, while the SMR countries accounted for less than 3 percent of the EU's total exports and imports.

Against this background, in 1992 the Lisbon European Council called for an evaluation of the "global policy of the EU in the Mediterranean region and possible initiatives to strengthen this policy in the short and medium term." In 1995, the Barcelona Declaration was adopted, spelling out the new EU Mediterranean strategy.

This new initiative does not represent a break with the past, but rather a deepening of past efforts. Nevertheless, there are several differences: renewed emphasis on a multilateral framework for the region; more comprehensive coverage of issues, including social and environmental areas; financial assistance originating from a "common pot," with access being on a competitive basis and related to the economic reforms undertaken by each country; and financial assistance going beyond project financing—and the previously limited sectoral and structural reform loans—to support broader macroeconomic and structural reform. Finally, with the conclusion of the Uruguay Round, the new strategy should involve more open trade policies by the EU, particularly with respect to imports of agricultural and certain manufactured products from the SMR countries.

Three sets of final objectives are spelled out under the new strategy: (1) engendering political stability in the SMR countries and containing political tensions arising from immigration; (2) encouraging balanced and sustainable growth with an eye to reducing the income and social disparities between the EU and the SMR countries; and (3) dealing with a number of challenges that require common EU-SMR cooperation, such as the protection of the environment.

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Guided by the multilateral framework of the Barcelona Declaration, the new framework foresees the signing of bilateral agreements with each of the SMR countries with five sets of intermediate objectives and instruments: (1) creating a free-trade area between the EU and the SMR countries over 12–15 years; (2) increasing investment flows into the SMR countries; (3) fostering SMR intraregional economic links; (4) establishing institutional mechanisms for political and economic dialogue; and (5) providing performance-linked financial support from the EU, estimated at ECU 4.7 billion in grants over the 1995–99 period, with a similar amount of loans expected to be extended by the EIB.

Agreements have already been signed with Israel, Morocco, and Tunisia, and negotiations are under way with other SMR countries. The agreements with Morocco and Tunisia involve a number of common features, notably, confirmation of free access to the EU for most of their manufactured goods; elimination of tariff and nontariff barriers to imports from the EU, the latter immediately upon the effectiveness of the agreement and the former within 12 years; limited improved access to the EU for agricultural goods; the reciprocal right of establishment for investors; adaptation of the regulatory framework in Morocco and Tunisia to approximate that in the EU in the areas of competition, government procurement, subsidies, and technical standards; and strengthening cooperation on migratory issues. (See the article by Jbili and Enders in this issue.)

The agreement with Israel—which differs from that with Morocco and Tunisia because of differences in levels of economic and industrial development—has four main components: expansion of the free-trade area to include nontraditional Israeli agricultural products, although Israel will "restrain" its exports of oranges to the EU; revision of the 1975 trade agreement with regard to rules of origin; initiation of negotiations aimed at opening the Israeli government procurement market—under preferred terms—primarily in the field of telecommunications; and inclusion of Israel (albeit without voting rights) in committees administering EU research and development projects.

Benefits and costs

The free-trade area is expected to generate significant long-term economic benefits for the region, but it will also involve transitional costs. Over time, welfare gains would accrue as trade liberalization results in factors of production being reallocated toward sectors where each country has a comparative advantage; as the anti-export bias present in many of the SMR countries' trade regimes is reduced; as these countries become more attractive to foreign investors; and as incentives for industrial restructuring increase. The size of welfare gains will also be related to the extent to which the SMR countries implement trade reform with non-EU countries. If they do so, this will ensure that trade creation outweighs trade diversion. The latter could result from entry into a free-trade agreement with the EU. However, the impact of trade diversion is likely to be limited—geographical proximity and established trade links would suggest that the EU will always remain a dominant trade partner of the SMR countries.

While substantial benefits should accrue to the SMR countries from having freer access to what is currently one of the world's largest markets, the incremental benefits are limited, since most of the SMR countries' manufactured goods already have free access to the EU. However, if the agreements were to allow substantially increased access to European markets for agricultural products and for those manufactured products currently subject to monetary barriers—products in which the SMR countries have a comparative advantage, such as textiles and clothing—the benefits to the SMR countries would be substantially higher.

Efficiency improvements will also accrue to the SMR countries from harmonizing standards and measures, and regulations in areas such as subsidies, competition policy, and public procurement. Further productivity gains would result from the increased competitive pressures that will reduce monopolistic rents and from the absorption of technological know-how associated with foreign direct investments.

The SMR countries can expect to benefit from the positive credibility effect associated with being "locked into" a liberalization schedule with a major regional trade grouping. This will help foster a more favorable investment climate that will encourage further domestic and foreign direct investment. However, a cost to the region could arise from the so-called "hub-spoke" effect, resulting from the establishment of a free-trade agreement with the EU while each SMR country maintains high intraregional trade barriers. In this case, foreign investors, who otherwise might have invested in a SMR country because of the access it offered them to that country's domestic market, would have an incentive to invest in the "hub" (the EU), which offered them access to all the SMR countries (the spokes).

While an intraregional free-trade area could minimize the hub-spoke effect, closer intra-SMR linkages are complicated by divergent macroeconomic policies, the absence of harmonious trade and regulatory regimes, and the need for further development of regional communications and infrastructure. The EU's Mediterranean strategy aims to create a free-trade area not only with the center, but also among the SMR countries by eliminating economic, regulatory, and physical bottlenecks to trade in the region. In the final analysis, however, trade diversion and hub-spoke effects can be minimized only by a uniform reduction of trade barriers with all trading partners.

As far as transitional costs are concerned, trade liberalization with the EU will affect protected industries, which will need to adjust to the increased external competition, possibly by reducing labor costs through labor shedding. This could raise unemployment, pending the reallocation of resources. This unemployment effect may be limited temporarily, since there could be an initial increase in effective protection depending on the sequencing of tariff reductions. This would be the case if tariffs on inputs and intermediate goods were eliminated early on, while tariffs on final goods were maintained—a sequence envisaged in the EU's agreements with Morocco and Tunisia. However, the welfare losses associated with increased effective protection may offset the temporary gains from reduced unemployment.

The agreements are also likely, at least initially, to worsen the current account of the balance of payments. The elimination of quantitative restrictions and tariffs may raise overall consumption levels and cause consumers to buy imports instead of domestic goods. In addition, the higher levels of investment fostered by the agreement will require higher imports of capital goods. However, a major expansion in exports is not likely in the short run, given that the SMR countries already enjoy preferential access to the EU market, and reallocating resources and raising investment in export industries will take time.

Preconditions for success

The establishment of a free-trade area between the EU and the SMR countries is at the heart of the EU's Mediterranean strategy. For the SMR countries to maximize the

Countries of the southern Mediterranean region: selected readiness indicators, 1995 [1]

	Algeria	Egypt [2]	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia
Inflation (annual percent change)	29.7	7.2	10.1	2.4	10.6	6.1	12.0	6.3
Inflation variability (standard deviation: 1985–95)	9.2	5.0	82.8	7.4	129.2	2.0	15.4	1.3
Government balance (in percent of GDP)	-1.4	-1.3	-4.4 [3]	-1.4	-18.0	-5.1	-3.8	-4.2
Change in the real effective exchange rate (standard deviation: 1985–95)	14.6	12.4	3.5	6.5	88.0	3.2	21.3	5.5
Current account balance (in percent of GDP)	-5.6	-0.3	-4.7	-3.7	-43.0	-4.3	-2.9	-3.7
Trade taxes (in percent of fiscal revenues)	13.4	12.9	8.0	14.6	45.0	17.9	10.9	25.2
External debt (in percent of GDP)	76.4	47.1	22.5	105.4	11.2	67.6	31.2 [4]	51.5
Average statutory tariff rates (in percent) [5]	25.0	34.0	14.9	21.0	...	24.5	35.0	28.5
Total merchandise trade (in percent of GDP)	43.7	27.9	52.2	83.0	69.6	36.7	56.8	71.5

Sources: Data provided by national authorities and IMF staff estimates.
[1] Preliminary.
[2] For the fiscal year 1995/96 (June/July).
[3] Includes net credit by the government.
[4] Excludes the stock of short-term private sector liabilities and military debt.
[5] For Algeria, Egypt, and Syria, average unweighted tariff. For Israel and Jordan, average import-weighted tariff. For Morocco and Tunisia, average unweighted tariff in 1992 and 1990, respectively.
...: Indicates data not available.

benefits and minimize the costs of entry into a free-trade area with the EU, they should endeavor to meet a number of conditions:

• ***Macroeconomic stability.*** Removing import barriers, other things being equal, leads to a depreciation of a country's equilibrium real exchange rate. Countries need to adopt a responsive exchange rate policy supported by sound monetary and fiscal policies. In addition, the larger a country's past macroeconomic instability, the greater the credibility gap it will have to overcome to attract investors.

• ***Low reliance on trade taxes.*** Participation in a free-trade area is likely to lower revenue from trade taxes. Thus, the higher a country's initial reliance on trade taxes, the larger the effort required to change the structure of taxation toward domestically based taxes and the greater the expenditure restraints that may be needed to limit the fiscal impact of entry into a free-trade area.

• ***Low external debt burden.*** A large external debt at the outset of trade liberalization complicates macroeconomic adjustment and may cloud the prospects for attracting investors. This is because high debt service places a heavy burden on the budget and the balance of payments. Moreover, investors would be concerned if the debt burden reflected large past macroeconomic imbalances and if they believed that it might lead to a future increase in taxation or a reintroduction of trade and exchange controls.

• ***High degree of openness.*** A country that starts comprehensive trade reform long before its entry into a free-trade area minimizes the shock of structural adjustment from such entry, fosters a smoother reallocation of resources, and minimizes trade-diversion effects. The trade reform would have to include an across-the-board reduction in tariffs and the elimination of quantitative restrictions and nontariff barriers.

• ***Liberal regulatory framework.*** Controls on goods and factor markets hinder the efficient reallocation of resources and limit the transmission of the positive effects of trade reform. Price controls also often involve explicit or implicit budgetary subsidies, making fiscal discipline more difficult to sustain. It is essential that the decontrol of goods and factor markets be complemented by an appropriate regulatory framework that does not hinder the industrial restructuring prompted by trade reform. The benefits of liberal export-oriented policies can be magnified by the privatization of public enterprises, which can contribute to increasing overall economic efficiency and savings, as well as widening the scope for the private sector in the economy.

• ***Comprehensive social safety net.*** The reallocation of resources from previously protected sectors to the export sector and to efficient import-substituting activities is likely to take time, thus resulting in temporary employment losses. In addition, macroeconomic adjustment and the implementation of comprehensive liberalization measures may cause the real incomes of some groups to decline in the short term. In order to minimize the transition costs, a social safety net, targeting benefits to the most vulnerable and providing support and retraining for displaced workers, is critical.

Readiness indicators

To assess how close the SMR countries are to meeting these preconditions, a number of "readiness" indicators were examined.

Four indicators were used to assess macroeconomic stability: inflation, the budget deficit, the real effective exchange rate, and the external current account position. Regarding inflation—an indicator of a country's financial policy stance—Egypt, Jordan, Morocco, and Tunisia achieved the lowest rates in 1995 (see table). The volatility of inflation rates over the last 10 years is a useful indicator of past macroeconomic instability. On this measure, inflation rates in Israel and Lebanon were the most volatile. Inflation rates and inflation volatility in most SMR countries were significantly higher than the EU average in 1995.

The budgetary position reveals the extent to which a country is vulnerable to excess demand pressures. In 1995, many SMR countries had smaller budget deficits than the EU average. However, Lebanon and, to a lesser extent, Israel, Morocco, and Tunisia still have to pursue tight fiscal stances. Fiscal discipline is a relatively recent development in most SMR countries; this is a trend that needs to be reinforced.

High volatility of the real effective exchange rate can suggest past macroeconomic imbalances. The pattern in some SMR countries reveals high inflation rates coupled with insufficient exchange rate flexibility which resulted in prolonged periods of overvaluation of the real exchange rate, followed by large corrective nominal exchange rate swings. This was the pattern in Algeria (until 1994), Egypt

(until 1991), and Syria. Lebanon's real exchange rate was volatile despite the country's historically flexible exchange rate regime and reflected political uncertainties. The remaining SMR countries appear to have followed macroeconomic policies designed to prevent large real exchange rate volatility. Nevertheless, in terms of this criterion, nearly all SMR countries fared worse than EU members.

The external current account, another indicator of macroeconomic stability, has to be examined cautiously since, in some countries, trade and/or exchange restrictions limit imports. Egypt had a current account surplus during 1990–94 but registered a small deficit in 1995. Algeria had current account surpluses during 1990–93, mostly as a result of trade and exchange restrictions. As these were relaxed, a deficit emerged in 1995. Lebanon's recorded deficit was about 43 percent of GDP in 1995, and the remaining SMR countries have recently been registering moderately high deficits.

These indicators suggest that all the SMR countries need to strengthen macroeconomic policies, particularly as inflation remains higher than the EU average. This will require tighter financial policies. Lebanon, in particular, has a long way to go in terms of fiscal adjustment. Even though the other SMR countries have relatively low budget deficits, additional fiscal adjustment will be needed. Judging by the volatility of the real effective exchange rate, Algeria, Egypt, Lebanon, and Syria may need to allow the exchange rate to be more responsive and/or adopt more restrained fiscal and monetary policies to minimize potential divergences between the actual and new equilibrium real exchange rates.

Virtually all the SMR countries rely heavily on trade taxes and, thus, have to strengthen their domestic tax systems as they phase out tariffs vis-à-vis the EU and other trading partners. Lebanon and, to a lesser extent, Tunisia and Morocco will have to make the greatest effort, but significant changes will also be needed in the remaining SMR countries.

Lowering the external debt-to-GDP ratio will be critical for Algeria and Morocco, and Jordan—where a fiscal adjustment stronger than that suggested by its actual budget deficit will be needed. Although they have lower external debt-to-GDP ratios, all other SMR countries, except for Lebanon and Israel, will also have to make serious efforts to reduce this ratio. The SMR countries' external debt burden is moderated, however, by the fact that some of the debt was contracted on concessional terms.

Two indicators were used to assess trade openness: import tariffs and the ratio of total trade to GDP. Regarding import tariffs, Israel and, to a lesser extent, Jordan have relatively low average tariff rates while the other SMR countries have quite high tariff structures that are often augmented by import surcharges. In terms of the ratio of total trade to GDP, Jordan and Tunisia appear to be the most open. In Egypt and Morocco, external trade accounted for less than 40 percent of GDP in 1995; however, these countries, particularly Egypt, appear more open if external trade in services (e.g., tourism) is taken into account. The remaining countries fall between these extremes. Even judging by the trade-to-GDP ratio, most SMR countries remain less open than other, faster-growing developing countries. Thus, nearly all SMR countries need to pursue measures that foster economic openness.

The degree of liberalization of the regulatory framework cannot be easily quantified. Nevertheless, one can gain an idea of the openness of the regulatory framework by examining the extent of price controls, labor market rigidities, investment regulation, and privatization. Egypt, Israel, Jordan, Lebanon, Morocco, and Tunisia have already made significant progress in decontrolling their price systems. Algeria has recently made considerable effort in this area, but, together with Syria, Algeria still maintains a considerable array of controls. Jordan and Lebanon have fairly liberal labor market regulations. Israel, however, still regulates the labor market closely, although there has been a marked improvement in the functioning of the market in recent years. Considerable labor market rigidities remain in Algeria, Egypt, Morocco, Syria, and Tunisia. These rigidities particularly limit employers' ability to carry out labor force adjustments in response to changing economic conditions.

Turning to investment regulations, Israel, Jordan, and Lebanon have maintained fairly liberal systems, while Morocco and Tunisia have liberalized them significantly only recently in the context of newly adopted unified investment codes. Algeria and Syria maintain, to different degrees, restrictions on private investment. Israel, Jordan, and Morocco have been moving rapidly to privatize public enterprises, while more limited progress has been achieved in Egypt and Tunisia. Algeria and Syria still maintain a dominant public enterprise sector. By contrast, Lebanon has traditionally confined public sector involvement mainly to the utilities sector.

All the countries surveyed, with the exception of Israel, still have to put in place cost-effective measures intended to protect the most vulnerable groups. However, Jordan and Tunisia have recently made considerable progress in this regard. The SMR countries, except for Israel and Lebanon, maintain general subsidies on basic necessities that are administered through price controls. Those subsidies have had an adverse impact on the countries' budgetary positions. Furthermore, their administrative and institutional capacities to identify the truly needy and to provide support and retraining for dislocated workers are severely limited.

Conclusion

The new Mediterranean strategy is an ambitious step toward reinforcing the traditionally close ties between the EU and the SMR countries. Compared with previous initiatives, the new strategy benefits from more clearly defined global objectives, both political and economic; from more specific intermediate policy objectives, such as creating EU-SMR and intra-SMR free-trade areas and fostering investment flows within these areas; and from better-targeted instruments, such as institutional mechanisms for promoting dialogue, technical assistance, and performance-related financial assistance.

The success of the strategy hinges critically on progress toward achieving the intermediate objectives, which, in turn, will depend on the ability of the SMR countries to meet a wide range of preconditions. Considerable adjustment and reform efforts are needed in all the SMR countries, although to varying degrees.

As strong adjustment and reform efforts will be essential for the eventual success of the EU's Mediterranean strategy, the EU correctly not only plans to tie its financial support to the implementation of such policies but also intends to tailor its assistance to each country according to the intensity of the efforts it makes. The recent agreements signed with Israel, Morocco, and Tunisia will be supplemented with understandings on the modalities under which technical and financial assistance will be provided, including those relating to macroeconomic and structural reform performance. The EU and a number of the SMR countries are seeking to closely coordinate their efforts with the World Bank and the IMF to ensure that actions under the new Mediterranean strategy are taken in the context of coherent financial and economic programs. F&D