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Middle East Free Trade Association (MEFTA)?

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Abstract

This paper examines the notion that there is no simple relationship between integration economic development and expanding trade among selected Middle Eastern states. The paper suggests that government intervention and heavy handed involvement in the market serves as a forceful deterrent to the formation of a free trade arrangement among these countries. The paper concludes that, the conditions necessary for the Middle East to transfer itself into a free trade association currently does not exit.

Introduction

Since the end of the cold war, Middle Eastern leaders have scrambled to bring about greater peace and harmony to the region. However, on economic grounds, integration still remains as one of the aspiration of the people of the region. Experience has indeed left behind a certain degree of skepticism as to the validity of some of the objectives and approaches of the past. Middle Eastern economic integration has not been attempted region-wide. However, there have been attempts among groupings of countries in the sub-region of the Middle East and among specific few countries, i.e., the Maghreb Economic Community, the Arab Common Market (ACM), Organization for Economic Cooperation (OEC), as well as the Gulf Cooperation Cooperation Council (GCC) to name but a few. GCC and the European Union (EU) are gradually moving toward a free-trade zone in two to three years. If agreement is reached, all tariffs and import restrictions would be eliminated over eight to ten years for most products. presently no such agreement exists among the countries in the region.

The Middle East and North Africa region extends from Mauritania in the west, to the persian Gulf in the east. while uniform in certain elements of culture, such as religion and Language (with the exception of the Iranians), the region displaus considerable economic and political diversity. This study concentrates on the Islamic states, particularly the persian Gulf area. Israel is not included in the study. The purpose of this study is to systematically analyze and evaluate political, economic, and cultural factors influencing the prospects for integration, trade and foreign direct investment among the member states.

During most of the history of Middle Easterm societies, their economies have been agrarian and rural. The need for integration has been minimal; therefore, coexistence with other societies was not too difficult and interactions were kept at a minimum. This changed abruptly in the 1970s. Many Middle Eastern countries were rich in petroleum, a commodity in high demand in western nations. Sales of this commodity brought inconceivable amounts of pertodollars into the region. Suddenly, the states became among the world's largest traders. While the desire for economic development to modernize society and bring it closer to other regions in the world was prevalent, this modernization was to take time. In the meantime, trade was expanding and infrastructural needs to accommodate further economic development was skyrocketing.

Post-world War II Record Of Integrration: the Conceptual Dilemma

Free trade in the modern era begin in Great Britain with the repeal of the corn laws in 1846 and the accompanying tariff reductions. The Anglo-French Treaty of 1860 introducted the concept of most- favored nations status, which enhanced international trade. This practice provided preferential treatment of selected trading partners which allowed for free movement of goods and services.

The literature on economic integration is impressive, including possible approaches to integration, its modalities, the obstacles related to this process, NAFTA and other regional integration arrangements (schott, 1988, Suriamongkol, 1988, stockel, 1990).

A historical review of integration literature points out that David Mitrany is among forerunners of integration theorists in the late nineteenth century. However, his functionalism centered on cooperation among trade unions and associations across national boundaries. F. Machlop (1980) stated that the term "integration" in economics was used first in industrial organization to refer to combined firms. Integration of economics of separate states are not found in economic history literature prior to J. viner (1950). The author introduced the foundation of the theory of customs unions, which represents the core theory of economic market integration. Following viner, the works of Balassa, Robson,Machlop and Richard Cooper were welcome new addition to the field. They each contributed to the literature by evaluating and analyzing the effects of integration on the national, regional and global economy. In practice, however, official integration arrangements in the Middle East, with a core of persian Gulf states, including Bahrain, Iran, Iraq, Kuwait, Saudi Arabia, United Arab Emirates (U.A.E.) and some of the more peripheral states of North Africa remain nonexistent.

The Middle East's recent history is riddled with attempts to integrate in the post-world war II period. However, the nature and range of economic activities and the pattern of trade, both regional and international, have shifted from extractive industries to agricultural commodities to more downstrean manufacturing industries. In this process there has been some value added to the existing trade, moving away from the trade of simple raw material to processed and manufactured goods.

Empirical studies indicate that nations that have reached the second or third level of W.W. Rostow's economic development stages have a better chance of forging a working integration arrangement (Rostow, 1964). By the mid-1970s many Middle Eastern states were approaching that stage. Stage one includes the traditional substence leval of economic development. The second stage is reached when an economy is able to produce some og it's basic needs and enjoys some manufacturing capabilities (pre-take off stage). The third stage involves the take off stage in which an economy is capable of producing much of its own manufacturing needs and can also export some.

As Wilber Moore (1979) suggests in his book World Modernization, modernization may appropriately ne described as a "rationalization" of the way life and activities are organized.

Moore wrote that this process is limited by three conditions:

1 . the logical limit: the criteria used in choosing the procedures needed to reach a stated goal or objective.

2 . the bio-psychological limit: the human tendencies toward emotion, ethical convention, and sentiment.

3 . the psychlological limit: the form of legitimate power that coordinates the differentiated units within the society.

These three limits create a restraining force on the evolution of a modern society, which is a prerequisite for the convergence of ideological differences as well as a determining factor in clarifying a nation's comparative advantages. In most societies, rules are followed, beliefs are accdepted, and authority is obeyed because that is the way life has always been organized. Common beliefs and practices are the building block of an integrated society.

The rationale for beliefs, practices and sources of legitimate power have traditional roots. Tradition is especially important in its effect on the logical limit. These traditionalized beliefs and practices are the components of the limit and are not always based on "rational" thought.

The desire for an orderly society led members to use fact and logic in choosing behavior that would propel society toward the achievement of various goals. But, as people took charge of their own destiny, they shifted away from the environment, and began to adapt the invironment to themselves, providing more order in their existence. Environmental adaptation brought about the development of the technology needed to order the natural elements. This movement toward rationalization is fundamental to the economic modernization process (Ajami, Khambata, Kavoossi, 1992).

As the use of technology in the modernization process made societies more productive and efficient, production increases led to utilization of the economies of scale where trade increased. With the end of serfdom and feudal property systems, labor markets and enlarged capital markets were realized. Commercialization became more complete and complex, which gave rise to integrated market systems. This integration and consequent development of societal economics was and still is a crucial mechanism for the rationalization of exchange and distribution (Ajami, et al. 1992).

Market Integration and the Developing Nations of the Middle East

In subsistence economies, market integration is minimal and often non-existent. Producers and investors tend to be identical and dapends on prior accumulation of capital. Trade policies to help protect the owner of capital and reliance on heavy government expenditure have been the major components of the economic and trade policies and processes in these countries.

Markets in more sophisticated developing countries are often inefficient and dominated by heavy-handed state-owned enterprises. The primary trade is in raw materials or in processed matural resources. Other products, such as light manufacturing, strive to break through the international or regional markets. There is intense competition with neighboring economies for access to export markets. Since the government plays such a large role in the economics of less developed countries (LDCs) there is usually balanced trade, which is brought about by export/import controls.

If long-term growth and development is the objective, trade policy should be directed toward the eradication of inefficiencies existing in the various sectous of the LDCs. The role of trade must be viewed in developing countries as that of a distribution agent through which the unproductive sectors of the economy are channeled to other sectors where internalization and sector integration takes place. This developmental theories linking trade and economic integration to development.

Such theories stipulate that more rapid growth requires more investment in trade-based industries and manufacturing. The focus of trade and development theories is on increasing the flow of goods and serveces from the surplus sectors into the integrated markets, and on increasing the level of trade balances. This objective is not simply to increase aggregate trade, but to promote transferrable factors of production by increasing the ratio of differentiated investments to total trade.

Empirical evedence indicates that the elasticity of demand for goods and services is related to the stages of economic development. As markets become better organized, the range of products offered is widened. The higher the level of economic development, the more integrated an economy becomes. This allows markets to produce a wide variety of goods and serveces.

Empirical studies have established that trade among the persian Gulf states of the Middle East is not unrestricted, but is fairly protectionist (Foreign Trade Barriers, 1993). This evedence indicates that there is no proper channel leading to the utilization of the respective country's comparative advantage or corporate competitive advantage. The absence of coordinated and enforced intellectual property protection serves as a further deterrent. Government procurement, standards, labeling and export subsidies are common practice.

It seems that markets in the Middle Eastern countries provide goods and serveces to the public, but do little in the way of channeling surplus goods or serveces into productive sectors, either domestically or across national boundaries. Market distortions caused by government intervention and inadequate transportation prevents free flow of goods and serveces produced.

Table 1: Selected Middle East Countries Trade Barriers

	Intellectual Property Protection		Standards	Government Procurement	Other
	Copyrights	Patents	Certification	Purchasing Domestic	Export Subsidies
Bahrain	-	*	-	*	-
Iran	-	*	*	-	*
Kuwait	-	-	-	*	*
Oman	-	-	-	*	*
Qatar	-	-	-	*	*
Saudi Arabia	*	*	*	*	*
U.A.E.	-	-	-	*	*

source: Compiled from Foreign Trade Barriers, Washington D.C., 1993

Islamic Economics and Integration

The previous discussion points to primary issues of concern in the development of a free trade association among developing countries, including the Middle East. These issues include:

* socio-economic differences
* level of economic development
* political factors and consideratios
* cultural factors, such as religion and language

As stated eartier, the basic function of trade is to act as the arbiter of consumption and production in channeling goods and serveces as an efficient allicator of factors of production in a free-moving trade environment. This process furthers economic growth and the "subsequent" economic development, which is desperataly needed today in most Middle Eastern nations. The challenge is to devese a system that promotes this activity while preserving the current standard of living in the participating nations as well as Islamic values.

The Islamic evaluation of modern free trade associations centers around the Western concept of comparative advantage. Islamic economists fault contemporary Wastern free trade practices on four accounts:

1 . the western economic system does not take into account social welfare conditions of the society.

2 . it legitimizes and perpetuates wealth and income inequalities.

3 . those with control and greater access to factors of production can direct resources into production and serveces harmful to society.

4 . market forces are blind and indiscriminate.

The fundamentalists and Islamists (centrists), who aspire to restore Islam to its original purity and escape from alien influences, have attempted to prove the suitability and adaptability of Islamic doctuine of economics to the needs of modern times. They have further developed the concept of Islamic economics, with its functional components consisting of trade, banking and finance.

The sponsors of these concepts argue that Islamic economics is not much different from the familiar Western economics that prevail the world over. The only difference is that Islamic economics are not based on Adam Smith's style of capitalism. From this perspective, the Islamic pattern of trade not only does not lead to inequality among nations, it further reduces existing inequalities.

Economic Features and Issues of the Middle East

There has been a general economic stagnation in the Mideast region since the early 1980s. While the region performed fairly well in the 1970s, annual economic growth declined sharply to an average of 0.5% per year in the 1980s and did not improve significantly in the 1990s, in spite of its good resource endowment. However, in studying this phenomenon four additional factors should be taken into account to illustrate some of the distortions at work.

First, about one half of the region's food comes from outside the region with little inter-regional agricultural trade given the similarity of crop production. The only two countries capable to some degree of food and agricultural exports, Iran and Iraq, have remained inactive or incapacitated for various reasons:

* an eight year Iran-Iraq war diverted national resources away from agriculture;

* the Gulf war and the subsequent United Nations economic and trade sanctions on Iraq.

Secondly, the region's industrial base remains extractive. For the region as a whole, it is estimated that extractive industries generated more than two thirds of the value added in the economy, dominated by petroleum and natural gas. Generally, industrial development in the region indicates some progress. Nevertheless, the role of manufacturing in the regional economy remains limited in comparison with other developing countries, such as India, Turkey, Indonesia, Malaysia, Singapore or China. The pattern of international trade reveals a high degree of edpendency on OECD countries, in particular in the areas of transfer of technology or sources of capital. It is estimated that less than 6% of the region's exports to the OECD represents manufactured goods. The larger portion of the region's imports are manufactured products developed in industrialized countries. The region relies heavily on foreign patents, technical know-how, engineering designs and management.

Another factor to consider is that, with a few exceptions, many countries in the region may be facing a water crisis in the not too far future. Most water supplies are cross-national, leading to increased tension and possible conflict, giving greater urgency for cooperation on this front. This is important because if water resources are not adequately shared, it can lead to an actual process of economic protectionism and a possible trend towards disintegration.

Finally, on the issue of economic management, the largest economies in the region suffer from chronic economic problems. Iran is faced with unemployment, high inflation and a high debt burden, aggravated by U.S.-imposed sanctions in 1995. Iraq, faced with United Nations sanctions, suffers from the most fundamental economic problems and a deterioratiog infrastructure. Saudi Arabia suffers from high dual trade and budget deficits, and a widening income disparity. Bahrain, Kuwait, United Arab Emirates and Qatar have successfully stabilized their economies in the aftermath of the persian Gulf War and declining oil revenues while facing increased military expenditures, and have successfully resumed a path towards stable economic growth. However, others such as oman and Yemen are still confronted with enormous challenges and systems of governments that lack responsiveness, accountability and predictability. perhaps with the exception of Iran, this is true for most of the nations discussed above.

Table 2: Direction of Trade, the Three Largest Economies in the persian Gulf, 1993 (billions of USS)

	Imports	Exports
Iran	16.0	12.0
Saudi Arabia	30.0	22.0
U.A.E.	20.0	24.5

Source: Direction of Trade Statistics, International Monetary Fund, 1994

In addition, the following elements serve as forceful limits to an effective integ ration arrangement:

* Legal and political uncertainteis;
* slow down of privatization process in some of the key countries, including Iran;
* underdeveloped financial markets.

Nevertheless, some basic elements for economic integration seem to exist and are potentially promising:

* the region is relativrly rich in resources; two-thirds of the total known oil and gas reserves ara located in the region
* the proximity of the region to Europe, Africa and the markets of the newly independent states (NIS), as well as Indonesia, Thailand, Malaysia and Singapore, is a strategic significance in the international economic order
* the region has a diversified, relatively large skilled and inexpensive

labor force

* the existence of an entrepreneurship tradition absent in many other parts og the world. A historical experience with self initiative and a private enterprise orientation.

Motives for Mefta

Closer trads links between Middle Eastern countries will generate gains for the member states. First, there will be a specialization and efficiency gains from the exploitation of the traditional comparative advantages of trading partners, gains from the availability of a greader variety of goods, and, possibly efficiency gains from economies of scale and increased competition. Second, first-round gains in efficiency and output will provide a second-round boost to output over the medium-term. Increased efficiency in the first-round will raise the return to capital,thereby leading to increased to investment. Saving will also rise, either because of higher returns to saving or because part of the initial increase in output is saved - or both. In an empirical study (Levin and Renelt, 1992), resarchers provide evidence of increased openness leading to higher levels of investment. The second-round effect could the from of permanent increase in the greater rate of output if there are sufficient spillovers or economies of scale.

In theory, such growth could happen in several ways. For example, trade integration could allow firms to spread the cost of research and development over a larger market, thus reducing unit costs and encouraging greater innovation and technical progress. This can, in turn, generate positive spillovers as successful innovations are applied more broadly. Furthermore, intrgration can also boost productivity growth allowing increased specialization. In this regard MEFTA is not going to be any different than other integration arrangements such as NAFTA.

Estimating the actual gains from growing trade integration is very difficult. However, MEFTA would need to implement the following recommendations to start with.

* abolition of all quantitative import restrictions; from member states; and
* extended preferential access for agriculture exports to member states.

Several other motives can be advanced towards the creation of MEFTA. Generally, economic integration is advocated for political reasons. It tends to reduce conflict, providing a common ground for shared interests, thereby enabling countries to direct resources to economic development. Economic factors are equally important. Cooperation in trade enlarges markets, improves terms of trade of the regional trade blocks in relation to the rest of the world by increasing leverage and possibly by their bargaining power. It allows for the emergence of efficient manufacturing and possible recognition of the comparative advantage of nations. Economic integration increases production arising from specialization. It induces changes affecting factor inputs: capital flows can improve allocation of resources between countries. Many infrastructural and environmental projects can only be implemented in a regional context; such projects hold the promise of contriguting both to economic prosperity and a lasting peace. Bu clarifying the parameters of an eventual MEFTA, trade may increase the welfare of the integrated groups by utilizing the economies of scale, free flow of goods and services, capital flow and the subsequent increases in jobs and income.

MEFTA: Prospects and Limitations

While much of the world is moving towards economic blocks, the Middle East seems to have fallen behind this trend. This may be attributed to several socio-ecomomic factors hindering the process, not unlike those found in other regional groupings:

1 . inadequate willingness on the part of the political leadership in many countries to move beyond parochialism to regionalism, resisting possible diminution of national sovereignty.

2 . uneven lavels of economic development as well as significant differences in economic systems of potential participants.

3 . uneven market sizes and the sizes of GNPs, which puts fears in the minds of the smaller states of domination by the their bigger neighbors.

4 . absence of grassroots consumer groups, business interest groups to advance and embark on a national dabate on the issues relating to integration. In general this refers to the inadequacies and unrepresentative nature of many Middle Eastern states.

5 . no clear engine of economic growth or powerhouse in the region that can esrve as a possible Germany of the Middle East to pull along others, at least in the initial stages. However, prospects for a potential MEFTA remain promising.

While past records are not very encouraging and many hurdles remain in place, an empirical study demonstrates the advantages of integration can be significant for the region (Zarouk, 1992). This study indicates that a 100% removal of tariff barriers among the Arab Middle Eastern nations will increase inter-region trade by about 1.5 billion dollars at the and of the first 5 years of the implementation, and by 5.2 billion dollars at the end of ten years.

Conclusion

As suggested here, modernization and development may be described as the rationalization of the way life and activities are organized. This concept also applies to the development of integrated markets. As market integration theory postulates, there is a process of rationalization that markets must pass through in order to contribute to the development of their respective economies. In order for the rationalization process to commence, two important changes must occur. The first must be a change in attitude towards integration as a means for furthering economic development and modernization. If the complimentary relationship that exists between integration and development is not accepted, trade will not be seen as a tool for development. If this attitude change does not occur, market intermediaries, i.e., free trade associations, will be useless as channels through which comparative advantage can be attained and economies of scale can become useful. The second change must occur in the marketplace itself. policies must be instituted that will free up trade by developing intra-region channels and permit them to efficiently allocate surplus resources.

This to not to imply that government should completely bow out of the picture. Government investment contributes the largest part of the total investment in most Middle Eastern countries, and it has not yet been established that private investment would increase enough to maintain appropriate development levels if government reduced its activities. Consequently, there may be a case for government entry into the market, possibly in the form of government guarantees, financial as well as technical assistance and for providing working capital to importers exporters, as long as its function is to stimulate competition among private firms. Government interaction in the Middle East is part of the sociological limit to development of these markets, and might well be the most forceful deterrent.

The conditions necessary for the Middle East to transform itself into a free trade association currently do not exist. Middle Eastern countries have only succeeded in providing a framework within which the number of states have transformed and corrected their relations with one another based on bilateral or multilateral arrangements. As global competition increases and countries within trading blocks gain added advantage, Middle Eastern countries need to forge closer ties to remain viable and relevant in the 21st century.

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