FEMISE RESEARCH PROGRAMME

2004-2005

South-South Trade Monetary and Financial Integration and the Euro-Mediterranean Partnership: An Empirical Investigation

Research n°FEM22-39
Directed By
Simon Neaime, Institute of Financial Economics,
American University of Beirut- Beirut, Lebanon

June 2005

Ce rapport a été réalisé avec le soutien financier de la Commission des Communautés Européennes. Les opinions exprimées dans ce texte n'engagent que les auteurs et ne reflètent pas l'opinion officielle de la Commission.

This report has been drafted with financial assistance from the Commission of the European Communities. The views expressed herein are those of the authors and therefore in no way reflect the official opinions of the Commission.

Femise Coordinators

Economic Research Forum
For the Arab Countries, Iran and Turkey

Institut de la Méditerranée

Institute of Financial Economics

PROJECT FEM22-39

Title of Project

South-South Trade Monetary and Financial Integration and the Euro-Mediterranean Partnership: An Empirical Investigation *

Research Director

Simon Neaime
(sn01@aub.edu.lb)

*This work has benefited from a financial grant from the Commission of the European Communities within the context of the FEMISE program. The views expressed are those of the beneficiary and therefore in no way reflect the official opinion of the Commission. Participants in this research project are: Myra Yazbeck as senior researcher and Rima El-Kadi as research assistant.

June 2005

Institute of Financial Economics, American University of Beirut-Beirut, Lebanon.
P.O.Box: 11-0236. Fax (9611) 744484-Tel (9611)744485-

South-South Trade Monetary and Financial Integration and the Euro-Mediterranean Partnership: An Empirical Investigation

TABLE OF CONTENTS

List of Tables

APPENDIX

ABBREVIATIONS

ADF	Augmented Dickey-Fuller
AIC	Akaike Information Criterion
ECB	European Central Bank
EFTA	European Free Trade Association
EIB	European Investment Bank
EMU	European Monetary Union
EU	European Union
FD	First Difference
FDI	Foreign Direct Investment
FTA	Free Trade Area
GAFTA	Greater Arab Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
IMF	International Monetary Fund
ITA	Information Technology Agreement
LAS	League of Arab States
MED	Mediterranean
MERCOSUR	Mercado Comun del Cono Sur
MMU	MED Monetary Union
MPCs	Mediterranean Partner Countries
NAFTA	North American Free Trade Agreement
OCA	Optimum Currency Area
PP	Phillips-Perron
TRIP	Trade-Related Aspects of Intellectual Property Rights
USD	United States Dollar
US	United States
VAR	Vector Autoregression
WTO	World Trade Organization

EXECUTIVE SUMMARY

This research project studies the past and current attempts to enhance economic integration in the Mediterranean (MED) region, and looks at how far the region has come in terms of regional trade, monetary, and financial integration. It investigates how macroeconomic instability has been an impediment to economic integration in the past in the MED region, and discusses whether it is likely to be the case in the future. Specific proposals for macroeconomic cooperation to sustain the regional integration process are outlined next, emphasizing the links between macroeconomic policies and economic integration. All of these issues are related with the recent objectives set out by the Barcelona Declaration which envisage a Euro-MED free trade area by the year 2010, and enhanced economic integration of the two regions.

Mediterranean Partner Countries (MPCs) are aiming for increased regional economic integration. A significant part of economic integration is the expansion of intra-regional trade, thereby allowing a higher degree of inter-Mediterranean specialization, and improved allocation and distribution of resources in the region. Moreover, the dynamic effects of increased goods market competition, such as improved efficiency, and greater opportunities for economies of scale, are expected to prepare the MED economies for international goods market competition. Although MPCs face numerous stumbling blocks to increasing regional trade, a consensus exists among MPCs that MED economic integration is crucial for meeting the challenges of globalization from a regional stronghold, and is a strategy to boost growth and economic welfare. Liberalizing trade through reductions in tariffs, as provided for in the Greater Arab Free Trade Area (GAFTA) agreement, is a first and necessary step on the way to increasing trade integration.

After a general introduction, the project presents a detailed evaluation of the stumbling blocks to South-South economic integration by studying the prospects and status of trade, monetary and financial integration. Trade integration is analyzed through an evaluation of the status of tariff and non-tariff barriers, and the required steps to be taken by MPCs before removing these barriers. We present a detailed overview of the current South-South trade agreements, by emphasizing what they accomplished and what still needs to be implemented, as well as the prospects for enhancing intra-regional trade agreements. Finally, we look at South-South financial and monetary integration by analyzing FDI and portfolio flows to the region as well as intra regional capital flows.

The next main section of the project is empirical in nature. It presents a detailed evaluation of the stumbling blocks to South-South monetary and financial integration. It evaluates the consequences of South-South integration on the evolution of exchange rate regimes. The diverse exchange rate regimes have so far been a hindering factor toward deeper South-South integration. The issue of a regional currency union adopting the euro, among the Greater Arab Free Trade Agreements members is also carefully studied. The implications of a common currency on Euro-MED trade is analyzed. Finally, this section analyzes closely the issue of South-South financial and monetary integration.

It is now well known that an integral part of deepening regional trade integration is some form and degree of macroeconomic, monetary, and financial policy coordination. The European Union (EU) has come furthest in its efforts to eliminate macroeconomic instability by having irrevocably locked nominal exchange

rates through the introduction of a single currency and a European Central Bank. Other regions are following in the European Union's footsteps, with the Gulf Cooperation Council (GCC) countries planning for the introduction of a single currency by the year 2010, and MERCOSUR including a potential future monetary union among the options for increasing macroeconomic policy coordination in the future, in response to recent macroeconomic instability, which have proved highly disruptive to regional trade.

The project shows that the trade and investment creation processes generated by the reduction of trade barriers among MED countries resulting from GAFTA agreements are still not enough to generate a MED region that is highly integrated and that can better integrate with the world economy in general, and with the EU economies in particular.

While GCC countries are still negotiating trade agreements with the EU, we do not expect much alteration in the structure of the individual country specialization arising within the context of the Euro-MED partnership in the future. Oil will still dominate exports of these countries, even given the recent efforts devoted by some of these countries to diversify their export and production structures away from the oil sector into more industrial products.

Unlike GCC countries where most manpower is imported at relatively high costs rendering the production of labor intensive goods rather costly, most non GCC MED countries have certainly a comparative advantage in the production of labor intensive goods. Labor is available abundantly and at relatively low costs. These MED countries have already realized this and are relying more and more on the production of goods which are labor intensive.

In light of the signing of the Euro-MED Partnership by some MED countries and the continued negotiations of others, we expect no effects of greater EU-MED trade integration to have any impact on MED primary product exports, which constitute more than half of the composition of total exports. Even the industrial sector, where one would expect the region to be mostly affected by increased trade with the EU, our trade data indicate that the technological composition of MED exports appear to be relatively very low, and may suffer only a little as a result of greater integration with the EU. Overall, we do not expect any significant shifts in the technological composition of MED exports as a result of greater integration with the EU. The MED region will continue to specialize in the exports of primary and resource based products, and will most likely import more and more low, medium, and high tech products from the EU.

The lack of economic integration in the MED region is still a main factor behind the low level of FDI. Intra-regional capital flows are primarily in the form of workers' remittances and foreign assistance—mainly from the oil MED countries like Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates to poorer countries, like Egypt, Jordan, Lebanon and Yemen—which is highly correlated with the donor's economic circumstances, and thus with fluctuations in world market prices of oil.

Private capital and portfolio flows within the region have been also relatively limited. While cross border transactions between the financial markets of the GCC countries increased significantly in recent years, they remained negligible with the other MED countries. Intra-regional investments have been made mainly in those MED countries that implemented policies conducive to strengthening the operational framework of the domestic financial market, such as Egypt and Jordan.

The project shows that one way to attract more FDI into the region may be through the establishment of a MED customs union. A customs union would enhance competitiveness in the union's enlarged market and tend to create significant stimulants for upgrading the productivity of factors of production. A larger MED market will be able to better attract FDI and portfolio flows. Another desirable feature of the customs union is the creation of a common customs barrier, which will stimulate the relocation of European or international FDI in order to take advantage of the larger market created by the customs union. However, a MED free trade area without a customs union will generate the opposite effects, and reduce the incentives for FDI to relocate in countries included in the free trade area, particularly if the individual countries are joining international free trade agreements such as an association or a partnership agreement with the European Union, or in some other cases with the US.

On the other hand, an important part of economic integration is the increase in cross border trade through the lifting of trade barriers as provided for in the GCC and the GAFTA agreements, and other MED trade agreements. However, given the unstable monetary, macroeconomic and financial environments in certain parts of the MED region, the project shows that pursued macroeconomic policies may not provide the required stability for increasing economic integration on a regional scale. Moreover, while this project shows that macroeconomic instability has in fact been so far a detriment to trade integration in the MED region, it is argued that as regional and global liberalization proceeds, policies formed under former macroeconomic conditions will become increasingly under pressure for not providing the stability needed for sound economic development in the new context of regional integration. Macroeconomic policy coordination, as an integral part of multilateral free trade agreements in the MED region, may therefore prove indispensable for successful economic integration in the region.

The empirical section of the project shows that a very small group of MED economies have become more open to one another since the beginning of the GAFTA period. The existence of high and significant correlation coefficients in some instances can be explained by the increase in trade flows, and their consequent impact on the growth rates of GDP. However, the majority of MPCs economies are somehow not at pace with each other. In fact, some GAFTA economies are largely independent of each other, and if anything else they tend to move in opposite directions. The MED countries that fall under this category are: Bahrain, Saudi Arabia, Egypt, Yemen, and Morocco. The remaining countries of Jordan, Lebanon, Syria, Tunisia and Kuwait are somewhere in the middle exhibiting high correlations with some countries and low or negative correlations with the others. The empirical evidence cannot provide a strong support to the claim that: (1) For those MPCs that have ratified the GAFTA Agreements, greater trade integration is gradually leading to greater economic integration within the MED region; And (2) the MPCs' business cycles are becoming relatively highly synchronized with one another. We could not therefore declare the GAFTA region as an OCA.

The policy recommendations of the project can be summarized as follows:

(1) Despite the success of GAFTA in abolishing tariff barriers, the share of intra-MED trade in total trade of the MED region remained below 10 percent. MED governments should devote more efforts with regard to installing an effective mechanism to appropriately deal with (i) Dispute Settlements; (ii) Exemptions; (iii) Rules of Origin; and (iv) Non-Tariff Barriers.

(2) A combined MED market would be large enough to allow for economies of scale if regional industrial hubs form to supply the growing regional market as well as export demand outside the region. To achieve this goal, MED governments should facilitate and enhance the transition of MED economic structure from small domestic industries competing with one another to produce the same kind of goods, to more specialization across countries in the MED region. One way to achieving the type of specialization required is to have the MED oil economies specialized in capital intensive goods and the remaining non-oil economies in labor intensive goods.

(3) MED governments need to exert intensive efforts to raise their share in global FDI inflows. The measures that could be taken include the acceleration of south-south economic, financial, and trade integration efforts, coupled with enhanced reform programs, and stressing the institutional aspects in particular. Moreover, these countries need to accelerate the implementation of the privatization process, which represents an important factor in promoting the inflows of FDI and portfolio flows at the global level, particularly the privatization of the services sector. MED countries would also have to fight financial and administration corruption and eliminate bureaucracy, which represent strong impediments to the inflow of FDI.

(4) Fixed exchange rates may be the optimal monetary arrangement among MED countries that are subject to similar and symmetric economic shocks, mainly shocks to oil prices and revenues. The oil MED economies are more likely to have correlated economic shocks, and thus may require a common policy response.

(5) Even though trade flows within GAFTA appear to be on the rise, they appear not to be enough to qualify the region as an OCA. We still see significant divergence in business cycles and exchange rate polices. The existence of exchange rate overvaluations and misalignments within GAFTA countries are still hindering intra-regional trade flows. Thus, macroeconomic policy divergence within the region appears to be among the main obstacles towards achieving further trade and monetary integration. One way to circumvent this problem is perhaps through the adoption of a common currency within the MED region.

(6) The exchange rate literature stipulates that the benefits of monetary unification, by adopting a common currency, are in the form of elimination of the costs associated with exchange rate misalignments and currency conversion. Unlike the GCC agreements, the recent GAFTA agreements do not immediately provide for labor mobility within the region, for fiscal cross-border transfers in order to smooth out economic and financial shocks, or for the adoption of a common currency sometime in the foreseeable future. Further, the various MED central banks do not possess a good track record of maintaining price stability, and a flexible exchange rate, which allows them to pursue their own independent monetary policy. Therefore MED

central banks should perhaps pursue a monetary policy that adopts a common currency in the long-run, or a monetary policy that ties the various non-oil MED currencies closely to the euro and not the dollar in the short run can turn out to be instrumental in borrowing monetary credibility from the European Central Bank (ECB), and thus, may reduce the MED region inflation and interest rates.

(7) If a MED central bank wants to purse monetary policy independence, then a flexible exchange rate regime is better in the presence of structural economic differences between the different MED countries. However, Lebanon, Egypt, Morocco and Tunisia's experience with flexible rates has been disappointing, given the high volatility of their real exchange rates, and the prolonged misalignment of their respective currencies from its equilibrium value. Similar arguments were made pointing out that flexible exchange rates have not delivered the expected results in the MED region. Unemployment rates in Egypt, Lebanon, Morocco and Tunisia have remained high and labor market flexibility has been lower because of flexible rates. Also, the high volatility of their exchange rates has increased the exchange rate risk premium and resulted in higher interest rates. A common currency, would improve the four countries financial and monetary position within the MED region, by eliminating exchange rate misalignments and currency convergence costs and exchange rate risk premia, and by reducing interest rates and general price variability.

(8) A MED monetary policy adopting a common currency like for instance the euro- justified by strong trade links these countries have with the EU- will lead in the future to the intensification of not only MED trade, but also Euro-MED trade, justified also by the elimination of real exchange rate overvaluations and misalignments and by the reduction of currency conversion costs.

(9) There exists a weak convergence in monetary policies in the MED region. This very weak convergence is not surprising, and is due to the lack of coordination of monetary and exchange rate polices, and to the fact that there is a significant degree of heterogeneity in MED exchange rates policies. It also indicates that several MED countries appear to be setting their exchange rates independently. While some MED exchange rates have been behaving quite differently especially during the various episodes of exchange rate volatility, others have been strictly pegged to the US dollar, and in some other instances fixed to a basket of currencies where the dollar is given the highest weight. MED central banks should set their future exchange rate policies to better reflect their changing trading patterns after the ratification of GAFTA and the signing of the Euro-MED partnership. The full adoption of a common currency like the euro by MPCs in the future may contribute to enhancing MED trade flows as well as Euro-MED trade flows.

(10) Macroeconomic and monetary policy coordination is still lacking in the region and more efforts need to be devoted in that respect. Appropriate economic policy remedies to these factors are expected to better prepare the region for further integration in the future.

(11) Genuine efforts should be devoted to improve government macroeconomic policies. These policies have not yet been able to enhance trade and monetary integration. There is a need for more harmonization of exchange rate and interest rate policies. The optimal monetary policy option is a monetary union between those

countries. However, since a monetary union between GAFTA members is a somewhat distant prospect, these countries should perhaps follow the Egyptian, Tunisian and Moroccan examples and introduce in the short run more flexibility in their exchange rates, as a first step before greater fixity and subsequently the adoption of a common currency. This will allow those countries to correct for any imbalances in their current and capital accounts, and ease up any fiscal pressures on domestic interest rates emanating from public budget deficits and accumulated public debts. In the long-run, when fiscal and monetary imbalances ease up, these countries including Egypt can opt for more fixity through a rigid peg or an exchange rate target zone as a preliminary step before the adoption of a common currency.

(12) Among the oil MED economies, the homogeneous pegging of local currencies to the USD will greatly facilitate the formation of a currency union in 2010, and is currently justified due to the fact that oil exports which are denominated in USD constitute more than 80 percent of total exports. The Gulf Cooperation Council States should accelerate their efforts to achieve monetary integration and work towards the eventual inclusion of the remaining GAFTA members in a larger regional currency union. Such unification is expected to eliminate regional exchange rate misalignments and their negative impact on intra-MED trade.

(13) Flexible exchange rate regimes in MED countries may not be a viable alternative for the majority of the MPCs, given the virtual absence of independent monetary policies and well-developed capital markets. Another consideration is that underdeveloped monetary, political and policy-making institutions tend to undermine the effectiveness of discretionary monetary policy. For now, some type of fixed arrangement may be the safest option for most of these countries. For MED countries engaged in a significant amount of trade with the EU, a euro peg may be more appropriate than a dollar peg. In all cases, those countries maintaining fixed exchange rate arrangements must implement crisis-prevention measures, namely by exercising fiscal discipline, managing their debts and foreign reserves, and avoiding currency appreciation. As countries in the MED region improve their monetary and fiscal infrastructures and become more integrated with global capital markets, they should opt for a currency union.

(14) The exchange rate in the GCC countries has effectively been fixed to the US dollar. However, these economies have not yet liberalized their capital accounts, and cross-border capital transfers are restricted to the repatriation of workers' remittances. Portfolio flows are limited, and the same is true for foreign direct investment. Thus, the GCC countries have been able to use effectively their monetary policy to preserve their dollar peg. Among the GCC economies, the homogeneous exchange rate peg to the dollar may prove to be instrumental in facilitating the formation of a sub regional currency union in 2010. The GCC countries should accelerate the monetary integration process and give serious thought to expanding the currency union to include the other MED countries. The establishment of the Gulf-based currency union will eliminate regional exchange rate misalignments and their negative impact on intra-MED and international trade. As long as these economies remain undiversified and can count on substantial regular inflows of hard currency from oil exports, a fixed exchange rate peg to the dollar is sustainable and can be justified. This is not the case for the other MPCs, which have a high concentration of trade with the EU and much more diversified exports and production structures; these countries should give

serious consideration to adopting the euro as an alternative peg in the foreseeable future.

(15) MED central bank should also introduce more harmonization in terms of the targets, instruments, and goals of monetary policy. Some MED countries like for instance Lebanon, and Jordan have opted for price stability as the main goal of monetary policy. Others are still pursuing discretionary policies aiming at stimulating the rate of growth GDP. In addition, MED central banks have been using different monetary policy tools to achieve different goals. While countries like Kuwait, Bahrain Lebanon, Jordan and Egypt are using the rate of interest as their main policy instrument, others like Saudi Arabia, Syria, Morocco and Qatar are using M2 as their main policy instrument. These divergences in monetary policy instruments and goals are having important negative consequences on exchange rates, trade and the rate of growth of GDP.

(16) MED central banks should improve financial and monetary policy coordination to allow them to deal more effectively with financial and monetary imbalances. One way this may be achieved is through enhanced regional financial integration. The formation of an integrated MED capital market, for instance, would lower the region's interest rates, benefiting those MED countries burdened with high levels of debt. Specifically, a larger, integrated regional market would reduce the huge costs associated with servicing the accumulated public debt, and would lower the cost of raising capital, allowing companies in the region to rely increasingly on the local market rather than the world market for economic development resources; lower capital-raising costs translate into higher investment and GDP growth rates.

I. Introduction

Mediterranean Partner Countries (MPCs) are aiming for increased regional economic integration. A significant part of economic integration, is the expansion of intra-regional trade, thereby allowing a higher degree of inter-Mediterranean (MED) specialization and improved allocation and distribution of resources in the region. Moreover, the dynamic effects of increased goods market competition, such as improved efficiency, consolidation, and greater opportunities for economies of scale, are expected to prepare the MED economies for international goods market competition. Although MPCs face numerous stumbling blocks to increasing regional trade, from lack of mechanisms to commit to and enforce the already ratified free trade agreements, to a highly troubled geopolitical situation, a consensus exists among MPCs that MED economic integration is crucial for meeting the challenges of globalization from a regional stronghold, and is a strategy to boost growth and economic welfare.

Liberalizing trade through reductions in tariffs, as provided for in the Greater Arab Free Trade Area (GAFTA) agreement, is a first and necessary step on the way to increasing trade integration. But tariffs are far from being the only obstacles to trade. Unsustainable or uncoordinated macroeconomic policies often translate into excessive price or exchange rate volatility or misalignment, which in turn affect the real exchange rate and hence competitiveness and trade.

As the experience of regional economic integration efforts around the world illustrates, an integral part of deepening regional trade integration is some form and degree of macroeconomic, monetary, and financial policy coordination. The European Union (EU) has come furthest in its efforts to eliminate macroeconomic instability by having irrevocably locked nominal exchange rates through the introduction of a single currency and a European Central Bank. Other regions are following in the European Union's footsteps, with the Gulf Cooperation Council (GCC) countries planning for the introduction of a single currency by the year 2010, and MERCOSUR including a potential future monetary union among the options for increasing macroeconomic policy coordination in the future, in response to recent macroeconomic instability, which have proved highly disruptive to regional trade.

This research project will study carefully the following issues. It first outlines the past and current attempts to enhance economic integration in the MED region, and looks at how far the region has come in terms of regional trade, monetary, and financial integration. It will then investigate how macroeconomic instability has been an impediment to economic integration in the past in the MED region, and discusses whether it is likely to be the case in the future. Specific proposals for macroeconomic cooperation to sustain the regional integration process in the MED region are outlined next, emphasizing the links between macroeconomic policies and economic integration. All of these issues will be related to the recent objectives set out by the Barcelona Declaration which envisage a Euro-MED free trade area by the year 2010, and enhanced economic integration of the two regions.

World trends towards globalization, e-commerce, and the rising tide of regional trade blocs require that the Mediterranean Partner Countries take the necessary actions to address the challenges from an increasingly integrated world economy, as well as seize the opportunities that globalization and regional integration present. Positive steps have been made by selected countries of the region, through increased awareness of and participation in multilateral trading agreements, bilateral inter-regional agreements, bilateral intra-regional trading agreements, transport and trade facilitation, energy policy coordination, and promotion of the sectors most vital

to the region's economies. Many challenges remain for Mediterranean Partner Countries to maximize the economic benefits from globalization and deepening of MED regional integration.

This research project is set out to examine the issues of South-South economic integration pertaining to the Mediterranean Partner Countries.[1] It is well known that progress in south-south integration is vital for re-establishing balance in the vertical relations with the European Union. The second section of the project will present a detailed evaluation of the stumbling blocks to South-South economic integration by studying the prospects and status of trade, monetary and financial integration. Trade integration is analyzed through an evaluation of the status of tariff and non-tariff barriers, and the required steps to be taken by MPCs before removing these barriers. This section will also highlight the current South-South trade agreements, by emphasizing what they accomplished and what still needs to be implemented. It will also explore the prospects for enhancing intra-regional trade agreements. Particular emphasis will be put on the issue of how MPCs could benefit from a regional integration in their trade with the EU, by evaluating issues relating to the flow of capital and foreign direct investment (FDI), labor mobility and trade in agriculture and services. In particular, this section will analyze: (1) South Mediterranean trade characteristics and incentives for external trade (small regional and national markets, products concentration and/or diversifications, natural resources based trade); And (2) the areas of South MED specialization and overlap and the prospects for future specializations with the purpose of evaluating the extent of adjustments that should take place; Trade diversion and creation effects, and the consequences in terms of factor reallocation and the distribution of income. Finally, this section looks at South-South financial and monetary integration by analyzing FDI and portfolio flows to the region as well as intra regional capital flows.

The third section of the project is empirical in nature. It will present a detailed evaluation of the stumbling blocks to South-South monetary and financial integration. It will evaluate the consequences of South-South integration on the evolution of exchange rate regimes (flexible anchoring with the euro, target zones anchored on the euro). The diverse exchange rate regimes have so far been a hindering factor toward deeper South-South integration. The issue of a regional currency union adopting the euro, among the Greater Arab Free Trade Agreements Members will also be carefully studied. The implications of a common currency on Euro-MED trade will also be analyzed. Drawing from the theory of optimum currency areas (OCAs), and the convergence criteria for European monetary unification, we will collect and analyze macroeconomic, trade and monetary data for 12 MPCs in order to assess the conditions for both the existence of an OCA and/or a successful monetary union within GAFTA. Finally, this section will analyze closely the issue of South-South financial and monetary integration, and the prospects for enhanced financial integration with the EU.

[1] In this research proposal the Mediterranean Partner Countries are the Greater Arab Free Trade Agreements Members (Algeria is excluded from our empirical analysis because it joined GAFTA only in 2002). These are divided into two groups the non-oil producing countries of: Egypt, Jordan, Lebanon, Morocco, Syria, Tunisia and Yemen; and the oil-producing countries of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

II. Overview of South-South Economic Integration

A quick overview of bilateral trade and investment flows in the MED region shows that intra-regional exports, imports, FDI and portfolio investments have been declining for the MED region in recent years, contrary to the experience of other regionally integrating areas of the world, and to expectations from the newly ratified intra-regional trade. Moreover, the level of intra-regional exports is low compared to other regions to begin with, specifically when oil-exports are excluded. One reason for the low level of intra-regional trade is rooted in the unsuccessful implementation of past trade agreements in the MED region on one hand, and the low complementarity of production capacities, but this is not the only reason behind the outright fall in intra-regional trade over the last decade.

Past efforts to enhance intra-regional trade in the MED region have been numerous, but so far, none of these agreements have been fully implemented and all have failed, for various reasons. The most recent attempt at regional economic integration is the Greater Arab Free Trade Area, for which 15 MED member countries have currently signed up. GAFTA has taken into account some of the problems, which resulted in the failure of previous trade agreements, but other obstacles have not been addressed, such as macroeconomic instability in the region in addition to financial and monetary integration. No formal initiatives to establish macroeconomic policy coordination have been taken so far, and there is currently no common vision for establishing such macroeconomic policy coordination in the future.

Since the early 1950s, many steps were taken by MED countries to integrate more fully into the world economy. In addition to active participation in the World Trade Organization (WTO), some MED countries negotiated and signed bilateral trading arrangements with the European Union countries. These agreements benefit the MED countries and the region in several ways. Among others is the direct benefit of increased access for MED exports in EU markets. Increased market access directly benefited MED firms, MED employment, and their domestic industries that provide inputs and services for the export sectors. MED countries benefited indirectly in terms of improved transparency, standardization of procedures and regulations, technical expertise, and government revenues that provided funds for improved education and health care. A third gain to the region from these early inter-regional trading arrangements was increased intra-MED labor flows, spreading the benefits of export-earnings outside the countries implementing the agreements. Earlier trading arrangements with Europe, included European technical and financial assistance for the MED partner countries.

Improvements in production capacity as a result of these bilateral trade agreements raised the competitiveness and opportunities for MED exports in all regions of the world.[2] These new generation Euro-Mediterranean Association

[2] Eleven countries in the Southern Mediterranean region and the Palestinian Authority implemented or are continuing to negotiate bilateral trading agreements with the European Union (EU). These southern Mediterranean partner countries are: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia, and Turkey. Cyprus and Malta became full members of the EU in 2004, negating their bilateral trade agreements. In addition, the recent set-backs in reuniting the Greek and Turkish halves of Cyprus will result in the Greek half joining the European Union. Turkish plans to join the EU were also thwarted and no date is set for Turkey to formally join the EU. A new generation of bilateral association agreements have been implemented between the EU and Israel, Jordan, Morocco, the Palestinian Authority, Lebanon and Tunisia, to replace the original association and cooperation agreements. New association agreements with Egypt and Algeria are signed and awaiting ratification. Libya maintains

Agreements come under the umbrella of the Euro-Mediterranean Partnership (Barcelona Declaration) initiated in November 1995 to replace the first generation cooperation agreements with these countries, some dating back to the 1960s and 1970s. The first cooperation agreements provided nonreciprocal access for Mediterranean manufactured goods entering the EU market. The early agreements did not include reciprocal market access for European goods into the Mediterranean partner countries. The new generation of association agreements increases market access for both the Mediterranean partners and European countries by providing gradual liberalization of European agricultural markets and reciprocal trade liberation by the Mediterranean partners for European manufactured goods. The 1995 Barcelona Declaration provides financial and technical support for Mediterranean partner countries undergoing the transition from protected markets to free trade with the EU member states. The long-term goal of the Euro-Mediterranean Partnership Agreement is to establish a Euro-Mediterranean Free Trade Area (FTA) by 2010. This FTA will require trade liberalization among the Mediterranean partners. The Mediterranean partners have been highly successful in negotiating Association Agreements with the EU, however, much progress needs to be made on regional integration to achieve the 2010 target of a Euro-Mediterranean FTA.

The goal of the Euro-Mediterranean Partnership Agreement is to expand the process of Mediterranean regional trade liberalization by forming a WTO-compatible free trade area within a 12-year transition period. In order to fully achieve this objective, MPCs need to liberalize mutual trade, an issue which will be thoroughly assessed in the next section. The EU established a Working Group on Trade Measures Relevant for Regional Integration to assist the Mediterranean partners. In addition, the Barcelona Declaration provides financial and technical support for Mediterranean partners undergoing the transition to a regional FTA. There are a number of reasons why it is imperative for the Mediterranean partners to move quickly to liberalize intra-regional trade and investment flows.

A- South-South Trade Integration

MPCs have devoted considerable efforts towards regional unity since the formation of the League of Arab States in 1945. Other efforts towards regional integration and cooperation included the 1950 Treaty for Joint Defense and Economic Cooperation, in 1953 the Convention for Facilitating and Regulating Transit Trade, in 1957 the Arab Economic Unity Agreement, in 1964 the Arab Common Market, in 1981 the Gulf Cooperation Council, in 1989 the Arab Cooperation Council and in 1989 the Arab Maghreb Union. However, most of these regional agreements were not fully implemented or effectively enforced. The most recent efforts towards MED regional integration, primarily since the late 1990s, have been more successful. The Gulf Cooperation Council has made significant success toward forming a customs union and the adoption of a common currency in 2010, and the Greater Arab Free Trade Area has been reinitiated, in addition to several bilateral trade agreements between MED countries.

The main objective of regional integration is to realize, through the combined size of their capacities and markets, a form of economic synergy among different

observer status, while the ratification of the agreements with Syria were put on hold after its latest crisis with the United Nations and the implementation of resolution 1559.

MED countries, and subsequently enhanced growth opportunities through both trade and investment creation generated by a reduction of trade barriers among MED countries (tariffs, quotas and Non Tariffs Barriers (NTBs)); and the coordination of macroeconomic and monetary policies. All these factors are expected to better prepare the region for further integration with the world economy in general and with the EU in particular.

The benefits to the region from stimulating intra-MED integration are significant. First and foremost are the trade creation possibilities which are the result of: (1) Eliminating all diverting trade barriers among member countries which will increase bilateral and multilateral trade; (2) Achieving enhanced efficiencies in production by exploiting comparative advantages in domestic markets and economies of scale; (3) enhancing competition in the domestic market with greater consumer choice and lower prices; (4) Achieving higher production capacities due to better exploitation of economies of scale made possible by expanded markets; And (5) improved national terms of trade based on cheaper imports.

The MED region has historically suffered from low intra-MED trade flows, primarily due to the factor endowment of the region, rich in oil and poor in water, the nature of the products produced for export, the overlap in the specialization and production structures, and government policies giving preferential treatment to domestic industries. Protectionist policies are slowly being dismantled, although much work remains to improve market access by standardizing customs procedures, increasing transparency of rules of origin, and improving intra-MED transportation infrastructure. Due to the small population size in MED countries, domestic markets have not been sufficient to sustain competitive industrial clusters. However, the combined MED market is large enough to allow for economies of scale, if regional industrial hubs form to supply the growing regional market as well as export demand outside the region. Thus, there is a need for transition of MED economic structure from small domestic industries competing with one another to produce the same type of goods, to more specialization across countries in the MED region based on comparative advantage. In addition, market forces would insure this transition, if allowed to evolve in an environment of trade facilitation. Although, regional producers may not be prepared to fully compete with producers from more developed countries, it is possible that regional liberalization can assist in the adjustment process necessary for regional producers to eventually compete in the global market place. The fact is that MED countries have the advantage of close proximity to one another, lowering intra-MED transportation costs and giving them a cost advantage over Asian and North American products competing in the MED marketplace.

The main factors that have hindered intra-MED trade so far can be summarized as follows: (1) Oil and oil derivatives accounting for the major share of the region's exports, are sold outside the region; (2) Produced goods in many MED countries are of low quality leading to dependence on imports from outside the region; (3) Similar production structures of MED economies prevents major gains from comparative advantage and economies of scale. For example, GCC countries produce and export primarily oil and oil derivatives, petrochemicals, and aluminum. The more diversified MED economies export primarily textiles, metal products and machinery. Many of these products have low demand within the region and compete with one another in the limited MED market; (4) Many exceptions for industrial and agricultural products are typically included in MED trade agreements to protect non-competitive domestic producers; (5) There is no accurate definition for rules of origin in MED trade agreements; (6) Higher consumer prices due to high levels of tariffs on

imports and exports; (7) There are no dispute settlement mechanisms; (8) Non-Tariff Barriers considerably reduce MED intra-regional trade; (9) High transportation costs due to poor infrastructure between MED countries contribute to high prices; (10) The absence of incentives for policy makers to combat monopolies gaining the most from maintaining the status quo in trade policies; And (11) The absence of a compensation mechanism to assist domestic producers and consumers who may be harmed during the transition from protectionism to trade liberalization.

1- GAFTA and Intra-Regional Trade Liberalization in the MED Region

1.1 Overview of the GAFTA Agreements

The Greater Arab Free Trade Area launched in 1981 was unsuccessful in reducing barriers to trade among MED states. In 1997 the agreement was revived with the Executive Program for Arab Free Trade for the creation of the GAFTA. Fourteen of the 22 Arab League members participated in the 1997 re-launching of GAFTA. These 14 countries account for 95 percent of total MED foreign trade and 90 percent of intra-MED trade. Algeria joined GAFTA in 2002, increasing the number of members to 15. The provisions of GAFTA provide for across-the-board reductions or eliminations of tariffs, and non-tariff barriers on intra-GAFTA trade in manufactured goods over a ten-year period, which began January 1, 1998. By January 2005, the 14 GAFTA member states had effectively reduced tariffs on intra-GAFTA industrial trade by 100 percent. At a meeting of the Economic and Social Council of the League of Arab States in February 2002, members agreed to reduce the period for the implementation of GAFTA from 2007 to 2005. The time schedule for liberalization included a 60 percent reduction in tariffs barriers by 2003, an 80 percent reduction by 2004, and tariff elimination between GAFTA members was achieved in January 2005. MED countries share a very similar history; nevertheless, their economic and social developments are very different. They constitute in those terms a heterogeneous group where some countries have very high GDP levels, like Saudi Arabia and the UAE, as opposed to others like Yemen and Syria whose GDP are relatively much lower.

Economic integration does appear to be a distant goal in this region since many attempts have so far failed and did not reach any positive outcomes. The Greater Arab Free Trade Area constitutes the most recent and until now the most comprehensive step taken by MED countries to achieve a significant level of economic integration. The decades of the 1980's and 1990's have witnessed renewed interests within the MED region for economic integration. GAFTA was subsequently established in February 1997 and the original signatories of the Agreement were Bahrain, Egypt, Iraq, Jordan, Libya, Morocco, Oman, Syria, and Yemen, with Lebanon and Tunisia joining later. The Agreement provides that commodities enjoying the privileges of trade liberalization should not be exposed to either tariffs, or non tariff barriers, except for commodities whose import is banned for reasons of health, security or environment. Goods selected for gradual tariff reductions are agricultural and animal products, mineral and non-mineral raw materials and other selected goods agreed upon by the council. Under the program of implementing the GAFTA, countries are required to implement the Harmonization System of tariffs to facilitate commercial interchange among them.

The main objectives of the executive program may be summarized as follows: (1) Abolishing tariffs on all goods exchanged between member countries, according to a progressive liberalization with an annual reduction of 10 percent in tariffs applied in January 1998, reaching the zero tariff rate in January 2005; (2) MED goods' rules of origins are set at 40 percent of the added value; (3) Conformity with WTO requirementrs; (4) Special treatment of the less developed MED countries; (5) The private sector will participate in monitoring implementation of these agreements; And (6) agricultural products are not part of the tariff reduction scheme during the harvest season.

To insure a smooth transition, exceptions relating to the liberalization of industrial products were allowed. However, these exceptions have disappeared when GAFTA came into force fully, in January 2005. GAFTA is expected to increase economic integration and cooperation among the MED member countries. So far Member countries succeeded in implementing some of the program elements. Those include: (1) Tariff elimination; (2) Classification of goods according to a unified system; (3) Presentation of the agricultural yearbook of the member countries; (4) Preparation of lists of products excluded from the program for religious, health, security or environmental reasons; And (5) general rules of origin for MED goods were defined by the relevant committee for a transition period, until detailed rules are defined, and the economic and social council adopts the Arab origin certificate.

Some elements were either not applied or partially applied, like those relating to the removal of non-tariff barriers. Non-tariff barriers including administrative, monetary or quota restrictions are still applied by some countries. Although, GAFTA is proving to be the most successful attempt of integration in the Arab region, yet, it is not showing very considerable positive results, and this is due to the lack of homogeneity among the member countries.

1.2. Stumbling Blocks in the Implementation of GAFTA

With GAFTA entering its eighth year at the beginning of 2005, the reduction in customs duties and taxes with similar effects on goods of MED origin reached 100 percent relative to the situation prevailing at the end of 1997. The number of member countries reached 20 in 2004, and included Algeria, Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Palestine, Qatar, Tunisia, Mauritania, Somalia, Saudi Arabia, Sudan, Syria, United Arab Emirates, and Yemen.

1.2.1. Liberalization of Trade in Goods within the GAFTA Framework

The main factors still hindering the liberalization of MED intra-regional trade under GAFTA include: (i) The lack of an effective dispute settlement mechanism; (ii) The large number of exemptions granted to some countries; (iii) The inadequate definition of rules of origin for MED products; And (iv) NTBs.

i- Dispute Settlement Mechanism

The Arab Economic and Social Council is entrusted with resolving disputes arising between the parties to the agreement. Similarly, GAFTA provided for the establishment of a committee for the settlement of disputes in all matters related to the implementation of the Agreement on Facilitation and Development of Trade between MED Countries. It was necessary, in view of the expected large number of complaints by the private sector concerning obstacles facing exports to some MED countries, dumping operations, subsidies and rules of origin, to formulate rules defining the

manner of resolving disputes within the framework of GAFTA. A draft proposal of a schedule for the settlement of disputes, in four stages, has been prepared by a group of legal and trade experts.

ii- Exemptions

The large number of exemptions granted to some MED countries is among the major obstacles to the effective implementation of GAFTA. Exemptions from the gradual reduction of custom duties were granted at the time to Egypt, Jordan, Lebanon, Morocco, Syria, and Tunisia. The exemptions covered a number of commodities that were specified by these countries and were intended to apply for limited durations ranging between 3 and 4 years, after which the gradual reduction agreed upon should be applied.

Jordan, Lebanon and Morocco have ceased to apply these exemptions. However, Egypt, Syria and Tunisia have continued to apply the exemptions granted to them, and which were supposed to have expired by September 2002. In such case, the other MED countries can apply the reciprocity principle to products originating in these countries and deny them tariff reductions given to other members.

iii- Rules of Origin

Until relatively recently detailed rules of origin for MED products have not been implemented. These rules are needed to identify the source of goods to determine if they are of MED origin so as to qualify for the advantages that membership in GAFTA provides. Although MED countries have not yet reached an agreement on the rules of origin with respect to several goods, progress has been achieved towards resolving this obstacle, with the help of the study being prepared by the General Secretariat of the League of Arab States, in cooperation with the World Customs Organization, to deal with the rules on which there is still disagreement. It is expected that the study will be completed before the end of 2005 so that these rules can be reviewed again by the Technical Committee on Rules of Origin.

iv- Non-Tariff Barriers

GAFTA stipulates the removal of all non-tariff barriers to trade. However, the actual experience of GAFTA since its re-launching shows that many of these barriers have persisted and have reduced the effectiveness of MED intra-regional trade liberalization. Attempts to remove these barriers have been obstructed by the difficulty of identifying such barriers. To resolve this issue, the General Secretariat of the League of Arab States (LAS) has taken steps to identify non-tariff barriers in all MED countries and study their effects on MED intra-regional trade, with the help of field task forces operating in member countries. The General Secretariat is preparing a comprehensive study on non-tariff barriers in the MED countries, based on the results of the field work. In the context of dealing with this issue, the said study will be discussed in the Trade Negotiations Committee, which is concerned with the removal of non-tariff barriers. The Committee will present its recommendations to the Arab Economic and Social Council.

Having reviewed the main obstacles facing the effective implementation of GAFTA and the efforts made to overcome them, the following section will review efforts to integrate trade in services into GAFTA.

1.2.2. Liberalization of Trade in Services within the GAFTA Framework

In view of the importance of trade in services in MED trade, in general, and in MED intra-regional trade, in particular, and considering that 9 MED countries are already members of the WTO (Bahrain, Egypt, Jordan, Kuwait, Morocco, Oman, Qatar, Tunisia and the UAE), in addition to 4 other countries that have initiated negotiations to join (Algeria, Lebanon, Saudi Arabia, and Yemen), MED countries have expressed a growing interest in liberalizing intra-regional trade in services. The Jordan 2000 Arab Summit stressed the importance of integrating trade in services within GAFTA rules, and requested the Arab Economic and Social Council to take the necessary steps towards that end.

After studying the Agreement on Facilitation and Development of Trade among MED Countries, it was found necessary to prepare a new agreement to liberalize trade in services between these countries; and work on this agreement started in 2001. Among the main principles taken into consideration in the draft MED agreement on the liberalization of trade in services is that it ought to conform to the WTO General Agreement on Trade in Services (GATS), and not contradict or affect the commitments of MED countries members of the WTO. Moreover, the services sectors liberalized under the agreement should exceed the commitments made by MED countries in the GATS. The MED Agreement for Trade in Services comprises two parts. Part one relates to general provisions for liberalizing trade in services. The second part concerns schedules of commitments of the parties to the agreement.

2.The Gulf Cooperation Council and Intra-Regional Trade Liberalization

2.1 Overview of the GCC Agreements

In 1981, the UAE, Bahrain, Saudi Arabia, Oman, Qatar and Kuwait established the Gulf Cooperation Council, to achieve economic and social integration among the Member States, and to achieve unity at a later stage. The six member countries have a lot in common in terms of economical, cultural, historical, social and religious values. These factors along with geographic proximity facilitated interaction and created homogenous values and characteristics.

In order to achieve the above-mentioned objectives, the council has set up several agreements. The following are among the most important ones: (1) The member states should allow free imports and exports of agricultural, animal, industrial and natural resource products; (2) A unified custom tariff should be applied on products originating from non-GCC countries, to protect domestic goods from foreign competition; (3) Coordinated commercial policies with other regional economic groups to create balanced trade relations and terms of trade with the rest of the world; (4) Free movement of human and physical capital; (5) Investment rules and regulations should be unified; (6) Member states will have to coordinate their financial, monetary and banking policies and enhance cooperation between monetary authorities and central banks.

The next target of the GCC is to move from cooperation and coordination to advanced stages of economic integration. Consequently, GCC countries have set up a free trade zone in 1983. Members are about to set up a customs union according to a timetable approved in the 1999 Saudi Arabia summit. The timetable states that the union should have been operative in March 2005, but until June 2005 did not materialize. Moreover, GCC is working on fulfilling the third stage of integration: the initiation of a Gulf Common Market. Such a goal involves free movement of goods,

labor and physical capital. Finally, the GCC aims at achieving full monetary and financial integration by adopting a common currency by the year 2010.

The above-mentioned goals require some changes in the existing laws to introduce equal treatment of GCC citizens. Some of the achievements that have been realized include practice of retail and wholesale trade, ownership of shares and real estates, engaging in different professions and economic activities such as agriculture, industry, contracting and obtaining loans from industry development funds and banks in the GCC countries.

GCC states have made significant progress in terms of unifying their economic policies relating mainly to agriculture and industrial development. At present, negotiations are ongoing with the European Union to reach a free trade agreement.

2.2 Stumbling Blocks in the Implementation of the GCC Agreements

Efforts have been intensified towards unifying GCC's foreign trade policies, and subsequently towards establishing a customs union in January 2003. The establishment of a customs union is still facing several obstacles and did not materialize even after 2 years of its intended date. The insistence of customs authorities in member countries on applying rigorous inspection is significantly delaying the flow of goods between member countries, and has been a major obstacle hindering the customs union.

In March 2003, the Secretariat of the GCC announced that it intends to look into the factors that are hindering the implementation of the customs union at customs entry points. Moreover, the customs union is expected to provide a conductive environment for establishing large Gulf companies and for the better exploitation of comparative advantages in each of the GCC member countries.

On the other hand, in conformity with the decision to adopt a common currency by 2010, the Kuwaiti Dinar which was pegged to a basket of currencies has been recently fixed to the US Dollar, in harmonization with the remaining GCC member countries- an essential step towards the adoption of a common currency in 2010.

3- Bilateral South-South Free Trade Agreements between MED Countries

This section highlights the historical and current evolution of intra-MED bilateral trade arrangements. Among others, Lebanon and Egypt ratified a trade agreement effective January 1, 1999. This agreement eliminates customs duties on particular agricultural and manufactured goods, allowing protection for some products identified in both countries. The Egypt-Tunisia Free Trade Area was ratified in 1999. Under this agreement, tariffs on manufactured goods are to be abolished by 2007. Exemptions are allowed for certain goods. Preferential rules of origin were set at 40 percent. Egypt and Iraq had envisaged establishing a free trade area in January 2001, which did not materialize due to the Iraqi crisis. In 1998, Jordan and Tunisia signed a bilateral Free Trade Zone Agreement. In 1977, Syria and Tunisia signed a trade agreement exempting tariffs for all originating products with a minimum of 40 percent integration rate. As members of the Arab Maghreb Union, Morocco and Tunisia are working on enhancing their trade relations. These two countries are also partners with Egypt and Jordan in the Agadir Declaration ratified in May 2001, which will set up a Free Trade Area among Arab-Mediterranean countries.

Table 1 summarizes MED bilateral free trade agreements that were concluded during the past decade between MED countries. Egypt has signed trade agreements with Jordan, Lebanon, Morocco, Saudi Arabia and Tunisia. Jordan has signed trade agreements with Kuwait, Lebanon, Saudi Arabia and Tunisia. Lebanon has signed agreements with all MED countries except Morocco, Tunisia and Yemen. Morocco has signed trade agreements with Tunisia.

Table 1. Intra-Regional Trade Agreements

Country	Egypt	Jordan	Kuwait	Lebanon	Morocco	Saudi Arabia	Syria	Tunisia	UAE	Yemen
Egypt	*	X		X	X	X		X		
Jordan	X	*	X	X		X		X		X
Kuwait		X	*	X						
Lebanon	X	X	X	*		X	X		X	
Morocco	X				*			X		
Saudi Arabia	X	X		X	X	*	X	X		
Syria				X		X	*	X		
Tunisia	X	X			X	X	X	*		
UAE				X					*	
Yemen		X								*

Notes: An X means signing of a bilateral trade agreement.
Source: Author's Estimates.

These bilateral trade agreements share a number of common features, of which the most important are: (a) Gradual removal of tariffs and other taxes imposed on imported products; And (b) Preparation of lists showing exemptions not falling under the trade liberalization program. The following are some of the more important bilateral agreements and discussions that took place in 2003 with regard to trade liberalization among a number of MED countries:

i- The free trade agreement signed between Egypt and Jordan was amended to reduce the list of goods exempted from tariff reduction under the agreement. The byproduct of this agreement was a significant increase in bilateral trade.

ii-Jordan and Lebanon signed the agricultural calendar for the 2003/2004 season, as part of their efforts to enhance trade in agricultural products. The result was a significant increase in bilateral trade in agricultural goods.

iii- Jordan and Syria signed the agricultural calendar aiming at enhancing the exchange of agricultural products. Trade in agricultural products between the two countries has increased significantly due mainly to the increase in the number of agricultural products exempted from customs duties.

iv- Egypt, Jordan, Morocco and Tunisia intensified their efforts to activate the 2001 Aghadeer Declaration stipulating the establishment of a free trade area. The objective of this free trade area is to promote trade among the four member countries, increase productivity, and remove obstacles to increasing exports to Europe within the framework of the European-Mediterranean partnership. It is worth noting that such sub regional agreements in the MED region could also help to encourage the flow of

investments to these countries within the framework of the said partnership agreement.

Such agreements among MED countries are expected to increase MED intra-regional trade, but not necessarily its share in their total trade, as most MED countries have either already concluded free trade agreements with countries and blocks outside the MED region (such as the European-Mediterranean Partnership and the United States-Jordan Free Trade Area agreement), or are involved in discussions to sign such agreements (as those between Morocco and Egypt, on one side, and the United States on the other, and the Egyptian-Russian discussions). There is no doubt that agreements with non-MED countries and blocs would promote faster integration of MED economies in the global economy, and contribute to expand trade between the MED countries and the rest of the world.

4-South-South Trade: Some Recent Trends

4.1 South–South Exports, Imports and Total Trade

MED countries continue to trade significantly with the rest of the world. This is due mainly to the factor endowment of the region-rich in oil and poor in water. However, over the past two decades, the share of intra-MED trade in total trade of the MED region remained below 10 percent. By comparison with other integrated regions worldwide, the share of intra-Asian trade was about 55 percent, and that of intra-Latin American trade was about 45 percent in 2004. Also in 2004, the share of intra-NAFTA trade was 55 percent of its total trade; and of intra-EU trade, it was almost 62 percent. Moreover, the speed of regional trade integration diminished—the annual average rate of growth of intra-regional imports dropped from 14 percent during the period 1986-1989, to 7 percent during the period 1990-1996, bouncing back to 10 percent during the 1997-2004 period.

The MED region, as a whole, has lagged behind other regions in terms of trade integration into the world economy, despite a stronger level of integration achieved by a limited number of individual countries. MED countries appear relatively open, with a total average trade-to-GDP ratio of 70 percent—high by international standards. However, this indicator is influenced by the particular factor endowments of the region—rich in oil and short in water—which result in sizable oil exports and basic food imports, and thus a comparatively high traded goods ratio. This does not necessarily reflect greater integration or competitiveness in global markets. The ratio of manufactured exports to total exports—a good indicator of a country's competitiveness in foreign markets, technological progress and production diversification—is below the average for developing countries. This ratio is on the rise for non-oil MED countries, but not for major oil-exporting countries. For most GCC countries, Syria and Algeria, the bulk of foreign export earnings is still comprised of fuel exports. Only a limited number of countries—Bahrain, Egypt, Jordan and, more recently, Oman—have a significant ratio of non-fuel exports to total exports.

The MED region's relative performance was evident in the 1990s, when most other developing countries witnessed a surge in trade integration. For example, Bahrain, Egypt, Kuwait and Syria exhibited negative growth rates in their trade-to-GDP ratios over several years in the 1990s. Moreover, the share of exports in total world exports for the MED region decreased by more than half since 1985—from about 5 percent in 1985 to nearly 2 percent in 1997 and up to only 3 percent in 2004. East Asia's export share, on the other hand, increased from 4 percent to almost 7 percent over the same period. Similarly, the share of MED imports in total world imports dropped from 5.5 percent in 1985 to 1.5 percent in 1997 and up to 2 percent in 2004.

Trade barriers in the region have been reduced in recent years, but they remain relatively high for many non-GCC countries. While most GCC countries—such as Bahrain, Oman, and the United Arab Emirates—have open trade regimes with average tariff levels below 15 percent, the levels are close to or above 30 percent for most non-GCC countries (compared with 10 percent in Latin America and 7 percent in Asia in 2004). In most recent years, a number of MED countries, like Egypt, Jordan, Morocco and Tunisia, have pursued greater trade liberalization by dismantling the systems of quantitative controls, cutting tariff levels and streamlining tariff systems, and introducing export promotion schemes and current account convertibility. Policies to promote non-oil, non-mineral exports were also implemented in some MED countries that relied heavily on primary commodities.

Table 2 indicates that total MED foreign trade registered a significant increase in between 1997-2003, increasing from about USD 312.8 billion in 1997 to USD 428 billion in 2003, an increase of about 37 percent. Intra-MED trade reached USD 35.7 billion in 2003, a slight increase of about 6 percent compared over its 2002 level.

Table 2. Total and Intra MED Trade (USD Million)

	1997	1998	1999	2000	2001	2002	2003
Total Foreign Trade	312768	270715	305375	400919	406120	417950	427950
Total Intra-MED Trade	28424	26038	26937	32274	30544	33925	35689
Percent	9.1	9.6	8.8	8.1	7.5	8.1	8.3

Source: IMF, Direction of Trade Statistics, 2004.

After declining in the two subsequent years after 1997, Intra-MED trade as a share of total foreign trade increased for the first time in 2002, to 8.1 percent, and subsequently to 8.3 in 2003. Intra-MED trade as a percentage of total foreign trade had declined from 9.6 percent in 1998 to 7.5 percent in 2001.

The ratio of Intra-MED trade to total foreign MED trade during the period 1998-2003, i.e. the six years that followed the establishment of the Greater Arab Free Trade Area, has remained relatively low and has averaged 8.26 percent only. This highlights the need for intensification of efforts by MED countries to overcome the stumbling blocks obstructing the liberalization of intra-MED trade, and to further enhance south-south trade integration.

Table 3. Total and Intra MED Exports (USD Billion)

	1997	1998	1999	2000	2001	2002	2003
Total MED Exports	145.3	147.9	171	252.7	237	240.5	245.9
MED Intra-regional Exports	11.1	13.8	14.1	16.3	17.8	21.3	22.5
Percent	7.6	9.3	8.3	6.5	7.5	8.9	9.1

Source: IMF, Direction of Trade Statistics, 2004.

Total MED intra-regional exports have increased steadily from USD 11.1 billion in 1997 to USD 22.5 billion in 2003, recording a mere 100 percent growth rate over that period. In relative terms, however, the share of MED intra-regional exports in total MED exports has increased in between 1997-1998, but then declined between 1998 and 2001, to revert back to 9.1 percent in 2003, averaging at about 8.17 percent (Table 3). The decline is not due to a real decline in Intra MED exports but can rather be attributed to the increase in total MED exports due to the world rise in oil prices during that period, given that oil accounts for the bulk of MED exports. Tables 2 and 3 indicate that since GAFTA came to force in 1997, total intra-MED trade and intra-MED exports appear to be on the rise. Thus, one can argue that there is evidence that this agreement is having a positive impact on MED intra-regional trade. However, in percentage of total trade, intra-MED total trade and total exports have remained below the 10 percent level, indicating that this agreement is still not being able to intensify MED trade and stimulate further trade integration in the region.

Looking at oil producing MED countries individually, specific country contributions to intra-MED trade appear to be higher than is the case for non-oil producing MED countries. Saudi Arabia has maintained its leading position, with its trade with the other MED countries in 2003, reaching USD 8.5 billion, followed by the United Arab Emirates and Oman with USD 6.8 and USD 3.1 billion, respectively (Table 4). The combined intra-MED trade of these three countries totaled USD 18.4 billion in 2003, representing around 52 percent of total Intra-MED trade in that year. At the lower end of the scale stand Bahrain, Kuwait and Qatar with intra-MED trade values of USD 2, USD 1.7, and USD 1.2 billion, respectively, in 2003.

For the non-oil producing MED countries, Morocco has maintained its leading position, with its trade with the other MED countries in 2003 reaching USD 3.3 billion, followed by Jordan and Egypt with US 2.98 and USD 1.9 billion, respectively. The combined intra-MED trade of these three countries totaled USD 8.1 billion in 2003, much lower in absolute terms when compared with the top three GCC countries. At the lower end of the scale stand Algeria, Tunisia and Yemen with intra-MED trade values of USD 0.592, USD 1.35, and USD 1.33 billion, respectively, in 2003 (Table 5).

Table 4. Aggregate and Intra-MED Trade by Country: 1997-2003 (USD Million)

GCC MED Countries	1997	1998	1999	2000	2001	2002	2003
Bahrain							
Total trade	10406	10018	10220	11670	12467	12272	12574
Intra-regional trade	2446	1525	1482	1787	1813	1913	2001
percent	23.5	15.2	14.5	15.3	14.5	15.6	15.9
Kuwait							
Total trade	22671	17600	18437	23437	17188	24226	25321
Intra-regional trade	1364	1345	1198	305	…	1691	1789
percent	6	7.6	6.5	1.3	…	7	7
Oman							
Total trade	12509	11057	11768	15917	17835	15397	16784
Intra-regional trade	2455	2778	2643	3247	3096	2828	3195
percent	19.6	25.1	22.4	20.4	17.4	18.4	19
Qatar							
Total trade	8371	8277	8565	14779	17017	16505	17345
Intra-regional trade	635	827	751	1271	1189	1167	1236
percent	7.5	10	8.8	8.6	7	7.1	7.1
Saudi Arabia							
Total trade	89135	68739	75711	110879	108962	114419	117621
Intra-regional trade	8200	6717	7170	8426	8312	7839	8526
percent	9.2	9.8	9.5	7.6	7.6	6.9	7.2
UAE							
Total trade	54227	50613	62436	80652	83250	86112	87894
Intra-regional trade	3576	4208	4913	6356	5873	5848	6824
percent	6.6	8.3	7.9	7.9	7	6.8	7.7

Source: IMF, Direction of Trade Statistics, 2004.

Jordan, Lebanon, Oman, Yemen, Bahrain and Morocco come fist with respect to the ratio of intra-MED Trade to total foreign trade of individual MED countries, with ratios reaching 35 percent, 27.6 percent, 19 percent, 18.3 percent, 15.9 percent and 14.3 percent, respectively, in 2003. In connection, it is worth noting that the share of intra-regional trade in Jordan's total trade has diminished after 1997 to reach 11.6 percent in 2001, influenced by the coming into effect of the free trade agreement with the United States (Table 5).

Table 5. Aggregate and Intra MED Trade by Country: 1997-2003 (USD Million)

Non-GCC MED Countries	1997	1998	1999	2000	2001	2002	2003
Algeria							
Total trade	22423	19429	21913	30566	32073	31850	32587
Intra-regional trade	588	436	458	536	499	554	592
percent	2.6	2.2	2.1	1.7	1.5	1.7	1.8
Egypt							
Total trade	17076	19674	19497	27293	27562	24780	25658
Intra-regional trade	1167	1444	1463	1806	1939	1875	1925
percent	6.8	7.3	7.5	6.6	7	7.6	7.5
Jordan							
Total trade	5388	5037	4907	5754	5814	7931	8523
Intra-regional trade	1695	1352	1361	1656	674	2100	2985
percent	31.4	26.8	27.7	28.8	11.6	26.5	35.0
Lebanon							
Total trade	8167	7776	6882	6942	7482	7236	7589
Intra-regional trade	839	755	685	858	1090	1199	1258
percent	10.3	9.7	10	12.4	14.6	16.6	27.6
Morocco							
Total trade	14073	13061	20055	20640	20669	21348	22486
Intra-regional trade	1221	2778	2643	3247	3096	2828	3315
percent	8.6	21.2	13.7	15.7	14.9	13.2	14.7
Syria							
Total trade	11341	6785	7296	10326	11842	12708	13365
Intra-regional trade	933	1113	1044	1276	1343	1369	1578
percent	8.2	16.4	14.3	12.4	11.3	10.8	11.8
Tunisia							
Total trade	14708	14140	17462	14579	16695	16162	117452
Intra-regional trade	902	806	946	1145	1186	1139	1356
percent	6.1	5.7	5.4	7.8	7.1	7	11.5
Yemen							
Total trade	4286	3664	4650	6399	6594	6991	7236
Intra-regional trade	525	718	672	1011	890	1133	1331
percent	12.2	19.6	14.4	15.8	13.5	16.2	18.3

Source: IMF, Direction of Trade Statistics, 2004.

Table 6 ranks 14 MED countries by average absolute and relative value of intra-MED trade during the period, 1994-2003. In terms of absolute values, Saudi Arabia occupied the highest rank on the list followed by the UAE, Oman, Bahrain, and then Jordan; whereas Algeria, Qatar and Yemen occupied the last three positions. In terms of the relative importance of intra-regional trade in total trade, Jordan, Bahrain, Oman and Yemen, in that order, occupied the five top positions, whereas Kuwait and Algeria occupied the last two positions.

Table 6. Ranking in Terms of Trade Integration in the MED Region, 1994-2003

Ranking in Terms of Absolute Value	Ranking in Terms of Share of Intra-Regional Trade in Total Trade	
1.Saudi Arabia	1	Jordan
2.United Arab Emirates	2	Bahrain
3.Oman	3	Oman
4.Bahrain	4	Yemen
5.Jordan	5	Lebanon
6.Egypt	6	Syria
7.Syria	7	Qatar and Saudi Arabia
8.Morocco	8	United Arab Emirates
9.Kuwait	9	Egypt
10.Tunisia	10	Tunisia
11.Lebanon	11	Morocco
12.Qatar	12	Kuwait
13.Yemen	13	Algeria
14.Algeria		

Source: IMF, Direction of Trade Statistics, 2004.

4.2 MED Countries Specialization and Comparative Advantage

In general, a given country specializes and exports commodities in which it has a comparative advantage in producing a given good depending on the respective costs of labor and capital, or in which it is initially well endowed like primary products or natural resources. While GCC countries are still negotiating trade agreements with the EU, we do not expect much alteration in the structure of the individual country specialization arising within the context of the Euro-MED partnership in the future. Oil will still dominate exports of these countries even given the recent efforts devoted by some of these countries to diversify their export and production structures away from the oil sector into more industrial products. However, the Aluminum and Iron industries in both Bahrain and the UAE may suffer as a result of a potential signing of a trade agreement with the EU. Alcohol products and their derivatives in Bahrain and the motor cars industry in Oman may also suffer (Table 7). Therefore, GCC countries have little room to maneuver and may not be able to further specialize and use efficiently their comparative advantages as those are generally poor and sometimes totally absent. Table 7 indicates that Kuwait ranks first in terms of the export of oil related products with about 92 percent of its total exports, followed by Oman with 75 percent, and Saudi Arabia with 73 percent. In the bottom of the list comes the UAE and Bahrain with very little oil exports.

Table 7. Major Specialization in Exports for GCC Countries, 1997-2003.

Country	3-digit SITC commodities		Export Share (%)
Bahrain	684	Aluminum	55.2
	671	Pig iron, sponge iron, iron or steel	10.2
	512	Alcohols, phenols, phenol-alcohols and their derivatives	7.5
Kuwait	333	Petroleum oils, crude and crude oils obtained from bituminous minerals	92.3
	334	Petroleum products, refined	28.6
	335	Residual petroleum products, n.e.s. and related materials	9.5
Oman	333	Petroleum oils, crude and crude oils obtained from bituminous minerals	75.2
	781	Passenger motor cars	5.63
Qatar	333	Petroleum oils, crude and crude oils obtained from bituminous minerals	59.8
	341	Gas, natural and manufactured	8.9
	334	Petroleum products, refined	7.56
Saudi Arabia	333	Petroleum oils, crude and crude oils obtained from bituminous minerals	73.2
	583	Polymerization and co-polymerization products	18.2
	334	Petroleum products, refined	11.7
UAE	684	Aluminum	29.8
	846	Undergarments, knitted or crocheted	14.3
	793	Ships, boats and floating structures	6.52

Source: Authors' computation based on UNCOMTRADE data.

With regard to non-GCC MED countries the scenario is rather different. In non-GCC MED countries, Syria is a major oil exporter with oil exports of about 45 percent of total exports, followed by Algeria with 42 percent of total exports, and Egypt with about 24 percent. Unlike GCC countries where most manpower is imported at relatively high costs rendering the production of labor intensive goods rather costly, most non GCC countries have certainly a comparative advantage in the production of labor intensive goods. Labor is available abundantly and at relatively low costs. These MED countries have already realized this and are relying more and more on the production of goods which are labor intensive. A case in point is the production of Cotton in both Syria and Egypt, and the production of textile related products in Egypt and Tunisia (Table 8). However, and as a result of greater integration with the EU, Jordan may loose ground in the production and exports of Fertilizers and other inorganic elements. While Jordan has been able to compete regionally, it has faced more and more competition from the EU market where these types of products are produced at lower costs. Also, Morocco's Crustaceans industry has also suffered from increased competition with the EU.

Tables 7 and 8 indicate that most MED countries with the exception of Tunisia and Jordan, have more than half of their exports concentrated in three commodities (at the 3-digit SITC level), most of which are primary products. Indeed, most countries of the region still rely on agriculture, crude materials or minerals as their main exports. In addition, to crude petroleum and petroleum products which are the major exports for most GCC countries, major exports consist of gas (Qatar), fertilizers (Jordan), cotton (Egypt and Syria) and vegetables (Morocco). This continued dependence on primary products makes the region vulnerable to the high variability in their prices on world markets, and may impact negatively on their overall competitiveness as a result of greater competition from EU countries. Other countries, however, include

manufacturing products as one of their major exports—Bahrain (aluminum), Oman (cars), the UAE (aluminum and garments) and Egypt and Tunisia (textiles and garments).

Table 8. **Major Concentration in Exports for Non-Oil MED Countries, 1997-2003.**

Country	3-digit SITC commodities		Export Share (%)
Algeria	333	Petroleum oils, crude and crude oils obtained from bituminous minerals	42.46
	341	Gas, natural and manufactured	32.94
	334	Petroleum products, refined	15.72
Jordan	271	Fertilizers, crude	20.62
	541	Medicinal and pharmaceutical products	8.16
	562	Fertilizers, manufactured	9.52
Morocco	522	Inorganic chemical elements, oxides and halogen salts	12.25
	36	Crustaceans and mollusks, whether in shell or not, fresh, chilled	7.12
	562	Fertilizers, manufactured	6.35
Syria	333	Petroleum oils, crude and crude oils obtained from bituminous minerals	53.85
	334	Petroleum products, refined	8.47
	263	Cotton	7.12
Egypt	333	Petroleum oils, crude and crude oils obtained from bituminous minerals	24.13
	334	Petroleum products, refined	19.75
	651	Textile yarn	9.56
Tunisia	842	Outer garments, men's and boys', of textile fabrics	21.65
	843	Outer garments, women's, girls' and infants', of textile fabrics	11.32
Yemen	333	Petroleum oils, crude and crude oils obtained from bituminous minerals	92.45

Source: Authors' Computations based on UNCOMTRADE data.

In light of the signing of the Euro-MED Partnership by some MED countries and the continued negotiations of others, it is instructive to look at the technological composition of MED exports and see whether greater competition with the EU will harm MED exports, and the kind of specialization-which should be based on comparative advantage- that will arise after the establishment of a free trade area in 2010. For this purpose, Table 9 below looks at the evolution of the technological composition of MED exports from 1985 to 2003. It is clear that the export of primary products constitute more than half of the composition of total MED exports. We therefore expect no effects of greater EU-MED trade integration to have any impact on the exports of MED primary product exports. Primary products mean basically natural resources based products, i.e, oil and oil related products in the oil producing MED countries. Oman ranks first with primary products constituting about 94 percent of its total exports in 1985, although this ratio drops to 70 percent in 2003. Saudi Arabia comes second with about 83 percent in 1985 with a slight drop to 65 percent in 2003. Ratios in Qatar are hovering within the same range from 73 percent in 1985 to 62 percent in 2003.

Among the non-GCC countries Egypt ranks first with a ratio of 75 percent in 1985 but with significant drop to 42 percent in 2003. Algeria and Syria rank second with ratios of about 60 percent in 1985. However, Algeria's ratio increases to 85

percent in 2003 while Syria's ratio drops to 51 percent in 2003. Jordan, Morocco, and Tunisia rank last with ratios below 40 percent. All of the above mentioned countries should not be affected by greater competition resulting form greater integration with the EU. They will continue to specialize and export goods which are primary products.

Looking at the industrial sector where we expect the MED region to be mostly affected by increased trade with the EU, it is clear from Table 9, that the technological composition of MED exports appear to be relatively very low, and may suffer only a little as a result of greater integration with the EU. From among the non-oil MED countries, Tunisia ranks first with low technology based exports constituting about 38 percent, followed by Morocco, Jordan and Egypt with ratios of 15.9, 13.7, and 9 percent respectively in 1985. These ratios appear to have gone up a little in 2003. Specifically, the low technological composition of Tunisian exports has gone up to 56 percent, while that of Jordan went down to 8.2 percent. There is a slight increase in Egypt to about 10 percent, and in Morocco to 25 percent. For the GCC countries these ratios are significantly lower. The UAE takes the lead with 16.1 percent in 1985 but with an increase to 30 percent in 2003, followed by Bahrain with a range of 11-15 percent in between 1985-2003, and Saudi Arabia with almost the same range.

Moving to medium and high technological composition of MED exports, these ratios decline significantly over the period under consideration. When looking at high tech products, Jordan takes the lead in 1985 with only 14.4 percent, followed by the UAE with a 5.6 percent ratio. All the remaining ratios fall below the 2 percent level. In 2003, even Jordan's ratio falls to a mere 6 percent with no change for the UAE. For the medium technology category, the situation is quite similar with Jordan still in the lead followed by Oman and Bahrain. For the low tech category the situation is not quite similar with Tunisia taking the lead in 2003 with a 57 percent ratio followed by Morocco and Syria with ratios around 26 percent.

Overall, we do not expect any significant shifts in the technological composition of MED exports as a result of greater integration with the EU. The MED region will continue to specialize in the exports of primary and resource based products, and will most like import more and more low, medium and high tech products from the EU.

Table 9. Evolution of Technological Composition of MED Exports (in percent)

	Primary Products	Resource-Based Manufactures	Low Technology Manufactures	Medium Technology Manufactures	High Technology Manufactures
1985					
Algeria	60.1	39.3	0.1	0.5	0
Bahrain	54.4	10.9	11.8	22	0.6
Jordan	43.7	10.3	13.7	16.6	14.4
Morocco	44.5	30.6	15.9	8.5	0.4
Oman	93.8	0.7	0.4	3.3	1.2
Qatar	72.2	11	5.2	11.4	0.1
Saudi Arabia	82.7	13.6	0.6	2.9	0.1
Syria	61.6	26.4	7.8	4	0.2
UAE	22.3	15	16.1	33	5.6
Tunisia	27	15.9	38.6	17.1	1.2
Egypt	74.7	15.4	8.8	0.4	0.3
Yemen	9.6	90.3	0	0.1	0
1997					
Algeria	81.2	17.7	0.2	0.7	0
Bahrain	56.1	12.5	13.1	16.7	1.5
Jordan	39	19.8	8.2	26.5	5.9
Morocco	35.1	30	22.4	12.2	0.9
Oman	76.9	5.7	2.6	11.8	1.6
Qatar	67.4	10.5	7.9	13.9	0.3
Saudi Arabia	74.5	18	1.6	5.7	0.2
Syria	30.2	10	8.3	1.1	0.2
UAE	35.6	14.9	33.4	15.7	0.3
Tunisia	13.9	14.4	48.4	18.2	4.1
Egypt	31.4	34.4	26.8	5.5	1.6
Yemen	92.5	5.6	0.6	0.9	0.1
2003					
Algeria	84.8	14.2	0.4	0.6	0
Bahrain	58.4	10.6	15.1	17.3	1.0
Jordan	40	20.0	8.2	25.8	6.0
Morocco	30.9	28.1	25.4	14.6	1.0
Oman	70.1	2.9	7.1	19.9	1.0
Qatar	61.4	13.6	6.0	13.7	0.3
Saudi Arabia	64.2	19.5	8.5	7.7	0.1
Syria	50.8	16.6	28.5	3.3	0.8
UAE	45.6	5.9	30.4	12.5	5.6
Tunisia	10.2	23.7	56.6	8.2	1.3
Egypt	41.6	40.7	10.2	4.5	3.0
Yemen	81.5	15.5	2.0	0.9	0.1

Source: Authors' Computations based on UNCOMTRADE data.

B-South-North Trade Integration

1-WTO Membership and Trade Liberalization

Bahrain was the first MED country to submit a draft proposal to the World Trade Organization and has been a WTO member since January 1, 1995. Since its independence, Bahrain has followed liberal trade and investment policies and aimed at integrating its economy with the world economy. By joining the WTO Bahrain hopes to diversify its economy, being heavily dependant on the exports of oil related products. In 1999, it signed a bilateral investment treaty and an open skies agreement with the US in preparation to the Free Trade Agreement with the latter. Bahrain will become the first GCC country to sign an FTA with the US. On the legislative side, new commercial laws that are meant to meet the new challenges imposed by the new economic order were implemented. On the technical side, the government has taken severe measures to fulfill the local, regional and international requirements of various global organizations including the WTO. On July18th, 2003, Bahrain joined the WTO agreement on removing all tariff barriers to information technology products, the ITA (Information Technology Agreement).

Egypt became a member of the WTO on June 30th, 1995 and is promising to fulfill all the required commitments by 2005. The government of Egypt has also implemented some liberal trade promoting policies. However the existing bureaucracy remains a significant hurdle and adds to the cost of doing business. To comply with the Uruguay Round commitments, it has reduced the maximum tariff rate for most imports from a high of 50 percent to 40 percent. However, tariffs remain high relatively to other developed and developing countries because Egypt applies additional surcharges on some goods. Egypt has increased its efforts in order to conform national regulations to international standards. Though it has signed the Intellectual Property Right agreement, it is not applying the total protection needed. The country made commitments regarding construction, tourism, financial services and international maritime. Egypt's WTO financial services commitment in the securities sector allows unrestricted market access. International investors are permitted to operate on the Egyptian stock market without any restriction. It has joined the WTO's Information Technology Agreement on April 24th, 2003. Even though Egypt has been actively enhancing trade liberalization by signing WTO agreements, it is still reluctant to undertake some reforms, which are either not applied correctly or not even applied at all. In some circumstances, it has been regarded as a violation of WTO agreements.

Jordan joined the WTO on April 10th, 2000. It has agreed to assume all its WTO obligations upon accession. The country engaged in bilateral negotiations with 16 WTO member countries in 1999 proving the interest it has in adopting trade liberalization policies. Jordan has signed two plurilateral agreements on government procurement and on trade in civil aircraft. Jordan's accession package includes market-access commitments on goods and services. The country had to employ major economic and legislative reforms in order to bring the Jordanian foreign trade regime into conformity with WTO requirements. Adjustments were made to many existing laws like the Intellectual Property Right law, other laws were newly introduced and some existing ones had to be replaced because they do not confirm with WTO requirements. Privatization schemes are also actively pursued. Jordan promises to provide a liberal access to foreign suppliers and investors on a wide range of services sectors. Tariff rates are lowered and are ranging from 0 to 30 percent; it is expected to have a maximum bound rate of 20 percent by the year 2010. The Jordanian market is

today more secure than previously because it is guaranteed under WTO rules, hence the increased attraction of foreign investors.

Kuwait has been a member of the WTO since January 1st, 1995. It was given a grace period of five years within which it was expected to comply its regulations with those of the WTO. In March 2000, however, Kuwait asked for an extension of four years. Despite some recent efforts, the Kuwaiti government did not yet achieve any significant progress in terms of implementation of new conforming reforms. Laws regarding foreign investments and the Intellectual Property Right – two fundamental requirements of the WTO- are not yet applied. Stock markets are still segmented to a certain extent from the rest of the world. Foreign investors can only access very few Kuwaiti markets and through mutual funds only. Thus, although Kuwait seems to attempt rigorously at conforming its different reforms to the WTO, it still has to pursue significant efforts so as to fulfill all of its requirements.

With a population of approximately 4 million people, the Lebanese market is considered relatively small in comparison to other countries in the WTO. Lebanon was one of the founding members of the GATT. It was and continues to be a liberal and open market economy, despite the fact that many of the Lebanese laws are outdated due to neglect as a result of the unfortunate events that lasted in Lebanon from the mid 1970's to the early 1990's. Lebanon has signed several bilateral trade agreements with Arab countries and it is a member of the Arab Free Trade Area. It has already signed in 2002 the Partnership Agreement with the European Union. Most of Lebanon's trading partners are either members of the WTO or in the process of acceding to it. Hence, Lebanon will sooner or later have to take measures to indirectly conform certain aspects of its foreign trade regime to the WTO.

Lebanon was granted an Observer Status to the WTO on January 30th, 1999. The negotiations on its accession started in 2002 and the last round of negotiations was conducted in December 2003. The WTO working party negotiating terms for Lebanon's future membership identified a number of areas where Lebanon will need to bring its legislation into WTO compliance. A lack of conformity with WTO requirements on sanitary and phytosanitary measures, technical barriers to trade, import licensing and intellectual property prevail in the country. The government is working on a draft privatization law in order to raise funds and be able to join the WTO. Currently, there are three potential targets: the telecommunications sector, the national airline and the power sector. Another major step Lebanon has taken in preparation for its accession is the implementation of the copyright law meeting the prerequisites of the TRIP (Trade-Related Aspects of Intellectual Property Rights) agreement.

Syria does not even have an observer status in the WTO. The US administration has so far opposed Syria's application to join the World Trade Organization because Syria is assumed to be a sponsor of terrorism, and puts pressure on the Arab League to boycott Israeli goods, a violation of WTO anti-discrimination rules.

Oman obtained an observer status in 1995 and started accession negotiations in April 1996. The WTO's General Council approved the accession on October 10, 2000 and Oman is an official WTO member since November 9th, 2000. It agreed to apply WTO rules and has been following WTO principles since the decision to apply for accession. Oman has successfully implemented the TRIPS agreement (compatible with the intellectual property regime), has revised its customs regulations in order to implement the WTO customs Valuation Agreement and is ensuring that imports are not disadvantaged by unduly restrictive regulation. Oman has also expressed its

interest in becoming a member in the Agreement on Government Procurement, the Information Technology Agreement and the Chemical Harmonization Agreement. Oman is devoting efforts in terms of liberalization and diversification of its economy by conforming its legislation to the WTO obligations and is boosting its private sector so that the Gulf MED state moves away from its heavy dependence on oil revenues. In fact, the country's main exports are mining products; particularly fuel, accounting for 78 percent of the Sultanate's total exports and its main imports are manufactures, machinery and transport equipment. WTO will create a trade regime that will enhance the country's economic growth and development, and will hence attract more investment especially that Oman is planning to reform its foreign capital investment law of 1994 and will allow 100 percent of foreign investment and ownership.

Qatar received its accession approval to the WTO in November 1995 and is an official member since January 13th, 1996. It has not been very active in its compliance activities like most of the other GCC WTO members. Nevertheless, it has implemented to some extent the Intellectual Property Right agreement. Joining the WTO gave Qatar the stimulus to change its trade and investment policies and became an open economy. Qatar hosted the follow-up to the 1999 Seattle ministerial meeting of the WTO in November 2001, despite the unstable political situation and the lack of security following the September 11 attacks in the United States. The country offered to host the previously mentioned meeting in order to boost its international profile. It must continue in this spirit and open its sectors to other members in order to fully reap the benefits of the WTO membership.

Saudi Arabia is in advanced stages of negotiations with the US to access the WTO. The working party on its accession was established on July 21st, 1993 and the country is hoping to join WTO in 2005. Saudi Arabia aims at breaking into a profitable foreign market, at increasing its exports and at diversifying its oil-dependant economy. The government has set a growth target of 10 percent of non-oil exports to lessen the heavy reliance of the country on the volatile oil earnings and to guarantee a sustainable growth. For instance, weak oil prices in some years have led to severe recessions at a time when the kingdom's population was growing at a rate of four percent. WTO membership will enable the country to achieve the mentioned goal and reach its diversification goals. Saudi Arabia is the only GCC country that has not joined the WTO yet. Saudi officials said that the kingdom has already met all of the economic conditions set by the WTO, however, the accession procedure is obstructed by non-economic demands that includes unacceptable requests for allowing the production, import and sale of products prohibited by religion.

The United Arab Emirates joined the WTO on the 10th of April 1996 in the hope that it provides an agreed system of rules and an effective forum for liberalization and expansion of world trade. The UAE government has agreed to open up to foreign competition some trade sectors that are ready for globalization. However, as a developing country, it has the right to protect the initial development of its infant industries. In fact, the UAE does not intend to open up its banking and other financial services sector to foreign investors because it believes that the country is overbanked in terms of the number of operating banks compared to its 3.3 million population and trade. Moreover, the UAE's current policies give priority to nationals in the services sector and encourage citizens to invest at home, prohibit the acquisition of land and real estate by foreigners, allow for a maximum of 49 percent in foreign equity participation and limit the number of foreign managers, executives and others to 50 percent. UAE is also granted the right to give preferential treatment to members of the Gulf Cooperation Council (GCC) even if they are not WTO

members. The piracy issue has been a major concern for the UAE and the country decided not to bring its legislation up to the TRIPS agreement before it ensures to obtain the benefits and advantages pertaining to the WTO membership.

Yemen initiated procedures to join WTO since 1998. It was granted an observer status in 1999 and its application stating the desire to enjoy full membership and set up a negotiation team was received in April 2000. A national committee was formed to prepare procedures and negotiate the accession of Yemen to the organization. The government has already approved a number of trade laws and legislations, which will pave the way for Yemen's acceptance. Yemen's accession to the WTO has been rejected several times due mostly to the weakness in production, the smuggling and the dumping policy in the local markets. Yemen has to fulfill some requirements among which are the privatization provisions, the investment laws and custom duties laws. It has to meet all the commitments set by the member-state of the organization and has to offer periodical reports showing improvement in terms of modification in the country's economic reforms.

2-Trade in Services: Constraints and Prospects

The General Agreement of Trade in Services (GATS), which has emerged from the Uruguay Round (UR), has established a basic set of rules for world services' trade. The Agreement covers, in principle, all commercially traded services. The motivation behind liberalizing trade in services is to allow rationalization of services activities along the lines of comparative advantage. It also intends to expand the sales and profits of the service providers who were relying on those comparative advantages. The gains from free trade in services are very similar to those of trade in goods. The only difference is the difficulty in measuring and monitoring trade in services.

2.1 Liberalization of Trade in Services: Framework and Gains

Services liberalization should become a priority for MED countries, if they were to effectively compete in world markets. Awareness is growing of the importance of services related activities in the world economy. Technological advances are also playing a key role in bringing trade in services to the forefront of policy makers' concerns. Advances in transport and information technology have contributed to a rapid expansion of services trade. While many international transactions were considered expensive, they are now easy due to the huge flow of electronic information.

The benefits of services liberalization are embedded in the stylized facts that countries which have improved the performance of trade related services (transport, finance, utilities and telecommunications) seem to have achieved substantial increase in their exports and FDI inflows. Domestic reforms aiming at lowering the cost of transportation and doing business may play a crucial role in improving linkages to global markets. On one hand, services liberalization would strengthen export responses to trade reforms, and on the other hand, it will enable local producers to better coordinate their activities with input suppliers located in high-income countries, and hence make the country more attractive to FDI.

2.2 Other Benefits

Liberalizing trade in services can create more investment opportunities for the domestic private sector and help attract more non debt creating foreign financing such as FDI and portfolio investment, since FDI in services has been a main engine of FDI

flows around the globe in the 1990's, and recently accounts for about half of the inward FDI stock in the world (UNCTAD 2004).

MED countries however find it difficult to benefit from these global trends because they have tended to approach service reforms in a piecemeal fashion. Privatization has been slower than in other parts of the world, barriers to entry are still inhibiting for both foreign and domestic investors.

Opening up of services markets in the MED region to competition can offset the costs of adjustment stemming from merchandise trade liberalization: Pro-competitive reforms that facilitate entry by new firms can generate large employment opportunities for skilled and unskilled workers who are employed by governments in low productivity jobs. Because services often cannot be traded, increasing access to services markets is likely to entail the entry of foreign competitors through FDI. This will lead to the introduction of new technologies as well as hiring domestic labor. Simulation studies for Egypt reveal that the potential income gains from liberalization of trade in services are two-fold those realized from trade in goods. This is because the reforming of the services sector affects the economy as a whole and not just the external sector, eliminating wastes in form of transactions costs.

3- The Euro-Mediterranean Partnership

From among the different MED countries, the European Commission has so far signed and ratified agreements with Tunisia (1995), Morocco (1996), Jordan (1997), Lebanon (2002) and an interim agreement with the Palestinian Authority was signed in 1997. With the exception of Syria with which negotiations are still under way, Algeria (2002), and Egypt (2001) have now signed but their agreements are awaiting ratification. The Euro MED agreement covers partnership in trade, agriculture, services, health, transport, energy and so on. The main implications of the Euro-MED Agreement can be summarized as follows:

(1) Progressive elimination of all tariffs on industrial goods. All major tariffs on industrial goods should be phased out over a 12 years period, and anti–dumping measures should be taken within 6 years. During the transition period, GATT rules should apply. Since EU is the major trading partner of MED countries, and also the major industrial partner, major MED exports received preferential customs treatment both by the Generalized System of preferences (GSP) and the existing bilateral agreements.

(2) Gradual trade liberalization for agricultural products. Since many MED countries depend on food imports, they will have to undertake new commitments under the Euro-MED agreement that are consistent with those agreed under the Uruguay Round (UR), including the requirement to convert all non tariff measures into custom duties, safeguard measures like the possibility of suspending the liberalization calendar for some products under certain difficulties, exceptional measures in certain cases for three years beyond the transitory period, and the possibility of modifying the agreement if the agricultural policy is modified.

(3) Measures to liberalize services. This is featured only in the agreement with Lebanon, where it proposes a liberalization of services without a reference to the GATS protective clauses. Although the small size of MED firms could be a barrier to entry into the EU market, reciprocity remains a major concern. Liberalization of the right of establishment are in the agreement with Lebanon, and by doing so, Lebanon signals that it is open to FDI, thus encouraging foreign firms to establish themselves.

(4) Free trade Area 2010. The Barcelona Declaration and the creation of a Free trade Area in 2010 is expected to bring together the EU member states and the 12 Mediterranean partners. Together with EFTA and Central and Eastern European candidate countries for EU enlargement, at a later stage, this zone will include around 45 states and around 850 million consumers, thus becoming one of the most important trade entities. With a view to developing gradual free trade in this area, tariffs and non tariff barriers to trade in manufactured products will be progressively eliminated as noted before, taking as a starting point traditional trade flows, as well as progressively eliminating trade in agricultural products through reciprocal preferential access among the parties and trade in services with regards to the GATS agreement.

3.1. Economic and Financial Cooperation

Cooperation will be developed in the following areas: (1) Acknowledge that economic development must be supported by domestic savings, thus creating an appropriate FDI environment through the elimination of different barriers to investment, which could facilitate technology transfer; (2) enhance infrastructures, including the establishment of an efficient transport system, and the development of information technology and the modernization of telecom industries; (3) Financial cooperation is needed through financial assistance. This will be supplemented by European Investment Bank (EIB) assistance in the form of increased loans and bilateral financial contribution from Member states; (4) Sound macroeconomic management is of fundamental importance in ensuring the success of the partnership; And (5) EU countries are expected to help provide MED countries training assistance and programs for job creation.

3.2 Policy Implications of MED Trade Liberalization with the EU

Trade liberalization, will, in the long run, benefit MED countries. However, in the short run, there will be costs associated with the process of trade liberalization. Substantial fiscal revenue losses are expected due to the importance of trade taxes in fiscal revenue. Moreover, manufactured goods with relatively high tariffs constitute a large share of imports from the EU (61.5 percent), so the loss in customs revenue from the Euro MED agreement would be large. Trade liberalization implies that some currency depreciation might be needed to restore balance of payments' equilibrium. In the absence of the required exchange rate adjustment, the trade deficit would widen, necessitating either depreciation or a reversal of trade liberalization. There will be short-term adjustment costs for both labor and capital, as increased competition will lead to reallocation of factors of production. With a generally high unemployment rate in MED countries, the loss in employment that might be generated by the EU agreements could create social pressures.

Long run benefits will arise out of trade liberalization, and for that, MED countries need to comply with increasing globalization, and integration of the world economy. Policy implications, however, vary from one country to another depending on their current trade regime, including the commitments made within the framework of the WTO. The transition costs of trade liberalization can be minimized if complementary macroeconomic and regulatory reforms and the maximum amount of benefits can be obtained through: (1) Fully participating in the multilateral initiatives, by making substantial commitments to the implementation of trade reforms. These reforms would lock in benefits and enhance the credibility of the MED countries, as well as increase transparency of the economic environment; (2) Pursue appropriate macroeconomic policies that allows non inflationary growth , to ensure that the region will attract FDI and maintain competitiveness of its already successful exports sectors; (3) Eliminate restrictions that inhibit the efficient allocation of resources among sectors; And (4) attain greater intra regional trade, by promoting free trade agreements among MED countries. This would boost merchandise trade, enhance services flows, and encourage intraregional investments, create more job opportunities and improve the living standards.

C-South-South Financial and Monetary Integration

Monetary Integration in the MED region is still a far reaching goal with the exception of perhaps the genuine efforts devoted by GCC countries to achieve full monetary integration by the year 2010 through the introduction of a common currency. However, while labor markets in the MED region are highly integrated relative to other integrated regions of the world, financial markets are still far from being integrated for several reasons. Large intra-regional labor movements have been the main vehicle of the region's economic integration, triggering substantial financial flows in the form of workers' remittances. To a large extent, intra-regional labor movement has been from non-oil to oil MED countries. In the early 1990s, the stock of foreign labor in the GCC countries reached 4.5 million and accounted for about two thirds of the total GCC labor force; of these, 55 percent came from non oil MED countries. This share has decreased since the mid-1990s, while the share of Asian labor has increased. The MED labor force in the GCC countries is expected to decline further as policies of substituting nationals for foreign labor are implemented by the GCC countries.

The inflow of MED Labor into the GCC countries has been beneficial for both the exporting and importing countries. For the GCC oil economies, it provides needed skilled and unskilled manpower in various fields. For non oil exporting countries, it is a source of employment for often unused factors of production. Moreover, capital flows in the form of labor remittances have a direct positive balance of payments impact and account for much of the private investment in certain countries in the region, such as Jordan, Egypt, and Lebanon. Remittances have recently amounted to about one quarter of the exports of goods and services of non-oil exporters in the region and have exceeded 30 percent in Lebanon, Jordan and Yemen. Workers' remittances were equivalent to about 29 percent of GDP for Jordan, 11 percent of GDP for Egypt, and 25 percent of GDP for Lebanon in 2003.

1. FDI Global flows

World foreign direct investment flows declined in 2003, for the third consecutive year. Table 10 below indicates that after plummeting in 2001 to reach USD 817.5 billion- representing a decline of about 70 percent from their 2000 level- they dropped by a further 20 percent in 2002 and 21 percent in 2003 to USD 678.7 and USD 559.5 billion respectively. With regard to developing countries, FDI inflows have been on the decline since 2000 dropping from USD 1107.9 billion in 2000 to USD 571 and 489 billion in 2001 and 2002 to reach USD 366 billion in 2003. The MED region's share in global FDI inflows is much lower and has remained below the 1 percent level over the period 1998-2003.

2. FDI Inflows to MED Countries

Inflows of FDI to the MED countries witnessed a sharp decline in 2002, when they dropped to USD 4.6 billion, compared with USD 7.1 billion in 2001 (Table 10). However these inflows to the region revert back to USD 6.3 billion in 2003. The MED countries may be divided into 3 sub-groups with regard to attracting FDI inflows. The first group comprises those countries that managed to achieve considerable growth in the inflow of FDI. For instance, Tunisia's FDI inflows increased by about 70 percent to reach USD 821 million in 2002, compared with USD 486 million in 2001. However there is a trend reversal in 2003 to USD 584 million. In Bahrain, the inflow of FDI increased in 2002 to USD 217 million, compared with only USD 81 million in 2001, representing a 2.7 fold increase, with a further 2 fold increase in 2003 to USD 517 million. Egypt has also benefited from higher inflows of FDI, which amounted to USD 647 million in 2002, compared with UDD 510 million in 2001 but which, nevertheless, remained much below their level in 2000 of USD 1235 million. The decreasing trend has remained in 2003 to about USD 237 million. Qatar has also benefited from higher inflows with a significant increase in 2002 to USD 631 million compared to USD 296 million in 2001, representing a two fold increase. There is however a trend reversal in 2003 to USD 400 million. Jordan is in a similar situation with a significant increase in 2003 to USD 379 million up from USD 56 million in 2002

The second group includes those countries that achieved only limited growth in FDI inflows. In Syria, FDI inflows rose from USD 115 to USD 150 million in between 2002 and 2003; and Lebanon, where a minimal increase was registered in 2003 to USD 358 million, up from USD 257 million in 2002.

The third group includes those countries where FDI inflows dropped in 2002 and include Algeria, where the inflow of FDI declined in 2003 to USD 634 from a high of USD 1.05 billion in 2002, representing a drop of 80 percent. But the sharpest decline was experienced in Morocco, where FDI inflows dropped in 2002 to USD 481 million from USD 2.8 billion in 2001 (Table 10). This can be attributed to the fact that 2001 witnessed the privatization of part of the Morocco telecom, which led to a sharp increase in FDI inflows in that year. However, in 2003 Morocco experienced a sharp increase to USD 2.2 billion. In Yemen, FDI inflows also dropped sharply from USD 102 millions in 2002 to an outflow of USD 89 million in 2003 (Table 10).

Table 10. FDI Inflows to MED Countries: 1998-2003 (USD Million)

	1998	1999	2000	2001	2002	2003
Bahrain	180	454	364	81	217	517
Egypt	1076	1065	1235	510	647	237
Jordan	310	158	787	100	56	379
Kuwait	59	72	16	-147	7	67
Lebanon	200	250	298	249	257	358
Oman	101	39	16	83	23	138
Qatar	347	113	252	296	631	400
Saudi Arabia	4289	-780	-1884	20	-615	208
Syria	82	263	270	110	115	150
UAE	258	-985	-515	1184	834	480
Yemen	-219	-308	6	136	102	-89
Tunisia	668	368	779	486	821	584
Algeria	501	507	438	1196	1065	634
Morocco	417	850	215	2825	481	2279
MED Countries Total	8269	2066	2277	7129	4641	6342
World	690905	1086750	1387953	817574	678751	559576
Developing Countries	472545	828352	1107987	571843	489907	366573

Source: UNCTAD, World Investment Report, 2004.

3. Ratio of FDI to GDP in MED Countries

Available data indicate that the ratio of FDI stocks to GDP in 4 MED countries did not exceed the 10 percent level in 2002 and 2003. In 2003, this ratio varied from a high of 72 percent in Bahrain and 66 percent in Tunisia, to 28 percent in Jordan and 26 percent in Egypt, but stood at only 1.2 percent, 4.4 percent 9.5 and 11 percent in Kuwait, the UAE, Syria and Lebanon respectively (Table 11).

Only in Bahrain, Egypt, Jordan, Tunisia and Morocco the ratio of FDI stocks to GDP exceeded the global average of 22.3 in 2002,[3] and only two countries, namely Bahrain and Tunisia, managed to exceed the ratio of 31 percent achieved by developing countries as a whole (Table 11).

MED countries need to exert intensive efforts to raise their share in global FDI inflows which has remained relatively low. The measures that could be taken include the acceleration of south-south economic financial and trade integration efforts coupled with enhanced reform programs, and stressing the institutional and governance aspects in particular. Moreover, these countries need to accelerate the implementation of the privatization process, which represents an important factor in promoting the inflows of FDI at the global level, particularly the privatization of the services sector. MED countries would also have to fight financial and administration corruption and eliminate bureaucracy, which represent strong impediments to the inflow of FDI. The political instability the region has been facing as a result of failure to achieve comprehensive peace continues to exert a negative influence on the ability of the Arab countries to attract FDI.

[3] UNCTAD, World Investment Report, 2004, Annex Table B6.

Table 11. FDI Inflows to GDP in MED Countries: 1990-2003 (%)

	1990	1995	2000	2001	2002	2003
Bahrain	0	41.1	74.1	75.4	72.9	72.4
Egypt	25.6	24.4	20.1	20.4	24.3	26.2
Jordan	15.3	9.2	26.7	26.7	26	28.3
Kuwait	0.1		1.5	1.1	1.1	1.2
Lebanon	1.9	1.2	6.8	8.2	9.4	11
Oman	16.4	18.3	13.2	12.7	12.6	12.6
Qatar	1	5.5	11.7	13.4	14.7	16
Saudi Arabia	21.5	17.5	13.8	13.9	13.4	12.1
Syria	3	8	9.5	9.8	9.6	9.5
UAE	2.2	4.1	1.5	1.9	2	4.4
Yemen	3.7	44.8	14.6	13.7	13.3	11
Tunisia	62	61	59.3	58.4	66.2	66
Morocco	1.9	1.8	2.2	2.4	2.3	26
World	9.3	10.3	19.6	21.2	22.3	22.9
Developing countries	14.8	16.6	31.1	33.4	36	31.4

Source: UNCTAD World Investment Report, 2004.

4. Intra MED Investments

Intra-regional capital flows are primarily in the form of workers' remittances and foreign aid—mainly from the oil MED countries like Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates to poorer countries, like Egypt, Jordan, Lebanon and Yemen—which is highly correlated with the donor's business cycle and thus with fluctuations in world market prices of oil. During the period 1993-1995, MED transfers averaged between 4 and 7 percent of the individual GDP of non-oil MED countries, however these low ratios improved significantly after the recent hikes in oil prices reaching the 20 percent level in 2003. Private capital flows within the region have been relatively limited. While cross border transactions between the financial markets of the GCC countries increased significantly in recent years, from about 5 percent of their total transactions with the world in 1992 to 40 percent in 2002, they remained negligible with the other MED countries, at 2 percent of total transactions. Intra-regional investments have been made mainly in those MED countries that implemented policies conducive to strengthening the operational framework of the domestic financial market, such as Egypt and Jordan.

Over the 22 year period 1980-2001, intra-MED investment amounted to USD 22.5 billion, or the equivalent of an average of around USD one billion a year only. However, in 2002 alone, the value of intra-MED investment flows reached around USD 2.1 billion pointing to a significant improvement relative to the previous years.

4.1 Receiving MED Countries

Of a total intra-MED investment of USD 2.1 billion in 2002, Lebanon received the largest inflow of USD 650 million, or around 30 percent of the total, then comes Saudi Arabia with USD 622.21 million, or around 29.5 percent of the total (Table 12). The combined value of MED investments flowing to theses two countries was around USD 1.27 billion, or 59 percent of the total in 2002. Compared to 2001, intra-MED investment registered an increase in 8 countries (Egypt, Lebanon,

Morocco, Qatar, Syria, Tunisia, UAE, and Yemen), and a decrease in three countries (Algeria, Jordan and Saudi Arabia).

It is worth noting the large increase recorded in intra-MED investments in each of Lebanon and Yemen. Where declines were recorded, they were not large. MED Investment flows to Lebanon increased from USD 225 million in 2001 to USD 650 million in 2002, while in Yemen they increased by more than 20-fold, to reach USD 139.4 million.

4.2 Exporting Countries

As a source of intra-MED investments in 2002, Saudi Arabia comes first with investments of around USD 654 million, or 31.1 percent of total intra-MED investments, benefiting some 12 MED countries, with Lebanon receiving USD 350 million (Table 12). Kuwait ranked second with around USD 418 million, or 20 percent of total intra-MED investments, the bulk of which went to Bahrain, Lebanon, the UAE and Tunisia, in that order, with smaller amounts going to other MED countries. The United Arab Emirates occupied third place with around USD 223 million, or 10 percent of total intra-MED investments, that went mainly to Qatar and Lebanon. In comparison to 2001, Saudi Arabia and the UAE maintained their first and third position, respectively, while Syria lost two positions in 2002 to occupy second place. It is worth noting in this context the large decline in intra-MED investment outflows in the case of Bahrain, which declined by 99.5 percent; whereas outflows from Saudi Arabia increased by 88.8 percent.

Intra-MED investments in 2002 were concentrated in the services sector, which received around 50 percent of the total, followed by industry and agriculture in that order. Notwithstanding the many negative effects of the 11 September events, these events, nevertheless, had some positive implications for intra-MED investments as was evident in the case of Lebanon, where the large arrivals of MED tourists, especially in 2002, led to a noticeable increase in investments in real estate and improvement in the balance of payments.

Table 12. Intra Regional MED Investments, 2002 (USD Million)

Exporting MED countries	Host MED Countries												
	Algeria	Bahrain	Egypt	Jordan	Lebanon	Morocco	Qatar	Saudi Arabia	Syria	Tunisia	UAE	Yemen	Total
Algeria	*					1.87				0.5			2.37
Bahrain		*		0.14									0.14
Egypt	21.35	0.57	*	3.17		0.03		97.01	0.96	0.71		0.4	124.2
Jordan	5.22	0.25	6.09	*		0.02	2.64	114.93	5.81	0.29		7.96	143.21
Kuwait		111.39	5.64	0.15	100		30.35		29.93	65.68	72.86	2.41	418.41
Lebanon	11.19	14.14	0.68	1.09	*			110.13	5.37	0.15		2.68	145.43
Morocco			0.23			*		6.54		0.5			7.27
Qatar		0.42	0.23	0.1			*				39.15		39.9
Saudi Arabia	2.24	25.87	23.48	3.35	350	7.3	14.04	*	2.53	0.57	105.49	120.04	654.91
Syria	11	0.02	22.35	3.02	9.5	0.04		218.8	*	0.36		1.64	266.73
Tunisia	2.06					2.73		2.67		*		0.42	7.88
UAE		6.7	1.13	0.59	190.5	0.75	21.47				*	2.81	223.95
Yemen			0.22	0.07				72.13				*	72.42
Total	53.06	159.36	60.05	11.68	650	12.74	68.5	622.21	44.6	68.76	217.5	138.36	2106.82

Source: Inter-Arab Investment Guarantee Cooperation, Investment Climate in the Arab Countries, 2002, Kuwait 2003.

5. Efforts to Promote Intra-MED Investment

At the country level, investment promotion policies focused on three main elements, namely, (1) enacting and updating investment promotion laws, (2) establishing national committees to oversee investment projects and facilitate administrative procedures relating to these projects; And (3) establishing free trade areas.

At the regional level, the Investment Development Committee in the MED countries was established under the Economic Unity Council in September 2003. The Committee aims to provide information pertaining to the development of intra-MED investment and the promotion of MED investment projects through research and analysis of the investment situation in the MED world, and the periodic issuance of a MED investment map that identifies investment opportunities in the region, both geographically and by sector. The investment map that was issued lately included four thousand investment projects spread over 15 MED countries, as well as a list of the main obstacles to intra-MED investment. The Committee is also working towards the establishment of a MED investment area in an effort to attract migrant MED capital.

In this connection, it is worth noting the establishment of the Islamic Development Bank Fund for Infrastructure in 2002, with the aim of attracting MED migrant capital to invest in infrastructure projects in the Islamic MED world. Recently, the Fund has approved three projects worth around USD 200 million, which were selected from 200 investment projects submitted by 55 countries members of the Islamic Development Bank.

6. FDI and a MED Customs Union

The tendency of the MED countries to liberalize their bilateral trade by joining the European partnership agreements, the WTO, and by signing bilateral free trade agreements with the US may further reduce the incentives for FDI to relocate the US and EU countries to markets in the Less Developed MED countries. The removal of trade barriers permits US and EU firms to achieve the desired levels of international trade without the need to relocate investment to the MED region. In contrast, the establishment of a customs union within the MED region would help to attract FDI as follows. A customs union would enhance competitiveness in the union's enlarged MED market and tend to create significant stimulants for upgrading the productivity of factors of production. A larger MED market will be able to better attract FDI and portfolio flows. Another desirable feature of the customs union is the creation of a common customs barrier, which will stimulate the relocation of US and EU FDI in order to take advantage of the larger market created by the customs union. However, a MED free trade area without a customs union will generate the opposite effects, and reduce the incentives for FDI to relocate in countries included in the free trade area.

III. Empirical Analysis and Econometric Modeling

1. Background

While the generally rather low and stable inflation rates coupled with the widespread commitment to fixed exchange rate regimes of MPCs may lead to the conclusion that macroeconomic instability is not an obstacle to further economic integration in the MED region, this conclusion may prove wrong, for two reasons.

First, economic integration – both regionally and on the global scale - may in itself lead to increasing macroeconomic instability. When capital becomes increasingly mobile across national borders, and nominal exchange rates are fixed, monetary policy becomes increasingly subordinated to defending the nominal exchange rate peg. In the extreme case, free capital movements and pegged exchange rates render the independence of monetary policy obsolete, as interest rates will have to shadow the interest rate of the anchor currency to which national currencies are pegged, irrespective of whether this foreign interest rate level suits the economic situation of the country. The relationship between fixed exchange rates, perfect capital mobility and independence of monetary policy, usually referred to as the impossible trinity, as the three cannot exist at the same point in time, is considered the main reason for the European Monetary System (EMS) crisis of 1992, as well as the breakdown of the Argentinean currency board, in addition to many other currency crises in recent history. The point is that even though the macroeconomic environment of the MED region in general seems relatively stable and fruitful for increasing economic integration, there is no insurance that this situation will be an everlasting constant in the future of economic cooperation in the region. On the contrary, if not anticipated and accommodated, the process of economic integration itself may lead to increased macroeconomic instability.

On the other hand, MPCs are opting for increased regional economic integration in the future. An important part of economic integration is the increase in cross border trade through the lifting of trade barriers as provided for in the GCC and the Greater Arab Free Trade Area agreements, and other MED trade agreements. However, given the unstable monetary, macroeconomic and financial environments in certain parts of the MED region, it is doubtful whether pursued macroeconomic policies will provide the required stability for increasing economic integration on a regional scale. Moreover, as regional and global liberalization proceeds, policies formed under former macroeconomic conditions may come increasingly under pressure for not providing the stability needed for sound economic development in the new context of regional integration. Macroeconomic policy coordination, as an integral part of multilateral free trade agreements in the MED region, may therefore prove indispensable for successful economic integration in the region. This section analyses therefore whether macroeconomic instability is a detriment to trade integration in the MED region, and provides policy recommendations for policy coordination to increase stability. To this end, the relationship between macroeconomic policies and economic integration and the experience of other regions in terms of policy coordination will be discussed. In turn, a comparative analysis of the degree of macroeconomic stability in the MED region will be carried out and the impact of real exchange rate variability on trade in the MED region will be assessed. Finally, the options for macroeconomic policy coordination as a tool to limit the current and potential future adverse effects of real exchange rate variability in the

region are highlighted.[4] The experience of integrating regions around the world shows that macroeconomic policy coordination is important for the successful implementation of a free trade agreement in regions with high macroeconomic instability.

2. Literature Review

2.1 Monetary Integration

Following monetary unification in Europe and the successful introduction of the euro currency,[5] the renewed debate about trade monetary and financial integration within the MED region gained considerable momentum.[6] Closer MED trade links imply greater economic links among those countries, and greater prospects for monetary unification in the future. The debate has centered on trade and monetary arrangements within the MED region and the advantages and disadvantages of fixed versus flexible exchange rates (see Mansoorian and Neaime 2002, 2003, and Neaime 2000). The emerging literature which is still very limited has reached diverging conclusions.

Subsequent to Mundell's (1961) classic contribution on the theory of optimum currency areas, interest on this topic intensified in the 1990's with a lag of almost 30 years. Mundell demonstrated that fixed exchange rates are the optimal monetary arrangement among a group of countries or regions that are subject to similar and symmetric economic shocks. On the other hand, if the shocks are asymmetric or idiosyncratic, factor mobility among the regions, wage-price flexibility and fiscal transfers are required to sustain fixed exchange rates.

McKinnon (1963) extended the theory by suggesting openness of an economy as a criterion for choosing an OCA. Kenen (1969) added the criterion of economic diversification, in the sense that diversified economies are more likely to have correlated economic shocks and thus require a common policy response.

No doubt interest in the theory of OCAs was renewed with developments in Europe for economic and monetary unification and the prospects for greater economic integration in North America following the signing of the North American Free Trade Agreement (NAFTA) among the US, Canada and Mexico in 1994. This theory has

---

[4] These macroeconomic obstacles to trade integration have been realized for some time in many economically integrating regions in the world, and provisions for reducing their detrimental effects have been taken. The most prominent example of this is the European Union, which after many decades of varying degrees of macroeconomic policy coordination has introduced a common currency and a common central bank. In the GCC countries, the example of the European Union is being emulated to some degree, and a timeline for entering into a monetary union is set for 2010. In the MERCOSUR region, macroeconomic instability has been severe and is currently threatening the existence of the MERCOSUR agreement. In spite of this, and in spite of numerous attempts at initiating macroeconomic policy coordination between the member countries, the degree of macroeconomic policy coordination has not reached levels, which would mitigate the adverse impact on trade integration. NAFTA on the other hand, has not taken any steps toward macroeconomic policy coordination, leaving NAFTA unprepared for future potential macroeconomic instability just as ASEAN was when the Asian financial crisis hit that region. This crisis subsequently triggered a strain of initiatives to increase macroeconomic policy coordination in the ASEAN region, including increased information exchanges and proposals for an Asian Monetary Fund. There are recent talks aiming at a common currency in both the NAFTA and ASIA regions, where the US dollar will be used in the former and the Japanese Yen in the latter to circumvent and reduce the negative implications of macroeconomic instability.

[5] For a detailed discussion of the introduction of the euro currency and the future euro-dollar exchange rate see Neaime and Paschakis 2002.

[6] For a detailed discussion of the implications of the euro currency on MED countries see Neaime 2001, 2002 and Colton and Neaime 2003.

provided the main framework for the introduction of the *euro* in the European Union (EU) and the literature on the prospective monetary and exchange rate arrangements within NAFTA.

Since the early 1990's the literature on OCAs has been large and growing. Primarily applied researchers have studied the conditions under which certain groups of countries or regions are OCAs. Among others, Eichengreen (1992) examined the question of whether the EU is an OCA by computing the volatility of bilateral real exchange rates and comparing it to the volatility of relative prices within different regions of the US. The basic idea is that regions with more highly correlated shocks will have less volatile real exchange rates. He found that EU real exchange rates were more volatile than the relative prices of the US regions. The implication of this finding is that the EU was further away than the US from being an OCA.

Decressin and Fatas (1995) examined regional labour dynamics in Europe and compared their findings to those obtained by Blanchard and Katz (1992) for the US. They found that shocks to labour markets in Europe are 80 percent region specific. Also, in Europe labour market shocks are absorbed in changes in the participation rates, while in the US they induce labour migration. Based on Mundell's OCA criteria these results suggested that the EU would form a less suitable monetary union than the US.

Bayoumni and Eichengreen (1997) related movements in actual European exchange rates to variables suggested by the OCA theory: asymmetric output disturbances, trade links and country size. They reported empirical support for the theory of OCAs. Frankel and Rose (1997) pointed out that both international trade patterns and business cycle correlations are endogenous, in the sense that countries that trade more tend to have more highly correlated business cycles. Thus, economic integration may help a country to satisfy the conditions for entry into a currency union.

On the other hand, there is ample empirical evidence suggesting (see for example Rose (2000), and Glick and Rose (2002)) that the adoption of a common currency, by joining a currency union, has a significant positive impact on trade. For instance, using a sample of 217 countries covering the period 1948-1997, Glick and Rose (2002) have shown that countries joining a currency union have experienced economically and statistically significant increases in trade. They also show that the increase in trade could be as high as 300 percent. Rose (2000) used data for a large number of countries between 1970 and 1990 and found that bilateral trade was higher for a pair of countries that used the same currency than for a pair of countries with their own sovereign monies.

2.2 Financial Integration

The empirical finance literature is rich with studies that try to explore financial integration in both developed and developing financial markets. The literature includes many recent studies on the extent to which movements in one stock market can be transmitted to other stock markets. Traditionally, the literature has focused on the global integration of the world's major stock markets (for example, King and Wadhani 1990, Joan and Von Furstenberg 1990). Recently, there has been a shift in attention to the emerging markets of developing countries (Bekaert and Harvey 1997, DeSantis and Imrohoroglu 1997). The new focus stems from the belief that these markets- if not regionally or internationally integrated- may present portfolio and fund managers a new possibility to enhance and optimize their portfolios. To a large extent, these advantages hinge on the elimination of barriers to entry and the free flow of

capital in emerging markets. For example, Harvey (1993), and Ferson and Harvey (1993) found that stock market returns in emerging markets were high and predictable but lacked strong correlation with major markets. As emerging markets mature, they are likely to become increasingly sensitive to the volatility of stock markets elsewhere. Their increasing degree of integration with world markets will diminish their ability to enhance and diversify international portfolios.

The concept of stock market integration is broad. The following section of the study investigates how MED equity markets display different co-movements over time. Greater degrees of co-movements generally reflect a greater financial market integration. The aim is to reveal issues relating to regional integration and segmentation of MED financial markets. Questions of market integration are of concern both to policy makers, and firms in the region that make capital budgeting decisions. Specifically, if segmentation exists and a firm is forced to raise capital locally, then its cost of capital is likely to be higher than that of a company with unrestricted access to the region capital markets. Therefore, one would expect the restriction to the local capital market to raise a firm's marginal cost of capital and subsequently interest rates. We will measure the extent to which capital market segmentation imposes restrictions on the free mobility of capital in the MED countries and the incremental costs a firm is forced to bear (Korajczyk 1996).

Moreover, within MED countries, our results identify financial markets, which are regionally integrated. Overall, these findings are expected to contribute to the understanding of the prospects of greater financial integration within the MED region, a stepping stone towards enhanced EU-MED financial integration. In many ways, the MED stock markets remain somewhat unsophisticated. Better regulation and more transparency would help to strengthen their market fundamentals. However, as these countries liberalize their financial markets, their returns are likely to correlate more with the European markets. This would raise the question of whether their volatilities will suffer. This section of the study constitutes an important attempt at studying a broad number of stock markets in the MED region (8 markets). Previous studies covered shorter periods of time and a smaller number of markets in this region. These include El-Erian and Kumar's (1995), which covered five markets over the peiod 1992-94, and Darrat and Hakim's (1997) covering three markets and the period 1996-97.

3. Empirical Methodology and Results

This section of the project uses the statistical concept of cointegration, which is a useful device to formalize government policy convergence, and to evaluate empirically the prospects of South-South trade, monetary and financial integration. Specifically, if there exist stationary linear combinations of a set of n nonstationary variables, then we say that these variables are cointegrated. These linear combinations or cointegration relations describe stable long-run equilibrium among these variables that are driven by a number of common stochastic trends. If the number of cointegrating relations is r then the number of common stochastic trends is n-r**.** For a concrete example, consider the exchange rates of Lebanon, Egypt and Jordan, and assume that each is a nonstationary variable. If the three exchange rates are cointegrated once, then they are bound together by a stable long-run equilibrium relation, which in turn implies that the exchange rate policies of the three countries have converged to two stochastic common trends that determine the stable equilibrium relation. For the interpretation of the empirical results, there will be complete convergence of government macroeconomic and trade policies among a set

of n countries, if there exist $r = n - 1$ cointegrating relations, and a single common stochastic trend among them. Otherwise, if r is in the interval $0 < r < n-1$, then there will be only partial convergence of government policies. Convergence in this context means that government policies have been coordinated so that the variables of interest move to a long run equilibrium, and do not drift too far apart over time. Convergence of government macroeconomic and trade policies constitute a pre-requisite for full South-South macroeconomic and trade integration.

To explore the current and future prospects for trade, monetary, and financial South-South integration, the present section uses yearly data for the period 1970-2002 collected from the International Financial Statistics database, and the Arab Monetary fund. The data set includes data on trade flows, exports, imports, indices for economic openness, regional GDP growth rates, stock market indices, interest rates, exchange rates and inflation rates.

In a second step the empirical analysis will consider the Optimum Currency Area conditions empirically as in Bayoumi and Eichengreen (1994) by analyzing trade, monetary and financial data in the 12 MED countries. Subsequently, the prospects of a MED Monetary Union (MMU) will be evaluated using co-integration analysis on variables inspired by the Maastricht treaty criteria for nominal convergence within the EMU.[7,8]

The Johansen (1991, 1995) cointegration test will be used to test for the existence of a long run relationship between the data series (X_i) outlined above after establishing non−stationarity of the individual series by applying both the Phillips-Perron (PP) and Augmented Dickey−Fuller (ADF) Unit Root Tests.

The following regressions will be carried out

$$\Delta X_t = \beta_1 + \beta_2 X_{t-1} + \sum_{i=1}^{k} \delta_i \Delta X_{t-i} + \varepsilon_t, \qquad (1)$$

where Δ is the first−difference operator; $(X_{i,t})$ represents the respective time series of interest; β_i, δ_i, are constant parameters; and ε_t is a stationary stochastic process. The number of lags (k) will be determined based on the Akaike Information Criterion (AIC).

To determine the order of integration of the series, model (1) is modified to include second differences on lagged first and k lags of second differences. That is,

$$\Delta^2 X_t = \lambda_1 \Delta X_{t-1} + \sum_{i=1}^{k} \mu_i \Delta^2 X_{t-i} + \varepsilon_{1t} \qquad (2)$$

where, $\Delta^2 X_t = \Delta X_t - \Delta X_{t-1,;}$ λ_i, μ_i, are constant parameters; and ε_{1t} is a stationary stochastic process. The k lagged difference terms are included so that the error terms ε_t and ε_{1t} in both equations are serially independent.

The Johansen (1991, 1995) efficient maximum likelihood test is applied using alternative lag lengths in the vector autoregression (VAR). More specifically:

Consider a VAR of order z:

$$X_t = A_1 X_{t-1} + ... + A_z X_{t-z} + \varepsilon_t, \qquad (3)$$

[7] McKinnon (1963) showed that for a small open economy wishing to achieve simultaneously internal balance, external balance and price stability the optimal is to adopt fixed exchange rate. In this setting, flexible exchange rates contribute to greater variability of the domestic price level and the negative effects to exchange rate variability are likely to be larger the more open is the economy.

[8] See also, Abed, et al (2003).

where X_t is our y-vector of the non-stationary I(1) macroeconomic series, and ε_t is a vector of innovations. We can rewrite the VAR as:

$$\Delta X_t = \theta X_{t-1} + \sum_{i=1}^{z-1} \lambda_i \Delta X_{t-i} + \varepsilon_t, \quad (4)$$

$$\text{where,} \quad \theta = \sum_{i=1}^{z} A_i - I_i, \quad (5)$$

$$\text{and} \quad \lambda_i = -\sum_{j=i+1}^{z} A_j. \quad (6)$$

Granger's representation theorem asserts that if the coefficient matrix θ has reduced rank r<y, then there exist y x r matrices ω and Ω each with rank r such that $\theta = \omega\Omega'$ and $\Omega' X_t$ is stationary. r is the number of cointegrating relations (the cointegrating rank) and each column of Ω is the cointegrating vector. The elements of ω are known as the adjustment parameters in the vector error correction model. Johansen's method is to estimate θ matrix in an unrestricted form, then test whether we can reject the restrictions implied by the reduced rank of θ.

Based on correlation and cointegration techniques in order to detect long run co-movements in the stated variables, this section establishes the current status of South-South trade, monetary and financial integration and identifies the future prospects for enhancing South-South economic integration. The recent MED trade agreements and the establishment of a free trade area are all expected to accelerate and enhance the trade, monetary and financial links among MED countries on one hand and the EU-MED countries on the other. The empirical findings of this section constitute an essential tool for policy makers in the region formulating future trade monetary and financial policies. It will be argued that the MED region should accelerate the trade, financial and economic integration process to better absorb the negative effects of external shocks whether financial or monetary on their economies.

3.1 MED Trade Integration

This section examines empirically south–south trade integration in light of the relaunching of GAFTA in 1997. Recent trade data is used depending on data availability from 1993 to 2003, collected from the International Financial Statistics' Direction of Trade Statistics database. We follow empirically the methodology as in Bayoumi and Eichengreen (1994) by analyzing trade data and correlations of GDP growth rates in the 12 GAFTA member countries.

It should be clear from the earlier discussion that if a group of economies is subject to symmetric economic shocks, the economies are flexible enough to handle asymmetric shocks, and they are also open economies with high trade links, then it is highly likely that they will have synchronized business cycles and will require a common policy response; that is the group of economies are well integrated and may constitute an OCA.[9]

[9] A currency area is basically a collection of countries or regions that operate under some tight form of fixed exchange rates. Kenen (1997) gives a useful definition of a currency area: "A currency area is a group of countries that undertake to contain their bilateral exchange rates within narrow bands defined in respect of agreed central rates which they can change unilaterally." The Exchange Rate Mechanism (ERM) of the EMS is an example of a currency area. Based on Mundell's pioneering contribution, economists have basically agreed on the following criteria that make a currency area optimal, that is criteria for an OCA to exist: (1) Regions are exposed to common economic shocks; (2) The shocks are similar or symmetric; (3) The regions should have similar responses to common shocks; (4) If regions

To check this hypothesis empirically, we first look at trade links among the GAFTA members. Those are Bahrain, Egypt, Jordan, Kuwait, Lebanon, Morocco, Qatar, Saudi Arabia, Syria, Tunisia, Yemen, and the UAE.

Tables 13, 14 and 15 report intra-regional MED trade flows over the period 1993-2003 in million of US dollars. As seen from those tables, total exports, imports, and total trade, have all increased uniformly among GAFTA countries since the re-launching of GAFTA in 1997. Tables 13 reports total exports between each MED country and the remaining GAFTA members. From 1993 to 2003, the increase in exports has been significant across GAFTA members where exports appear to have more than doubled across all MED countries in 2003 relative to 1993. With the exception of perhaps Bahrain and Morocco, the same is also true for imports across all MED countries and thus total trade.

Table 13. Intra-Regional Exports of GAFTA Countries: 1993-2003

Intra-MED X in Million of USD	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Bahrain	312	381	465	462	388	476	452	461	480	522	599
Egypt	412	403	364	396	355	418	319	553	429	554	655
Jordan	276	287	325	493	497	420	392	365	449	491	569
Kuwait	222	179	293	224	291	282	383	380	446	466	547
Lebanon	309	325	324	636	308	306	253	281	332	339	395
Morocco	111	167	160	195	186	102	186	189	180	198	225
Qatar	201	213	239	223	230	248	251	717	311	293	332
Saudi Arabia	3419	3564	4573	5695	6147	4506	4759	4992	5001	5255	6250
Syria	708	850	824	610	682	696	660	697	1414	1183	1388
Tunisia	114	111	118	128	135	116	111	124	145	130	168
UAE	810	919	974	1065	1064	1318	1422	1549	1639	1737	2016
Yemen	44	158	216	82	72	140	125	163	178	315	355

Notes: Algeria is excluded from the sample since it joined GAFTA in 2002.
Source: IMF, Direction of Trade Statistics, 2003. X represents exports.

are subject to asymmetric or region specific shocks, they need to be capable of quick adjustment. The more open an economy is the more ready it will be to join on OCA (McKinnon (1963)). Along with the OCA criteria, some additional conditions must be satisfied for a successful monetary union (i.e., one money, one central bank and one monetary policy Kenen (1997)) to exist. Whatever these conditions may be, they must include credible policy action by the member states that make their economic policies converge to common trend that is consistent with achieving and maintaining a currency union. The nominal convergence criteria laid down by the Maastricht Treaty in the context of the EMU countries had to satisfy specific target with respect to their bilateral exchange rates, inflation rate, long-term interest rate and government deficits and debts in order to qualify for participation in the EMU.

Table 14. Intra- Regional Imports of GAFTA Countries: 1993-2003 (USD million)

Intra-MED M in Million of USD	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Bahrain	1600	1519	1682	1949	2019	1004	996	1239	1343	1432	1805
Egypt	174	282	339	408	582	783	894	1143	1005	1092	1375
Jordan	239	303	374	494	375	343	345	367	434	471	591
Kuwait	561	790	935	1016	1061	1034	995	1312	1217	1216	1352
Lebanon	493	574	369	571	623	570	523	725	742	798	979
Morocco	645	554	591	550	647	340	409	482	662	712	902
Qatar	316	319	310	370	378	555	477	522	487	468	520
Saudi Arabia	1319	1238	1376	1615	1519	1723	1944	1574	1605	1617	1803
Syria	238	321	341	342	223	280	282	355	372	400	494
Tunisia	137	143	199	210	198	188	191	222	249	239	323
UAE	1048	1073	1338	1367	1373	1513	1590	1599	2500	2274	2531
Yemen	557	502	482	366	439	554	645	728	811	1059	1335

Notes: Algeria is excluded from the sample since it joined GAFTA in 2002.
Source: IMF, Direction of Trade Statistics, 2003. M represents imports.

Table 15. Total Trade Among GAFTA Members: 1993-2003 (USD million)

Total Trade in Million of USD	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Bahrain	1913	1901	2147	2411	2407	1480	1448	1699	1824	1954	2404
Egypt	586	685	703	804	937	1201	1213	1695	1434	1645	2031
Jordan	516	590	699	987	873	763	737	732	883	962	1160
Kuwait	783	968	1228	1240	1351	1317	1378	1692	1663	1682	1898
Lebanon	803	899	693	1207	930	876	776	1005	1074	1136	1374
Morocco	756	721	750	745	833	443	596	672	843	910	1127
Qatar	518	532	549	593	607	804	728	1239	799	761	852
Saudi Arabia	4738	4802	5949	7310	7666	6229	6704	6566	6606	6872	8053
Syria	945	1171	1165	952	904	976	942	1051	1785	1583	1882
Tunisia	251	254	317	339	333	304	302	347	394	369	491
UAE	1858	1992	2312	2432	2437	2831	3012	3149	4139	4011	4547
Yemen	601	660	697	448	510	694	770	892	989	1374	1689

Notes: Algeria is excluded from the sample since it joined GAFTA in 2002.
Source: IMF, Direction of Trade Statistics, 2003.

Table 15 reports the index of economic openness measured as total exports plus imports within GAFTA. It shows that all MED economies have become more open to one another since the beginning of the GAFTA period with the exception of Bahrain and Lebanon which had already extensive trade with the remaining GAFTA members. One can thus conclude that GAFTA is gradually rendering the MED region an integrated trade region.

Tables 16 report the correlation of GDP growth rates for the respective GAFTA members. As shown in this table, the correlation coefficients between each pair of MPCs are rather ambiguous and vary tremendously across countries. The existence of high and significant correlation coefficients in some instances can be explained by the increase in trade flows, and their consequent impact on the growth rates of GDP. For instance, Tunisia's rate of growth of GDP is highly correlated with Egypt, Morocco, Saudi Arabia and the UAE with correlation coefficients of 0.74, 0.45, 0.54 and 0.55 respectively. The UAE's rate of growth of GDP is highly correlated with Egypt, and Saudi Arabia with correlations coefficients of 0.49 and 0.30 respectively. Syria is also

in a similar situation where the rate of growth of GDP is highly correlated with Jordan, Lebanon, and Morocco with correlation coefficients of 0.46, 0.76 and 0.37 respectively. The high correlations between the Syrian and Lebanese rate of growth of GDP (0.76) can be attributed to (1) Strong and extensive labour links, with about 1 million Syrian workers working in Lebanon and with an average of USD 1 billion annual Syrian workers' remittances since 1990; And (2) strong exports from Syria to Lebanon amounting to about USD 400 million contrasted with a mere USD 40 million of exports going to Syria.

By contrast, the remaining MPCs economies are somehow not at pace with each other. In fact, the evidence in Table 16 shows that some GAFTA economies are largely independent of each other, and if anything else they tend to move in opposite directions. The MED countries that fall under this category are: Bahrain, Saudi Arabia, Egypt, Yemen, and Morocco. The remaining countries of Lebanon, Kuwait are somewhere in the middle exhibiting high correlations with some countries and low or negative correlations with the others. The evidence provided in Table 16 cannot provide a strong support to the claim that: (1) For those MPCs that have ratified the GAFTA Agreements, greater trade integration is gradually leading to greater economic integration within the MED region; And (2) the MPCs' business cycles are becoming relatively highly synchronized with one another. Since the rule for declaring a strong OCA is an average of 70 percent cross-correlation, and the rule for declaring a weak OCA is an average of 40 percent cross-correlation value in the regional GDP growth rates, then, we cannot even declare the GAFTA region as a weak OCA.

Table 16. Correlations of GDP Growth Rates of GAFTA Members: 1997-2003

MED Country	Bah	Egy	Jor	Kuw	Leb	Mor	SA	Syr	Tun	UAE	Yem
Bah	1.00	-0.53	0.01	0.78	0.09	-0.33	-0.21	-0.04	-0.34	-0.40	-0.02
Egy		1.00	-0.45	-0.86	-0.81	-0.10	0.10	-0.76	0.74	0.49	0.12
Jor			1.00	0.42	0.73	-0.52	-0.59	0.46	-0.90	-0.27	0.32
Kuw				1.00	0.60	-0.24	-0.40	0.34	-0.73	-0.67	-0.22
Leb					1.00	-0.01	-0.18	0.76	-0.78	-0.25	0.06
Mor						1.00	0.53	0.37	0.45	0.25	-0.51
SA							1.00	0.21	0.54	0.30	0.27
Syr								1.00	-0.56	-0.15	0.12
Tun									1.00	0.55	-0.17
UAE										1.00	0.31
Yem											1.00

Note: Bah represents Bahrain, Egy: Egypt, Jor: Jordan, Kuw: Kuwait, Leb: Lebanon, Mor: Morocco, SA: Saudi Arabia, Syr: Syria, Tun: Tunisia, UAE: United Arab Emirates, Yem: Yemen.
Source: Authors' Estimates.

Thus, even though trade flows within GAFTA appear to be on the rise, they appear not to be enough to qualify the region as an OCA. We still see significant divergence in business cycles and exchange rate polices. The existence of exchange rate overvaluations and misalignments within GAFTA countries is still hindering intraregional trade flows. Therefore, macroeconomic policy divergence within the region appears to be among the main obstacles towards achieving further trade and monetary integration. One way to circumvent this problem is perhaps through the adoption of a common currency within the MED region. This issue will be studied further in the section below.

3.2 MED Monetary Integration

The exchange rate literature stipulates that the benefits of monetary unification, by adopting a common currency, are in the form of elimination of the costs associated with exchange rate misalignments and currency conversion. The recent GAFTA agreements do not immediately provide for labor mobility within the region and for fiscal cross-border transfers in order to smooth out economic and financial shocks. Further, the various MED central banks do not possess a good track record of maintaining price stability, and a flexible exchange rate, which allows them to pursue their own independent monetary policy. A monetary policy that adopts a common currency or that ties the various MED currencies closely to the euro and not the dollar can turn out to be instrumental in borrowing monetary credibility from the European Central Bank (ECB), and thus, may reduce the MED region inflation and interest rates.

If there is a desire for monetary independence, then a flexible exchange rate regime is better for MED countries in the presence of structural differences between the different MED countries. However, Lebanon, Egypt, Morocco and Tunisia's experience with flexible rates has been disappointing, given the high volatility of their real exchange rates, and the prolonged misalignment of their respective currencies from its equilibrium value. A weak domestic currency contributes to the low productivity of domestic firms competing in the foreign sector. Since these countries are moving toward greater trade links with each other, greater exchange rate fixity vis-à-vis the euro might be favored.

Similar arguments were made pointing out that flexible exchange rates have not delivered the expected results in the MED region. Unemployment rates in Lebanon, Morocco and Tunisia have remained high and labor market flexibility has been lower because of flexible rates. Also, the high volatility of their exchange rates has increased the exchange rate risk premium and resulted in higher interest rates. A common currency, would improve the three countries financial and monetary position within the MED region by eliminating exchange rate misalignments and currency convergence costs and exchange rate risk premia, and by reducing interest rates and general price variability.

In the previous section, it was shown that the MED GAFTA countries do not even form a weak OCA. The present section uses yearly data for the period 1960-2003, collected from the International Financial Statistics database, and the Arab Monetary Fund to study the status of monetary integration within the MED region and the prospects for the adoption of a common currency. We exclude from our sample the MPCs that have not ratified the GAFTA Treaty. The data set includes data on regional GDP growth rates, short-term interest rates, nominal exchange rates and inflation rates.

The Johansen (1991, 1995) cointegration test will be used to test for the existence of a long run relationship between the data series (X_i) corresponding to GDP, inflation rates, interest rates, and nominal exchange rates, after establishing non−stationarity of the individual series by applying both the Phillips-Perron (PP) and Augmented Dickey−Fuller (ADF) unit root tests. The unit root tests results are reported in Tables A.1-A.12 of the Appendix. The results show that in general all variables are non-stationary in the level, and thus contain a unit root. In other words, they are all integrated of order one, I(1) series. There are, however, few exceptions.

Since most series are integrated of order one, I(1), we next move to study whether the series are cointegrated. We study South-South monetary integration to see whether the MPCs set their macro and monetary policies independently, or follow

some sort of policy convergence, and can therefore adopt a common currency. For this purpose, the Johansen (1991, 1995) efficient maximum likelihood test is applied using alternative lag lengths in the vector autoregression (VAR).

The cointegration test results are reported in Tables 17-20. The South-South cointegration results show that there is no convergence in MED monetary or macroeconomic policies in general.

Table 17. Cointegration Tests on the Rate of Growth of GDP

Hypothesis			**Critical Values**	
Null	Alternative	Trace Statistics	5%	1%
r = 0	r ≥ 1	379.6392**	182.82	196.08
r ≤ 1	r ≥ 2	256.8444**	146.76	158.49
r ≤ 2	r ≥ 3	184.2248**	114.9	124.75
r ≤ 3	r ≥ 4	122.6518**	87.31	96.58
r ≤ 4	r ≥ 5	72.28679**	62.99	70.05
r ≤ 5	r ≥ 6	46.53728*	42.44	48.45
r ≤ 6	r ≥ 7	26.21199*	25.32	30.45
r ≤ 7	r =8	9.469541	12.25	16.26

Notes: 1-The Johansen Cointegration Likelihood Ratio Test is based on the Trace of the Stochastic Matrix. 2-The test allows for a linear deterministic trend in the data, and no constant. 3-r represents the number of cointegrating vectors. Maximum lag 1 year in VAR. 4-A **and * indicate significance at the 1 and 5 percent level of significance respectively. The asymptotic critical values are from Osterwald-Lenum (1992). 6- The tested countries are: Jordan, Kuwait, Morocco, Saudi Arabia, Syria, Tunisia, UAE, and Lebanon.

Table 17 reports 7 cointegerating vectors and one stochastic trends pointing towards a strong long run relationship between the GDP growth rates of Jordan Kuwait, Morocco, Saudi Arabia, Syria, Tunisia, UAE, and Lebanon,[10] indicating a strong convergence in MED business cycles. The increased MED trade is apparently leading to higher co-movements in the rates of growth of GDP, and more synchronization in MED business cycles. While this can perhaps be explained by the fact that greater trade links resulting from GAFTA are gradually leading to similar dynamics of the rates of growth of GDP, these GDP growth rates are highly correlated with oil price fluctuations. This is not only true for the oil producing MED countries of Saudi Arabia, Kuwait and the UAE, but also true for the remaining non-oil producing MED countries through the significant effects of workers remittances working in oil-MED countries. This factor is an important determinant of the dynamics of the rate of growth of GDP in this region. One can thus safely conclude that the strong convergence in the rate of growth of GDP is not really the result of greater trade integration, but is rather driven by the dynamics of oil prices.

No doubt the full adoption of a common currency like for instance the euro by MPCs- justified by strong trade links these countries have with the EU- will lead in the future to the intensification of not only MED trade but also Euro-MED trade, justified also by the elimination of real exchange rate overvaluations and misalignments, and by the reduction of currency conversion costs. There is ample empirical evidence suggesting (see for example Rose (2000), and Glick and Rose (2002)) that the adoption of a common currency, by joining a currency union, has a significant positive impact on trade. For instance, using a sample of 217 countries covering the period 1948-1997, Glick and Rose (2002) have shown that countries

[10] We have excluded from our sample all countries with stationary growth rates of GDP and those countries with negative correlations in the rate of growth of GDP.

joining a currency union have experienced economically and statistically significant increases in trade. They also show that the increase in trade could be as high as 300 percent. This hypothesis is further explored below.

Table 18. Cointegration Tests on Nominal Exchange Rates

Hypothesis			Critical Values	
Null	Alternative	Trace Statistics	5%	1%
r = 0	r ≥ 1	175.9087**	124.24	133.57
r ≤ 1	r ≥ 2	103.5991**	94.15	103.18
r ≤ 2	r ≥ 3	61.24887	68.52	76.07
r ≤ 3	r ≥ 4	38.37533	47.21	54.46
r ≤ 4	r ≥ 5	20.02772	29.68	35.65
r ≤ 5	r ≥ 6	9.544155	15.41	20.04
r ≤ 6	r = 7	1.106671	3.76	6.65

Notes: 1-The Johansen Cointegration Likelihood Ratio Test is based on the Trace of the Stochastic Matrix. 2-The test allows for a linear deterministic trend in the data, and no constant. 3-r represents the number of cointegrating vectors. Maximum lag 1 year in VAR. 4-A **and * indicate significance at the 1 and 5 percent level of significance respectively. The asymptotic critical values are from Osterwald-Lenum (1992). 6- The tested countries are: Jordan, Egypt, Kuwait, Morocco, Syria, Tunisia, and the UAE.

Table 18 reports the cointegration results for nominal exchange rates in Jordan, Egypt, Kuwait, Morocco, Syria, Tunisia, and the UAE.[11] The table points to the existence of two cointegrating vectors and 5 stochastic trends. This very weak convergence is not surprising, and is due to the lack of coordination of monetary and exchange rate polices, and to the fact that there is a significant degree of heterogeneity in MED exchange rates policies. It also indicates that at least 5 of the seven MED countries appear to be setting their exchange rates independently. While some MED exchange rates have been behaving quite differently especially during the various episodes of exchange rate volatility, others have been strictly pegged to the US dollar and in some other instances fixed to a basket of currencies where the dollar is given the highest weight. MED countries should set their future exchange rate policies to better reflect the changing trading patterns after the ratification of GAFTA and the signing of the Euro-MED partnership. The full adoption of a common currency like the euro by MPCs in the future may contribute to enhancing MED trade flows as well as Euro-MED trade flows.

Table 19. Cointegration Tests on the Rates of Inflation

Hypothesis			Critical Values	
Null	Alternative	Trace Statistics	5 %	1%
r = 0	r ≥ 1	102.5718**	76.07	84.45
r ≤ 1	r ≥ 2	52.95727	53.12	60.16
r ≤ 2	r ≥ 3	29.49081	34.91	41.07
r ≤ 3	r ≥ 4	11.45428	19.96	24.6
r ≤ 4	r = 5	3.018908	9.24	12.97

Notes: 1-The Johansen Cointegration Likelihood Ratio Test is based on the Trace of the Stochastic Matrix. 2-The test allows for no deterministic trend in the data, and no constant. 3-r represents the number of cointegrating vectors. Maximum lag 1 year in VAR. 4-A **and * indicate significance at the 1 and 5 percent level of significance respectively. The asymptotic critical values are from Osterwald-Lenum (1992). 6- The tested countries are: Bahrain, Egypt, Jordan, Saudi Arabia and Syria.

[11] We have excluded from our sample all countries with stationary nominal exchange rates series.

Next we test for cointegration between the inflation rates of Bahrain, Egypt, Jordan, Saudi Arabia and Syria.[12] Table 19 points to the existence of a very weak convergence of MED monetary policies with respect to inflation. The Table reports the existence of one cointegrating vector and four stochastic trends. The presence of four stochastic trends implies that four of the five MPCs are setting their inflation policies independently. This very weak convergence in government monetary policies cannot be attributed to more coordination in MED monetary polices, but is rather due the fact that all MPCs have been devoting significant efforts to contain the inflationary pressures of the late 1980s. After several episodes of high inflation rates, these rates appear to have been contained in early 1990s in all MPCs.

Table 20 reports the cointegration results for the rate of interest in Bahrain, Lebanon and Morocco only.[13] The Table indicates no cointegrating vectors between the interest rates of those MPCs. This adds another evidence to our earlier findings that monetary policies in the MED region appear to be set independently and that greater monetary policy coordination is required between the various central banks. Overall, the empirical results are pointing towards little convergence in MPCs monetary policies, and the prospects of a currency union within the MED region are still a far-reaching goal. Greater monetary and macroeconomic policy coordination is required in the MED region.

Table 20. Cointegration Tests on Interest Rates

Hypothesis			Critical Values	
Null	Alternative	Trace Statistics	5 %	1 %
r = 0	r ≥ 1	19.46397	29.68	35.65
r ≤ 1	r ≥ 2	5.438896	15.41	20.04
r ≤ 2	r = 3	0.861054	3.76	6.65

Notes: 1-The Johansen Cointegration Likelihood Ratio Test is based on the Trace of the Stochastic Matrix. 2-The test allows for a linear deterministic trend in the data, and no constant. 3-r represents the number of cointegrating vectors. Maximum lag 1 year in VAR. 4-A **and * indicate significance at the 1 and 5 percent level of significance respectively. The asymptotic critical values are from Osterwald-Lenum (1992). 6- The tested countries are: Bahrain, Lebanon and Morocco.

Overall, this section has shown that South-South monetary integration is still a far reaching goal. However, a weak convergence of business cycle polices have started to emerge within the MED region. Although the intensification of trade between MPCs may be leading to more synchronization in MED business cycles, the prospects for the establishment of a MED OCA and may be a currency union are still weak despite some very weak signs of convergence of MED government policies. More government policy coordination is required in the future to achieve monetary integration within the MED region.

MED countries will need to abolish all the obstacles that have so far hindered the intensification of trade within the region. Even though GAFTA constitutes one step in the right direction, more efforts are still needed to further enhance and stimulate trade flows within the region. Tariffs between GAFTA members have now been abolished, but there still exist other non-tariff barriers hindering further intensification of trade.

[12] We have excluded from our sample all countries with stationary inflation rates series.
[13] We have excluded from our sample all countries with stationary interest rates series or those with insufficient number of observations due to the lack of long data series for the remaining MPCs.

One area where genuine efforts should be devoted relates to government Macroeconomic policies. These policies have not yet been able to enhance trade and monetary integration. There is a need for more harmonization of exchange rate and interest rate policies. The policies of fixed exchange rates to the USD have led to real exchange rate overvaluations with detrimental impacts on intra-regional trade. Two policy options are available. The optimal monetary policy option is a monetary union between those countries. However, since a monetary union between GAFTA members is a somewhat distant prospect, these countries should perhaps follow the Egyptian Tunisian and Moroccan examples and introduce in the short run more flexibility in their exchange rates. Egypt recently managed a successful exit from its pegged exchange rate regime; the move entailed relatively low macroeconomic costs and immediately eased the pressure on foreign reserves and the nominal rate of interest. The country can now enjoy the full effectiveness of an independent monetary policy. The shift is expected to stimulate GDP and export growth in the future; there is already empirical evidence pointing in that direction. In the long-run these countries can opt for more fixity through a rigid peg or an exchange rate target zone as a preliminary step before the adoption of a common currency.

Among the oil MED economies, the homogeneous pegging of local currencies to the USD will greatly facilitate the formation of a currency union in 2010. The Gulf Cooperation Council (GCC) States should accelerate their efforts to achieve monetary integration and work towards the eventual inclusion of the remaining GAFTA members in a larger regional currency union. Such unification is expected to eliminate regional exchange rate misalignments and their negative impact on intra-MED trade.

These oil economies have adopted a strict peg to the US currency, which has ensured a steady inflow of dollars from oil exports and enhanced the Gulf countries' internal and external stability. Moreover, the current and capital account convertibility has contributed to increased monetary policy integration between these countries, which will facilitate the establishment of the GCC monetary union by 2010. The dollar's appreciation prior to 2002 had little effect on the subregion's overall export competitiveness, since these countries rely mainly on exports of oil, the price of which is determined in world markets. Non-oil exports were more seriously affected by the appreciation of the dollar; however, since such exports account for a very small proportion of the overall total among the GCC countries, the impact was negligible.

The depreciation of the euro relative to the dollar (between the time the euro was introduced in 1999 and the end of 2002) led to the appreciation of the real exchange rate in Lebanon, Egypt, Jordan Morocco, and Tunisia, seriously harming exports and undermining economic growth.[14] Many of these countries, including Jordan, Lebanon and, to a lesser extent, Egypt, continue to suffer because the burden of adjustment is borne by macroeconomic fundamentals. The nominal stability for which the pegged arrangement was originally instituted has been achieved. In principle, a more flexible exchange rate arrangement might help relieve some of the pressures generated by the internal and external imbalances and shocks these countries have experienced.

At present, however, this may not be a viable alternative for the majority of the MPCs, given the virtual absence of independent monetary policies and well-developed capital markets. Another consideration is that underdeveloped monetary, political and policy-making institutions tend to undermine the effectiveness of

[14] It should be noted that the euro has appreciated substantially relative the dollar since January 2003, which will improve the exchange rate situation in these economies.

discretionary monetary policy. For now, some type of fixed arrangement may be the safest option for most of these countries. For the MED countries engaged in a significant amount of trade with the EU, a euro peg may be more appropriate than a dollar peg. In all cases, those countries maintaining fixed exchange rate arrangements must implement crisis-prevention measures, namely by exercising fiscal discipline, managing their debts and foreign reserves, and avoiding currency appreciation. As the countries in the MED region improve their monetary and fiscal infrastructures and become more integrated with global capital markets, they should altogether adopt a common currency in the long run.

Any macroeconomic policy can, at best, accommodate only two elements of the impossible trinity of (a) full capital account liberalization; (b) a fixed exchange rate; and (c) an independent monetary policy geared towards the achievement of domestic objectives. A country following a floating exchange rate regime can enjoy a fully effective monetary policy and free international capital movement across its borders, while a country that has adopted a fixed exchange rate regime can depart from foreign interest rates and apply an independent monetary policy, provided international capital movement across its borders is prohibited. If the exchange rate is fixed and cross-border capital movements are free, then monetary policy is powerless to achieve domestic goals, since any attempt by the monetary authorities to tighten the money supply will also prompt them to sterilize capital inflows in order to prevent the exchange rate from appreciating.

As mentioned previously, the exchange rate in the GCC countries has effectively been fixed to the United States dollar. However, these economies have not yet liberalized their capital accounts, and cross-border capital transfers are restricted to the repatriation of workers' remittances. Portfolio flows are limited, and the same is true for foreign direct investment. Thus, the GCC countries have been able to use their monetary policy to preserve their dollar peg.

A different situation exists for the remaining economies of the region. Syria has followed a fixed exchange rate regime, and capital flows are largely restricted, so the country's monetary policy could theoretically be used to pursue an independent interest rate policy. However, empirical evidence shows that the Syrian Government has never implemented an independent or effective monetary policy. Yemen is in a similar situation; however, few details are available owing to the lack of relevant data.

Among the GCC economies, the homogeneous exchange rate peg to the dollar may prove to be instrumental in facilitating the formation of a sub regional currency union in 2010. The GCC countries should accelerate the monetary integration process and give serious thought to expanding the currency union to include the remaining MPCs. The establishment of the Gulf-based currency union will eliminate regional exchange rate misalignments and their negative impact on intra-MED and international trade. As long as these economies remain undiversified and can count on substantial regular inflows of hard currency from oil exports, a fixed exchange rate peg to the dollar is sustainable and can be justified. This is not the case for the other MPCs, which have a high concentration of trade with the EU and much more diversified exports and production structures; these countries should give serious consideration to adopting the euro as an alternative peg in the foreseeable future.

MED central bank should also introduce more harmonization in terms of the targets, instruments, and goals of monetary policies. Some MED countries like for instance Lebanon, and Jordan have opted for price stability as the main goal of monetary policy. Others are still pursuing discretionary policies aiming at stimulating the rate of growth GDP, at a time when the literature is full of empirical support that

monetary policy should be directed at price stability due to the existence of extensive lags in the economy and the failure of monetary policy to stimulate GDP. In addition, MED central banks have been using different monetary policy tools to achieve different goals. While some countries like Kuwait, Bahrain Lebanon, Jordan and Egypt are using the rate of interest as their main policy instrument, others like Saudi Arabia, Syria, Morocco and Qatar are using M2 as their main policy instrument. These divergences monetary policy instruments and goals are having important negative consequences on exchange rates, trade and the rate of growth of GDP.

3.3 MED Financial Integration

Capital markets in the MED region have traditionally been less important in channeling financial funds. A fairly developed commercial banking system has taken the lead in attracting and distributing funds. With the possible exception of Kuwait and Jordan (Amman), MED equity markets have only come to the fore in the 1990s. Despite their small market capitalization, during the past ten years, the MED equity markets have exhibited performance characteristics parallel to other emerging markets in similar stages of development (Papaioannou and Tsesekos 1997, Akdogan and Edgar 1995). With the exception of Tunisia, stock markets developments in the MED region have not been disappointing during the last decade. For example, the GCC market capitalizations of Kuwait and Saudi Arabia have remained relatively high growing by 306 and 442 percent respectively in between 1994-2003 (see Table 21). This significant increase in market capitalization is more likely due to the recent hikes in oil prices despite the fact that these markets have remained closed and fairly illiquid.

This scenario is quite similar when one looks at the remaining MED stock markets. Record market capitalization growth rates can be noted in Egypt (553 percent) and to a lesser extent in Jordan (137 percent) over the same period. This is due to massive privatization plans introduced in Egypt and Jordan and to the extensive sale of government assets to private firms, and to the considerable efforts devoted recently to enhancing the efficiency, depth, and liquidity of the two stock markets. While Liquidity ratios have remarkably improved in between 1994-2003 in Kuwait, Jordan, Oman, Saudi Arabia and Egypt, they have remained relatively low in Tunisia and Bahrain.

Table 21. Measures of Stock Market Developments: 1994-2003

	Number of Companies Listed 1994	Number of Companies Listed 2003	Stock Market Capitalization (US $ Million) 1994	Stock Market Capitalization (US $ Million) 2003	Growth 1994-2003 (%)	Shares Traded (Million of shares) 1994	Shares Traded (Million of shares) 2003
Bahrain	34	44	5,129.30	9,701.77	89.14	257.10	405.23
Egypt	700	967	4,258.82	27,847.48	553.88	27.27	1,368.13
Jordan	95	161	4,626.50	10,962.98	136.96	133.82	1,000.24
Kuwait	48	108	10,967.25	59,528.01	442.78	2,519.16	49,565.14
Morocco	61	52	4,446.10	13,050.18	193.52	2.97	35.24
Tunisia	21	45	2,559.29	2,439.55	-4.68	15.53	12.92
Saudi Arabia	62	70	38,693.33	157,306.44	306.55	152.10	5,565.86
Qatar	-	28	-	26,702.11	-	-	189.97

Source: Arab Monetary Fund.
Notes: 1-Number of companies listed: Year-end totals, excluding listed investment funds where possible. 2-Stock market capitalization: Year-end total value traded of listed domestic company shares. 3-Volume traded: Year-end total market values of listed domestic companies.

Table 22 indicates that GCC stock markets are still closed to foreign investors; even non-GCC MED countries face restrictions on portfolio investment in these stock markets. Various restrictions still exist in the face of MED portfolio flows and the removal of these restrictions is expected to improve and enhance financial integration of these markets. Table 22 also indicates that international investors have complete access to the Morocco, Egypt and Jordan stock markets. It should be noted that the open access to foreign investors has contributed significantly to the growth performances of MED stock market capitalization.

Increased financial integration within the MENA region is expected to bring considerable benefits to MED investors. A more liquid capital market offers lower borrowing costs for MED firms wishing to raise funds locally. Moreover, international financial institutions will be willing to diversify their portfolios by tapping the MED financial markets which will benefit from portfolio capital inflows, if the convergence of asset returns in the world markets leads international investors to increase their MED markets holdings in order to diversify across countries with a wide range of risk and returns.

Table 22. Accessibility of MENA Stock Markets to Foreign/MED Investors

Bahrain	- Open to GCC nationals. -Foreigners resident in Bahrain for at least three years may own up to 1percent of the capital of a single company. - Foreigners can trade shares in only four of the 41 listed companies.
Egypt	- Unrestricted access to foreign investors. - Repatriation of capital and dividends allowed.
Jordan	- Foreign investors can hold up to 50 percent of a company's capital. - Repatriation of capital and dividends allowed.
Kuwait	- Open to GCC nationals. - Non-Kuwait residents are allowed to own shares through mutual funds.
Morocco	- Unrestricted access to foreign investors. - Repatriation of capital and dividends are allowed.
Saudi Arabia	-Open only to GCC nationals who can own up to 25 percent of listed companies other than banks. - Shares traded over the counter through banks. - Opened recently to foreign investors through mutual funds only.

Source: Authors' Estimates.

Increased financial liberalization within the MED region is expected to enhance regional intermediation of resources through close integration of financial markets and increased access of MED residents to the world financial markets to finance investment. In addition, MED investors will have access to a variety of risks adjusted rates of return to enhance the efficiency of portfolio allocation and diversification, which will foster the efficiency of MENA's financial markets. Increased liberalization within the MENA region is expected to attract important portfolio investments to the region for diversification purposes.

3.3.1 Data and Sample

To empirically asses financial integration in the MED region we use financial data consisting of weekly closing price series for the major MED stock markets of Bahrain, Kuwait, Saudi Arabia, Jordan, Egypt, Morocco, Qatar and Tunisia. Compounded week-to-week returns are calculated as the natural log differences in prices: $\ln (P_t/P_{t-1})$. The database used for stock market indices is Reuters. There are differences in the data sample used for each index due to data availability. For Bahrain, the data goes back to the 4th of July 2004 and up till the 27th of March 2005. For Egypt, the data covers the period from the 26th of December 1999, till the 10th of April 2005. For Jordan, the data extends from the 17th of October 1999, till the 27th of March 2005. For Kuwait, the data extends from the 9th of March 1997 till the 10th of April 2005. For Morocco, the data extends from the 6th of January 2002 till the 10th of April 2005. For Qatar, the data extends from the 20th of May 2001 till the 27th of March 2005. For Tunisia the data extends from the 19th of December 1999, till the 10th of April 2005. Finally for Saudi Arabia, the data covers the period from the 16th of January 2000 till the 27th of March 2005.

3.3.2 Empirical Results

Table 23. Unit Root Tests for Major MED Stock Markets

	Bahrain	Jordan	Qatar	Saudi Arabia	Morocco	Tunisia	Egypt	Kuwait
Constant and Time Trend								
PP (3)	-1.62	4.48	2.66	2.72	-2.18	-2.20	2.63	2.22
	-3.53	-3.43	-3.43	-3.43	-3.43	-3.43	-3.43	-3.43
PP FD (3)	-5.90*	-16.61*	-14.03*	-15.16*	-10.49*	-15.77*	-13.10*	-18.46*
	-3.53	-3.43	-3.43	-3.43	-3.43	-3.43	-3.43	-3.43
Constant								
PP (1)	0.60	7.58	4.04	5.54	-0.74	-1.61	4.89	5.15
	-2.94	*-2.87*	*-2.88*	*-2.87*	*-2.87*	*-2.87*	*-2.87*	*-2.87*
PP FD (1)	-5.85*	-15.46*	-13.31*	-14.19*	-10.49*	-15.76*	-12.28*	-17.44*
	-2.94	*-2.87*	*-2.88*	*-2.87*	*-2.87*	*-2.87*	*-2.87*	*-2.87*
Constant and Time Trend								
ADF (1)	-1.49	3.34	1.10	2.18	-2.36	-1.91	2.56	1.77
	-3.53	-3.43	-3.43	-3.43	-3.43	-3.43	*-3.43*	-3.43
ADF FD (1)	-3.82*	-5.23*	-3.87*	-5.75*	-4.71*	-7.05*	-6.07*	-7.96*
	-3.53	-3.43	-3.43	-3.43	-3.43	-3.43	-3.43	-3.43
Constant								
ADF (1)	0.47	4.99	2.46	4.07	-0.79	-1.49	3.85	3.79
	-2.94	*-2.87*	*-2.88*	*-2.87*	*-2.87*	*-2.87*	*-2.87*	*-2.87*
ADF FD (1)	-3.76*	-3.91*	-3.26*	-4.63*	-4.71*	-7.08*	-4.80*	-6.61*
	-2.94	*-2.87*	*-2.88*	*-2.87*	*-2.87*	*-2.87*	*-2.87*	*-2.87*

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically significant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level.

Table 24. Cointegration Tests for MED Stock Market Indices

Hypothesis			Critical Values	
Null	Alternative	Trace Statistics	5%	1%
r = 0	r ≥ 1	239.7492**	182.82	196.08
r ≤ 1	r ≥ 2	177.6228**	146.76	158.49
r ≤ 2	r ≥ 3	126.7936**	114.9	124.75
r ≤ 3	r ≥ 4	89.20906*	87.31	96.58
r ≤ 4	r ≥ 5	59.76686	62.99	70.05
r ≤ 5	r ≥ 6	34.28139	42.44	48.45
r ≤ 6	r ≥ 7	17.55525	25.32	30.45
r ≤ 7	r =8	6.449895	12.25	16.26

Notes: 1-The Johansen Cointegration Likelihood Ratio Test is based on the Trace of the Stochastic Matrix. 2-The test allows for a linear deterministic trend in the data, and no constant. 3-r represents the number of cointegrating vectors. Maximum lag 1 year in VAR. 4- A **and * indicate significance at the 1 and 5% level of significance respectively. The asymptotic critical values are from Osterwald-Lenum (1992). 5- The tested countries are: Bahrain, Egypt, Jordan, Kuwait, Morocco, Qatar, Tunisia, and Saudi Arabia.

The unit root tests outlined in Table 23 indicates that all price series indices are non-stationary I(1) time series.

Next we turn to testing for cointegration between the stock market indices of Bahrain, Kuwait, Egypt, Jordan, Saudi Arabia, Morocco, Tunisia and Qatar. Table 24 points to the existence of a weak convergence of MED stock market indices. The Table reports the existence of four cointegrating vector and four stochastic trends. The presence of four stochastic trends implies that four of the eight MPCs stock markets are moving independently of the others. This weak convergence in stock market co-movements cannot be attributed to financial integration of the MED region, but is rather due the fact that the GCC stock markets are highly integrated with each others but not with the remaining MED stock markets.[15] Our empirical results suggest that the GCC countries that are close together geographically and which are already well integrated tend to have stronger financial ties with each other. In fact, since 1997 Bahrain and Kuwait have linked their stock markets by allowing the cross listing of local stocks. Other GCC stock markets are also moving in the same direction. Financial markets that are located in the same geographical area and have identical cohorts of investors are bound to have stock markets, which react to various shocks in the same way. In addition, when a stock is cross-listed in more than two markets, then a shock in one market is likely to be transmitted to the other, because investors will tend to react to various financial shocks in a similar way.

Overall, this section has shown that South-South financial integration is still a far reaching goal. However, a weak convergence of stock market co-movements has started to emerge within the GCC region. Although the intensification of financial and monetary integration between GCC countries has led to more synchronization in stock market indices, the prospects for enhanced financial integration within the MED region appears to be still weak.

IV. Conclusions and Policy Implications

After a detailed explanation of the factors that have hindered so far full South-South trade, monetary, and financial integration, this project has outlined the main stumbling blocks that are still facing the MED region in its strive to achieve successful South-South economic integration. It was argued that the trade and investment creation processes generated by the reduction of trade barriers among MED countries resulting from GAFTA agreements are still not enough to generate a MED region that is highly integrated and that can better integrate with the world economy in general, and with the EU economies in particular. Macroeconomic and monetary policy coordination is still lacking in the region and more efforts need to be devoted in that respect. Appropriate economic policy remedies to these factors are expected to better prepare the region for further integration in the future.

It was shown that the benefits to the region from stimulating intra-MED integration are tremendous. First and foremost are the trade and investment creation possibilities which will be the result of: (1) Eliminating all diverting barriers including non-tariff barriers among MED countries; (2) Realizing enhanced efficiencies in production realized by exploiting comparative advantages through the creation of an enlarged MED market; (3) Realizing intensified competition in the

[15] Cointegration tests have also been performed on the GCC countries as a separate group from the remaining MED stock markets. The empirical tests point to a strong convergence in the co-movements of these stock markets as a separate group.

domestic market with greater consumer choice and cheaper prices; And (4) improved national terms of trade through appropriate inflation and exchange rate policies.

In addition, a combined MED market would be large enough to allow for economies of scale if regional industrial hubs form to supply the growing regional market as well as export demand outside the region. Thus, there is a need for transition of MED economic structure from small domestic industries competing with one another to produce the same kind of goods, to more specialization across countries in the MED region. One way to achieving the type of specialization required is to have the MED oil economies specialized in capital intensive goods and the remaining non-oil economies in labor intensive goods.

While GAFTA was successful in eliminating tariffs in early January 2005, efforts are still needed with regard to installing an effective mechanism to appropriately deal with (i) Dispute Settlements; (ii) Exemptions; (iii) Rules of Origin; and (iv) Non-Tariff Barriers. Despite the success of GAFTA in abolishing tariff barriers, the share of intra-MED trade in total trade of the MED region remained below 10 percent. By comparison with other integrated regions worldwide, the share of intra-Asian trade was about 50 percent and that of intra-Latin American trade was about 40 percent in 2003. In 2003, the share of intra-NAFTA trade was 53 percent of its total trade; and of intra-EU trade, it was almost 60 percent.

While GCC countries are still negotiating trade agreements with the EU, we do not expect much alteration in the structure of the individual country specialization arising within the context of the Euro-MED partnership in the future. Oil will still dominate exports of these countries, even given the recent efforts devoted by some of these countries to diversify their export and production structures away from the oil sector into more industrial products.

Unlike GCC countries where most manpower is imported at relatively high costs rendering the production of labor intensive goods rather costly, most non GCC countries have certainly a comparative advantage in the production of labor intensive goods. Labor is available abundantly and at relatively low costs. These MED countries have already realized this and are relying more and more on the production of goods which are labor intensive. A case in point is the production of Cotton in both Syria and Egypt, and the production of textile related products in Egypt and Tunisia. However, and as a result of greater integration with the EU, Jordan may loose ground in the production and exports of fertilizers and other inorganic elements. While Jordan has been able to compete regionally, it has faced more and more competition from the EU market where these types of products are produced at lower costs. Also, Morocco's Crustaceans industry has also suffered from increased competition with the EU.

In light of the signing of the Euro-MED Partnership by some MED countries and the continued negotiations of others, we expect no effects of greater EU-MED trade integration to have any impact on the exports of MED primary product exports, which constitute more than half of the composition of total exports. Even the industrial sector, where one would expect the region to be mostly affected by increased trade with the EU, our trade data indicate that the technological composition of MED exports appear to be relatively very low, and may suffer only a little as a result of greater integration with the EU. Overall, we do not expect any significant shifts in the technological composition of MED exports as a result of greater integration with the EU. The MED region will continue to specialize in the exports of primary and resource based products, and will most likely import more and more low, medium and high tech products from the EU.

The lack of economic integration in the MED region is still a main factor behind the low level of FDI. Intra-regional capital flows are primarily in the form of workers' remittances and foreign assistance—mainly from the oil MED countries like Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates to poorer countries, like Egypt, Jordan, Lebanon and Yemen—which is highly correlated with the donor's economic circumstances and thus with fluctuations in world market prices of oil.

Private capital and portfolio flows within the region have been also relatively limited. While cross border transactions between the financial markets of the GCC countries increased significantly in recent years, they remained negligible with the other MED countries. Intra-regional investments have been made mainly in those MED countries that implemented policies conducive to strengthening the operational framework of the domestic financial market, such as Egypt and Jordan.

MED countries need to exert intensive efforts to raise their share in global FDI inflows. The measures that could be taken include the acceleration of south-south economic, financial, and trade integration efforts, coupled with enhanced reform programs, and stressing the institutional aspects in particular. Moreover, these countries need to accelerate the implementation of the privatization process, which represents an important factor in promoting the inflows of FDI and portfolio flows at the global level, particularly the privatization of the services sector. MED countries would also have to fight financial and administration corruption and eliminate bureaucracy, which represent strong impediments to the inflow of FDI. The political instability the region has been facing as a result of failure to achieve comprehensive peace continues to exert a negative influence on the ability of MED countries to attract FDI.

The project has argued that a one way to attract more FDI into the region may be through the establishment of a MED customs union. A customs union would enhance competitiveness in the union's enlarged market and tend to create significant stimulants for upgrading the productivity of factors of production. A larger MED market will be able to better attract FDI and portfolio flows. Another desirable feature of the customs union is the creation of a common customs barrier, which will stimulate the relocation of European or international FDI in order to take advantage of the larger market created by the customs union. However, a MED free trade area without a customs union will generate the opposite effects, and reduce the incentives for FDI to relocate in countries included in the free trade area, particularly if the individual countries are joining international free trade agreements such as an association or a partnership agreement with the European Union, or in some cases with the US.

As a regional arrangement, in addition to overcoming the "hub and spokes" effect encouraging the location of FDI in its member countries, a MED customs union would have the added advantage that its participating members are at levels of similar development. This feature suggests that the adjustment costs of liberalization would be much reduced in comparison with the context in which a country opens its markets to considerably more advanced trade partners. Moreover, the adjustment costs incurred by each participating country would be further mitigated by the benefits of reciprocal liberalization by the other participants in the arrangements, causing their respective imports to increase. In such a case, when any country of the free trade area joins the EU partnership, tariffs and other barriers to imports are eliminated and European firms have no incentive to relocate.

On the other hand, an important part of economic integration is the increase in cross border trade through the lifting of trade barriers as provided for in the GCC and

the GAFTA agreements, and other MED trade agreements. However, given the unstable monetary, macroeconomic and financial environments in certain parts of the MED region, it is doubtful whether pursued macroeconomic policies will provide the required stability for increasing economic integration on a regional scale. Moreover, while this project has shown that macroeconomic instability has in fact been so far a detriment to trade integration in the MED region, it was argued that as regional and global liberalization proceeds, policies formed under former macroeconomic conditions will become increasingly under pressure for not providing the stability needed for sound economic development in the new context of regional integration. Macroeconomic policy coordination, as an integral part of multilateral free trade agreements in the MED region, may therefore prove indispensable for successful economic integration in the region.

It was shown that fixed exchange rates may be the optimal monetary arrangement among MED countries that are subject to similar and symmetric economic shocks, mainly shocks to oil prices and revenues. We have also shown that the oil MED economies are more likely to have correlated economic shocks, and thus require a common policy response. International trade patterns and business cycle correlations are endogenous in the MED region, in the sense that countries that trade more tend to have more highly correlated business cycles. Thus, economic integration may help a country to satisfy the conditions for entry into a currency union.

The empirical section of the project has shown that a very small group of MED economies have become more open to one another since the beginning of the GAFTA period. The existence of high and significant correlation coefficients in some instances can be explained by the increase in trade flows, and their consequent impact on the growth rates of GDP. However, the majority of MPCs economies are somehow not at pace with each other. In fact, the empirical evidence has shown that some GAFTA economies are largely independent of each other, and if anything else they tend to move in opposite directions. The MED countries that fall under this category are: Bahrain, Saudi Arabia, Egypt, Yemen, and Morocco. The remaining countries of Jordan, Lebanon, Syria, Tunisia and Kuwait are somewhere in the middle exhibiting high correlations with some countries and low or negative correlations with the others. The empirical evidence cannot provide a strong support to the claim that: (1) For those MPCs that have ratified the GAFTA Agreements, greater trade integration is gradually leading to greater economic integration within the MED region; And (2) the MPCs' business cycles are becoming relatively highly synchronized with one another. We could not therefore declare the GAFTA region as an OCA.

Thus, even though trade flows within GAFTA appear to be on the rise, they appear not to be enough to qualify the region as an OCA. We still see significant divergence in business cycles and exchange rate polices. The existence of exchange rate overvaluations and misalignments within GAFTA countries are still hindering intra-regional trade flows. Thus macroeconomic policy divergence within the region appears to be among the main obstacles towards achieving further trade and monetary integration. One way to circumvent this problem is perhaps through the adoption of a common currency within the MED region.

The exchange rate literature stipulates that the benefits of monetary unification, by adopting a common currency, are in the form of elimination of the costs associated with exchange rate misalignments and currency conversion. Unlike the GCC agreements, the recent GAFTA agreements do not immediately provide for labor mobility within the region and for fiscal cross-border transfers in order to smooth out economic and financial shocks. Further, the various MED central banks

do not possess a good track record of maintaining price stability, and a flexible exchange rate, which allows them to pursue their own independent monetary policy. A monetary policy that adopts a common currency or that ties the various non-oil MED currencies closely to the euro and not the dollar can turn out to be instrumental in borrowing monetary credibility from the European Central Bank (ECB), and thus, may reduce the MED region inflation and interest rates.

If there is a desire for monetary independence, then a flexible exchange rate regime is better for MED countries in the presence of structural differences between the different MED countries. However, Lebanon, Egypt, Morocco and Tunisia's experience with flexible rates has been disappointing, given the high volatility of their real exchange rates, and the prolonged misalignment of their respective currencies from its equilibrium value. Similar arguments were made pointing out that flexible exchange rates have not delivered the expected results in the MED region. Unemployment rates in Egypt, Lebanon, Morocco and Tunisia have remained high and labor market flexibility has been lower because of flexible rates. Also, the high volatility of their exchange rates has increased the exchange rate risk premium and resulted in higher interest rates. A common currency, would improve the four countries financial and monetary position within the MED region by eliminating exchange rate misalignments and currency convergence costs and exchange rate risk premia, and by reducing interest rates and general price variability.

No doubt the full adoption of a common currency like for instance the euro by MPCs- justified by strong trade links these countries have with the EU- will lead in the future to the intensification of not only MED trade but also Euro-MED trade, justified also by the elimination of real exchange rate overvaluations and misalignments and by the reduction of currency conversion costs.

The project has also shown a weak convergence in monetary policies in the MED region. This very weak convergence is not surprising, and is due to the lack of coordination of monetary and exchange rate polices, and to the fact that there is a significant degree of heterogeneity in MED exchange rates policies. It also indicates that several MED countries appear to be setting their exchange rates independently. While some MED exchange rates have been behaving quite differently especially during the various episodes of exchange rate volatility, others have been strictly pegged to the US dollar, and in some other instances fixed to a basket of currencies where the dollar is given the highest weight. MED countries should set their future exchange rate policies to better reflect the changing trading patterns after the ratification of GAFTA and the signing of the Euro-MED partnership. The full adoption of a common currency like the euro by MPCs in the future may contribute to enhancing MED trade flows as well as Euro-MED trade flows.

Genuine efforts should be devoted to improve government macroeconomic policies. These policies have not yet been able to enhance trade and monetary integration. There is a need for more harmonization of exchange rate and interest rate policies. The optimal monetary policy option is a monetary union between those countries. However, since a monetary union between GAFTA members is a somewhat distant prospect, these countries should perhaps follow the Egyptian, Tunisian and Moroccan examples and introduce in the short run more flexibility in their exchange rates as a first step before greater fixity and subsequently the adoption of a common currency. This will allow those countries to correct for any imbalances in their current and capital accounts, and ease up any fiscal pressures on domestic interest rates emanating from public budget deficits and accumulated public debts. Egypt recently managed a successful exit from its pegged exchange rate regime; the

move entailed relatively low macroeconomic costs and immediately eased the pressure on foreign reserves and the nominal rate of interest. The country can now enjoy the full effectiveness of an independent monetary policy which could be targeted towards the correction of internal macroeconomic imbalances. The shift is expected to stimulate GDP and export growth in the short run; there is already empirical evidence pointing in that direction. In the long-run, when fiscal and monetary imbalances ease up, these countries including Egypt can opt for more fixity through a rigid peg or an exchange rate target zone as a preliminary step before the adoption of a common currency.

Among the oil MED economies, the homogeneous pegging of local currencies to the USD will greatly facilitate the formation of a currency union in 2010, and is currently justified due to the fact that oil exports which are denominated in USD constitute more than 80 percent of total exports. The Gulf Cooperation Council States should accelerate their efforts to achieve monetary integration and work towards the eventual inclusion of the remaining GAFTA members in a larger regional currency union. Such unification is expected to eliminate regional exchange rate misalignments and their negative impact on intra-MED trade.

These oil economies have adopted a strict peg to the US currency, which has ensured a steady inflow of US dollars from oil exports, and has enhanced the Gulf countries' internal and external stability. Moreover, the current and capital account convertibility has contributed to increased monetary policy integration between these countries, which will facilitate the establishment of the GCC monetary union by 2010. The dollar's appreciation prior to 2002 had little effect on the subregion's overall export competitiveness, since these countries rely mainly on exports of oil, the price of which is determined in world markets. Non-oil exports were more seriously affected by the appreciation of the dollar; however, since such exports account for a very small proportion of the overall total among the GCC countries, the impact was negligible. However, the dollar's appreciation led to the appreciation of the real exchange rate in Lebanon, Egypt, Jordan Morocco, and Tunisia, seriously harming exports and undermining economic growth. Many of these countries, including Jordan, Lebanon and, to a lesser extent, Egypt, continue to suffer because the burden of adjustment is borne by macroeconomic fundamentals. There was however a trend reversal in the dollar's appreciation since 2002 where the Euro appreciated by about 40 percent against the USD.

Flexible exchange rate regimes in MED countries may not be a viable alternative for the majority of the MPCs, given the virtual absence of independent monetary policies and well-developed capital markets. Another consideration is that underdeveloped monetary, political and policy-making institutions tend to undermine the effectiveness of discretionary monetary policy. For now, some type of fixed arrangement may be the safest option for most of these countries. For MED countries engaged in a significant amount of trade with the EU, a euro peg may be more appropriate than a dollar peg. In all cases, those countries maintaining fixed exchange rate arrangements must implement crisis-prevention measures, namely by exercising fiscal discipline, managing their debts and foreign reserves, and avoiding currency appreciation. As countries in the MED region improve their monetary and fiscal infrastructures and become more integrated with global capital markets, they should opt for a currency union.

Any macroeconomic policy can, at best, accommodate only two elements of the impossible trinity of (a) full capital account liberalization; (b) a fixed exchange rate; and (c) an independent monetary policy geared towards the achievement of

domestic objectives. A country following a floating exchange rate regime can enjoy a fully effective monetary policy and free international capital movement across its borders, while a country that has adopted a fixed exchange rate regime can depart from foreign interest rates and apply an independent monetary policy, provided international capital movement across its borders is prohibited. If the exchange rate is fixed and cross-border capital movements are free, then monetary policy is powerless to achieve domestic goals, since any attempt by the monetary authorities to tighten the money supply will also prompt them to sterilize capital inflows in order to prevent the exchange rate from appreciating.

As mentioned previously, the exchange rate in the GCC countries has effectively been fixed to the US dollar. However, these economies have not yet liberalized their capital accounts, and cross-border capital transfers are restricted to the repatriation of workers' remittances. Portfolio flows are limited, and the same is true for foreign direct investment. Thus, the GCC countries have been able to use effectively their monetary policy to preserve their dollar peg.

Among the GCC economies, the homogeneous exchange rate peg to the dollar may prove to be instrumental in facilitating the formation of a sub regional currency union in 2010. The GCC countries should accelerate the monetary integration process and give serious thought to expanding the currency union to include the other MED countries. The establishment of the Gulf-based currency union will eliminate regional exchange rate misalignments and their negative impact on intra-MED and international trade. As long as these economies remain undiversified and can count on substantial regular inflows of hard currency from oil exports, a fixed exchange rate peg to the dollar is sustainable and can be justified. This is not the case for the other MPCs, which have a high concentration of trade with the EU and much more diversified exports and production structures; these countries should give serious consideration to adopting the euro as an alternative peg in the foreseeable future.

MED central bank should also introduce more harmonization in terms of the targets, instruments, and goals of monetary policies. Some MED countries like for instance Lebanon, and Jordan have opted for price stability as the main goal of monetary policy. Others are still pursuing discretionary policies aiming at stimulating the rate of growth GDP. In addition, MED central banks have been using different monetary policy tools to achieve different goals. While some countries like Kuwait, Bahrain, Lebanon, Jordan and Egypt are using the rate of interest as their main policy instrument, others like Saudi Arabia, Syria, Morocco and Qatar are using M2 as their main policy instrument. These divergences in monetary policy instruments and goals are having important negative consequences on exchange rates, trade and the rate of growth of GDP.

Finally, MED countries should improve financial and monetary policy coordination to allow them to deal more effectively with financial and monetary imbalances. One way this may be achieved is through enhanced regional financial integration. An integrated MED capital market, for instance, would lower the region's interest rates, benefiting those MED countries burdened with high levels of debt. Specifically, a larger, integrated regional market would reduce the huge costs associated with servicing the accumulated public debt, and would lower the cost of raising capital, allowing companies in the region to rely increasingly on the local market rather than the world market for economic development resources; lower capital-raising costs translate into higher investment and GDP growth rates.

References

Abed, G., et al, (2003). The GCC Monetary Union: Some Considerations for the Exchange Rate Regime, International Monetary Fund Working Paper, WP/03/66, 2-24.

Akdogan, H., and E. Elgar, (1995). The Integration of International Capital Markets, Working Paper, Bilkent University and Boston University.

Azzam, H. T. (1997). The Emerging Arab Capital Markets*, Kegan Paul International* 1997, London.

Bayoumi, T., and Eichengreen, B. (1994). Monetary and Exchange Rate Arrangements for NAFTA, *Journal of Development Economics*, 43: 25-165.

Bayoumi, T., and Eichengreen, B. (1997). Ever Closer to Heaven? An Optimum Currency Area Index for European Countries, *European Economic Review*, 41: 761-770.

Bekaert G. and Harvey C.R., (1997). Emerging equity market volatility. *Journal of Financial Economics* 43, 403-444.

Bekaert, Geert, (1993). Market Integration and Investment Barriers in Emerging Equity Markets. In Stijn Claessens and Sudarshan Gooptu, ed. *Portfolio Investment in Developing Countries*. The World Bank.

Blanchard, O., and Katz, L. (1992). Regional Evolutions, *Brookings Papers on Economic Activity*, 1: 1-16.

Brennan M. and Schwartz E., (1979). A Continuous Time Approach to the Pricing of Bonds, *Journal of Banking & Finance* 3, 133-55.

Civelek M.A. (1991). Stock Market Efficiency Revisited: Evidence from the Amman Stock Exchange*. The Middle East Business and Economic Review*, 3(2):3-24.

Colton N., and S. Neaime, (2003). Implications of the Introduction of the Euro for the Mediterranean Countries, *Thunderbird International Business Review***,** Wiley Publisher, 45, 1: 31-49.

Cox J., Ingersoll J., and Ross S., (1985). A Theory of the Term Structure of Interest Rates, *Econometrica* 53, 385-407.

Darrat A. and Hakim, S., (1997). Price Linkages and Integration of Middle East Stock Markets. *Economic Research Forum,* Annual Conference*,* Beirut, Lebanon.

De Santis G. and Gerard B., (2001). International Asset Pricing and Portfolio Diversification with Time Varying Risk, *Journal of Finance* 5(52): 18-31.

De Santis G. and Imrohoroglu S., (1997). Stock Returns and Volatility in Emerging Financial Markets, *Journal of International Money and Finance,* l(4): 561-579.

Drecessin, J., and Fatas, A. (1995). Regional Labour Market Dynamics in Europe, *European Economic Review*, 39: 1627-1655.

Eichengreen, B. (1992). Is Europe an Optimum Currency Area?, Reprinted in *European Monetary Unification: Theory, Practice and Analysis*, B.J. Eichengreen (ed), Cambridge, MIT Press, 51-71.

El-Erian, Mohamed A. and Manmohan S. Kumar, (1995).Emerging Equity Markets in Middle Eastern Countries. *International Monetary Fund Staff Papers*, 42(2): 313-343.

Frankel, J. A., and Rose, A.K. (1997). Is EMU Justifiable Ex Post or Ex Ante?, *European Economic Review*, 41: 753-760.

Glick, R., and A., Rose, (2002). Does a Currency Union Affect Trade? The Time Series Evidence. *European Economic Review*, 46: 1125-1151.

IMF: *International Financial Statistics* Various issues.

Joen B.N. and Von Furstenberg G.M., (1990). Growing International Co-Movement in Stock Price Indexes, Quarterly Review of Economics and Business, 30, pp 15-30.

Johansen, S., (1991). Estimation and Hypothesis Testing of Cointegration Vectors in Gaussian Vector Autoregressive Models, Econometrica, 59, 1551-1580.

Johansen, S., (1995). Likelihood-Based Inference in Cointegrated Vector Autoregressive Models, *Oxford University Press*.

Kenen, P. B. (1969). The Theory of Optimum Currency Areas: An Electic View, in McKinnon, R. (1963). Optimum Currency Areas, *American Economic Review*, 53: 717-725.

Kim S.W. and Wadhwani S., (1990). Transmission of Volatility Between Stock Markets, *Review of Financial Studies*, 3, 5-33.

Korajczyk, R., (1996). A measure of stock market integration for developed and emerging markets: *The World Bank Economic Review,* 10(2).

Mansoorian A., and S. Neaime (2003). Durable Goods, Habits, Time Preference, and Exchange Rates, *North American Journal of Economics and Finance,* Elsevier Science Press, 14, 1: 115-130.

Mansooriann A., and S. Neaime (2002). Habits and Durability in Consumption and the Effects of Exchange Rate Policies, *International Economic Journal***,** 16, 2: 97-114.

Mundell, R. (1961). A Theory of Optimum Currency Areas, *American EconomicReview*, 51: 757-665.

Neaime S., (2000). *The Macroeconomics of Exchange Rate Policies, Tariff Protection and the Current Account: A Dynamic Framework*, APF Press, Toronto, Canada.

Neaime S., (2001). The MED Economies: Monetary and Financial Implications of the Euro-Currency, *Arab Economic Journal*, 10, 24: 3-28.

Neaime S., (2002). The Euro and the Future EU-MED Countries Trade Relations, *Arab Economic Journal*, 11, 29: 27-49.

Neaime S., and J. Paschakis (2002). The Future of the Dollar-Euro Exchange Rate, *North American Journal of Economics and Finance,* Elsevier Science Press, 13, 1: 57-72.

Osterwald-Lenum, M., (1992). A Note with Quantiles of the Asymptotic Distribution of the Maximum Likelihood Cointegration Rank Test Statistics." *Oxford Bulletin of Economics and Statistics*, 54, 461-472.

Papaioannou Michael G. and George Tsetsekos. *Emerging Markets Portfolios,* 1997.

Perron, P. (1989). "The Great Crash, the Oil Price Stock, and the Unit Root Hypothesis", *Econometrica* 57, 1361-1401. ERRATUM. *Econometrica* 61, (1993), 248-249.

Perron, P. (1997). "Further Evidence on Breaking Trend Function in Macroeconomic Variables," *Journal of Econometrics,* 80, 355-85.

Rose A., (2000). One Currency, One Market: Estimating the Effect of Common Currencies on Trade, *Economic Policy*, 20, 7-45.

Tauchen, G., (1986). Statistical Properties of Generalized Method-of-Moments Estimators of Structural Parameters Obtained From Financial Market Data, *Journal of Business & Economic Statistics,* 4, 397–416.

Vasicek, O., (1977). An Equilibrium Characterization of the Term Structure, *Journal of Financial Economics* 5, 177-188.

William N. Goetzmaun and Philippe Jorion. *Re-emerging Markets. NBER Working Paper No.5906*, January 1997.

APPENDIX

Table A. 1. Unit Root Tests: Bahrain

	GDP	Interest Rate	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-1.71	-3.46*	-2.01	-2.45
	-3.62	*-2.99*	*-3.55*	*-3.55*
PP FD (3)	-4.13*	--	-3.17	-6.10*
	-3.63	--	*-3.55*	*-3.55*
Constant				
PP (1)	0.24	-2.11	-3.22*	-1.93
	-3	*-2.98*	*-2.95*	*-2.95*
PP FD (1)	-4.02*	-6.62*	--	-6.14*
	-3	*-2.99*	--	*-2.95*
Constant and Time Trend				
ADF (1)	-2.21	-3.07	-3.52	-2.72
	-3.63	*-3.6*	*-3.55*	*-3.55*
ADF FD (1)	-3.70*	-4.42*	-5.91*	-4.06*
	-3.65	*-3.61*	*-3.56*	*-3.56*
Constant				
ADF (1)	0.27	-1.61	-3.87*	-1.79
	-3	*-2.99*	*-2.95*	*-2.95*
ADF FD (1)	-3.44*	-4.45*	--	-4.08*
	-3.01	*-2.99*	--	*-2.96*

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 2. Unit Root Tests: Egypt

	GDP	Interest Rate	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-2.04	-3.34	-1.69	-2.01
	-3.54	*-3.59*	*-3.55*	*-3.55*
PP FD (3)	-3.16	-2.36	-3.48	-13.38*
	-3.55	*-3.6*	*-3.55*	*-3.55*
Constant				
PP (1)	-0.14	-4.09*	0.38	-2.33
	-2.95	*-2.98*	*-2.95*	*-2.95*
PP FD (1)	-3.31*	--	-3.28*	-10.09*
	-2.95	--	*-2.95*	*-2.95*
Constant and Time Trend				
ADF (1)	-2.39	-2.4	-2.12	-1.11
	-3.55	*-3.6*	*-3.55*	*-3.55*
ADF FD (1)	-1.96	-2.26	-3.48	-7.03*
	-3.55	*-3.61*	*-3.56*	*-3.56*
Constant				
ADF (1)	-0.71	-2.29	0.04	-1.35
	-2.95	*-2.99*	*-2.95*	*-2.95*
ADF FD (1)	-2.3	-1.94	-3.24*	-5.81*
	-2.95	*-2.99*	*-2.96*	*-2.96*

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 3. Unit Root Tests: Jordan

	GDP	Interest Rate	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-2.01	-0.55	-1.95	-3.25
	-3.54	*-3.87*	*-3.55*	*-3.56*
PP FD (3)	-3.68*	-1.78	-3.24	-5.87*
	-3.55	*-3.93*	*-3.55*	*-3.56*
Constant				
PP (1)	0	-0.52	-0.43	-2.74
	-2.95	*-3.15*	*-2.95*	*-2.96*
PP FD (1)	-3.69*	-1.61	-3.28*	-5.94*
	-2.95	*-3.18*	*-2.95*	*-2.96*
Constant and Time Trend				
ADF (1)	-2.66	-0.76	-2.52	-3.79*
	-3.55	*-3.93*	*-3.55*	*-3.56*
ADF FD (1)	-3.56*	-1.41	-3.75*	--
	-3.55	*-3.99*	*-3.56*	--
Constant				
ADF (1)	-0.29	-0.85	-0.84	-2.79
	-2.95	*-3.18*	*-2.95*	*-2.96*
ADF FD (1)	-3.60*	-0.68	-3.76*	-4.68*
	-2.95	*-3.22*	*-2.96*	*-2.96*

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 4. Unit Root Tests: Kuwait

	GDP	Interest Rate	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-2.46	-3.51	-2.03	-5.57*
	-3.54	*-3.63*	*-3.55*	*-3.57*
PP FD (3)	-5.88*	-5.90*	-3.66*	--
	-3.55	*-3.65*	*-3.55*	--
Constant				
PP (1)	-1.2	-3.07*	-2.62	-5.43*
	-2.95	*-3*	*-2.95*	*-2.97*
PP FD (1)	-5.98*	--	-3.51*	--
	-2.95	--	*-2.95*	--
Constant and Time Trend				
ADF (1)	-2.05	-3.38	-2.94	-4.08*
	-3.55	*-3.65*	*-3.55*	*-3.58*
ADF FD (1)	-3.92*	-5.91*	-4.45*	--
	-3.56	*-3.66*	*-3.56*	--
Constant				
ADF (1)	-1.27	-3.13*	-3.29*	-4.10*
	-2.95	*-3.01*	*-2.95*	*-2.97*
ADF FD (1)	-3.98*	--	--	--
	-2.96	--	--	--

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 5. Unit Root Tests: Lebanon

	GDP	Interest Rate	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-0.99	-1.57	-1.82	-3.55*
	-3.54	*-3.66*	*-3.55*	*-3.55*
PP FD (3)	-4.78*	-3.72*	-3.78*	--
	-3.55	*-3.67*	*-3.55*	--
Constant				
PP (1)	1.65	-1.49	-0.46	-3.61*
	-2.95	*-3.02*	*-2.95*	*-2.95*
PP FD (1)	-3.76*	-3.30*	-3.82*	--
	-2.95	*-3.03*	*-2.95*	--
Constant and Time Trend				
ADF (1)	-1.05	-3.35	-1.98	-2.66
	-3.55	*-3.67*	*-3.55*	*-3.55*
ADF FD (1)	-3.23	-3.52	-2.85	-5.43*
	-3.55	*-3.69*	*-3.56*	*-3.56*
Constant				
ADF (1)	1.43	-2.47	-0.63	-2.74
	-2.95	*-3.03*	*-2.95*	*-2.95*
ADF FD (1)	-2.37	-3.13*	-2.89	-5.49*
	-2.95	*-3.04*	*-2.96*	*-2.96*

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 6. Unit Root Tests: Morocco

	GDP	Interest Rate	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-2.44	-2.09	-2.25	-3.65*
	-3.54	*-3.61*	*-3.55*	*-3.55*
PP FD (3)	-4.21*	-4.59*	-3.59*	--
	-3.55	*-3.62*	*-3.55*	--
Constant				
PP (1)	0.51	-1.94	-0.45	-3.18*
	-2.95	*-2.99*	*-2.95*	*-2.95*
PP FD (1)	-4.18*	-4.70*	-3.65*	--
	-2.95	*-3*	*-2.95*	--
Constant and Time Trend				
ADF (1)	-2.62	-2.07	-2.87	-2.75
	-3.55	*-3.62*	*-3.55*	*-3.55*
ADF FD (1)	-2.81	-3.23	-3.60*	-6.44*
	-3.55	*-3.63*	*-3.56*	*-3.56*
Constant				
ADF (1)	0.36	-1.85	-0.85	-2.03
	-2.95	*-3*	*-2.95*	*-2.95*
ADF FD (1)	-2.84	-3.31*	-3.64*	-6.14*
	-2.95	*-3*	*-2.96*	*-2.96*

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 7. Unit Root Tests: Qatar

	GDP	Interest Rate	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-1.49	-1.91	-1.68	-2.82
	-3.55	*-3.66*	*-3.55*	*-3.63*
PP FD (3)	-5.09*	-2.65	-3.44	-4.92*
	-3.56	*-3.67*	*-3.55*	*-3.65*
Constant				
PP (1)	0.08	-1.99	-3.04*	-2.69
	-2.95	*-3.02*	*-2.95*	*-3*
PP FD (1)	-5.11*	-2.71	--	-4.95*
	-2.96	*-3.03*	--	*-3.01*
Constant and Time Trend				
ADF (1)	-1.51	-3.26	-2.85	-3.97*
	-3.56	*-3.67*	*-3.55*	*-3.65*
ADF FD (1)	-4.21*	-4.13*	-5.32*	--
	-3.56	*-3.69*	*-3.56*	--
Constant				
ADF (1)	-0.14	-3.40*	-3.37*	-4.05*
	-2.96	*-3.03*	*-2.95*	*-3.01*
ADF FD (1)	-4.19*	--	--	--
	-2.96	--	--	--

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 8. Unit Root Tests: Saudi Arabia

	GDP	Interest Rate	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-1.99	-1.86	-2.04	-2.49
	-3.54	*-3.76*	*-3.55*	*-3.55*
PP FD (3)	-3.54	-2.24	-2.85	-3.84*
	-3.55	*-3.79*	*-3.55*	*-3.55*
Constant				
PP (1)	-1.3	-1.25	-2.48	-2.15
	-2.95	*-3.08*	*-2.95*	*-2.95*
PP FD (1)	-3.58*	-2.31	-2.57	-3.91*
	-2.95	*-3.1*	*-2.95*	*-2.95*
Constant and Time Trend				
ADF (1)	-2.68	-3.27	-3.35	-3.42
	-3.55	*-3.79*	*-3.55*	*-3.55*
ADF FD (1)	-3.98*	-2.94	-4.15*	-3.96*
	-3.55	*-3.83*	*-3.56*	*-3.56*
Constant				
ADF (1)	-1.71	-2.66	-3.59*	-2.84
	-2.95	*-3.1*	*-2.95*	*-2.95*
ADF FD (1)	-4.00*	-3.07	--	-3.99*
	-2.95	*-3.12*	--	*-2.96*

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 9. Unit Root Tests: Syria

	GDP	Interest Rate (singular matrix)	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-1.76	--	-2.19	-2.42
	-3.54	--	*-3.55*	*-3.55*
PP FD (3)	-3.78*	--	-5.66*	-5.38*
	-3.55	--	*-3.55*	*-3.55*
Constant				
PP (1)	-1	--	-0.82	-2.47
	-2.95	--	*-2.95*	*-2.95*
PP FD (1)	-3.84*	--	-5.75*	-5.35*
	-2.95	--	*-2.95*	*-2.95*
Constant and Time Trend				
ADF (1)	-2.04	--	-2.11	-2.94
	-3.55	--	*-3.55*	*-3.55*
ADF FD (1)	-3.01	--	-4.01*	-5.16*
	-3.55	--	*-3.56*	*-3.56*
Constant				
ADF (1)	-1.18	--	-0.82	-2.92
	-2.95	--	*-2.95*	*-2.95*
ADF FD (1)	-3.06*	--	-4.01*	-5.14*
	-2.95	--	*-2.96*	*-2.96*

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 10. Unit Root Tests: Tunisia

	GDP	Interest Rate (singular matrix)	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-1.76	--	-2.19	-2.42
	-3.54	--	*-3.55*	*-3.55*
PP FD (3)	-3.78*	--	-5.66*	-5.38*
	-3.55	--	*-3.55*	*-3.55*
Constant				
PP (1)	-1	--	-0.82	-2.47
	-2.95	--	*-2.95*	*-2.95*
PP FD (1)	-3.84*	--	-5.75*	-5.35*
	-2.95	--	*-2.95*	*-2.95*
Constant and Time Trend				
ADF (1)	-2.04	--	-2.11	-2.94
	-3.55	--	*-3.55*	*-3.55*
ADF FD (1)	-3.01	--	-4.01*	-5.16*
	-3.55	--	*-3.56*	*-3.56*
Constant				
ADF (1)	-1.18	--	-0.82	-2.92
	-2.95	--	*-2.95*	*-2.95*
ADF FD (1)	-3.06*	--	-4.01*	-5.14*
	-2.95	--	*-2.96*	*-2.96*

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 11. Unit Root Tests: UAE

	GDP	Interest Rate	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-1.56	--	-1.72	--
	-3.57	--	*-3.55*	--
PP FD (3)	-4.32*	--	-3.52	--
	-3.57	--	*-3.55*	--
Constant				
PP (1)	-0.16	--	-3.12*	--
	-2.96	--	*-2.95*	--
PP FD (1)	-4.35*	--	--	--
	-2.97	--	--	--
Constant and Time Trend				
ADF (1)	-1.7	--	-2.84	--
	-3.57	--	*-3.55*	--
ADF FD (1)	-3.95*	--	-5.50*	--
	-3.58	--	*-3.56*	--
Constant				
ADF (1)	-0.12	--	-3.42*	--
	-2.97	--	*-2.95*	--
ADF FD (1)	-3.94*	--	--	--
	-2.97	--	--	--

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.

Table A. 12. Unit Root Tests: Yemen

	GDP	Interest Rate	Nominal Exchange Rate	Inflation
Constant and Time Trend				
PP (3)	-1.45	-5.39*	-1.81	-0.98
	-3.83	*-4.58*	*-3.93*	*-4.35*
PP FD (3)	-2.6	--	-1.49	-1.44
	-3.15	--	*-3.99*	*-4.58*
Constant				
PP (1)	0.43	-5.84*	-0.45	-0.94
	-3.12	*-3.55*	*-3.18*	*-3.42*
PP FD (1)	-2.6	--	-1.75	-1.49
	-3.15	--	*-3.22*	*-3.55*
Constant and Time Trend				
ADF (1)	-3.13	-5.96*	-2.79	-3.26
	-4.08	*-4.93*	*-3.99*	*-4.58*
ADF FD (1)	-0.24	--	-2.07	-2.43
	-4.2	--	*-4.08*	*-4.93*
Constant				
ADF (1)	-0.2	-3.36	-1.17	-3.49
	-3.27	*-3.74*	*-3.22*	*-3.55*
ADF FD (1)	-2.33	-6.93*	-2.26	-2.52
	-3.34	*-4.07*	*-3.27*	*-3.74*

Notes: 1- PP is the Phillips-Perron test; FD is the first difference, and ADF is the Augmented Dickey Fuller. 2-The numbers in parenthesis are the proper lag lengths based on the Akaike Information Criterion (AIC). 3- A * indicates rejection of the null hypothesis of non-stationarity at the 5% level of significance. 4-For most variables the time trend variable is statistically insignificant. 5- The numbers in italic are Mackinnon's Critical Values at the 5% significance level. 6- -- refers to not applicable.