

The Development of Trade and Foreign Direct Investment under the Influence of the Barcelona Process – An Initial Assessment¹

Paper presented at the Conference
“Middle East and North African Economies –
Past Perspectives and Future Challenges”
(Brussels, 2-4 June 2005)

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Brussels

Version 3
August 2005

¹ The author would like to thank M. Dodini, F. Hansen, G. Krause, J. Leandro, B. Martens, C. Rames, M. Villani (EU Commission) and participants of the “Euro-Mediterranean Economic Transition Conference” in Brussels (April 2005) for valuable discussions and helpful comments. Thanks are also due to colleagues from Eurostat who have provided both advice and data. The author is also grateful to S. Bland and S.J. Ortelli for their critical and efficient editing. Comments are welcome and can be sent to arno.baecker@cec.eu.int.

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Summary

The creation of a Euro-Mediterranean Free Trade Area (EMFTA) as a catalyst for economic growth is a central objective of the Barcelona Declaration, which was adopted by the European and Mediterranean Foreign Affairs Ministers in 1995. The EMFTA shall be realised gradually through Euro-Mediterranean Association Agreements and free trade agreements between the Mediterranean partners. The Barcelona Declaration built on earlier cooperation between the EU and the Mediterranean partner countries, which included a unilateral opening of EU markets mainly for industrial products from the Mediterranean by the end of the 1970s. However, most Mediterranean countries started opening their markets for industrial products from the EU only recently. The establishment of complementary free trade areas among the Mediterranean countries is only just beginning.

This paper aims at an initial assessment of the impact of the Barcelona Process on trade and FDI which is mainly based on the direct interpretation of source data. It appears that Mediterranean countries which committed early to trade liberalisation and accompanying economic reforms under the terms of the Association Agreements generally also experienced a better trade performance with the EU than their peers. In spite of this, only a few Mediterranean countries increased their market share of world exports to the EU from 1995 to 2003, while the EU's market share in the Mediterranean remained fairly constant. This reflects the asymmetric trade liberalisation and the possibility that exporters in some Mediterranean countries were operating in unsatisfactory business climates. There is evidence of a considerable unexploited trade potential between EU and Mediterranean countries but trade liberalisation in the Mediterranean countries needs a complementary strengthening of the private sector and business environment.

The Barcelona Declaration also stresses the importance of improving the domestic business climate as a basis for investment, both domestic and foreign. Countries which committed themselves early to reforms by Association Agreements were able to attract more foreign direct investment in relation to their GDP than their peers. Yet, FDI inflows into the Mediterranean countries remain relatively low by international standards. In general, EU exports and FDI towards the Mediterranean countries are positively correlated. This indicates that, overall, EU exports and FDI are complements, and that features such as intra-firm trade probably prevail over export-substituting FDI. This seems to point to a somewhat advanced degree of EU-Mediterranean integration. Indeed there are key examples for labour division between the EU and Mediterranean countries.

1. Introduction

On 27 and 28 November 1995 the Euro-Mediterranean Conference of Ministers of Foreign Affairs held in Barcelona initiated the Euro-Mediterranean Partnership (*Barcelona Process*). The *Barcelona Process* has ambitious, long-term objectives, “turning the Mediterranean basin into an area of dialogue, exchange and cooperation guaranteeing peace, stability and prosperity”.³ It rests on three pillars: a political and security partnership, economic and financial partnership, and social, human and cultural partnership. The establishment of a free trade area (FTA), by the year 2010 as an original target date, is one of the central economic objectives of the partnership as a catalyst for economic growth (Box 1).

The EU’s initial partners in the Barcelona Process were Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, the Palestinian Authority, Syria, Tunisia, and Turkey. Since then, Libya has been given observer status at certain meetings as a future Mediterranean partner country. In addition, the EU and Turkey established a customs union on 1 January 1996, and Turkey officially became a candidate for EU membership in 1999. Cyprus and Malta joined the EU on 1 May 2004. Despite the changes in the status of Cyprus, Malta and Turkey, these countries are included in this study because they were original Barcelona partner countries in the reporting period 1995 to 2003.⁴ Furthermore, the fact that Cyprus, Malta and Turkey initiated far-reaching reforms at a relatively early stage distinguishes them from the other Mediterranean partners and allows interesting comparisons. After all, trade liberalisation and accompanying economic reforms, which create a favourable business climate and prompt more investment, are worth realising regardless of whether there is the prospect of EU membership.

Table 1: Basic agreements between the EU and MPC

	Association Agreement	Cooperation Agreement	Euro-Mediterranean Association Agreement			ENP Action Plan
	into force		signed	trade provisions into force	into force	
Algeria	-	1 November 1978	22 April 2002	-	1 Sept. 2005	-
Egypt	-	1 November 1978	25 June 2001	1 January 2004	1 June 2004	-
Israel	-	1975	20 November 1995	1 January 1996	1 June 2000	x
Jordan	-	1 November 1978	24 November 1997	-	1 May 2002	x
Lebanon	-	1 November 1978	17 June 2002	1 February 2003	1 March 2003 ^a	-
Morocco	-	1 November 1978	26 February 1996	-	1 March 2000	x
Palestinian Authority	-	-	24 February 1997	-	1 July 1997 ^a	x
Syria	-	1 November 1978	pending	-	-	-
Tunisia	-	1 November 1978	17 July 1995	-	1 March 1998 ^b	x
Cyprus ^c	1 June 1973	-	-	-	-	-
Malta ^c	1 April 1971	-	-	-	-	-
Turkey ^d	1 December 1964	-	-	-	-	-

Source: European Commission.

^a Interim Agreement.

^b Tunisia has unilaterally anticipated the implementation for industrial products from 1 January 1996.

^c A customs union was one of the long-term objectives of the Association Agreement but did not enter into force before the country became an EU Member State on 1 May 2004.

^d A customs union between the EU and Turkey entered into force on 1 January 1996. Turkey is a recognised candidate for EU Membership since 1999.

Economic and political cooperation between the EU and the Mediterranean began already a long time before the Barcelona Declaration. The EU and Turkey, for instance, signed an Association Agreement which entered into force in 1964. Malta and Cyprus followed also with Association Agreements at the beginning of the 1970s (Table 1). In the economic field these included the long-term objective of a customs union, and a timetable for reciprocal but asymmetric trade

³ See: Barcelona Declaration, http://europa.eu.int/comm/external_relations/euomed/bd.htm.

⁴ This also allows for comparisons with studies by Eurostat and other international institutions such as the ECB.

liberalisation on the basis of preferential treatment granted by the EU. The customs union with Malta and Cyprus was eventually put in place when they entered the EU in 2004.

Israel was a frontrunner in another group of countries which signed Cooperation Agreements with the EU. Its 1975 Cooperation Agreement followed up on an earlier agreement dating back to 1970. The 1975 Agreement with Israel already envisaged a free trade area for industrial goods with reciprocal liberalisation. In that respect it reflected the advanced development of the Israel's economy and was more comprehensive than the Cooperation Agreements with the other Mediterranean partners, which entered into force in 1978. However, these Cooperation Agreements included preferential trade arrangements granted by the EU.⁵ Customs duties on industrial products were phased out one year after the signature of the Agreements, and quantitative restrictions were abolished, apart from agricultural products and certain textile products. In addition, tariff concessions were granted for certain agricultural products. In exchange for this, the EU obtained Most Favoured Nation (MFN) status. But the Mediterranean countries were still entitled to introduce new customs duties or quantitative restrictions.

The EU's Mediterranean partners form a heterogeneous group of countries in many aspects (Table 2) and their different characteristics are fundamental determinants of trade and FDI. The population size ranges from nearly 70 million in Turkey and Egypt to 10 million or less in most other countries.⁶ The surface area of the smallest countries, which has an impact on transaction costs, represents less than 1% of Algeria's 2 382 000 square kilometres. GNI at purchasing power parities varies from USD 438 billion in Turkey and USD 253 billion in Egypt to less than USD 60 billion in most other countries. Israel qualifies as the only high income country with a GNI per capita of USD 16,020 and most others are lower middle income countries with a GNI per capita of less than USD 2,000. The unemployment rate is particularly high in Algeria and Morocco (29.8% and 25.5%) and lowest in Egypt (9%), on the basis of official figures.

The relative importance of the different economic sectors also varies substantially between the Mediterranean countries. The agricultural sector is the largest in Syria (23% of GDP) and negligible in Jordan (2% of GDP). Industrial production embodies 53% of GDP in Algeria (due to the dominance of the hydrocarbon industry) and 13% in the West Bank and Gaza. The latter has the highest services share at 80%, followed by Jordan with 72%. Services represent 50% of GDP in all countries except for Algeria (37%).

Table 2: Major trade and FDI relevant features of MED economies 2002

	Pop., million	Surface, 1000 sq. km	GNI p.c., USD	GNI, billion USD	PPP GNI, bn USD	GDP, billion USD	Structure of output (% GDP)				unempl. rate 2000- 02
							Agric.	Industr.	Man.	Serv.	
Algeria	31	2382	1,720	53.8	173	55.9	10	53	8	37	29.8
Egypt	66	1001	1,470	97.6	253	89.9	17	33	19	50	9.0
Israel	7	21	16,020	105.2	125	103.7	..	..	..	..	10.3
Jordan	5	89	1,760	9.1	22	9.3	2	26	16	72	13.2
Lebanon	4	10	3,990	17.7	20	17.3	12	21	10	67	..
Morocco	30	447	1,170	34.7	111	36.1	16	30	17	54	..
Westbank & Gaza	3	..	1,110	3.6	..	3.4	6	13	11	80	25.5
Syria	17	185	1,130	19.1	59	20.8	23	28	25	49	11.2
Tunisia	10	164	1,990	19.5	63	21.0	10	29	19	60	..
Cyprus	0.8	9.3	12,320	9.4	14	..	..	..	..	..	..
Malta	0.4	0.3	9,260	3.7	7	..	..	..	..	..	..
Turkey	70	775	2,490	173.3	438	183.7	13	27	17	60	10.6

Source: World Bank, World Development Indicators 2004.

⁵ See Inama, S. and L. Jachia (2000), "Assessing Market Access Preferences for Mediterranean Countries on the EU Market for Industrial Goods", Economic Research Forum for the Arab Countries, Iran and Turkey (ERF), Egypt, *Working Paper*, No. 2013.

⁶ Source: 2002 data from the World Bank, World Development Indicators 2004.

Box 1: Excerpts from the Barcelona Declaration on the establishment of a Euro-Mediterranean Free Trade Area¹

Free trade area

“The free-trade area will be established through the new Euro-Mediterranean Agreements and free trade agreements between partners of the European Union. The parties have set 2010 as the target date for the gradual establishment of this area which will cover most trade with due observance of the obligations resulting from the WTO.

With a view to developing gradual free trade in this area: tariff and non-tariff barriers to trade in manufactured products will be progressively eliminated in accordance with timetables to be negotiated between the partners; taking as a starting point traditional trade flows, and as far as the various agricultural policies allow and with due respect to the results achieved within the GATT negotiations, trade in agricultural products will be progressively liberalized through reciprocal preferential access among the parties; trade in services including right of establishment will be progressively liberalized having due regard to the GATS agreement. The participants decide to facilitate the progressive establishment of this free-trade area through:

- the adoption of suitable measures as regard rules of origin, certification, protection of intellectual and industrial property rights and competition;
- the pursuit and the development of policies based on the principles of market economy and the integration of their economies taking into account their respective needs and levels of development;
- the adjustment and modernization of economic and social structures, giving priority to the promotion and development of the private sector, to the upgrading of the productive sector and to the establishment of an appropriate institutional and regulatory framework for a market economy. They will likewise endeavour to mitigate the negative social consequences which may result from this adjustment, by promoting programmes for the benefit of the neediest populations;
- the promotion of mechanisms to foster transfers of technology.”

“... the participants ... affirm that regional cooperation on a voluntary basis, particularly with a view to developing trade between the partners themselves, is a key factor in promoting the creation of a free-trade area...”

Annex:

Work Programme for the Establishment of a Euro-Mediterranean Free Trade Area

“The establishment of a free trade area in accordance with the principles contained in the Barcelona Declaration is an essential element of the Euro-Mediterranean partnership. Cooperation will focus on practical measures to facilitate the establishment of free trade as well as its consequences, including:

- harmonizing rules and procedures in the customs field, with a view in particular to the progressive introduction of cumulation of origin; in the meantime, favourable consideration will be given, where appropriate, to finding ad hoc solutions in particular cases;
- harmonization of standards, including meetings arranged by the European Standards Organisations;
- elimination of unwarranted technical barriers to trade in agricultural products and adoption of relevant measures related to plant-health and veterinary rules as well as other legislation on foodstuffs;
- cooperation among statistics organizations with a view to providing reliable data on a harmonized basis;
- possibilities for regional and subregional cooperation (without prejudice to initiatives taken in other existing fora).”

¹ Adopted at the Euro-Mediterranean Conference of Foreign Affairs Ministers on 27/28 November 1995.

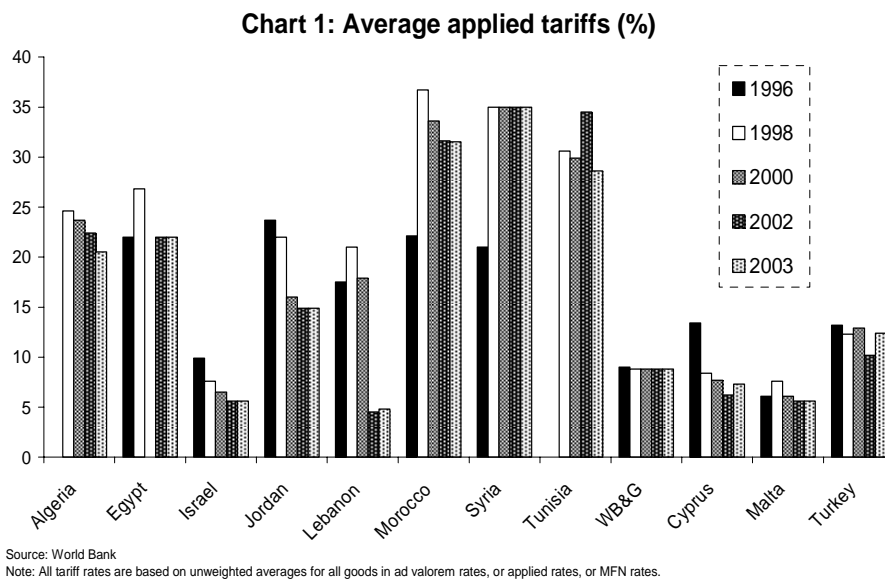
2. Trade provisions of the Association Agreements

The Barcelona Process has reinforced the relationships with the Cooperation countries through more comprehensive Euro-Mediterranean Association Agreements. They now shape the relationships with all Mediterranean partners, apart from Syria (the initialled Agreement awaits signature). The Association Agreements in force have prompted progressive tariff dismantling in

industry and agricultural preferences. Moreover, other work on trade and trade-related matters has been launched, such as the diagonal cumulation of origin within the Euro-Mediterranean area, services liberalisation at regional level and, more prudently, trade facilitation and approximation of product legislation and standards. In parallel, partners have been requested to conclude South-South free trade areas among themselves as an essential complement of the regional liberalisation efforts.

Trade liberalisation under the terms of the Association Agreements is reciprocal but asymmetric. In addition to the duty- and quota-free access for all industrial products, which the EU granted already in the Cooperation Agreements, the Mediterranean countries will open their markets gradually over a transitional period of up to 12 years.⁷ In principle, the degree of liberalisation of industrial trade depends on product groups, and in some countries it begins only after a transition of several years. However, Tunisia has anticipated the implementation of the trade liberalisation for industrial products on 1 January 1996, before the Association Agreement entered into force.

The envisaged liberalisation of agricultural trade is still very limited but will be reconsidered on the basis of revision clauses included in the Association Agreements. Even more important is the new approach to regional liberalisation of agricultural trade shortly to be presented by the European Commission. The Association Agreements also include a commitment to negotiations on services liberalisation not later than five years after they enter into force. This time has elapsed in the case of the West Bank and Gaza, and Tunisia. The possibility to start services negotiations is foreseen in the Framework Protocol adopted at Euro-Mediterranean Ministers level in 2004 and likely to occur soon.



The European Neighbourhood Policy, launched in 2003, strengthens the Association Agreements through bilateral Action Plans. They build on the above-mentioned initiatives in the Euro-Mediterranean context and identify joint priority actions, in particular in trade and trade-related areas, which are to be implemented in the short and medium term. By the end of 2004 Action Plans had been adopted with Israel, Jordan, Morocco, the Palestinian Authority and Tunisia. Furthermore, some Mediterranean partners had committed themselves to South-South sub-regional trade liberalisation in addition to the bilateral trade liberalisation with the EU. In February 2004 Egypt, Jordan, Morocco and Tunisia signed a regional free-trade agreement

⁷ The original deadline announced in the Barcelona Declaration was 10 years.

(Agadir Agreement) which creates an important link between Maghreb and Mashreq countries. Morocco, the Palestinian Authority, Tunisia and Syria also concluded free-trade agreements with Turkey.

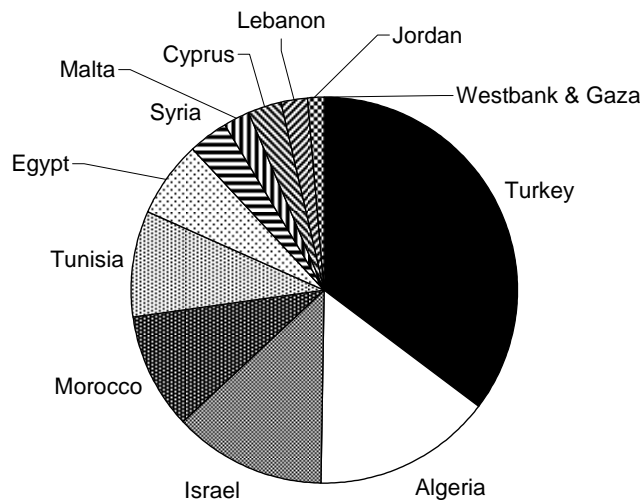
A simple comparison of the average MFN tariffs shows that countries which started liberalising trade with the EU at an early stage, such as Cyprus, Malta, Turkey, and later Israel and the Palestinian Authority, also applied substantially lower average tariffs than their peers (Chart 1). Apart from Egypt and Syria, which followed only in 2004, all countries lowered their average tariffs at the beginning of the new millennium. The reduction in Lebanon was particularly pronounced. However, Algeria, Lebanon, Syria, and the West Bank and Gaza are not WTO members. They are therefore not obliged to grant MFN status to each trading partner.

3. Trade developments⁸

3.1. EU-Mediterranean trade in goods

Trade flows between the EU and individual Mediterranean countries vary widely depending on fundamentals such as the size of their economies, transaction costs, in particular transport costs, and direct and indirect tariffs (Chart 2).⁹ In 2003 Turkey accounted for more than 1/3 of Mediterranean exports and imports with the EU. Algeria, Israel, Morocco and Tunisia together represent almost 1/2 of EU-Mediterranean trade (Algeria 15%, Israel about 13%, and Morocco and Tunisia almost 10% each). Egypt, Syria, and to a lesser extent Malta, Cyprus, Lebanon, Jordan and the Palestine Territories shared the remaining 20%.

Chart 2: Share in total EU trade 2003 (%)



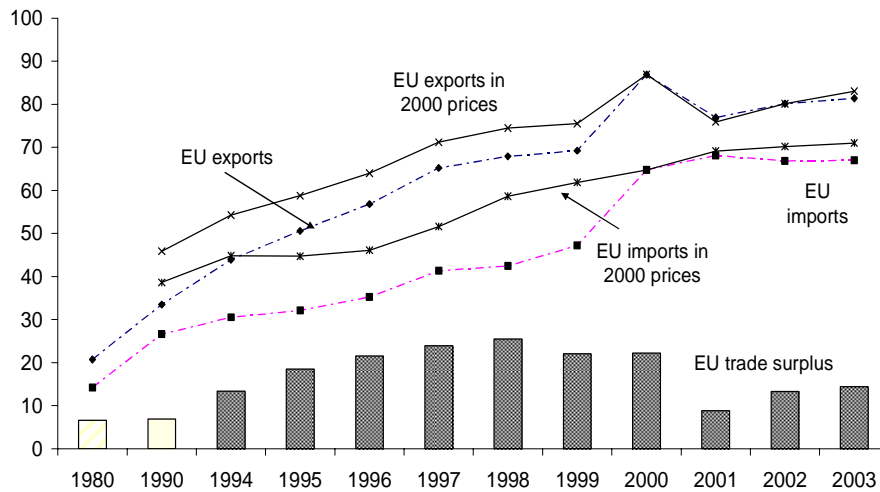
Source: European Commission.

⁸ Data sources used in this section are Eurostat (NEW CRONOS) and the IMF Department of Trade Statistics if not specified otherwise.

⁹ If exports and imports are analysed separately, the real exchange rate must also be taken into account. Trade flows can be predicted quite accurately by gravity models which include these factors. See for instance International Monetary Fund (2004), "Tunisia: Selected Issues", *Country Report*, No. 04/360, November and International Monetary Fund (2004), "Morocco: Selected Issues", *Country Report*, No. 04/164, June.

Trade in goods between the EU and Mediterranean has markedly increased over the last ten years (Chart 3). In 2003 the value of EU exports to the Mediterranean amounted to EUR 81.4 billion. That was almost 61% more than in 1995, the year of the Barcelona Declaration. Over the same period EU imports from the Mediterranean grew by almost 109% to EUR 67 billion. Trade increased particularly in 2000 due to a strong increase in exports to Turkey (10 billion EUR) after a sudden real appreciation of the Turkish lira (Table 3). The fact that EU imports grew more strongly than its exports can be attributed to the EU's unilateral market opening for industrial products at the end of the 1970s which eliminated significant trade barriers and made Mediterranean exports more susceptible to market forces. This applies also to EU trade with the former Cooperation Agreement countries more specifically.¹⁰

Chart 3: Trade between EU and MED (billion EUR)



Source: European Commission.
 Note: 1980 EU-9; 1990, 1994 EU-12; from 1995 EU-15. Unit values for EU trade with the "MED Basin" served as a proxy for the relevant MED price indices.

Trade values

The fact that some Mediterranean countries committed themselves early on to trade liberalisation and economic reform under the terms of Association Agreements is also clearly visible. EU exports to Tunisia, Morocco and Jordan, where the agreements entered into force at an early stage, grew much more than exports to their peers, except for Algeria which plays a special role as a major oil exporter (Table 3). EU trade with Turkey was also particularly dynamic as a result of the creation of the customs union in 1996.

EU exports to the Mediterranean exceeded imports in every year since 1995 (Chart 3). The EU's trade balance surplus reached its peak in 1998 (EUR 25.5 billion), subsequently falling to EUR 14.4 billion by 2003. The sharp drop in the surplus in 2001 was the result of a surge of energy prices and prices for other raw materials on the world market which were not compensated, unlike the previous year, by exceptionally high exports to Turkey. Only the EU trade balances with oil exporters Algeria and – apart from 1994 and 1998 – Syria were permanently in deficit (Tables 3 and 4). On average the balance amounted to EUR 7.2 billion and EUR 1.6 billion during the period 2001-2003. The EU's largest average surpluses over the same period were recorded with Israel, Egypt and Lebanon (EUR 4.6 billion, EUR 2 billion and EUR 2.9 billion respectively).

¹⁰ EU exports to the former cooperation countries grew by almost 44% (40% excl. Algeria) while imports grew by about 95% (63% excl. Algeria).

Table 3: EU exports of goods by destination, billion EUR

	1980	1990	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	growth since 1995, %
Algeria	5.3	5.0	4.6	4.7	4.1	4.4	5.3	5.2	6.1	7.5	8.1	7.8	64.5
Egypt	3.6	4.2	4.6	5.0	5.8	6.8	7.6	7.9	7.9	6.9	6.3	6.0	19.5
Israel	1.8	5.2	9.0	9.7	10.4	11.5	10.9	12.9	15.8	14.5	13.5	11.4	18.1
Jordan	0.8	0.8	1.0	1.0	1.2	1.2	1.1	1.2	1.6	1.8	2.0	1.8	73.9
Lebanon	1.2	0.8	2.2	2.5	2.7	3.1	2.8	2.7	2.9	3.1	3.0	3.3	34.0
Morocco	1.8	3.6	4.4	4.7	4.7	5.3	6.6	6.6	7.7	7.5	7.7	8.1	70.7
Syria	1.2	0.8	1.6	1.4	1.4	1.4	1.5	1.7	1.8	2.1	2.1	2.1	54.6
Tunisia	1.8	3.0	3.8	4.2	4.3	5.3	5.8	6.0	7.3	8.0	7.6	7.2	72.3
MED8 ^a	17.6	23.3	31.2	33.2	34.7	38.9	41.6	44.2	51.1	51.3	50.2	47.7	43.6
<i>excl. Algeria</i>	12.3	18.3	26.5	28.5	30.6	34.5	36.4	39.0	45.0	43.8	42.1	39.9	40.2
Cyprus	0.6	1.3	2.0	2.0	1.9	2.0	2.1	2.4	3.1	2.9	2.9	2.9	46.4
Malta	0.5	1.2	1.9	2.0	1.9	2.0	2.0	2.1	2.8	2.5	2.7	2.5	26.3
Turkey	2.0	7.7	8.9	13.4	18.3	22.4	22.2	20.6	30.0	20.3	24.3	28.2	110.9
MED11 ^a	50.6	75.1	101.6	112.3	122.2	138.6	145.9	152.5	183.0	172.1	172.4	169.0	50.5
<i>Extra EU</i>	212.1	355.2	476.7	573.3	626.3	721.1	733.4	760.2	942.0	985.8	997.2	979.6	70.9
<i>Africa</i>	39.5	44.9	45.8	51.6	53.4	52.1	58.7	56.9	66.1	69.9	69.0	69.2	34.2
<i>North Africa</i>	17.2	22.8	24.1	26.0	26.7	24.5	28.7	28.9	32.5	33.8	33.7	32.9	26.8

Source: European Commission.

Note: 1980 EU-9; 1990, 1994 EU-12; from 1995 EU-15.

^a Trade with West Bank and Gaza is described separately below because of different data sources and trade magnitudes.

Table 4: EU imports of goods by country of origin, billion EUR

	1980	1990	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	growth since 1995, %
Algeria	4.6	7.0	5.9	4.8	5.5	8.4	6.8	7.8	16.4	16.0	14.3	14.6	202.4
Egypt	2.4	2.3	2.8	2.2	2.8	2.6	2.5	2.4	3.4	3.1	3.2	3.4	55.1
Israel	1.8	3.5	4.1	4.7	5.3	6.3	6.9	7.6	10.0	9.6	8.5	7.5	60.6
Jordan	0.0	0.1	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.2	37.8
Lebanon	0.0	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.2	0.2	64.9
Morocco	1.4	3.1	3.7	4.0	4.2	4.8	5.3	5.6	6.0	6.2	6.3	6.2	55.0
Syria	0.9	1.2	1.6	1.7	2.0	2.0	1.5	2.2	3.4	4.1	4.1	2.8	63.6
Tunisia	1.4	2.3	3.0	3.4	3.6	4.0	4.3	4.8	5.5	6.2	6.0	6.1	82.5
MED8 ^a	12.5	19.5	21.3	21.0	23.7	28.4	27.7	30.7	45.2	45.8	43.0	41.1	95.2
<i>excl. Algeria</i>	8.0	12.5	15.4	16.2	18.2	20.0	20.9	22.9	28.8	29.7	28.7	26.4	63.2
Cyprus	0.3	0.6	0.6	0.7	0.6	0.4	0.4	0.6	1.0	1.0	0.7	0.9	24.7
Malta	0.3	0.6	1.0	1.1	0.8	0.7	0.8	0.9	1.0	1.2	1.1	1.0	-11.7
Turkey	1.1	5.9	7.5	9.2	10.2	11.9	13.6	15.1	17.5	20.2	22.0	24.0	160.0
MED11 ^a	34.7	58.6	67.3	69.3	77.2	89.8	91.0	100.8	138.7	143.6	138.5	134.5	94.0
<i>Extra EU</i>	281.1	404.4	474.3	545.3	581.0	672.6	710.5	779.8	1033.4	1028.4	989.2	992.8	82.1
<i>Africa</i>	43.7	49.8	46.3	46.9	52.3	56.8	53.1	57.0	83.9	87.1	81.2	81.6	74.0
<i>North Africa</i>	17.6	23.6	22.8	21.3	24.3	27.4	24.6	27.4	44.4	43.1	39.4	41.4	94.2

Source: European Commission.

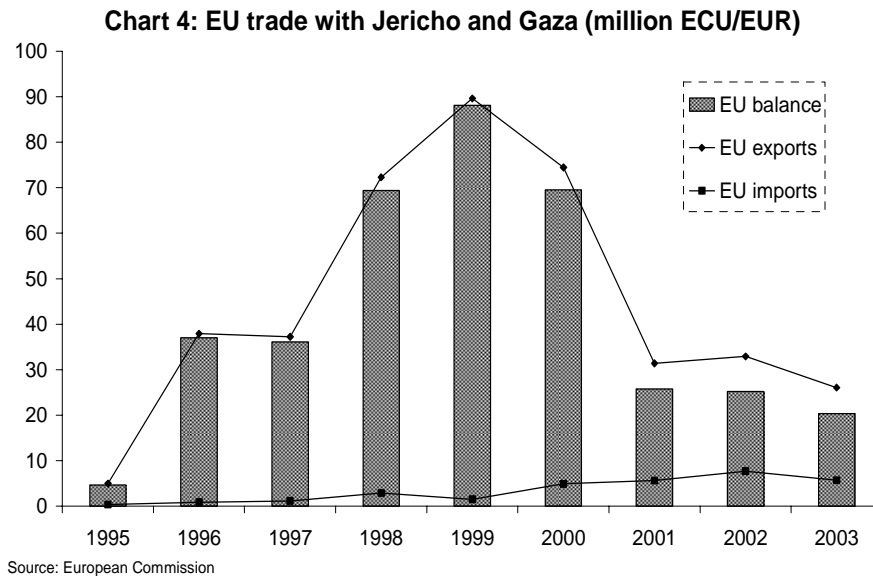
Note: 1980 EU-9; 1990, 1994 EU-12; from 1995 EU-15.

^a Trade with West Bank and Gaza is described separately below because of different data sources and trade magnitudes.

EU trade with the West Bank and Gaza, the smallest economy in the region, was of course proportionately smaller than the other bilateral EU-Mediterranean goods trades but nevertheless developed dynamically until the intifada (Chart 4).¹¹ Imports from the EU increased spectacularly, from EUR 5 million in 1995 to almost EUR 90 million in 1999. This reflects the gradual opening of markets for EU industrial products since 1997 and probably also aid inflows which were used for imports. Later on the regional political situation created border frictions which severely impeded trade. From the beginnings of the intifada in 2000 until 2003 imports

¹¹ The Palestine Territories are described separately here because of their much smaller trade-flow level with the EU. Moreover, the relevant data come from a different source (COMEXT instead of NEW CRONOS, both Eurostat).

from the EU fell again. However, they remained at least five times higher than in 1995 (EUR 26.1 million in 2003). Exports to the EU grew almost continuously, to EUR 7.7 million in 2002, before falling again to EUR 5.7 million in 2003. They only amounted to a fraction of imports, reflecting limited production capacity and border frictions. Therefore the trade balance with the EU was dominated by the pattern of EU exports.



Comparing the total trade of goods values of 1995, the year of the Barcelona Declaration, and of 2003 is helpful to summarise and to visualize that an early commitment to trade liberalisation and economic reforms in the Mediterranean countries has led to stronger commercial ties with the EU (Chart 5). Of course, this simple comparison has to be treated with some caution because of other important factors at play for trade development. But the data confirm, in principle, the expectation that the removal of trade impediments in the form of tariffs and non-tariff barriers can open a considerable potential for EU-Mediterranean trade and related efficiency gains.¹²

The factual development of total trade displays indeed considerable performance differences of the Mediterranean countries vis-à-vis the EU:

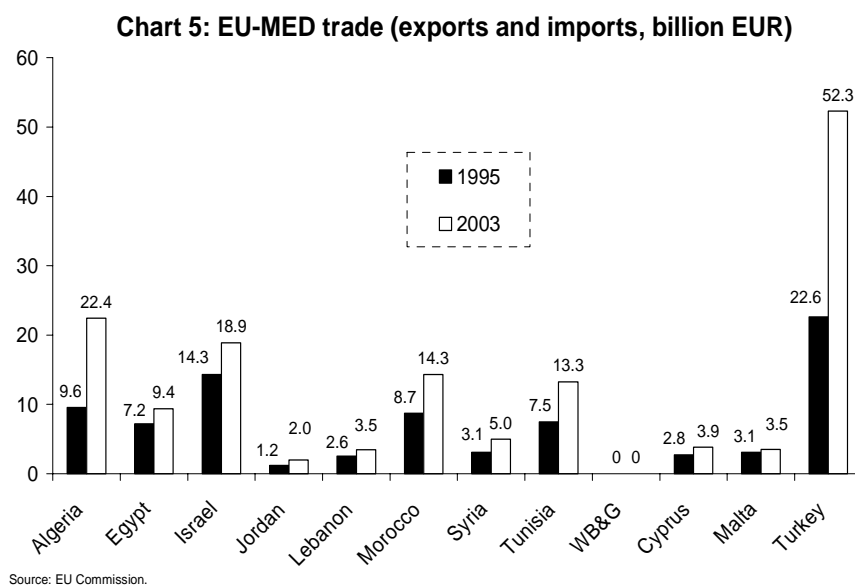
- Algeria (+134.3%) and Turkey (+131%) experienced the strongest trade increases. In Turkey's case it was the 1996 customs union with the EU that boosted trade, whereas Algeria, which signed an Association Agreement only in 2002, benefited from increasing hydrocarbon output which met EU demand. In fact Algerian exports consist predominantly of oil and natural gas.
- Tunisia, which anticipated trade liberalisation more than two years before its Association Agreement with the EU entered into force in 1998, expanded EU trade from 1995 to 2003 by almost 77%.
- Jordan and Syria saw trade growth with the EU of almost 70% and 60% respectively, although they are lagging behind in trade liberalisation with the EU (Table 1). But both countries started from a low level, and Syrian trade figures also reflect the favourable conditions for oil exports.

¹² This prima facie evidence is underpinned by an IMF study which controls for other factors such as GDP, location etc. on the basis of a 90-country (85% of world trade) gravity model for six Mediterranean countries (Egypt, Jordan, Morocco, Syria, Tunisia, and imports from Algeria). International Monetary Fund (2004), "Morocco: Selected Issues", *Country Report*, No. 04/164, June.

- Morocco, like Israel a frontrunner in liberalising via Association Agreements, expanded its EU trade by 63.5%. The smaller growth of Israeli trade can be explained to some extent by the fact that the country started trade cooperation with the EU already in 1970, and later strengthened it with the 1975 Cooperation Agreement. It might therefore be closer to its trade potential than Morocco.

- Association Agreements with Lebanon and Egypt entered into force only in 2003 and 2004 respectively, which partly explains their less rapid trade growth of 35.3% and 30.3%.

- Cyprus and Malta, which have maintained strong ties with the EU since the early 1970s (and became Member States in 2004), may have been trading close to potential for some time. This could explain their relatively modest trade expansion of 40.6% and 13.1% respectively.

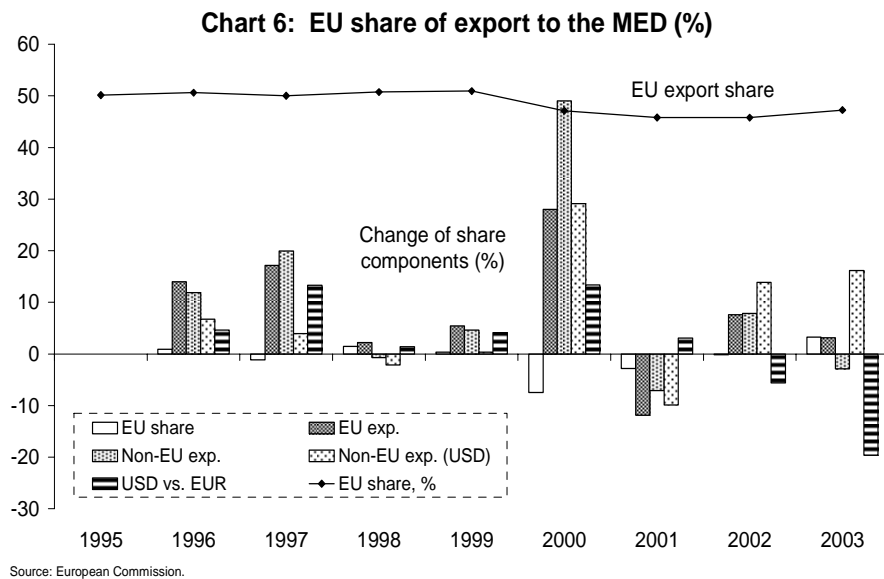


Market shares

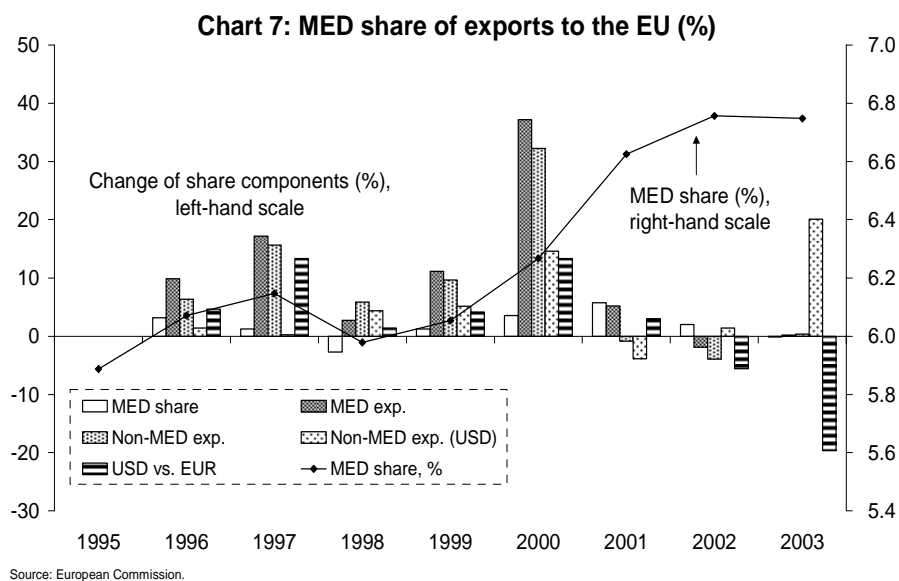
The EU's market share of world exports to the Mediterranean was relatively stable, taking into account statistical conversion effects. It ranged between 50% and 51% in the period from 1995 to 1999. On first sight, it declined subsequently to 45.8% in 2001 and 2002 but rose again to 47.3% in 2003 (Chart 6). However, these changes in market share are exaggerated due to a pure conversion effect since they are derived from euro values serving as numeraire.¹³ In order to draw a tentative conclusion about the conversion effect, non-EU exports were treated as dollar trade. It appears that the decline of the EU's market share in 2000 and 2001 and the recovery in 2003 were mainly the result of currency developments and not because of other competitive and structural changes. This result does not change in substance if EU exports to Algeria or to the old Association Agreement countries Cyprus, Malta and Turkey are excluded. However, trade

¹³ In principle, EU market shares are overstated (understated) during periods of euro appreciation (depreciation), because in the denominator the euro trade value of depreciating currencies diminishes (increases). General experience suggests that the EU's exports to the Mediterranean are predominantly invoiced in euro (Grassman's law) and that the Mediterranean's exports to the EU are invoiced in main trading currencies such as the dollar, euro, and pound sterling. See: European Central Bank, Review of the international role of the euro, Frankfurt am Main, 2005.

liberalisation in the Mediterranean countries was effective. The 1995-2003 growth of EU exports to early Association Agreement partners, except for Israel, was at least as high as the average growth of extra-EU exports (Table 3).



The Mediterranean’s market share of exports to the EU increased from 1995 on, but this was mainly caused by Turkish exports (Chart 7). The Mediterranean’s total market share increased initially from 5.9% in 1995 to 6.1% in 1997. After an intermediate reduction to around 6% in 1998 it rose continuously to 6.8% in 2002, before dropping marginally to 6.7% in 2003. It appears that the trend increase in the market share is not determined by the choice of the numeraire currency (a distortion described above). In fact, disaggregating the Mediterranean’s market share by country indicates that the increase was mainly caused by Turkish exports following the 1996 customs union. Algerian exports also contributed, but Algeria mainly exports oil and natural gas and benefited from steep oil price increases from 1998. This means that the exports of other countries rose at best in line with total extra-EU imports. Some countries even lost market share.



3.2. EU-Mediterranean trade in services¹⁴

Trade in services between the EU and Mediterranean more than doubled from 1995 to 2002 when it reached 33.3 billion EUR (Table 5). Despite a generally low degree of liberalisation, trade in services grew broadly in line with the trade in goods. This is mainly due to tourism. Consequently, the share of services trade in total trade was constant at about 20%. But it is far below the sector's proportion in the economies, as the services sector is the biggest sector in the EU and in all Mediterranean countries apart from Algeria, where hydrocarbon output dominates GDP (Table 2).

Table 5: EU-15 current account vis-à-vis the MED (billion EUR)^a

	1992-94 p.a. avg.	1995	1996	1997	1998	1999	2000	2001	2002	growth since 1995, %
Credit										
Current account	43.2	49.5	54.3	63.9	67.1	68.1	84.3	93.7	94.2	90.3
Goods ^b	32.4	37.8	42.0	49.0	52.7	51.8	64.8	70.9	73.8	95.4
Services	5.8	6.6	6.6	8.9	9.1	9.4	11.1	14.4	13.6	106.1
Transportation	1.9	1.8	1.8	2.5	2.3	2.1	2.8	3.4	3.2	79.9
Travel	1.0	1.7	1.9	2.3	2.4	2.5	3.0	3.8	3.9	126.7
Other services	2.6	2.9	2.9	4.1	4.4	4.8	5.3	7.0	6.3	117.0
Services not allocated	0.3	0.2	0.1	0.0	0.0	0.0	0.0	0.2	0.2	-3.2
Income	4.6	4.6	4.7	5.0	4.4	6.0	7.6	7.3	5.8	25.3
Current transfers	0.3	0.5	0.9	0.9	0.9	0.9	0.9	1.2	1.0	97.1
Debit										
Current account	41.2	45.6	49.6	56.5	56.4	61.7	80.9	98.9	93.6	105.1
Goods ^b	24.5	26.4	28.9	33.2	34.4	36.8	51.5	63.6	62.6	136.8
Services	9.0	9.7	10.8	12.6	12.2	13.9	17.7	20.6	19.7	102.9
Transportation	2.8	3.0	2.9	3.5	3.4	3.6	4.4	4.8	4.4	48.4
Travel	4.1	4.5	5.5	6.0	5.7	7.1	9.5	10.9	10.5	135.5
Other services	2.0	2.2	2.4	3.1	3.1	3.2	3.8	5.0	4.7	115.4
Services not allocated	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-36.6
Income	2.3	3.1	4.2	4.8	4.0	5.0	5.4	6.6	3.8	25.6
Current transfers	5.4	6.4	5.8	5.8	5.8	6.0	6.3	8.0	7.5	16.1
Net										
Current account	2.1	3.9	4.7	7.4	10.7	6.4	3.5	-5.2	0.6	-84.9
Goods ^b	7.9	11.3	13.1	15.8	18.3	15.0	13.3	7.2	11.2	-1.2
Services	-3.1	-3.1	-4.1	-3.7	-3.1	-4.5	-6.6	-6.3	-6.1	96.0
Transportation	-0.9	-1.2	-1.1	-1.1	-1.1	-1.5	-1.6	-1.4	-1.2	0.7
Travel	-3.1	-2.8	-3.6	-3.7	-3.3	-4.7	-6.6	-7.1	-6.7	140.8
Other services	0.6	0.7	0.6	1.1	1.4	1.7	1.6	2.1	1.7	122.0
Services not allocated	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.1	17.5
Income	2.3	1.5	0.6	0.2	0.4	1.1	2.1	0.7	1.9	24.9
Current transfers	-5.1	-5.9	-4.9	-4.9	-4.9	-5.2	-5.4	-6.8	-6.5	9.0

Source: European Commission, January 2004.

^a Excluding Cyprus and Malta due to lack of data. Data for Israel are included only from 2001.

^b According to the Balance of payments concept: exports fob, imports fob.

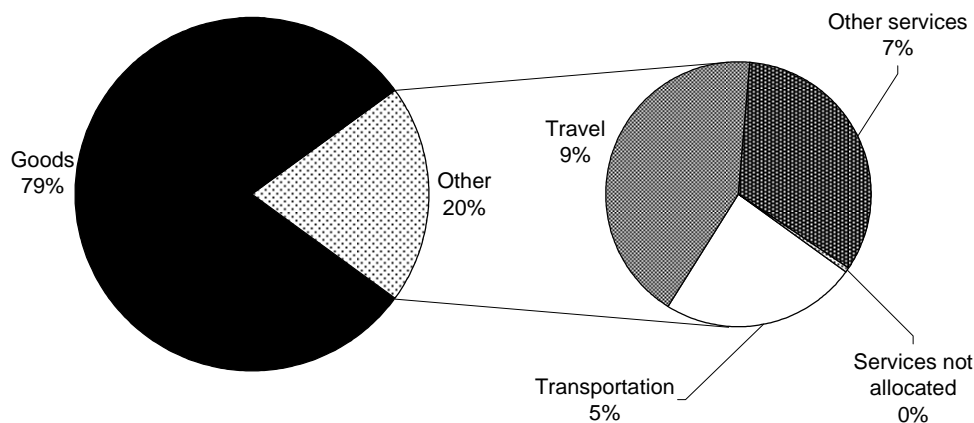
¹⁴ Data used here are February 2004 balance of payments data from the COMEXT database and not directly comparable to the NEW CRONOS data used in the previous subsections. Moreover, Cyprus and Malta are not included at all, while data for Israel are included only from 2001.

The dominance of tourism in the services trade and the rising EU demand for tourism-related services are responsible for the almost continuous increase of the EU's structural deficit in trade in services over the last decade to more than 6 billion EUR per year in the period from 2000 until 2002. This offset its surplus in trade in goods by about 50% in the years 2000 and 2002, and almost neutralised it in 2001.

Between 2000 and 2002 travel (including tourism) and transportation accounted for 8.6% and 4.8% respectively of total services trade (Chart 8). Other services contributed 6.6% to services trade. The fact that these other sectors contributed so little suggests that a liberalisation of financial, IT and telecom services, which are major catalysts for economic activity, would probably enable a huge trade potential to be tapped.¹⁵ This would in turn attract more FDI and thereby help to generate dynamic efficiency gains.

The EU is likely to have a know-how advantage in skilled services such as construction work. This is reflected in the EU's surplus in trade in "other services" which include this type of short-term work abroad. However, the EU displays a large current transfer deficit with Mediterranean countries. This can largely be explained by remittances of workers from Mediterranean countries.¹⁶ Special data on remittances were collected at Member State level in early 2004, but the picture remains very incomplete.¹⁷ For those Member States where remittance data is broken down by recipient country, the direction of remittance flows reflects, as one would expect, the composition of the immigrant population in each Member State. Mediterranean countries are the main recipients of remittances from a number of Member States.

Chart 8: EU-MED trade of goods and services 2000-2002



Source: European Commission.

¹⁵ Müller-Jentsch, D. (2005), "Deeper Integration and Trade in Services in the Euro-Mediterranean Region", World Bank, Washington.

¹⁶ Remittances are defined as current transfers by migrants if they are employed or intend to remain employed for more than a year in the EU and if they are considered residents. Some developing countries classify workers' remittances as a factor income receipt (and thus as services income and a component of GNI), in deviation from international accounting standards.

¹⁷ Full EU data on remittances are not yet available. The European Commission participates in UN and G7 working groups on the improvement of data collection.

3.3. Intra-Mediterranean trade

Whereas Association Agreements with the EU have now entered into force in all Mediterranean countries apart from Syria, the grid of free trade agreements among the Mediterranean partners is incomplete despite other bilateral and multilateral agreements.¹⁸ Currently only the Agadir Agreement signed by Egypt, Jordan, Morocco and Tunisia in February 2004 fulfils the intra-Mediterranean ambitions of the Barcelona Declaration (Table 6). It provides for the creation of a free trade area by 1 January 2006, and closer economic cooperation notably in the field of standards and customs procedures harmonisation. On the basis of its 1996 customs union with the EU, Turkey grants the same concessions to the Mediterranean countries as the EU. Morocco, the Palestinian Authority, Syria and Tunisia signed free trade agreements with Turkey in 2004 in order to bring about reciprocal trade liberalisation, but these agreements are not yet in force.

The Arab partners other than the Palestinian Authority committed themselves in 1998 (apart from Algeria, which did so in 2002) to an Arab League initiative to revive previously unsuccessful attempts at regional integration through a Greater Arab Free Trade Area (GAFTA).¹⁹ In February 2002 the Arab League's Economic and Social Council decided at its 69th meeting in Cairo to accelerate the establishment of GAFTA. The deadline is now set for 2005 instead of 2007. The GAFTA countries (18 out of 22 Arab League countries) agreed to reduce tariffs on trade among themselves initially by 50%. Tariffs should be reciprocally reduced by 60% in 2003 and 80% in 2004 to reach zero by 2005. However, there are numerous problems besetting efforts to forge closer trading ties. The specification system has not been determined and an agreement on certificates of origin still needs to be reached. Observers also report a tendency to ask for a large number of exemptions. Furthermore, the level of integration of the GAFTA is lower than that envisaged by the Euro-Mediterranean Free Trade Area. For instance, it does not include accompanying anti-dumping and anti-subsidy mechanisms.²⁰

Table 6: MED trade agreements (extra EU)

	WTO joined	COMESA joined ^a	GAFTA signed ^b	AGADIR FTA signed	US MEFTA into force ^c
Algeria	observer	-	2002	-	-
Egypt	1995	1998	1998	2004	-
Israel	1995	-	-	-	1985
Jordan	2000	-	1998	2004	2001
Lebanon	observer	-	1998	-	-
Morocco	1995	-	1998	2004	probably 2005
Palestinian Authority	-	-	-	-	-
Syria	-	-	1998	-	-
Tunisia	1995	-	1998	2004	-
Cyprus	1995	-	-	-	-
Malta	1995	-	-	-	-
Turkey	1995	-	-	-	-

Sources: European Commission, White House, World Bank, WTO.

^a Common Market for Eastern and Southern Africa.

^b Greater Arab Free Trade Area.

^c US-Mediterranean Free Trade Area suggested by President Bush in 2003.

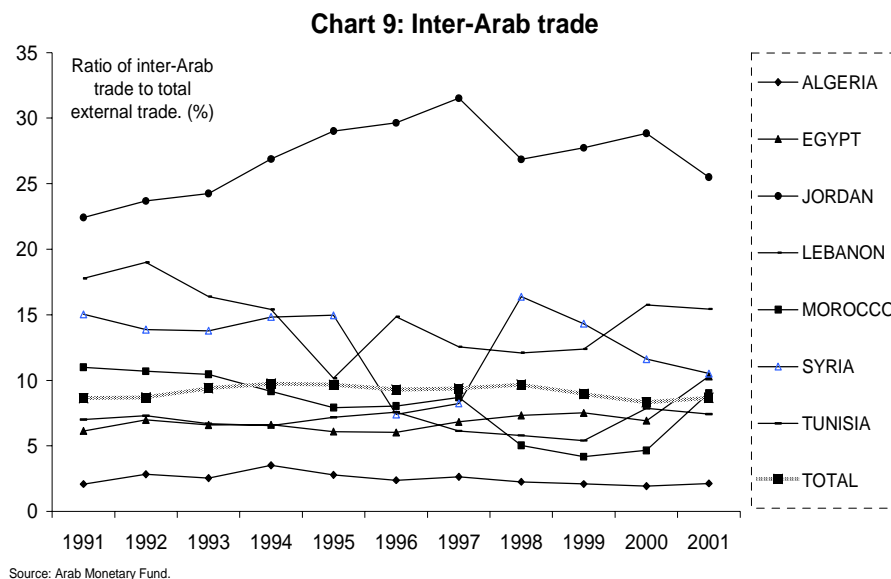
¹⁸ Algeria, Lebanon, the Palestinian Authority and Syria are not even members of the WTO. However, Algeria and Lebanon are currently negotiating their membership. The other Mediterranean partners joined the WTO in 1995, except for Jordan which became a member in 2000.

¹⁹ Also called Pan-Arab Free Trade Area (PAFTA).

²⁰ Source: UNCTAD, <http://r0.unctad.org/trains/2001%20Jordan.html>.

The current patchwork of heterogeneous regional trade agreements should be enhanced to free intra-Mediterranean trade and to maximise the benefits of trade by containing the risk of trade diversion.²¹ In addition, the current rules of origin need to be improved. Even the Euro-Mediterranean Free Trade Area rules, which are more advanced than in the GAFTA, are considered as a major obstacle to intra-regional trade.²² The extension of Pan-European rules of origin to the Mediterranean partners agreed by the third Euro-Mediterranean Trade Ministers' Conference in Palermo in July 2003 should facilitate trade (implementation pending). But the Pan-European rules of origin allow only diagonal and not full cumulation.²³ In addition trade restrictions remain in the form of processing requirements and administrative costs of proving compliance which are a particular burden for small and medium-sized companies in the Mediterranean.

A look at inter-Arab trade shows that Jordan, Lebanon and Syria were the top Mediterranean performers from 1991 until 2001, with Jordan clearly leading (Chart 9).²⁴ However, the position of these three countries hardly reflects an advanced degree of inter-Arab trade integration. It is rather the result of their relatively small trade flows with the rest of the world.²⁵ Egypt, Morocco and Tunisia ranged in the middle of the field and experienced less volatility in their inter-Arab trade ratios. Algeria showed the lowest inter-Arab trade ratio because around 90% of its exports consisted of hydrocarbon products, which were exported mainly to non-Arab countries.



An IMF study concludes that there is no evidence of an increase in intra-Mediterranean trade over the period 1991 to 2002, something which can be attributed to administrative hurdles and insufficient progress on tariff dismantling.²⁶ This result is based on a comprehensive gravity model for EU-Mediterranean trade, but including only Algeria, Egypt, Jordan, Morocco, Syria

²¹ World Bank (2005), *Global Economic Prospects: Trade, Regionalism and Development*, Washington.

²² Müller-Jentsch, D. (2005), "Deeper Integration and Trade in Services in the Euro-Mediterranean Region", World Bank, Washington, pp. 86 ff..

²³ "Full cumulation" allows any processing activity from any country in a regional trade bloc as "qualifying content" for exports to the free trade area. "Diagonal cumulation" permits only the use of intermediate inputs.

²⁴ The inter-Arab data of a group of 19 countries reporting to the Arab Monetary Fund are used as a proxy for intra-Mediterranean Arab trade due to a lack of data.

²⁵ Moreover, Jordan and Syrian inter-Arab trade is particularly affected by commerce with Iraq.

²⁶ International Monetary Fund (2004), "Morocco: Selected Issues", *Country Report*, No. 04/164, June, p. 27.

and Tunisia. Similar conclusions are presented by the World Bank.²⁷ However, this is not only an economic but also a political issue. Apart from Israel and the Palestinian Territories, for instance, trade between Algeria and Morocco has occasionally suffered from border frictions because of the Western Sahara problem.

4. Development of foreign direct investment (FDI)²⁸

The Barcelona Declaration encourages the promotion of FDI as a complement to domestic investment and stresses the importance of creating favourable investment conditions. The progressive elimination of obstacles to investment could lead to the transfer of technology and increase production and exports (Box 2). The importance attributed to the improvement of the investment climate recognises the fact that (foreign direct) investment ultimately depends on the investors' general portfolio optimisation strategy and on estimated returns which in turn depend on the perceived local investment conditions (and country risk factors). The Barcelona Process should also stimulate FDI inflows into the Mediterranean because it fosters trade, and general studies show that FDI and trade exert a significant reciprocal influence.²⁹ However, FDI ultimately depends on a satisfactory business climate. In this context, the Mediterranean countries benefit from financial and technical EU support for reforms which should have improved investment conditions.

The development of FDI can be interpreted to some extent as an indicator for a country's economic reforms and trade performance because investors base their decisions in particular on possible local revenue, production costs, tax conditions and administrative hurdles. Whereas the revenue is influenced by the size of the market and competition, the production costs will mainly be determined by the local labour market supply, supply of primary and intermediary goods, financial services, infrastructure (which are important for shipping costs), and governance.³⁰ The quality of the legal system and absence of (organised) crime also play a major role.³¹ Many of these factors are reflected in investment climate indicators.³²

Regional trade agreements (RTA) such as the Agadir Agreement can potentially lead to more FDI inflows into the region because they create a larger integrated market, but some countries in the RTA can benefit asymmetrically, for instance, if they are more developed or have a better educated workforce than the others.³³ However, it can be assumed that FDI flows into Mediterranean countries largely depend on national investment conditions, since their markets are still hardly integrated at all (section 2).

²⁷ World Bank Group (2003), "Trade Investment, and Development in the Middle East and North Africa", *MENA Development Report*, Washington.

²⁸ The data source for this section is the UNCTAD World Investment Report 2004 if not specified otherwise.

Statistically FDI flows are defined as the sum of equity, reinvested earnings and loans remitted from the parent firm and related firms abroad to an affiliate in which it controls an ownership share above a certain threshold (i.e. 10%).

²⁹ OECD (2003), Economic Outlook No. 73, pp. 163 ff.. See also Sekkat, K. and M. Véganzonès-Varoudakis (2004), "Trade and Foreign Exchange Liberalization, Investment Climate, and FDI in the MENA Countries", *World Bank Working Paper Series*, No. 39, September.

³⁰ For a more detailed overview see: European Investment Bank (2004), "The Internationalisation of Production in Europe – Causes and Effects of Foreign Direct Investment and Non-equity Forms of International Production", *EIB Papers*, Vol. 9, No. 1, 2004.

³¹ See Méon, P. and K. Sekkat (2004), "Does the Quality of Institutions Limit the MENA's Integration in the World Economy?", *The World Economy*, Vol. 27, Issue 9, pp. 1475-1498.

³² See the article on the 'Business Climate in the Mediterranean region' in this Occasional Paper.

³³ Jaumotte, F. (2004), "Foreign Direct Investment and Regional Trade Agreements: The Market Size Effect Revisited", *IMF Working Paper*, No. 04/206, November.

Box 2: Excerpts from the Barcelona Declaration on investment¹

Economic cooperation and concerted action

“Cooperation will be developed ... and in this respect the participants acknowledge that economic development must be supported both by internal savings, the basis of investment, and by direct foreign investment. They stress the importance of creating an environment conducive to investment, in particular by the progressive elimination of obstacles to such investment which could lead to the transfer of technology and increase production and exports.”

“[The participants] acknowledge the pivotal role of the energy sector in the economic Euro-Mediterranean partnership and decide to strengthen cooperation and intensify dialogue in the field of energy policies. They also decide to create the appropriate framework conditions for investments and the activities of energy companies, cooperating in creating the conditions enabling such companies to extend energy networks and promote link-ups...”

Annex:

Work programme for investment

“The object of cooperation will be to help create a climate favourable to the removal of obstacles to investment, by giving greater thought to the definition of such obstacles and to means, including in the banking sector, of promoting such investment.”

Work programme for energy

“... With a view to creating appropriate conditions for investment in and activities by energy companies, future cooperation will focus, inter alia on: fostering the association of Mediterranean countries with the Treaty on the European Energy Charter; energy planning; encouraging producer-consumer dialogue; oil and gas exploration, refining, transportation, distribution, and regional and trans-regional trade; coal production and handling; generation and transmission of power and interconnection and development of networks; energy efficiency; new and renewable sources of energy; energy-related environmental issues; development of joint research programmes; training and information activities in the energy sector. ...”

Work programme for the environment

“Cooperation will focus on ... stimulating coordination of investments from various sources, and implementation of relevant international conventions.”

¹ Adopted at the Euro-Mediterranean Conference of Ministers of Foreign Affairs on 27/28 November 1995.

A priori, the net relationship between trade, one of the Declaration’s main targets, and FDI is not clear. FDI can diminish trade, but it can also be an instrument for market entry and near-client services, or serve as a means for cost-cutting in vertically integrated firms by dislocating parts of the production process according to cost criteria.³⁴ This involves intra-firm trade with capital goods, intermediate goods and final products. Empirical studies show that the correlation between the development of FDI and trade is usually significantly positive.

Finally, it is important to keep in mind that the Barcelona Declaration does not differentiate between different sources of investment (domestic investment, FDI from the EU or from the rest of the world). Measures which enhance the business climate increase a country’s attractiveness for both domestic and international investors. However, FDI has a special value because it can entail a transfer of technology.

³⁴ Deutsche Bundesbank (1999), “The Relative Position of the German Economy in the Central and Eastern European Reform Countries, *Monthly Report*, No. 10, October.

4.1. Total FDI flows

The Mediterranean countries have been relatively successful in attracting FDI flows over recent years. Compared with the 1992-1997 annual average, FDI inflows in the Mediterranean countries more than doubled in 2003 to 9.927 million USD (Table 7). This is relatively successful since world FDI inflows in developing economies increased by only 45%, albeit from a much higher starting point. However, the Mediterranean countries' share of FDI flows to developing countries remained low (5.4% on average in 2001-2003).

Table 7: FDI inflows, by host region and economy, 1992-2003 (million USD)

	1992-1997 <i>p.a. avg.</i>	1998	1999	2000	2001	2002	2003	2001-2003 <i>p.a. avg.</i>
Algeria	93	501	507	438	1,196	1,065	634	965
Egypt	820	1,076	1,065	1,235	510	647	237	465
Israel	1,069	1,887	3,111	5,011	3,549	1,721	3,745	3,005
Jordan	67	310	158	787	100	56	379	178
Lebanon	52	200	250	298	249	257 ^a	358 ^a	288
Morocco	551	417	850	215	2,825	481	2,279	1,862
Palestinian Territory	154 ^d	218	189	62	20	..	..	..
Syria	108	82	263	270	110	115	150 ^a	125
Tunisia	457	668	368	779	486	821	584	630
Cyprus	150	264	685	804	652	614	830	699
Malta	126	267	822	622	281	-428	380	78
Turkey	750	940	783	982	3,266	1,038	575	1,626
Total	4,243	6,830	9,051	11,503	13,244	6,387	10,151	9,927
Developing economies	118,596	194,055	231,880	252,459	219,721	157,612	172,033	183,122
Africa	5,936	9,114	11,590	8,728	19,616	11,780	15,033	15,476
North Africa	1,926	2,904	3,032	2,918	5,490	3,631	5,784	4,968

Source: Unctad, World Investment Report 2004.

^a Estimate.

Table 8: FDI inflows, by host region and economy, 1992-2003 (% of total)

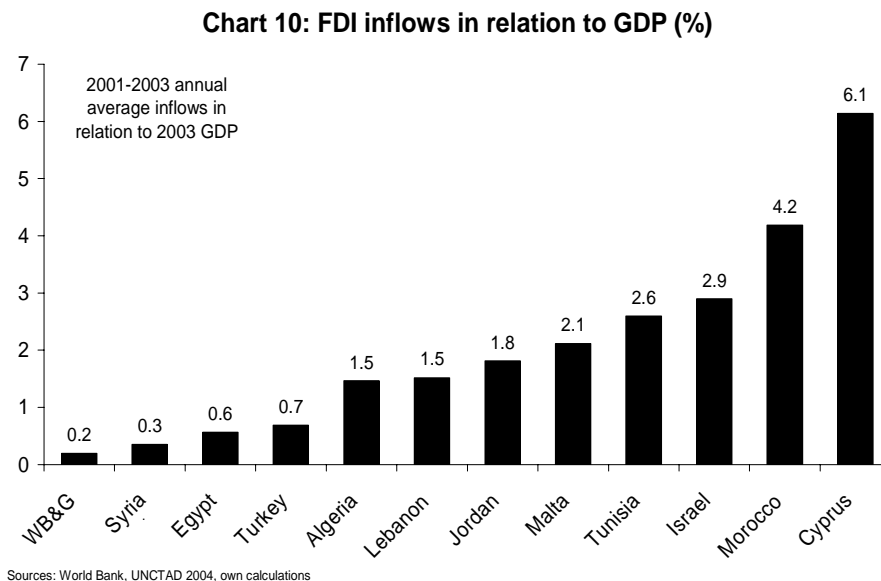
	1992-1997 <i>p.a. avg.</i>	1998	1999	2000	2001	2002	2003
Algeria	2.2	7.3	5.6	3.8	9.0	16.7	6.2
Egypt	19.3	15.8	11.8	10.7	3.9	10.1	2.3
Israel	25.2	27.6	34.4	43.6	26.8	26.9	36.9
Jordan	1.6	4.5	1.7	6.8	0.8	0.9	3.7
Lebanon	1.2	2.9	2.8	2.6	1.9	4.0 ^a	3.5 ^a
Morocco	13.0	6.1	9.4	1.9	21.3	7.5	22.5
Palestinian Territory	3.6	3.2	2.1	0.5	0.2	..	..
Syria	2.5	1.2	2.9	2.3	0.8	1.8	1.5 ^a
Tunisia	10.8	9.8	4.1	6.8	3.7	12.9	5.8
Cyprus	3.5	3.9	7.6	7.0	4.9	9.6	8.2
Malta	3.0	3.9	9.1	5.4	2.1	-6.7	3.7
Turkey	17.7	13.8	8.7	8.5	24.7	16.3	5.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Developing economies	2,795.1	2,841.2	2,561.9	2,194.7	1,659.0	2,467.7	1,694.7
Africa	139.9	133.4	128.1	75.9	148.1	184.4	148.1
North Africa	45.4	42.5	33.5	25.4	41.5	56.8	57.0

Source: Unctad, World Investment Report 2004.

^a Estimate.

Moreover, the Mediterranean countries' capability to attract FDI was not spread equally (Tables 7 and 8).³⁵ Turkey more than doubled its annual average FDI inflows in the period 2001-2003 compared with 1992-1997. In the same reference periods, inflows tripled in Israel, Jordan and Morocco, quadrupled in Cyprus and reached ten times their average 1992-1997 level in Algeria. Notwithstanding the positive trend, inflows were quite volatile in many countries. Egyptian inflows shrank after an initial expansion which culminated in 2000 to less than half of the reference level. At the end they were also lower in Malta but only due to a major one-off backflow in 2002. In the period 2001-2003 four countries, Israel, Morocco, Turkey and Algeria, on average received more than 45% of the Mediterranean countries' FDI inflows. Following the October 1998 reactivation of Malta's efforts for EU membership, inward FDI more than tripled in 1999. Only Syria saw a similar increase in 1999, but starting from a lower and probably exceptional value.

Similar to empirical trade models, FDI inflows can be estimated by gravity models which allow scaling factors like country size to be separated from other factors such as transport costs and tariff hurdles.³⁶ Dividing inward FDI flows by the host countries' GDP controls approximately for the size factor. Therefore, the resulting ratios are a rough measure for unaccounted factors such as the business climate.³⁷ They reveal that a number of countries, in particular Cyprus, Morocco, Israel, Tunisia, and Malta, attracted a much larger share of FDI inflows compared to their GDP than others, presumably due to more attractive investment conditions (Chart 10).



A variety of factors determine a country's FDI attractiveness. In Cyprus and Malta the longstanding cooperation with the EU on the basis of first generation Association Agreements (Table 1) and the prospect of EU membership certainly played a role. Israel is the region's only high-income economy, and its rapidly expanding high technology sector was particularly attractive for FDI. In addition Israel, Morocco and Tunisia were frontrunners in that they signed Association Agreements years before their peers and generally started early with related economic reform programmes.

³⁵ The time pattern and geographical shares of FDI are distorted by exchange-rate developments due to the US dollar numéraire since FDI from the EU makes up a considerable part of total FDI inflows.

³⁶ See Brenton, P., F. Di Mauro and M. Lücke (1999), "Economic Integration and FDI: An Empirical Analysis of Foreign Investment in the EU and in Central and Eastern Europe", *Empirica, Journal of Applied Economics and Economic Policy*, Vol. 26, No. 2, pp. 95-121.

³⁷ A detailed analysis would also have to account for factors like the war in Iraq.

The participants of the Barcelona Declaration acknowledge that economic development should be supported both by internal savings (S), the basis of investment (I), and by FDI. According to basic identities in the systems of national accounts and balance of payments, savings and FDI are different sources for investment, in principle together with other net capital imports (C) and foreign exchange reserves (R):

Equation 1

$$I = S + FDI + C + R .$$

However, it should be noted that FDI inflows alone do not reveal the full picture, as they comprise only part of the financing of foreign operations in host countries because of co-financing from domestic or foreign capital markets. For that reason they often understate the FDI impact on investment, particularly if they entail complementary capital imports rather than domestic co-financing, which can crowd out investment of local firms.³⁸ On the other hand, FDI flows are a source of corporate finance which can be used not only for fixed investment but also for purchasing non-fixed assets (usually portfolio investment) and reducing financial liabilities. This can lead to capital exports rather than material investment. This differentiation is particularly relevant if FDI concerns the purchase of existing capital stock rather than the increase of the capital stock through greenfield investment. The net increase of investment then depends on the allocation of the payment received by the previous owner.

In principle, the effect of FDI on investment also depends on the exchange rate system. With flexible rates the FDI-related currency appreciation diminishes exports and increases imports. This can crowd out investment by local firms. With fixed exchange rates, interest decreases to counter the appreciation effect of FDI, and can trigger additional domestic investment. But these effects are probably fairly small in most cases due to the overwhelming weight of other exchange rate determinants like trade. Only Cyprus, Morocco, Israel and Tunisia had sizeable FDI inflows in the period from 2001-2003 (Chart 10).

In 2001-2003 most Mediterranean countries experienced an increase of the FDI share in their investment compared with 1992-1997, albeit with considerable volatility (Table 9). This suggests an actual increase of foreign contributions to domestic investment, as envisaged by the Barcelona Declaration, on the assumption that the other components of FDI such as domestic savings have not receded over the period as a whole (equation 1).

The importance of FDI for Gross Fixed Capital Formation (GFCF) varied substantially between countries and across time. Cyprus, Morocco and Israel increased the FDI share in GFCF to an annual average of 40.4%, 21.8% and 15.4% respectively. They also reached the biggest FDI inflows in relation to GDP on average from 2001-2003 (Chart 10). Malta, like Cyprus a candidate for EU membership at the time, also performed generally very well with inflows ranging between 14.2% and 96.5% of GFCF during the whole period, but saw a smaller average in 2001-2003 due to an exceptional withdrawal of FDI in 2002. Tunisia's FDI inflows hovered around an average of 11.5% of GFCF throughout the period. Only in the Palestinian Territories (data available until 2001) and Egypt did the FDI contribution to GFCF decrease in line with dwindling inflows in USD terms.

In most Mediterranean countries the relation of *outward* FDI to GFCI remained at a low level of less than 1% of GFCF during the whole period. This is only a fraction of the inflow ratio, reflecting limited savings and the priority need for domestic investment. However, in a few countries the FDI outflows ratio has increased over time and reached a substantial proportion of

³⁸ UNCTAD (2004), *World Investment Report 2004*, September.

GFCF. In Cyprus and Israel the annual average outflows during 2001-2003 amounted to 16.5% and 6.2% of GFCF respectively. For comparison, the EU outward ratio of 21.5% was close to the inward ratio of 20.8%.

Table 9: FDI flows as a percentage of gross fixed capital formation

		1992-97 p.a. avg.	1998	1999	2000	2001	2002	2003	2001-03 p.a. avg.
Algeria	inward	0.8	4.0	4.3	3.7	9.6	7.7	3.9	7.1
	outward	0.1	-	0.4	0.2	0.1	0.7	0.1	0.3
Egypt	inward	8.9	5.9	5.7	6.7	3.2	4.3	2.0	3.2
	outward	0.4	0.3	0.2	0.3	0.1	0.2	0.2	0.2
Israel	inward	4.9	8.4	14.0	22.0	16.7	9.3	20.1	15.4
	outward	3.3	5.2	4.3	15.2	3.0	6.1	9.5	6.2
Jordan	inward	3.6	18.5	8.3	44.2	5.7	2.3	19.2	9.1
	outward	-1.3	0.1	0.2	0.3	0.5	1.0	0.1	0.5
Lebanon	inward	1.5	4.2	7.0	10.0	8.9	8.3	12.1	9.8
	outward	0.4	-	0.1	4.2	3.3	2.4	3.3	3.0
Morocco	inward	8.3	5.3	10.2	2.7	37.4	5.8	22.2	21.8
	outward	0.3	0.3	0.2	0.7	1.3	0.3	0.1	0.6
Palestinian Territories	inward	11.8 ^a	14.5	11.2	4.3	1.3	..	..	..
	outward	10.8	10.7	10.0	15.0	24.6	..	..	..
Syria	inward	0.9	0.6	1.9	1.9	2.7	2.2	1.9	2.3
	outward	..	..	..	..	..	..	..	..
Tunisia	inward	10.6	13.6	7.0	15.2	9.3	15.5	9.6	11.5
	outward	0.1	-	-	-	-	-	-	-
Cyprus	inward	9.0	14.8	39.7	51.0	40.4	32.1	48.8	40.4
	outward	1.4	3.9	8.5	12.8	13.5	15.6	20.3	16.5
Malta	inward	14.2	31.1	96.5	66.5	33.3	-53.0	34.2	4.8
	outward	0.7 ^b	1.7	5.3	2.8	2.8	-0.5	2.1	1.5
Turkey	inward	1.8	1.9	1.9	2.2	12.4	3.4	1.6	5.8
	outward	0.2	0.7	1.6	2.0	1.9	0.6	1.3	1.3
EU	inward	6.0	14.8	27.7	41.3	22.3	22.3	17.7	20.8
	outward	9.2	24.7	41.8	49.6	26.8	20.9	16.8	21.5
Developing economies	inward	7.9	12.3	14.7	14.9	13.1	9.9	10.0	11.0
	outward	3.4	3.3	3.8	6.1	3.6	3.0	2.1	2.9
Africa	inward	6.5	8.3	11.6	8.8	20.7	12.3	13.9	15.6
	outward	2.5	2.6	2.3	0.8	-2.6	0.2	1.1	-0.4
North Africa	inward	5.0	6.1	6.2	5.9	11.7	7.8	11.7	10.4
	outward	0.1	0.8	0.7	0.5	0.5	0.6	0.3	0.5

Source: Unctad, World Investment Report 2004.

^a 1996.

^b Average from 1993-1996.

The West Bank and Gaza (Palestinian Territories) experienced extraordinary FDI outflows.³⁹ They reached a level of about 10% of GFCF until 1999, almost overriding the inflows of between 11% and 15% of GFCF. In 2000 and 2001 outflows of 15% and 24.6% of GFCF largely surpassed rapidly receding inflows, thus leading to net FDI outflows. Whereas the outflows in Cyprus and Israel can be interpreted as normal features of relatively advanced economies with

³⁹ Data available until 2001.

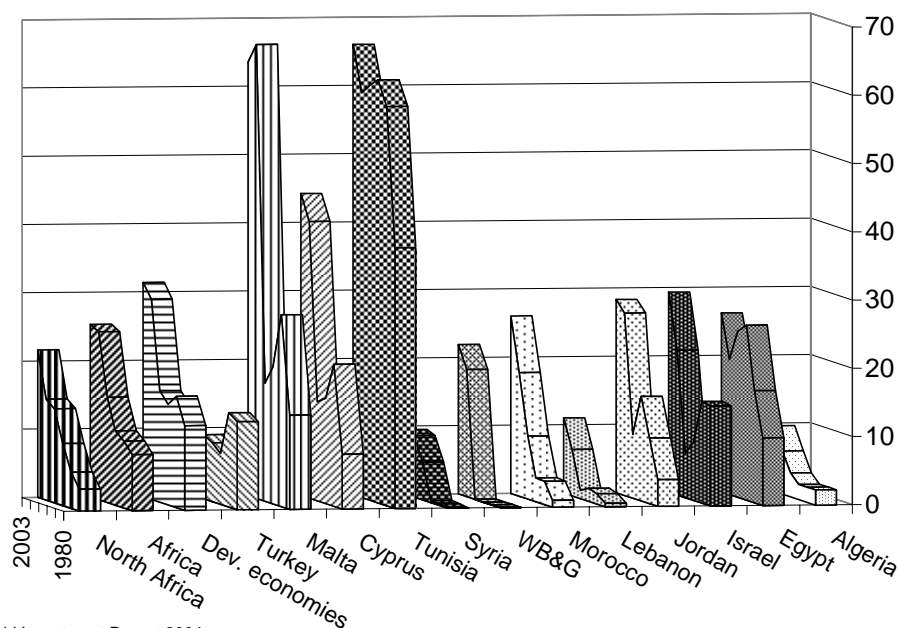
growing domestic savings and portfolio diversification, the development in the West Bank and Gaza is unusual.

Total FDI stocks

The Mediterranean countries' appeal to foreign investors can thus be illustrated by comparing their inward FDI stock in relation to GDP. The FDI stock is statistically defined as the value of capital and reserves (including retained profits) attributable to the investors (parent enterprises), plus the net indebtedness of affiliates to the parent enterprise. It can differ from the accumulated flows because of revaluations (changes of prices and exchange rates or other adjustments such as rescheduling or cancellation of loans, debt-equity swaps, etc.).

A longer-term comparison over selected years (1980, 1985, 1990, 1995, 2000 and 2003) reveals the following characteristics (Chart 11):⁴⁰ In the large majority of Mediterranean countries foreign investors considerably increased their FDI stock from 1980 until 2003, but there are significant differences between countries. Tunisia, Malta and Cyprus had already relatively high inward FDI stocks in 1980 and experienced further spectacular increases. Tunisia started with an inward FDI stock of 38.2% of GDP in 1980 and reached a level of almost 60% of GDP already in 1985. The 2003 figure was 66%. Malta and Cyprus departed in 1980 with ratios of broadly around 10% and climbed up to higher 2003 inward-FDI ratios of around 66% and 40% respectively. They continued to increase their relative levels by about 4% of GDP until 2003.

Chart 11: Inward FDI stocks, % of GDP



Source: UNCTAD, World Investment Report 2004.
 Note: FDI at book value or historical cost, GDP at current prices.

Egypt and Israel also showed comparably high ratios of FDI stocks already in 1980 (around 15% and 10% of GDP) but their increases did not go beyond 30% at any point up to 2003. The inward FDI-GDP ratios of Algeria, Jordan, Lebanon, Morocco and Syria were low in 1980 (between 0%

⁴⁰ FDI at book value or historical cost, GDP at current prices. Source: UNCTAD (2004), *World Investment Report 2004*, September.

and 4% of GDP).⁴¹ By 2003 they had expanded in Jordan and Morocco to 28.3% and 26% respectively; in Algeria, Lebanon and Syria the expansion was more modest and led to ratios of near 10%. Data for the Palestinian Territories were available only from 2000 and show a pattern similar to Morocco; in 2003 their inward FDI amounted to 21.9% of GDP. It is worth noting that Turkey is the only country where inward FDI in relation to GDP decreased during most of the selected years, from about 14% of GDP in 1985 to 7.6% in 2003. This could to some extent be related to Turkey's rapid economic growth over recent years, but also to other factors such as FDI diversification across the region.

The overview of inward FDI stocks in the selected years suggests that they increased continuously in most cases. Countries where the expansion was temporarily interrupted by a pronounced fall of around 5% of GDP or more are Egypt (between 1995/2000), Israel (ditto), Jordan (1990/1995), Cyprus (1985/1990) and Malta (1985/1990/1995). There are probably different reasons for these disinvestments. In some cases country risk factors might have been decisive; in others, conventional economic optimisation criteria on the part of investors may have been the reason.

It is worth noting that the growth of inward FDI stocks gained particular momentum between 1995, the year of the Barcelona Declaration, and 2000. This is obvious for the countries which were characterised by the smallest inward-FDI-to-GDP ratios: Algeria, Lebanon and Syria. Other countries which had experienced temporary declines of their FDI quotas at least returned to their former expansion track (Israel, Jordan, Cyprus and Malta).

Apart from Tunisia's early trade liberalisation with the EU, the country's relatively stable political situation, its attractiveness for tourism and central position in North Africa might have qualified it particularly as a base for FDI. A possible explanation for the distinguished position of Malta and Cyprus is their early cooperation with the EC dating to 1971 and 1973 respectively, and imminent EU Membership at the beginning of the new millennium (Table 1). While Turkey concluded a Cooperation Agreement with the EC as far back as 1964 and formed a customs union with the EU in 1996, the FDI ratio is depressed by high nominal GDP growth due to inflation, whereas the 2003 value of EU-FDI stocks in dollar terms (18.2 billion USD) is actually more than twice as high as their 1980 value. Nevertheless, periods of macroeconomic and financial instability may have limited FDI in Turkey.

Algeria and Lebanon committed themselves more strongly to reforms by signing Association Agreements, though they did so only in 2002, and an Agreement with Syria is still pending. But these countries may in any case have benefited from the general surge of FDI at the end of the nineties which is mirrored by the Developing Country data (Chart 11).⁴² Israel and Jordan may have received additional FDI impulses because they signed Association Agreements already in 1995 and 1997. Morocco, where the inward FDI stock over GDP grew significantly between 1990 and 2000, signed an Association Agreement in 1996.

The *outward* FDI stocks of most Mediterranean countries were only a fraction of inward stocks (Chart 12). In 2003 the outward FDI stock in relation to GDP of Cyprus (12.3%) and Israel (11.2%) was comparable to the Developing Countries average. Malta (6.6%) ranged between the Developing Countries and African average. The figure was low in the other countries, between 0.2% in Tunisia and 2.8% in Lebanon.⁴³ It is remarkable that, unlike in other countries, Tunisia's outward FDI stocks remained almost inert and did not increase with its ballooning inward FDI

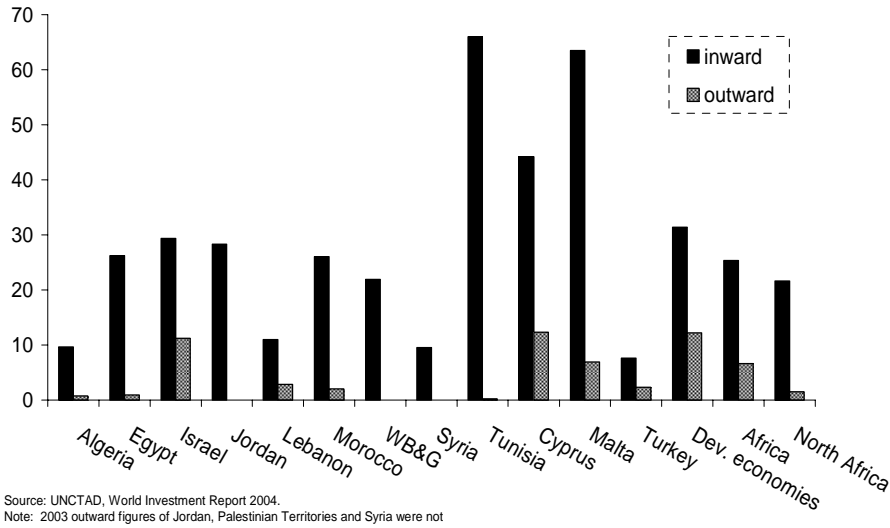
⁴¹ There is no data for Syria that year but the 1985 figure and the trend suggest that it was close to 0%.

⁴² Compared with 1980, world FDI outflows increased by 72% in 1995 and by 229% in 2000.

⁴³ Recent figures on the outward FDI stock were not available for Jordan, the Palestinian Territories and Syria.

stock. Israel, Cyprus and Malta had a relatively large per capita GDP for the group. This might be related to a higher degree of commercial presence abroad. In the case of Cyprus and Malta, EU accession and trade-related investments in the EU may also have played a role.

Chart 12: FDI stocks 2003 (% of GDP)



4.2. FDI flows from the EU⁴⁴

The Barcelona Declaration does not differentiate between the promotion of FDI from the EU and other FDI in the Mediterranean (Box 2). An increase in commerce, improvement of the business climate and reduction of country risk factors in the Mediterranean will make countries' economies more attractive to any foreign investor. Nevertheless, it is of some interest to investigate EU-FDI separately. After all, trade and FDI are interdependent and the liberalisation of trade between the EU and Mediterranean may have changed the behaviour of European investors.

EU-FDI in the Mediterranean increased substantially, from 0.7 billion ECU in 1995 to 3.6 billion EUR in 2003, with intermediate peaks of 5.3 billion EUR and 4.2 billion EUR in 2000 and 2001 respectively (Table 10). However, as a proportion of the EU's total FDI the Mediterranean remained insignificant, accounting for less than 1% of outward EU-FDI even in the more recent years. The relative position of the Maghreb and the Mashreq sometimes changed from year to year but grew broadly in parallel over the medium term. In 2003 these regions received EUR 1.4 billion and EUR 1.3 billion of EU-FDI respectively. The figures for Egypt and Morocco alone almost matched or exceeded the region's inward flows from the EU in 2003.

Israel's inflows were comparatively small. They peaked in 2000 at 0.7 billion EUR and showed sizeable withdrawals in both the previous and subsequent year. After the beginning of the intifada in the Palestinian Territories, EU-FDI in Israel dropped to pre-1995 levels. EU-FDI in Cyprus and Malta in the last years was without doubt largely influenced by their preparation for

⁴⁴ The data source is Eurostat unless otherwise indicated; therefore the data are not directly comparable to the UNCTAD data in the previous subsections. Since EU Member States do not report data on all Mediterranean countries to Eurostat, individual country data in the Maghreb and the Mashreq are only available for Morocco and Egypt.

EU membership and exposed to some volatility.⁴⁵ In some cases these countries saw even large FDI withdrawals, possibly in relation to the rearrangement of company holdings.

The decision of the Copenhagen European Council of December 2003 to accept Turkey, in principle, as an EU candidate country did not have an obvious impact on 2003 data. EU-FDI in Turkey hovered around 0.4 billion ECU in the years from 1994 to 1997, slightly up from the years before. It jumped to a level of about 1 billion ECU/EUR in the years after, with exceptional peaks of 1.4 billion EUR in 2000 and more than 3 billion EUR in 2001. This is probably the result of increased economic integration since the 1996 customs union with the EU.

Table 10: EU-15 outward FDI flows by country of destination (million ECU/EUR)

	1992-94									
	p.a. avg.	1995	1996	1997	1998	1999	2000	2001	2002	2003
Maghreb	151	100	201	659	520	-15	872	778	706	1,393
of which: Morocco	151	33	154	470	113	91	215	235	420	1,635
Mashreq	92	169	80	236	546	442	2,312	600	1,742	1,252
of which: Egypt	23	97	61	79	346	406	1,387	566	1,352	968
Israel	35	118	199	100	225	-227	653	-329	63	74
Cyprus	..	..	..	..	..	..	..	170	504	-462
Malta	..	..	..	..	..	..	..	-38	-2,218	432
Turkey	345	350	405	425	1,013	944	1,424	3,013	983	917
All MED countries ^a	623	737	885	1,420	2,304	1,144	5,261	4,194	1,780	3,606
World	72,509	124,099	143,393	206,573	368,197	747,623	1,128,387	623,107	482,521	383,342
Africa	497	1,532	2,484	4,256	3,505	4,608	7,899	9,327	2,883	7,630
Northern Africa	161	150	468	759	910	13	2,093	1,418	2,059	2,495

Source: European Commission.

^a Data from 1995 until 2000 without Cyprus and Malta.

Table 11: EU-15 outward FDI flows by country of destination (%)

	1992-94									
	p.a. avg.	1995	1996	1997	1998	1999	2000	2001	2002	2003
Maghreb	24.3	13.6	22.7	46.4	22.6	-1.3	16.6	18.6	39.7	38.6
of which: Morocco	24.3	4.5	17.4	33.1	4.9	8.0	4.1	5.6	23.6	45.3
Mashreq	14.8	22.9	9.0	16.6	23.7	38.6	43.9	14.3	97.9	34.7
of which: Egypt	3.6	13.2	6.9	5.6	15.0	35.5	26.4	13.5	76.0	26.8
Israel	5.6	16.0	22.5	7.0	9.8	-19.8	12.4	-7.8	3.5	2.1
Cyprus	..	..	..	..	..	..	..	4.1	28.3	-12.8
Malta	..	..	..	..	..	..	..	-0.9	-124.6	12.0
Turkey	55.4	47.5	45.8	29.9	44.0	82.5	27.1	71.8	55.2	25.4
All MED countries ^a	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
World	11,644.9	16,838.4	16,202.6	14,547.4	15,980.8	65,351.7	21,448.1	14,857.1	27,107.9	10,630.7
Africa	79.8	207.9	280.7	299.7	152.1	402.8	150.1	222.4	162.0	211.6
Northern Africa	25.9	20.4	52.9	53.5	39.5	1.1	39.8	33.8	115.7	69.2

Source: European Commission.

^a Data from 1995 until 2000 without Cyprus and Malta.

*EU-FDI stocks*⁴⁶

EU-FDI stocks in the Mediterranean increased almost continuously in most countries (Chart 13). However, Egypt showed a notable contraction in 2001 which is mirrored by the Maghreb aggregate. This might be related to dissatisfaction with the macroeconomic management and reform process at the beginning of 2000. Israel also experienced a (smaller) contraction in 2001 and 2002, probably related to the increased conflict in the region in that period. Stocks in Israel amounted to 1.1 billion EUR in 2002.

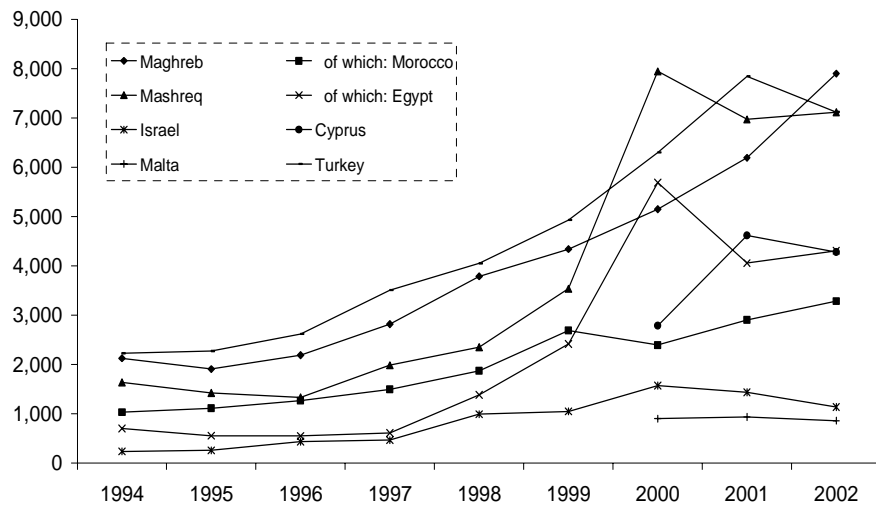
⁴⁵ Data for Cyprus and Malta were only available for 2000-2002.

⁴⁶ FDI stocks can differ from accumulated flows due to revaluations (changes of prices and exchange rates or other adjustments such as rescheduling, cancellation of loans, debt-equity swaps, etc.).

Broadly speaking, FDI stocks in the Maghreb and Mashreq as well as Turkey reached the same level in 2002 (between EUR 7.1 and 8.0 billion). In 2002 Morocco and Egypt each accounted for about half of the EU stocks in their respective regions. Whereas FDI stocks in Cyprus increased by more than 50% during the preparation of EU membership (to 4.3 billion EUR) the stocks in Malta decreased slightly from 2000 to 2002, to 0.9 billion EUR (earlier data were not available). If FDI stocks are considered in relation to the destination countries' GDP, it is apparent that EU stocks are dislocated according to the same kind of investment criteria as world stocks (described in the previous subsection): they are more attracted by stable countries which welcome reforms.

The sharp increase in absolute figures by 2001 reflects the general surge of extra-EU FDI and not necessarily a greater relative attractiveness of the Mediterranean to foreign investors. This is confirmed by the fact that the ratio of EU-FDI stocks in the Mediterranean to total extra-EU stocks decreased from 1.4% in 1994 to 1.0% in 1999 and jumped back to the original level only in 2000 where it remained until 2002.

Chart 13: EU-FDI stocks (million ECU/EUR)

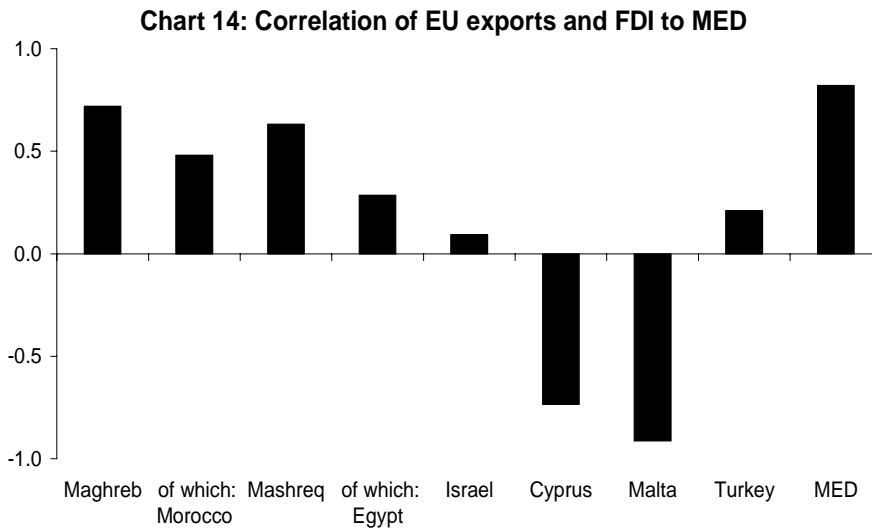


Source: European Commission.

Correlation of EU exports and outward FDI

The correlation of EU exports and EU-FDI towards the Mediterranean countries over the period from 1995 to 2003 is positive for all current partner countries (Chart 14). Only the data for Cyprus and Malta, which was available only from 2000 to 2002, showed a negative correlation indicating high outflows during that period. This could reflect extraordinary adjustments before EU membership. Therefore the correlations are difficult to interpret in these cases. The correlation is close to 0 for Israel and Turkey because of large FDI swings. EU exports and FDI towards the Maghreb and Mashreq as well as towards the whole Mediterranean are positively correlated. This indicates that, overall, EU exports and FDI are complements, and that features such as intra-firm trade probably prevail over export-substituting FDI. This seems to point to a somewhat advanced degree of EU-Mediterranean integration. Indeed there are key examples for labour division between the EU and Mediterranean countries, for instance in the textile industry.⁴⁷

⁴⁷ Quefelec, S. (2003), "Textile Industry in the Euro-Mediterranean Region", *Eurostat: Statistics in Focus*, Theme 6, March.



Source: European Commission
 Note: Correlation for the years 1995-2003, Cyprus and Malta 2001-2003.

5. Concluding Remarks

The Barcelona Process has increased the potential for trade between EU and Mediterranean countries mainly by a gradual liberalisation of industrial goods imports in the Mediterranean countries, thereby complementing the unilateral opening of EU markets at the end of the 1970s. However, the trade potential for agricultural products and services is still underexploited. The intra-Mediterranean trade potential is even more restricted because regional trade liberalisation has hardly begun. However, most Mediterranean countries are at least WTO and GAFTA members. Furthermore, trade liberalisation needs to be accompanied by measures which enable the private sector to compete internationally and to exploit its trade potential.

Since the beginning of the Barcelona Process some countries' trade with the EU developed more dynamically than others', something which is clearly linked to their appetite for reforms. In general, partner countries which committed themselves early to trade liberalisation and accompanying economic reforms under the terms of the Association Agreements also experienced a better trade performance with the EU than their peers. In this respect, Association Agreements helped to anchor domestic economic reforms and liberalisation.

The Barcelona Declaration emphasises the importance of a favourable business climate for domestic investment and for foreign direct investment. The EU supports the reform process in the Mediterranean countries with technical and financial aid. Furthermore, FDI is generally positively correlated to commerce. Therefore, the trade liberalisation stimulated by the Barcelona Process should also foster FDI flows into the Mediterranean countries. It should not come as a surprise that those countries which have signalled a particular willingness to undertake economic reforms by adopting the Association Agreements at an early stage have attracted more FDI in relation to their GDP than their peers.

The future economic integration and growth in the Euro-Mediterranean area will depend on the further liberalisation of goods and services trade, and on efforts to attract more investment, both of which will be guided by the European Neighbourhood Policy. However, without an assertive economic reform drive on the part of the Mediterranean partners to overcome the unsatisfactory level of the region's development, concerted Euro-Mediterranean efforts to improve the economic development may not be sufficient.

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