Intraregional Trade among Arab Countries: Building a Competitive Economic Neighborhood.

by

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Introduction.

Almost exactly a year ago, one of us (Derviş, 1997a) presented to the Middle East/North Africa Conference in Doha, Qatar some thoughts on the emerging concept of well-functioning economic neighborhoods as sources of accelerated growth and potential soundly-based integration into global markets. A core prerequisite of such integration is the ability of an integrating economy or set of economies--for example, members of a well-functioning regional economic “neighborhood” of countries--to compete effectively in the international trade arena. Our purpose in this paper is to review the opportunities for deepening and strengthening the Arab economic neighborhood of the Middle East and North Africa through enhanced intra-regional trade integration as a complement to multilateral trade opening under the auspices of GATT/WTO. We believe that appropriately designed “open” regionalism of this kind--as already being pursued by other regional groupings such as Mercosur, NAFTA and ASEAN--can offer participating Arab states a valuable steppingstone to successfully competitive integration into the wider global economy.

We recognize that past formal efforts to promote intra-Arab trade integration have had at best a mixed history. But we believe that the policy context in which those efforts were made--that of post-independence national (and nationalistic) policies ultimately based on the notion of state-centered import-substituting industrialization--doomed them to inevitable breakdown. By contrast, today’s very different policy context--one of increasing adherence among governments across the region to a growth model based on private sector oriented openness and competitiveness--offers a far better chance of success with respect to broad-based regional trade expansion and integration.

This paper is divided into three parts. Part I looks at some of the key features of current patterns of intra-Arab trade, with some interesting and possibly surprising results. Part II briefly examines the history of trade integration (or lack of it), with special reference to formal treaty-based efforts to promote it. Part III suggests some priority areas for attention in strengthening the Arab economic neighborhood with respect to open, trade-based, competitive, private sector oriented economic growth and welfare for its peoples.
I. Trends in Intra-Arab Trade

In principle, the Arab states of the Middle East and North Africa (MENA) region offer good opportunities for mutual trade. While they include countries with widely varying per capita incomes, ranging from the very poor (Yemen, for example, with $260 per capita a year) to high income countries, such as the United Arab Emirates (UAE: $17,400), most fall into the lower middle income group—and even the wealthier countries have non-oil productive structures similar to those of the relatively less well-off.\(^1\) Domestic markets also vary widely in size, ranging from Egypt’s nearly 60 million to Kuwait’s less than 2 million, but with a mid-range cluster of countries with populations of 14-28 million. Taking the region as a whole, economic activity is also quite diversified; productive structures reflect the importance for regional GDP of agriculture and, increasingly, light manufacturing as well as the oil wealth of the Gulf. Nevertheless, the persisting importance of oil (and oil prices) against a background until recently of inward-looking, statist economic strategies, has meant that regionwide economic growth was very slow in the decade following the oil price slump of the mid-1980s.

Oil is the region’s main export to the rest of the world. Many Arab states maintain high levels of revealed comparative advantage with respect to trade with Europe in oil products (Yeats, 1996).\(^2\) In addition to obtaining virtually all its oil from Arab countries, Western Europe has traditionally been the region’s principal external trading partner for many non-oil goods (agriculture and industrial products).

Intra-Regional Non-Oil Trade: An Underrated Factor?

In contrast to extra-regional trade, non-oil products predominate in intra-regional exports (Figure 1). The very low conventional figure for Arab countries’ intra-regional trade as a proportion of their total trade—about 5 percent\(^3\)—reflects the huge predominance of oil in the latter: if oil is excluded, intra-regional exports are a quite respectable proportion of total exports. In fact, non-oil intra-regional exports are about 19 percent of total Arab non-oil exports—a percentage comparable to intra-regional exports in Mercosur and ASEAN, although evidently far smaller in absolute amounts.

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\(^1\) Data in this paragraph are taken from World Bank, 1997a; per capita incomes are in 1995 US$. Additional information on national economies over the past two decades is given in Appendix Tables 1, 2, and 3.

\(^2\) For a brief technical description of revealed comparative advantage, see Appendix 1.

\(^3\) Trade data for Arab states were retrieved from the UN TARS Database at the SITC three-digit level. All data are denominated in US$, so growth rates must be interpreted with caution. There are significant gaps in import and export reporting to the UN; calculations in this paper were based on non-oil exports reported as imports by partner countries, so as to avoid inconsistencies between reported exports by one partner and imports by another. Delayed shipments or partial deliveries of goods would largely account for such discrepancies. Appendix Tables 4, 5 and 6 give data on no-oil exports reported as imports by Arab countries for 1982/3, 1988/9 and 1995/6.
This is a point of substantial interest for our topic, because it indicates that more may be going on in terms of intra-regional trade than aggregated data that include oil would suggest, and that intra-regional non-oil trade may have the potential for acting as a basis for developing international competitiveness in non-oil goods. Two other facts revealed by careful research into intra-regional non-oil trade are also of special interest in this context. First, the pace of this component of Arab countries’ trade has been accelerating markedly in recent years—with its annual average growth rate almost doubling in the 1990s compared to the 1980s (from 6 percent average growth in the former decade to an 11 percent annual rate in the latter). Second, the 1990s have also seen more rapid growth in intra-regional non-oil exports than in global non-oil exports. Whatever these trends might suggest about MENA countries’ integration (or lack of it) into the global trading system, they certainly call into question the conventional view of a region that barely trades with itself and has little prospect of doing more in this respect.

This having been said, it is fair to note that the countries of the region vary substantially in their proportion of intra-regional to total non-oil exports (Figure 2). Syria, Lebanon, the UAE, Saudi Arabia and Jordan, together with Libya and Yemen, have high proportions in the 30-45 percent range. In Egypt and Kuwait, along with other Gulf States (Bahrain, Oman and Qatar) the proportion is somewhat lower—ranging from 14 to 24 percent. And the Maghrebian countries of Morocco and Tunisia, with their much closer ties to Europe have only very small proportions of intra-regional non-oil exports, of less than 5 percent, as does Algeria.

**The Broadening Scope of Non-Oil Intra-Regional Trade**

In addition to being a dynamic segment of Arab countries’ trade, non-oil intra-regional exports have diversified geographically over the past two decades. Research based on trade intensity indices (TII)s helps to define the pattern of change.

Perhaps not surprisingly in view of their oil wealth and low tariffs, the Gulf states were overwhelmingly the main market for intra-regional non-oil exports in the early 1980s, to the point where Saudi Arabia alone attracted about half of all such exports. TII show that almost every Arab state had an above-average tendency to export to the Kingdom, the only exceptions being the Maghreb countries (Algeria, Morocco, Tunisia) and Libya.

Since the late 1980s, however, the pattern of trade intensity seems to have diversified in potentially interesting ways. At the sub-regional level, trade intensity within the Mashreq has been on the rise; for example, Jordan’s trade intensity with Syria has nearly quadrupled between 1988/9 and 1995/6, while its trade intensity with Saudi Arabia has grown by a much smaller amount (about 60 percent). At the same time, the propensity to export from the Mashreq countries of Syria and Lebanon to the Maghreb countries of

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4 For a brief technical description of the trade intensity index, see Appendix 1; for the specialist reader, Appendix Tables 7, 8 and 9 give non-oil trade intensity indices by country for 1982/3, 1988/9, and 1995/6 respectively.
Morocco and Tunisia has also grown faster than their trade intensity with Saudi Arabia. While issues remain with respect to heavy concentration of trade in bilateral partnerships among Gulf countries (Figure 3), the direction of trade appears to have been shifting somewhat to the west and the east. For example, Egypt absorbed about 3 percent of intra-regional exports in 1988/9, but about 5 percent in 1995/6, and Syria’s share rose from 3 percent to 4 percent in the two reference years; meanwhile Saudi Arabia’s share fell from 24 percent to 20 percent.

These trends suggest a second important positive message from the point of view of opportunities for building a dynamic Arab economic neighborhood based on enhanced intra-regional trade. Not only has such trade been accelerating in the 1990s, as noted in the previous section; it has also begun to show signs of comprising a more widely diffused set of regional customers for each others’ exports. The implication: an apparent potential for an expanding network of trade relationships across the region as a whole (but note the caution about asymmetries in Figure 3).

Complementarity and Competitiveness in Intra-Regional Trade

Another way of looking at the potential for dynamic intra-regional trade is to look at the structure of production and trade among partner countries. The more diverse the production structures of different partners, the more potential in principle for productive trade. Analysis of the main non-oil products traded regionally (figure 4) indicates substantial diversity, ranging from relatively technology intensive goods (chemicals, steel shapes, aluminum) to more traditional items (fruits and vegetables, cement and building materials). And comparative analysis at the individual country level suggests that non-oil intra-regional exports tend to be more varied and to consist of higher value added goods than regional exports to the rest of the world.

Economists have several ways of testing the robustness of the potential for productive trade among a given set of partners. One of these is testing for “complementarity”, as measured by indices of revealed comparative advantage (RCA) in the goods produced by different partners. Countries with different comparative advantage profiles should in principle have more opportunities to trade with one another than those with similar RCAs.5

Regional complementarity in non-oil products as measured by RCAs appears to be high in a number of goods sectors. Moreover, intra-regional RCAs appear to cover many more sectors than RCAs with respect to global exports; many Arab countries, including Egypt, Syria, Jordan, Saudi Arabia and most Gulf States, have twice as many sectors with high RCAs for intra-regional exports as they have for global exports.6 7 (Figures 5 and 6

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5 For a brief technical description of RCA indices, see Appendix 1; for the specialist reader, Appendix Table 10a lists the ten products with the highest RCA indices for selected Arab countries in 1996
6 Detailed time series data for selected countries are given in Appendix Table 11.
7 There are some exceptions to this generalization. Lebanon shows a smaller gap between the number of sectors with high regional and global RCAs respectively, probably reflecting its greater openness to trade
illustrate this point with respect to Egypt.) Even for Morocco and Tunisia, which are relatively unintegrated into regional trade, the gap between regional and global RCA is twice as high in favor of the region for sectors with very high\textsuperscript{8} RCA. And finally, comparison between sectors with high RCA on the basis of intra-regional and global non-oil trade respectively shows very little sectoral overlap; to take just two examples (in both cases countries with high regional-to-global non-oil export ratios as discussed earlier): Lebanon has high regional RCAs for, e.g., mens’ and womens’ clothing but high RCAs for global exports of gold, silverware and jewelry, and iron and steel scrap, while Saudi Arabia exports milk and eggs regionally and largely chemicals (sulphur, polymerization products, phenols) internationally.

Another way of evaluating the extent and potential for intra-regional trade is calculation of indices for intra-industry trade (IIT).\textsuperscript{9} Analysis of these indices suggest that factors such as competitiveness have a small but growing degree of importance in explaining the significance (and potential) of intra-regional non-oil trade. Thus, for example, IIT indices for Arab states are in general higher for intra-regional trade than for global trade (Havrylshyn and Kunzel, 1997), and, although IIT is at a very low average level compared to regional groupings elsewhere in the world, it has been growing quite fast--since 1983, average Arab non-oil IIT has increased by nearly 20 percent, and IIT for manufacturing sectors has risen by nearly 90 percent.

As with our findings reported in previous sections, there are substantial inter-country variations in IIT indices (Figure 7), although most share the pattern of indices for manufacturing IIT exceeding indices for total trade--a potentially positive indicator of competitive manufacturing-based intra-regional trade. Rates of growth of total IIT have been substantial in recent years for a number of countries, virtually doubling for, e.g., Egypt, Lebanon, Kuwait and Morocco between 1987-89 and 1994-1996. With respect to the incidence of sectors traded intra-regionally with relatively high IIT indices, Saudi Arabia has the largest percentage (with 30 percent of all such sectors having IIT indices of 0.5-1.00 in 1996). In Jordan and Lebanon, over 25 percent of all sectors have indices in the same range; for Morocco, Egypt and Tunisia the comparable figure is 15-20 percent. The growth in numbers of sectors with high IIT indices has been especially rapid in Egypt (where the number of such sectors more than doubled between 1989 and 1993), Jordan (an increase of nearly 90 percent), Lebanon (over 70 percent) and Morocco (nearly 40 percent).

given its history as an entrepot; Jordan and Bahrain have much higher global than regional RCAs for sectors such as fertilizers in the case of Jordan and aluminum in the case of Bahrain, which is one of the developing world’s top aluminum exporters.
\textsuperscript{8} RCA greater than 2.25.
\textsuperscript{9} A brief description of IIT indices is given in Appendix 1. For the specialist reader, Appendix Table 12 gives time series data on the distribution of IIT indices for selected Arab countries.
In Summary....

At this point it is worth quickly drawing together the main findings from the research outlined in the preceding sections, and seeing what they might imply with respect to the potential for a dynamic, competitive Arab trading neighborhood. The findings are quite suggestive. First, although total intra-regional exports are small in absolute terms (hovering around $8 billion: Figure 1), and are also small in relation to total global exports (including oil) from the region, netting out oil gives a proportion of intra-regional non-oil exports to global non-oil exports that is comparable percentagewise to other regional groupings. Second, non-oil intra-regional exports have been growing quite dynamically in recent years, and their distribution has broadened from a near-exclusive focus on Gulf markets to include expanded intra-Mashreq and Mashreq-Maghreb trade. Third, evaluation of indices of revealed comparative advantage and intra-industry trade suggests that real and growing opportunities exist for mutually beneficial non-oil intra-regional trade, based on a broader range of sectors than those currently competitive globally. Taken together, these findings imply that there could be real scope for using accelerated intra-regional trade, along with complementary policies to enhance competitiveness at the national level, to bring the regional neighborhood closer to becoming internationally competitive in global markets. The research suggests that the potential exists: the question is how best to realize it. One option is through formal arrangements to create a regional free trade area, a topic that we take up in Part II.


Some Principles

Economic theory at its purest tells us that the optimal allocation of global resources results from wholesale opening up of goods and factor markets to free competition. Those who can compete will thrive; those who cannot will lose out, but the resources thus released will become available to expand existing competitive activities or to build new ones. But as tends to be the case with theory, this is a counsel of perfection, ignoring both economic and political realities—including systemic imperfections in factor and goods markets and the practical infeasibility of making businesses and workers hostage to forces over which the sovereign political units into which the world is still divided, nation states and their governments, may have little or no influence.

Hence, while universal free trade remains enshrined in principle, and while substantial efforts properly continue to be made under GATT/WTO towards it, many governments, while generally abandoning adherence to mercantilism and the policies associated with import-substituting industrialization (ISI), have turned increasingly to a “halfway house” towards universal free trade, namely regional groupings based on regional/free trade agreements/areas (RTAs/FTAs), within which trade is relatively (though rarely wholly) free of restrictions and distortions.
Traditional customs union theory suggests that elimination of trade barriers among RTA/FTA members helps to promote higher group welfare, to the extent that it results in greater levels of intra-group trade, or “trade creation”. But if trade within the customs union reduces trade with more efficient producers outside the union, then this so-called “trade diversion” reduces members’ welfare (Viner, 1950). Faced with the increasing proliferation of RTAs in recent years, some have argued that RTAs/FTAs should more properly be given the more stigmatizing title of “Preferential Trade Agreements” (PTAs), and should generally not be encouraged (with some reluctant exceptions on essentially political grounds), because they positively impede the wider goal of universal free trade (e.g., Bhagwati, in World Bank 1997b).

Most economists would hesitate to go this far. Consensus opinion centers on the view that, while RTAs need to guard against welfare-reducing trade diversion and the possibility that they could slow progress towards wider multilateral trade liberalization, each needs to be evaluated individually on the basis of careful exploration of the various sources of its costs and benefits—not confined to trade creation and diversion analyses, but also taking into consideration other factors, such as their impact on investment or productivity, that cannot necessarily be measured as precisely (e.g., Winters, in World Bank, 1997b).

Finally, it is generally accepted that RTAs have a better chance of being net trade-creating if they meet certain basic criteria, including the following; (i) relatively high initial tariff barriers among potential members; (ii) geographic contiguity; (iii) broadly similar stages of overall economic development; but (iv) varied national production structures. According to these criteria, the Arab countries of the Middle East and North Africa should be good candidates for the formation of an effective RTA. In practice, this has not yet happened, despite a plethora of multilateral and bilateral agreements designed to reduce trade barriers.

*Arab Trade Integration: Practice and Pitfalls.*

At the risk of some simplification, the century from roughly the mid-1880s to the mid-1980s exhibits two broad phases with respect to the economic history of most Arab countries--domination by colonial powers and post-colonial import-substituting industrialization, with the latter stemming at least in part from the adverse experience of the former, including with respect to trade. Thus in the late nineteenth century and the pre-first World War years of the twentieth, despite the effective freedom of intra-Arab trade based on the Ottoman customs union, such trade was essentially marginalized by the development of strong financial, processing and transport linkages with Europe, notably with Britain and France, characterized by traditional export enclaves (Owen, 1992). The disastrous post-World War I political settlement effectively legitimized a British and French carve-up of the region, with the effect, broadly speaking, of perpetuating and deepening this pattern (e.g., through incorporation of Arab countries into the Sterling and
Franc zones during the 1930s). Other factors contributing to reduce intra-regional trade included the development of distinctive taxation, legal and educational systems in Arab countries following the dissolution of the Ottoman Empire. Regional trade did, however, receive a temporary boost during World War II, based on the imposition of significant barriers to world trade and following the establishment in Cairo of the Middle East Supply Center to support the Allied war effort. As a result, intra-Arab trade in oil and light industrial products flourished briefly.

The post-World War II settlement, with its newly strengthened emphasis on self-determination of peoples and its effective diminution of the power--political, military, economic--of Britain and France, created a very different set of challenges and opportunities for Arab states. Two broad, and essentially opposed, policy approaches defined much of the subsequent period. On the one hand, most Arab countries chose to pursue initially economically fashionable (and politically alluring from a post-colonial, nationalistic viewpoint) policies of import-substituting industrialization (ISI), supported by government revenues that relied heavily on import duties and other taxes on trade. On the other hand, a wider sense of regional solidarity--the concept of an “Arab nation” not constrained by what were in many cases still considered essentially colonial frontiers--helped to give impetus to a countervailing movement that was effectively antithetical to strictly “national” ISI, a movement directed at Arab economic integration, notably including trade integration. The tension between these two strands of economic policy was to underlie the story--and the effective flouting--of formal trade integration efforts for nearly 50 years.

The main elements of the story can be simply told. As early as 1950, a Treaty for Joint Defense and Economic Cooperation was signed by Egypt, Jordan, Lebanon, Saudi Arabia, Syria and Yemen at the meeting of the Arab League’s Economic Council. Its main economic objectives were tariff reduction and liberalization of capital and labor flows. It was followed up in 1953 by the Convention for Facilitating Trade and Regulating Transit, which aimed at eliminating barriers to trade in agricultural goods and minerals. Efforts to lower tariffs on manufactures were largely thwarted by Iraq, Saudi Arabia and Yemen, which relied heavily for revenue on import duties.

The next move towards integration, involving efforts to create an Arab Common Market, began in the late 1950s, when Egypt, Jordan, Morocco, Syria and Kuwait agreed in principle to unify economic policies and legislation. The five states ratified this proposal in 1964, but the intention of effectively abolishing duties and quantitative restrictions over a 10-year period was undermined by four rounds of negotiations on exemptions. Attempts to establish a common external tariff were finally abandoned in 1971.

10 Nevertheless, there was a movement during the 1920s towards trade expansion among, e.g., Palestine, Syria and Transjordan. Trade among these countries was largely devoid of customs duties (though local manufactures and certain other categories of goods were exceptions to this rule). Egypt was also an important trade partner for Syria, accounting for one-third of the latter’s exports. During the 1930s, however, new Egyptian tariffs substantially reduced Syrian (and Palestinian) exports, leading them to fall back on trade with neighbors. (Musrey, 1969).
Another attempt to promote regional integration was the 1981 Arab League-sponsored Agreement for the Facilitation and Promotion of Intra-Arab Trade. The agreement represented a declaration of intent to negotiate full exemption from tariffs and non-tariff restrictions for manufactured and semi-manufactured goods. As with previous agreements, the 1981 effort had little effect on formal trade liberalization or actual trade. It lacked binding commitment to its terms and a timetable for implementation, and featured a “positive list” approach, whereby specific products for liberalization must be listed (as opposed to the “negative list” approach, whereby liberalization covers all items other than those specifically listed for continuing protection).

Meanwhile, subregional arrangements, such as the 1981 Gulf Cooperation Council—arguably the only effective Arab trade agreement to date, with its successful promotion of trade liberalization and free movement of capital and labor among member states—and the abortive 1989 Arab-Maghreb Union, along with a proliferation of strictly bilateral arrangements between trade partners have become a feature of the Arab scene. Bilateral treaties are now estimated to number more than 45. They typically comprise limited preferential arrangements, mostly confined to varying degrees of tariff exemptions for specific categories of agricultural goods and raw materials; their partial nature has had the net effect of hindering rather than stimulating wider inter-Arab trade (Hoekman, 1995).

What lessons can be drawn from the record of post-World War II efforts to promote Arab trade integration through formal treaty-based initiatives? The short answer is “many”. We will note only a few here. First, it seems fair to suggest that the process as a whole was fatally flawed by a conflict between its motivation and goals on the one hand and the broad thrust of most countries’ economic strategies for most of the period on the other—which was statist and directed at self-protective industrialization. This meant that if ever a trade partner began competing successfully in a given sector, the temptation was to abandon free trade for the sake of perceived domestic strategic priorities, abetted by local interests determined to maintain the status quo. Second, the importance of trade taxes of all kinds for public revenues meant that governments that might be eager to support Arab solidarity in principle with groundbreaking moves towards regional trade liberalization became understandably prone to second thoughts once the bold theory of liberalization was confronted with the cold reality of perceived revenue losses from e.g., substantial tariff cuts. Third, while noble political aspirations helped to initiate successive integration efforts, less noble political frictions equally often helped subsequently to vitiate them. Fourth, at the technical level, positive list-based liberalization is a far inferior and more easily derailable process than a negative list-based approach, if only because it explicitly identifies whose ox is to be gored and how deeply—and hence provokes immediate resistance.

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11 See Appendix Table 13.
But underlying all these factors, though intimately linked to the first one in particular, was a reluctance--understandable in the post-independence mind-set that later became ossified in state (and statist) policies virtually across the region--to accept the whole philosophy of free trade, based as it is on ideas of complementarity and competition rather than those of self-sufficiency and industrialization at the expense of wider concepts of efficient resource use. And, of course, economists and influential policymakers outside the region colluded with this line of thinking for much of the period up to the 1980s. We tend now to forget that before the so-called “Washington consensus” there had been the so-called “ECLA consensus” associated with broadly admired figures such as Raul Prebisch.

**Prospects**

So what can be said about prospects for a new formal approach to Arab trade integration today, an approach designed to capitalize on the potential described in Part I for dynamic, productive intra-regional trade? Despite the daunting past record, we are guardedly optimistic, and on two specific grounds.

**First**, for better or for worse, the combination of the new competition-oriented economic thinking that has swept policymaking circles across the world and the forces unleashed by globalization (fundamentally unstoppably, we believe, despite the recent turmoil in financial markets) has radically changed the strategic thinking and economic aspirations of governments--including those of Arab countries. The region, like others in the developing and the developed world alike, is undergoing nothing less than a policy revolution. Ten or even five years ago, it would have been near-unthinkable to hear Arab heads of state and government nail their colors to the mast of free markets and competitive private sector led growth. And this adherence to market economics is far from being merely lip service to a foreign fad. Across the region, from Algeria to Egypt to Yemen to Saudi Arabia and other Gulf states, governments are adopting--sometimes swiftly, sometimes more slowly, never without some short term pain but equally never without expectation of solid long term gain--programs of economic reform directed towards outward-looking, internationally competitive, efficiency-maximizing and sustainable economic growth and development.

The zeitgeist has changed. Is there a mechanism that might embody its new incarnation with respect to trade liberalization and integration in the Arab world?

In fact there is--or there well could be, and this is our **second** reason for guarded optimism. In 1997, eighteen Arab states signed a new Arab League initiative--the Executive Program for Arab Free Trade. This agreement differs from its predecessors in a number of important ways. It incorporates specific commitments and a time schedule for reductions in tariffs and tariff-like charges, of 10 percent a year over 10 years. It also addresses non-tariff barriers. It is designed to work on a “negative list” basis and to limit exemptions, incorporates the already-tested GCC formula for computing value added, and includes binding of national tariff schedules as applied on December 31, 1997.
Implementation is to be the responsibility of the Council of Ministers of the Arab League, backed by a working Secretariat; the private sector is encouraged to monitor progress through national chambers of commerce and industry, and the Union of Arab Chambers of Commerce is charged with submitting semi-annual reports on progress and problems.

The Executive Program is far from flawless. In particular, its agricultural provisions permit the maintenance of substantial protection during the transition period, and implementation will need to be accompanied by a range of complementary strategies, some of which we shall outline in Part III. But for the first time in many years there appears to be an auspicious conjunction of an economic philosophy/strategic direction in the region radically more favorable to openness and welfare-enhancing competition than in the past, and a potential vehicle for more effective implementation of intra-regional trade liberalization. Appropriately organized and complemented by governments’ domestic and external economic policies (notably continuing to participate in multilateral liberalization under GATT/WTO), the potential exists for the creation of a new, dynamic, internationally competitive Arab export sector, based on comparative advantage, fostering technology and knowhow exchange, human capital development and product upgrading and diversification—all unleashed rather than held in check by a well-designed and determinedly implemented program of formal intra-regional trade liberalization.

III. Getting to There from Here: Some Issues and Priorities for Open Regionalism

We conclude with a brief review of some of the challenges and policy choices related to the development of an Arab regional “neighborhood”, based on a free trade area dedicated to open regionalism and designed to prepare member countries for competitive participation in global markets. In order to narrow the field of discussion to manageable proportions, we intend to touch on just six of the many areas for potential debate, as follows:

• problems associated with existing tariff and other restrictions and impediments to free and smoothly organized trade;

• issues and priorities with respect to extra-regional trade and trade liberalization arrangements;

• liberalization of agricultural trade;

• liberalization of professional/technical services and associated mobility of labor;

• issues related to foreign investment, free movement of capital, creation of industrial linkages, and promotion of small and medium enterprises;

• some political economy considerations.
Tariffs and other restrictions

Despite tariff-related policy reforms carried out in recent years by a number of countries, tariffs remain high. In Egypt, Jordan, Morocco, Syria and Tunisia, for example, average tariff rates are in the 25-30 percent range and unweighted average tariff burdens represent 17 percent of the value of imports (data are for 1993: Hoekman, 1995). While progress is being made by some countries in reducing maximum rates, the practice of tariff escalation with higher levels of processing—in Saudi Arabia, for example, tariff rates are 0-12 percent on basic goods, but 12-24 percent on processed goods—means that effective protection remains high, and is distortionary with respect to intra-regional trade.

Non-tariff barriers are also substantial and widely used, mainly in the form of additional service fees, import levies and quantitative restrictions. In Yemen, for example, imports have been liable to more than ten additional taxes and surcharges; in Morocco, a special 15 percent import levy has been assessed on most imported goods (Hoekman, 1995). In addition to their direct costs, these fees and levies have the further deterrent effect of reducing the transparency of often already opaque tariff regimes. Quantitative restrictions are also a problem, although some countries where their incidence was previously severe (such as Egypt, Morocco and Tunisia) have made substantial progress in eliminating them.

Import licensing is widespread for many industrial products, and processed foodstuffs face additional hurdles in the form of health and safety standards. Several countries (Jordan and Yemen, for example) requires physical inspection of certain imported goods at Customs before a license is granted. While enforcement of appropriate standards is important for consumer protection and public health, the practice of non-recognition of international standards in some countries has led to the belief that standards regulations as sometimes applied constitute a technical barrier to trade.

Customs procedures are another area of difficulty. In Lebanon, 18 signatures are required before goods can be released. Customs valuation can be a problem, with assessed values sometimes exceeding invoice values (Hoekman, Konan and Mascus, 1998). Ship transport charges are sometimes onerously high and distortionary; Egyptian maritime transport costs, for example, have been estimated to be 25 percent higher than those for competitors on equivalent routes (Hoekman, Konan and Mascus, op. cit.). A comparison

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12 It was noted in Part II that Arab countries depend heavily on tariffs and trade taxes generally for government revenues; on average such taxes contribute about 20 percent of these revenues, nearly three times as high as their contribution in countries such as Mexico, Chile, Indonesia, Malaysia and Korea. New research, however, suggests that concerns about the fiscal impact of tariff reductions may be exaggerated, and that a well designed tariff reform might actually improve revenues overall even as statutory tariffs decline. Recent work on computable general equilibrium (CGE) models for Egypt (where import duties account for 15 percent of tax revenues) suggests that a preferential trade liberalization scenario involving a partnership agreement with the EU and membership in an Arab League FTA could stimulate taxable economic activity to the point where the General Sales Tax (the main alternative source of revenue) could actually be reduced and revenue neutrality maintained despite FTA-based tariff cuts.
between Lebanon and Qatar covering 140 different tradables indicates that the combination of informal barriers such as costly port infrastructure, customs clearance procedures and restrictive licensing rules in Lebanon has roughly doubled the protective impact of tariffs; Lebanese prices of tradables such as clothing are estimated at nearly 70 percent higher than prices for comparable goods in Qatar.

Costs associated with land transit of goods have long been a problem burdening intra-regional trade. As early as 1952, it was observed that a truckload of merchandise from Beirut to Teheran took seven days to travel less than 1,000 km., required six sets of customs formalities and documents, and involved unloading and reloading goods into four separate trucks driven successively by Lebanese, Syrian, Iraqi and Iranian drivers. And these and other restrictive transport practices are not a problem of the distant past; more recent surveys of such costs in the Maghreb indicate that burdens attributable to excess transport costs amounted to $94 million for Algeria, $30 million for Morocco and $71 million for Tunisia.

Evidently, there are no quick and easy solutions to these issues. What they do indicate, however, is the importance of moving rapidly forward with a regional trade liberalization process that encompasses not just the tariff cuts envisaged under the Executive Program, but also wide-ranging complementary measures in the other areas identified above as inhibiting the expansion of efficient, competitive intra-regional trade. Tariff reform is just the beginning.

**Linkages with Extra-Regional Trade Initiatives.**

We focus here on the need to ensure complementarity between open regionalism in the Arab “neighborhood” and wider trade liberalization under GATT/WTO on the one hand and the proposed Euro-Med partnership arrangements with a number of Arab states on the other.

The combination of trade liberalization in line with GATT/WTO initiatives complemented by a regional FTA that reinforces adoption of most favored nation (MFN) treatment of third parties should help to stimulate competitive export sectors and ready Arab economies for full participation in global markets. A number of Arab countries (Bahrain, Egypt, Kuwait, Morocco, Qatar, Tunisia and the UAE) had already become GATT members by the end of the Uruguay Round; Algeria, Jordan and Saudi Arabia are involved in accession talks. The Uruguay Round extended multilateral liberalization in the areas of agriculture, textiles and clothing, and services, strengthened rules with respect to subsidies, and bolstered the multilateral trade framework by the creation of the WTO.

We do not intend to go into detail here in describing the specifics of the post-Uruguay Round trade picture for Arab countries, including as it does a wide range of positive and negative features with complex and varying impacts on different sectors in individual countries. But two broad points emerge. First, the abolition of the Multifiber Agreement will be of special significance to Egypt, Morocco, Syria and Tunisia, where
textiles and clothing exports amount to 20-40 percent of total exports and up to 60 percent of manufactured exports. How these countries respond to the new environment will depend on how effectively they compete (notably in EU markets) with Asian and East European suppliers. An Arab FTA that helps to stimulate trade-based cost-efficient regional production in these sectors can only help in this respect—and if it does, Arab producers hitherto “protected” by the MFA may even end up gaining from the new export opportunities that its abolition offers. Second, Arab countries’ exports of fruits and vegetables may benefit from post-Uruguay Round conditions, depending on the extent to which they improve access to EU markets. Both the challenge and the opportunity are similar to those in the clothing and textiles sectors—and an Arab FTA that stimulates regional competition and its beneficial consequences for cost-efficient production and potential diversification is the most likely guarantor of success in both instances.

The Euro-Med partnership initiative also has both positive and potentially problematic features for the Arab countries involved. (Tunisia, Morocco, Jordan and the Palestinian National Authority are already signatories; Egypt, Lebanon, Syria and Algeria are expected to join them.) While the direct gains for Arab countries are not estimated to be very large (around 1.5-1.7 percent of GDP for Morocco and Tunisia, for example) the so-called “dynamic” benefits, in terms of business alliances, diffusion of product and market knowhow, technology transfer, harmonization of regulatory and standards regimes, increased foreign investment, etc., could be very substantial. Also of great potential value is the nearly $5 billion in grant assistance to be provided by the EU in order to help upgrade physical infrastructure, build human capital and improve business performance in partner countries.

On the negative side, unless Arab countries make good use of the transition period prior to 2010 when full free trade in industrial goods and services is to be achieved, there is a danger that they will be hard pressed to compete in the enlarged market. A second issue is the so-called “hub-and-spokes” question—simply put, the danger that investment and production will flow not to Arab partners (the “spokes”, linked to Europe but isolated from each other) but to the “hub” of the EU, from which exporters will flood individual partners’ markets opened up by elimination of tariff barriers to imports.

Again, a well designed Arab Free Trade Area could counterbalance the dangers and complement the opportunities offered by the Euro-Med initiative. Elimination of intra-Arab tariff barriers would help counter the hub and spoke problem by offering investors a large, open Arab market in which to locate and serve nearly 300 million new consumers, joining forces with Arab sources of capital and making use of a labor force that is relatively well educated but substantially cheaper than EU labor. It would open up opportunities for “production sharing” in which firms across the Arab world trade components which would be incorporated into final goods. It would also eliminate the potentially paradoxical situation that could emerge under current arrangements, whereby EU firms would have easier access to an Arab partner’s home market than firms located in other Arab countries (because without intra-Arab trade liberalization, the EU firm would be able to export to the Arab partner duty-free while other Arab producers would still be
hampered by tariff and other barriers). An Arab FTA could also help stimulate Arab entrepreneurship and grow Arab businesses that could take advantage of the economies of scale made possible by a barrier-free Arab market—simultaneously making good use of EU transition funds and the dynamic gains from entering into business alliances, marketing arrangements, etc., with EU firms from a position of greater strength than they currently enjoy.

**Liberalizing Intra-Arab Agricultural Trade**

We noted in Part II that the Executive Program permitted extensive protection of agriculture during its proposed ten-year transition period. Specifically, seasonal exemptions are provided from tariff and non-tariff liberalization for up to ten product items, and bilateral preferential agreements which incorporate additional tariff exemptions for items traded by signatories are not incorporated into the Executive Program (Zarrouk, 1998).

Agriculture is a sensitive area because of its continuing importance for individual countries’ GDP, employment and extra-regional export earnings, even in the region’s most diversified economies (it accounts for 8-22 percent of total exports in Egypt, Syria, Jordan, Lebanon, Morocco and Tunisia: Golding and Kherallah, 1996). Traditionally, the sector has been heavily protected by high tariffs and non-tariff barriers (NTBs) in the form of quantitative restrictions, working through mechanisms such as import bans and quotas, import licensing, and state monopolies over imports and exports. The effects have been substantial. With respect to tariffs, *ad valorem* rates on food imports averaged 30 percent for Algeria, Egypt, Kuwait, Morocco, Libya, Saudi Arabia, Syria and Tunisia over the 1984-93 period, with NTBs frequently higher (averaging 34 percent over the period).

Liberalization of intra-regional agricultural trade would have many benefits. It would help consumers by lowering prices in the context of expected higher post-Uruguay Round world food prices. It would benefit producers, by opening up wider regional markets and potentially attracting new investment to support higher output. Examination of RCA indices suggests the desirability of a phased liberalization program, beginning with fruits, vegetables, tobacco and beverages, followed by liberalization of cereals such as wheat and barley (which are lower value-added and more water-intensive crops—an important consideration in a water-poor region), but on a gradual basis so as not to alienate domestic cereal producer constituencies. Evidence from EU experience also suggests that regional integration may offer promising prospects for intra-industry trade (IIT) in agriculture (Figure 8).

Given the combination of sensitivity and benefits, it will be important to design the process of agricultural liberalization with care. A promising approach to the transition from heavy protection to liberalization might take the form of reducing the number of tariff rates; lowering maximum and average tariffs; incorporating other duties and charges into the tariff structure; and eliminating discretionary and other exemptions.
With respect to quantitative restrictions (QRs) and quotas currently used to deal with issues of seasonality, import surges and adverse price effects, the approach used by NAFTA might be a possible model. Under this approach, “tarification” was used to transform QRs into tariffs, by initially applying a low tariff to within-quota volumes of a given import and a prohibitive tariff to above-quota volumes, and then gradually reducing the latter until it reaches the low within-quota rate while at the same time eliminating the quota.

Finally on this topic, there is another important reason to undertake a comprehensive, transparent, dependably applied liberalization of the agricultural sector within the overall context of creating an efficient, competition-enhancing Arab FTA. If we are to be frank, the governments of the region have inherited from the past a credibility problem with respect to intra-regional trade liberalization; it has been remarked that the Middle East and North Africa is the region with the largest number of trade agreements but the least real liberalization. Bringing agriculture fully into the ambit of an Arab FTA on the basis of a rational and consistently implemented strategy for sector liberalization would do much to build credibility for the proposed FTA and the wider commitment to open regionalism that must underpin it.

**Liberalizing Professional/Technical Services and Associated Mobility of Labor**

Services cover a vast and varied field, ranging from professional/technical services through financial services, to traditional income-earning sectors such as tourism. Liberalization will require an equally varied set of measures. We focus here on liberalization and labor mobility in the critical area of professional and technical services, but the principles underlying the proposals in this section have broad generic relevance for wider services liberalization and labor mobility policy as a whole.

An effective Arab FTA and a strategy of open regionalism cannot afford to ignore liberalization with respect to services—and within the services sector, professional and technical services and the mobility of their providers, on which the unrestricted availability of such services must depend. A well-functioning professional and technical services sector is critical for promoting investment and technology transfer, enhancing value added in other sectors (notably including manufacturing), and moving Arab countries into the group of potentially high-growth economies that rely on sophistication rather than cheapness as their passport to competing globally. Intra-regional liberalization and labor mobility in these areas could also help develop an Arab professional/technical services sector that could participate effectively in a key segment of a world market in services that was recently estimated to amount to $180 billion in terms of commercial services exports from developing countries alone (World Bank, 1995). A regional agreement on professional/technical services could provide a “laboratory” for experimenting with increasingly sophisticated services. And finally, liberalization would complement and indicate support for the multilateral General Agreement on Trade in Services (GATS), to which Bahrain, Egypt, Kuwait, Morocco and Tunisia are already signatories.
A regional agreement on liberalization should enshrine such key principles as transparency, national treatment of foreign (regional) providers, non-discrimination among different foreign providers, mutual recognition (and desirably over time, harmonization) of qualifications, licensing and certification, and standards, and abolition of discriminatory measures that restrict access to particular market segments. The reciprocity involved in a regional agreement should be helpful in defusing domestic opposition to the opening up of services sectors.

Because many professional/technical service activities involve the physical presence of providers, liberalization is inseparable from the free movement of providers within a regional FTA. It should be clear that we are not referring here to traditional labor mobility issues related to the importation (or restrictions on it) of large numbers of unskilled workers to do jobs that do not attract nationals; rather we are addressing mobility issues related to the creation of a regionwide network of skilled professionals able to provide increasingly sophisticated services in regional markets, and to develop the capacity successfully to export those services internationally—in ways already being pioneered, incidentally in sectors such as petrochemical and chemical engineering. For example, a Tunisian company, Tunisia Engineering et Construction Industrielle, has developed expertise that has enabled it to export a range of services such as basic engineering for phosphoric acid plants in Greece, Romania and Turkey (Ghosh, 1997).

Measures for promoting professional/technical labor mobility in the context of an Arab FTA and a strategy of open regionalism might include removing restrictions on the admission of professionals from other member countries, general coordination of immigration regulations, and easing the process of granting visa and work permits for temporary movement of e.g., corporate personnel, training specialists, and other service providers such as architects, accountants, lawyers and engineers. Because skilled service provision involves not only professional expertise but also local knowledge, limitations on residency in one member country of an expert in his/her field who may happen to be a national of another member country can deprive the local economy of the higher levels of expertise that may not be locally available. From the point of view of efficiency, it is desirable that efficiency-enhancing people should be as mobile regionally as efficiency-enhancing goods. As production (and the overall process of economic development as a whole) becomes more and more knowledge intensive, it would be anachronistic to permit the free movement within an FTA of, say, computers while restricting the entry of the programmer from another member country who may be the best person available to develop new productive computer applications. And in economic terms, human capital and skills are highly complementary across the region: why should restrictions on labor mobility inhibit capitalizing on productive complementarity in skills while an FTA fosters it in goods?

As with agriculture, we recognize that this is a sensitive area, and that the agenda to address it is both complex and fraught with pitfalls. But making a start on services liberalization in an area that is arguably critical for raising efficiency and productivity (and for the expansion of non-traditional production and exports), and promoting free
movement of the people in whom provision of such services are embodied, needs to be high on the agenda of an Arab FTA designed to create the internationally competitive Arab economies of the 21st century.

FDI, Capital Movements, Industrial Linkages and SMEs

In this section we briefly consider a set of issues connected with supporting (mainly manufacturing) production within the context of an Arab FTA. We are not here concerned with traditional tariff-and-trade matters, but rather with opportunities for enhancing regional competitiveness through complementary policies and initiatives.

Encouraging foreign investment and the free movement of capital are inextricably linked. Despite the fall-out from the financial crisis of the past year, we believe that both these items, suitably organized and supported by appropriately regulated domestic banking and financial sectors, remain essential for enhancing the prospects for success of both an Arab FTA as a whole and its members’ ability to obtain the rewards of competing effectively in wider global markets.

Foreign savings--whether composed of official grants from Gulf states and remittances from overseas workers in the 1970s and 1980s, or FDI from increasingly prominent extra-regional sources in the 1990s--have played a critical role in the economic development of the countries of the Mashreq and the Maghreb. The trend towards extra-regional FDI is illustrated by the recent experience of Morocco, where roughly 20 percent of FDI comes from regional sources, but more than two-thirds originates in Europe (principally in France).

We single out here two areas where reform is needed to sustain, and if possible accelerate, investment inflows essential for building competitive production in an Arab FTA.

First, prudent capital mobility at the regional level needs to be enhanced. Measures to this effect could include the development of regionally uniform investment laws and regulations, introduction of transparent and accessible accounting and taxation treatment, and providing appropriate mechanisms for the settlement of disputes. A regionally applicable, market oriented legal and regulatory system (including protection of intellectual property rights) would also be central to a strategy for improving capital flows. Meanwhile, stock markets in the region are relatively small; an Arab FTA might appropriately consider encouraging cross-linkages between them and trading of shares across national boundaries. A further development might involve introduction of a single, region-wide electronic trading system, which would make it possible for governments to sell bonds in both domestic and regional markets.

Second, it is a matter of record that the Arab countries of the Middle East and North Africa have hitherto essentially been relegated to the sidelines in the huge expansion of private overseas investment flows of the past five years. This neglect of the region
partially reflects investors’ adverse perceptions of geopolitical stability within it, but it also reflects at least two other critical factors. The first is the relatively small size of most Arab countries’ domestic markets; this would be explicitly remedied by a well-designed Arab FTA. The second is the perception, evident from surveys of potential investors, that over-regulation, inadequate legal standards, cumbersome bureaucratic procedures and historic hostility to free market, private sector oriented development make the region a relatively unattractive location for investment. These are matters that need to be dealt with as a matter of urgency, through a combination of deeper domestic economic reform and, as appropriate, region-wide reforms in the context of FTA development.

Industrial linkages, both intra-regional and extra-regional, provide a valuable channel for technology transfer, investment inflows, market opening and firm-level performance upgrading. An interesting form of such linkages, which has been an important source of intra-industry trade expansion between Eastern European countries and the EU, is so-called “outward processing trade” (OPT). OPT offers potentially valuable opportunities both intra-regionally and externally. It typically involves the shipping of components from a relatively sophisticated partner to a less sophisticated “junior partner” with lower labor costs for further processing and reshipment back to the “senior partner”. OPT offers substantial opportunities for learning by doing on the part of the junior partner, along with the potential for attracting investment in the latter’s plant and the technical skills of its personnel. An Arab FTA could and should promote OPT on an intra-regional basis.

An Arab FTA also has potential for promoting the small and medium enterprise (SME) sector in the region. Experience from Europe indicates that expansion of the internal market and reduction of physical, fiscal and trade barriers has had a dynamizing effect on the SME sector. Young, growth oriented firms, operating in clusters of subcontracting and cooperation arrangements, have benefited disproportionately from EU integration. There is no reason to suppose that, suitably encouraged within the framework of an Arab FTA, similarly dynamic SME expansion should not also take place within Arab FTA member countries--and given the tendency of SMEs to be labor-using and proactive in carving out new, productive market niches, such an expansion could only be beneficial for the economies of the countries of the region.

**Political Economy Issues**

We conclude with just one or two remarks on political economy issues with respect to an Arab FTA. Three points seem of special relevance. **First**, formal agreements in the context of an FTA have the benefit of “locking in” policy reforms—including those that may be politically controversial domestically. As such they can also provide cover for reform-minded national leaderships if necessary. **Second**, economic integration does, of course, imply some loss of unlimited sovereignty and untrammeled exercise of autonomous power on the part of individual states. An Arab FTA could help to legitimize and facilitate this process. **Third**, a well-organized regional FTA enhances the collective bargaining power of its membership in international fora such as the WTO.
Conclusion

This paper has attempted to cover a great deal of territory within a relatively tight compass. Let us now very quickly recapitulate its main messages. In Part I, we explored some of the facts about intra-Arab trade, and concluded that non-oil intra-regional trade actually represented a not unrespectable proportion of total Arab non-oil trade, that such trade was becoming more widely diffused across the region, and that technical research suggested that there were good opportunities for its expansion based on evidence of trade complementarity (from RCA indices) and competitiveness (from IIT indices). In Part II, we described the generally unsuccessful nature of formal, treaty-based attempts to foster regional trade integration over the past 50 years, analyzed possible causal factors for failure—notably including their introduction as devices to support industrialization rather than to promote competitiveness, with inevitably negative results—and suggested that the new Executive Program for Arab Free Trade stood a much better chance of success, not only because of design improvements but more importantly because it was being undertaken within the context of a new economic zeitgeist that emphasized competitive participation in global markets as the route to rapid and sustainable economic growth. In Part III, we identified a few of the many important issues for successful implementation of an Arab FTA. Some aspects of the ensuing coverage and discussion, and the experience of regional economic groupings elsewhere in the world, suggest a final thought. Creating an Arab FTA that dynamically enhances competitive production and trade for its member countries requires a wide spectrum of complementary actions at the national and regional level that go far beyond traditional trade issues. In effect, trade liberalization that works—i.e., that genuinely expands welfare-enhancing trade in the economic “neighborhood” it serves—is too important to be left to the trade specialists.

13 For example, one important area for complementary action not discussed here is that of upgrading the physical infrastructure (especially power, transportation and telecommunications networks) on which expansion of intra-regional trade will critically depend. For an evaluation of current shortcomings and ways to address them, see World Bank, 1996 and Derviş, 1997b.
List of References


Havrylyshyn, Oleh and Peter Kunzel. 1997. “Intra-Industry Trade of Arab Countries: An


Appendix

1). Trade Intensity Index (TIN): The trade intensity index helps to determine the extent to which the value of trade between two countries is greater or smaller than would be expected on the basis of their importance in world trade. This index is defined as the share of one country’s exports going to a partner divided by the share of world exports going to the partner, and is calculated as: \( TI_{ij} = \frac{x_{ij}}{TX_i} \div \frac{x_{wj}}{TX_w} \) where \( x_{ij} \) and \( x_{wj} \) are the value of i’s exports and world exports to j respectively, \( TX_i \) are i’s total exports and \( TX_w \) are total world exports. An index of more (less) than one indicates that bilateral trade between two countries is larger (smaller) than would be expected, given the partner country’s importance in world trade, while a value less than might convey the effects of trade restrictions or lack of complementarity between trade partners. Small countries, however, maintain relatively low shares of world trade, leading to a trade intensity index which is frequently higher than indices for larger countries which are more highly integrated in the global economy. This is clearly apparent for trade intensity measures between the Gulf states such as the UAE and Oman which maintain extraordinarily high levels of trade intensity.

2). Revealed Comparative Advantage (RCA): The Balassa (1979) index of revealed comparative advantage employs commodity patterns of intraregional and international trade to examine a country’s ability to compete in a specific market. It relates the importance of each country as a supplier of agriculture and other products to the world market relative to all competing exporting countries. Calculation of revealed comparative advantage is as follows: \( RCA_{ij} = \frac{x_{ijw}}{TX_{iw}} \div \frac{x_{jw}}{TX_w} \) where \( x_{ijw} \) is the value of country i’s exports of j to the world (region), \( x_{jw} \) represents exports of commodity j by the world, (region), that is, exports of the commodity by all competing producers, \( TX_{iw} \) and \( TX_w \) represent total exports of all commodities by country i and the world (region), respectively. An RCA greater than one indicates that the share of product j in country i’s exports is more than the corresponding world trade share implying that the country has a revealed comparative advantage in production and trade of the product. Conversely, an RCA less than one suggests that the country has a comparative disadvantage in the good.

3). Intraindustry Trade (IIT): The IIT index used here follows the original work of Grubel and Lloyd (1975), and the following discussion is based on Havrylyshyn and Kunzel (1997). Trade in different products or inter-industry trade is defined as \( INT_e = |X_j - M_j| \) where \( X_j \) are total exports in product category j and \( M_j \) are total imports in product category j. Intraindustry trade is simply all trade that is not inter-industry trade or: \( IIT_j = [(X_j+M_j)-|X_j-M_j|] \). IIT can be normalized to obtain a measure of the share of intra-industry trade for each commodity: \( IIT_j = [(X_j+M_j)-|X_j-M_j|] \div (X_j+M_j) \). In this paper, Grubel-Lloyd indices for intra-industry trade are computed for each nonoil sector at the SIC 3 digit code, and summed over n nonoil sectors using the following aggregation index: \( \Sigma_n (X_j+M_j)-\Sigma_n|X_j-M_j| \div \Sigma_n (X_j+M_j) \). If there is no intra-industry trade, one of \( X_j \) or \( M_j \) will be zero so that the IIT index will be zero. On the other hand, if all trade is intra-
industry trade, then the IIT index will take a value of 1. The aggregation measure used here has been criticized as being biased downward by the degree of trade imbalance, so that the larger the trade imbalance, the larger the net trade and the smaller the IIT index. Adjustments to correct for this bias exist but previous studies show that they do not significantly change the unadjusted index. In addition, the IIT index does not discriminate against re-exports which do not indicate increased specialization but rather represent the simple flow of goods through a country. Re-exports are particularly relevant in the case of trade between the UAE and Oman. Interpretation of IIT indices are as follows: an IIT of 0.25 suggests a level of industrial advancement of 25% which is relatively low, since the majority of industrialized countries such as the EU have IIT levels on average of 0.86.