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Recent US Free Trade Initiatives in the Middle East: Opportunities but no Guarantees.¹

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Abstract. This paper evaluates the US initiative to establish a Free Trade Agreement with countries in the Middle East by signing bilateral agreements with the countries individually and then combining them into a single arrangement. These agreements present new opportunities for Arab countries, but to take full advantage, they will have to complement the agreements with additional policy measures, both individually, and together. The promise comes from the ability to use the agreements as a catalyst for improving regulatory rules and systems at home and facilitating integration with the rest of the region and the world. But the agreements also present problems for Arab countries, first in relating these US agreements to agreements with other trading partners – most importantly the EU; second in creating political difficulties associated with closer relations with the USA given problems in the region, and third, in undertaking the necessary economic and political policies that are necessary to realize the benefits.

¹ This article draws extensively on a study I have recently completed on the topic. For a more extensive discussion and elaboration see therefore, Lawrence (2006).

In 2003, in a speech at the University of South Carolina, President George W. Bush proposed creating a comprehensive free trade area (FTA) between the United and the Middle East (MEFTA) by first negotiating comprehensive free trade agreements with countries in the region bilaterally, and then combining these into a single overarching arrangement between the US and the region as a whole. The Bush Administration has begun to implement this strategy by negotiating FTAs with Morocco, Bahrain, Oman and the United Arab Emirates. In addition to the earlier agreements that had been signed with Jordan and Israel (and extended to the west Bank and Gaza) this meant that by 2006, the US had six concluded FTA arrangements with countries from the region and a seventh with the UAE was in prospect.

The US interest in MEFTA is not primarily economic. Rather, it reflects geopolitical and security considerations. The MEFTA initiative reflects the judgment that US interests cannot be advanced through purely military or political initiatives. To be effective in the battle for hearts and minds in the region the policy needs an economic component. By contrast, for Arab countries the interest in MEFTA is primarily economic.

For Arab countries, the attraction of Free Trade Agreements with the United States stems primarily from four types of economic advantages they could provide. First, there are the direct benefits that come from increased trade and investment. Free Trade Agreements afford preferential access to the large US market that could result in increased exports and more investment by both foreign and local firms. They will also improve consumer welfare by reducing domestic prices and increasing competition and choice in the domestic market. Second, the agreements can be used to improve trade

relations of Middle Eastern Countries vis-a-vis other trading partners. They will reduce the trade diversion that results from other preferential arrangements, such as the Euro-Med Agreements with the European Union. They will also enhance the region's bargaining power with other countries that will wish to be accorded treatment similar to that obtained by the United States. Third, the agreements can help to promote increased regional integration. If several countries in the region sign similar agreements, these can also be used as the basis for deepening regional economic integration. The most ambitious hope is that the US initiative could spur all Arab countries to take these necessary steps vis-a-vis the US and then with each other; a somewhat less ambitious outcome would be for a select group of countries to launch a regional integration that achieves deep economic integration among those countries who are willing. Finally, and perhaps most importantly, the agreements can assist with domestic reforms.²

But will these FTA agreements be effective in advancing the goals of those who sign them? Judged by the history of FTAs in the region, some skepticism is probably in order since many have not lived up to expectations.³ Middle Eastern countries have often grasped the symbols of Arab unity but been unwilling to engage in the fundamental systemic changes that would really make their markets mutually contestable. Foot draggers have also been able to stall meaningful agreements or taken steps that deny full implementation. In addition, there are also questions about size of the benefits such agreements might produce because most Arab countries have relatively modest trade and investment links with the United States; the European Union is by far a more important trading partner. In 2003 for example, EU imports and exports from Arab countries were

² See for example Galal and Lawrence 2005.

³ For an excellent review of Arab regional efforts see Fawzy (2003).

4.6 and 3.7 times larger than those from the US respectively while the non-oil exports to the US amount to around 6 percent of all exports from Arab countries and the US accounted for only 8 percent of these country's imports.⁴

Nonetheless, what *is* particularly striking about the agreements signed by Morocco, Bahrain and Oman is their comprehensive and deep character. They require liberalization, not only for trade in all goods, including agriculture, but also many services and foreign direct investment. In particular, the prototypical US agreement requires virtually complete liberalization of industrial and agricultural products, extensive coverage of market access for services, rights of establishment with few exceptions for foreign investment, obligations to protect intellectual property more extensive than those in the WTO Trade Related Intellectual Property (TRIPs) agreement, commitments on government procurement, policy transparency, technical barriers and standards, and provisions to adhere to labor, and environmental standards that are all enforced by dispute settlement agreements backed by the possibility of the suspension of concessions and/or payment of monetary assessments.⁵

The deep character of these agreements reflects the fact that while the Middle East has been given unique political priority, the US is also negotiating similar agreements based on a standard template with other countries in many parts of the world.

⁶⁷The Administration has tried not to depart from this template, partly because it reflects

⁴ See Lawrence (2006) pp 95-96.

⁵ The agreements also exclude commitments on agricultural subsidies and antidumping rules. The former because these can only be dealt with in a multilateral context since the US seeks reciprocal concessions from partners such as the EU, and the anti-dumping rules because of strong domestic political resistance to weakening them.

⁶ See Schott (2004) for an analysis of the US FTA strategy.

⁷ These have included NAFTA (with Mexico and Canada), Chile, Singapore, Australia, Central America (CAFTA), Dominican Republic. Negotiations have concluded with Colombia and Peru and are ongoing with Thailand, the South African Customs Union, South Korea, and Malaysia.

the type of agreement the US congress will support and partly because it does not want to set a precedent of departing from the framework that other countries can point to.

By contrast, with the exception of the GCC, most previous agreements signed by Arab countries both with the European Union and among each other, have generally dealt only with border barriers such as tariffs and quotas and, even with respect to these, coverage has often been incomplete. While the countries in the region have made some progress in reducing tariffs, particularly on regional trade, they have failed, therefore, to deal effectively with non-tariff barriers and the liberalization of services and investment. The pan-Arab, Greater Arab Free Trade Agreement (GAFTA) for example, covers only trade in goods and remains deficient with respect to rules of origin and implementation. The sub-regional Agadir Agreement (between Egypt, Jordan, Morocco, and Tunisia) has corrected the rules of origin issue for four countries.⁸ But Agadir deals only with trade in goods.

I will argue in this paper that the deep nature of the US agreements presents new opportunities for Arab countries. But to take full advantage, they will have to complement the agreements with additional policy measures, both individually, and together. The promise of the agreements comes from the ability to use them as a catalyst for increased economic benefits by improving regulatory rules and systems at home and facilitating integration with the rest of the region and the world. But the agreements are not panaceas. They also present problems for Arab countries, first in relating these US agreements to agreements with other trading partners – most importantly the EU, second

⁸ Agadir uses EU rules of origin issue to take advantage of EU provisions that allow value-added in any of the countries to count towards meeting the rule of origin for exporting to the EU (so-called diagonal cumulation) and the agreement is an important and positive example of the way in which agreements outside the region can form the basis for improved regional integration.

in creating political difficulties associated with closer relations with the USA given problems in the region, and third, in undertaking the necessary economic and political adjustments necessary to realize the benefits.

In what follows I will explore these issues in greater detail. I will first present some evidence on the need for MEFTA-type agreements by Arab Countries. I will then consider whether the particular approach the US is using is likely to result in an overarching agreement. Next I consider the relationship between the US agreements and those with the EU. I then evaluate the potential economic impacts of the agreement and finally suggest what the US and the Arab countries need to do to maximize the potential benefits from agreements and minimize their negative effects.

The Need for Change. MEFTA seeks to liberalize trade and investment, facilitate domestic reforms and encourage deeper regional trade arrangements. The Arab economies have both the need and the scope for adopting these policies. The need arises from the challenge of creating employment in the private sector for their growing labor forces and the scope from the poor state of the regulatory environment for private enterprise, particularly with respect to international trade.⁹

With only a few exceptions, almost all Arab countries have chronic unemployment problems that fail to meet the challenge of providing new labor force entrants with private sector employment opportunities. There are many reasons for this, but an important role is surely played by the very weak regulatory environment. Over the past decade, some reforms have been undertaken and per capita economic growth has generally accelerated but performance still falls short when benchmarked against other

⁹ See Nabli (2005), Noland and Pack (2006) and Yousef(2004).

countries and against the demand for jobs. According to work done at the World Bank, which uses a large number of sources, when ranked against other countries, the regulatory regimes and governance institutions in Arab countries do poorly.¹⁰ The weakest dimensions of governance in the region relate to the exercise of political freedom and accountability, but the region is also particularly weak with respect to regulatory policy. These results hold true even when income levels are taken into account.

With few exceptions, there has been little relative improvement in these regulatory policies over the past decade.¹¹ To be sure, there have been reforms in many Arab countries, but the rest of the world has also been changing, and thus comparatively the Arab countries have not risen in the rankings. By international standards, Arab administrative regimes for doing business in general and conducting trade across borders in particular are extremely burdensome. Even in Gulf States where tariffs are relatively low, trade is seriously impeded by bureaucratic intervention.

The current regulatory regimes in many Arab countries impede private sector entrepreneurship, but they have persisted because they also generate benefits for those who skilled in operating within the system and those people that the system empowers to grant benefits. Altering these regulatory regimes will create new winners and losers, and therefore has important political implications.

There is lots of evidence that the regulatory system has impeded international trade. A large number of studies suggest that judged by international norms, the countries in the region trade considerably less with each other, with the United States and

¹⁰ See Kaufmann et. al. (2005).

¹¹ See Dasgupta et. al (2002).

with the rest of the world than would be expected.¹² In addition, particularly in the Gulf countries, foreign direct investment is unusually low. Part of the explanation for this weak performance is trade and regulatory policies. Once non-tariff barriers are taken into account, on average trade protection in the region is higher than any other region in the world.

In addition to indicating considerable scope for improving regulatory policies in Arab countries, the governance measures highlight two challenges for MEFTA. First, there are major differences among Arab countries with respect to regulatory quality and administrative efficiency. The countries with whom the US has already signed are those with the highest regulatory quality, suggesting that the US has followed its announced intention to sign agreements with “countries that demonstrate a commitment to openness and reform.”¹³ The first five Arab countries the United States agreed to negotiate bilateral Free Trade Agreements with (Jordan, Morocco, Bahrain, UAE and Oman) rank among the top eight countries in terms of regulatory quality and among the top six when income levels are taken into account. But regulatory policies are much poorer in the rest of the region. This diversity in quality presents serious problems for comprehensive participation in a single agreement.

Second, as noted Arab countries uniformly have low rankings with respect to the political governance variables, particularly political accountability. This suggests that if the MEFTA is to become a reality within ten years, either the pace of political reform

¹² These are surveyed in Lawrence 2006 chapter 2. See also Soderling 2005

¹³ Robert B Zoellick “A Return to the Cradle of Free Trade” Washington Post OP ED 06/23/2003

will have to accelerate dramatically, or major political reforms should not be made a precondition for membership.

Will a bottom up Approach work? The MEFTA approach is bottom up. The US aims to first negotiating bilateral agreements, then link them in sub-regional agreements and only at the end of the process will construct a single MEFTA. There is clearly a trade off between mega-regional initiatives that are built bottom up and those that are constructed collectively in a single agreement with all participants simultaneously. The top-down approach has the virtue of allowing for a set of rules that is approved by all and under which all parties operate. But obtaining agreement can be difficult in a collective negotiation with many participants because foot-draggers can stall the process or water-down agreements that are actually concluded. Indeed the recent history of efforts such as Free Trade in the Americas (FTAA) and APEC point to the problems in this approach. By contrast, the bottom- up approach permits those most willing and able to move first. It also allows them tailor the details of their agreements to particular bilateral circumstances. The advantage of the MEFTA, therefore, is that it has allowed for the conclusion of deep and far-reaching agreements that almost certainly could not have been negotiated with universal Arab participation. But the cost of the approach is that it creates a number of overlapping trade regimes that present problems for eventual integration.

Even though the US has followed a boiler plate approach to the agreements, there are still important differences among them, mainly because the US blueprint has evolved over time. The US MEFTA initiative also presents signatories with problems of administering different systems of rules in their trade with the US, the EU, their regional

partners and the rest of world. These conflicts are most evident in relation to rules of origin. Producers in Jordan today, for example, have one set of rules of origin when exporting to the US under the special QIZ scheme, another with the US FTA, a third with respect to Arab League Partners, and a fourth with the EU and Arab countries that are the Agadir Agreement.

The piecemeal approach adopted by the US thus presents major challenges for eventually establishing a single MEFTA agreement. In particular, the early FTAs under which Palestine and Jordan and Israel operate are very different from more recent agreements signed by Morocco, Bahrain and Oman. This is evident from their length. US-Jordan is roughly twenty pages long; the more recent FTAs run into hundreds of pages. The agreements with Israel and the Palestinians cover only trade in goods. While the Jordan-US FTA includes services, in contrast with subsequent agreements, it uses a positive list approach. If the US insists that MEFTA should follow the more restrictive and demanding FTAs that have been negotiated starting with Morocco, the countries with early FTAs will be required to assume major new obligations. This is especially the case for rules of origin since the FTAs with Israel and Jordan (and the Egyptian QIZ) provide for rules of origin that are considerably less stringent than in the agreements with Morocco and Bahrain. These differences will make agreement on the final rules more difficult and absent such integration a hub-and-spoke arrangement centered on the US could emerge. Alternatively one could imagine an agreement with variable geometry in which countries have different levels of commitment.

The more recent agreements also differ in terms of coverage, the nature of the dispute settlement system and numerous other provisions from the earlier agreements

with Israel and Jordan. A particular challenge for eventual integration and a single MEFTA Agreement is presented by the unique Jordan system for dealing with disputes over rules for labor and the environment. The Jordan model is popular among US Democrats because it subjects violations of these rules to the same procedures as violations of other parts of the agreement. But, for precisely this reason, it is disliked by Republicans.

In sum, even aside the obvious political problems of achieving a single MEFTA that includes Israel and all the Arab Countries, there are numerous institutional barriers to its full realization. From the standpoint of Arab countries, the bottom-up approach is a mixed bag. The initiative creates tensions among Arab countries because it divides the region by separating countries according to their ability to integrate internationally and their political acceptability to the United States. This offers those most willing and able to negotiate the opportunity to differentiate themselves in both these respects. But for those who are less willing this is a problem.

In addition, the bottom-up approach prevents the Arab countries from initially forming coalitions, compelling them to bargain individually with the United States. The consequence will be initial agreements that are less reflective of their collective interests. At later stages, however, as an overarching MEFTA begins to emerge they should find it easier to coordinate their positions. Nonetheless, while the approach that has been selected is possibly less likely to guarantee that eventually a single MEFTA will emerge, it is more likely to ensure that the agreements that do emerge are likely to retain their deep character.

The MEFTA has the goal of encouraging regional integration, yet, in contrast to the EU, the willingness of the US to negotiate individually with GCC countries has created tensions for the operation of the common external tariff of its customs union. On the other hand, this has created a mechanism for those Gulf States that are most interested in economic reforms to place competitive pressures on those who are more reluctant to do so.

More recent developments have raised some questions about whether the US will actually be able to sustain the initiative to bring it to completion. ¹⁴When Dubai Ports World acquired the Peninsular and Oriental Steam Navigation Company, it obtained control over facilities at six US ports. The officials who sit on the US government interagency committee responsible for reviewing foreign acquisitions for possible threats to national security, (CFIUS), viewed the sale as routine and approved it in November 2005. However, the case became highly controversial when stirred up by a company with financial interests in the deal's failure and opposition mounted in the US Congress. The acquisition was painted in a highly negative light not only by the President's opponents who seized on the chance to be tougher than he was on a national defense issue but by many in his party. Eventually the Dubai Ports World Corporation responded to the controversy by selling the US port facilities to a US-controlled firm.

The entire affair marked a sea-change in the politicization of a process for reviewing Foreign Direct Investment that had previously been routine and technical. It revealed problems with the CFIUS process in general that may require reform.¹⁵ It also demonstrated how public fears can make it difficult to distinguish between America's

¹⁴ For a more complete discussion see Graham and Marchick (2006).

¹⁵ See Graham and Marchick (2006) Chapter 6 for a discussion of possible reforms.

Arab allies and genuine threats to its national security. This treatment certainly makes it more difficult for Arab countries to view the investment provisions of Free Trade Agreements as a genuine two-way street. The incident occurred at the same time as the US and the United Arab Emirates (which includes Dubai) were negotiating a Free Trade Agreement, and it was not surprising that in the immediate aftermath of the affair, the talks were temporarily postponed.¹⁶

The affair also affected the passage of the US-Oman FTA Agreement in mid 2006.¹⁷ While the Congress did ratify the agreement, in the House of Representatives the margin of victory was very narrow -- 221 votes in favor and 205 against. This was very different from the vote on the US-Bahrain FTA which passed in late 2005 by a vote of 327 to 95. In contrast to the bipartisan support that had characterized votes over earlier Middle East FTAs the agreement with Oman only garnered 22 votes from Democrats -- just seven more than the very controversial free trade agreement with Central American countries in 2005. The most contentious issue related to ability of the US to prevent an Omani firm from operating a U.S. port or other facility.¹⁸ US had not listed ports services as an exception to the Agreement and several Democrats based their opposition on concerns that the Agreement could give Oman the right to challenge national security decisions made by the US with respect to the operation of ports, despite the fact that the Agreement contains national security exceptions.

¹⁶ On March 10, the USTR announced that the fifth round of FTA talks between the U.S. and UAE, which were scheduled to begin on March 13 in Abu Dhabi, would be postponed.

¹⁷ The Congress can be counted on to interpret a vote on a bilateral FTA as a referendum its more general views of that country. This has made certain bilateral FTAs especially contentious. The NAFTA debate for example, introduced all kinds of issues relating to Mexico many of which were not directly linked with trade. Likewise the vote on CAFTA in 2005 generated controversies relating to human and labor rights and passed by a mere 217 for and 213 against in the House of Representatives.

¹⁸ Labor rights issues were another source of opposition.

The earlier, overwhelming and bipartisan support in the US congress for FTAs with Middle Eastern countries reflected political rather than economic considerations. The 2006 elections in which the Democrats have gained majorities in both houses of congress make the environment for trade agreements even more uncertain. These events demonstrate, however, that political considerations can be a double-edged sword. Earlier it was political considerations that made FTAs with the Middle East popular, more recently however, the politics has become problematic. This all highlights the importance of keeping the focus of the MEFTA process on economic issues and avoiding political issues that are better dealt with by other means

Are the US and European Initiatives Compatible? Another major challenge is presented by the European initiatives in the region. Like the US, the EU has also announced its intention to conclude a free trade agreement with the Middle East by 2010. The EU already has “Euro-Med” bilateral FTAs with most Arab countries outside the GCC. The EU has also developed a system for Pan-European rules of origin that permits diagonal cumulation among regional members with an FTA (like Agadir) that uses European rules of origin. The Euro-med agreements are part of Association Agreements that cover a far broader range of non-economic issues than the US agreements, but their trade provisions are more limited: they fail to include services and investment and have serious limitations with respect to agriculture. However, the EU is now moving to second phase in which willing partners will be invited to sign pluri-lateral agreements that cover services and investment. The EU is also negotiating individualized work programs (Partnership Agreements) with each Middle Eastern country that will support

reforms in areas mutually considered to be priorities.¹⁹ Countries are also being encouraged to adopt European standards and norms in addition to EU rules of origin.

An important issue is whether, in contrast to its earlier initiatives, the recent EU approach will be an effective anchor for reforms.²⁰ The fairly standardized nature of the US - FTAs allows reformers to argue that the entire package must be adopted. The requirements for full EU membership were perhaps even a more powerful anchor in the case of the countries that have recently acceded. But the ala-cart approach in the EU Neighborhood Policy may make it easier for countries to avoid reforms that are politically difficult.

The US and the EU share the broad goal of trying to promote economic development in the Middle East and encourage political and social reforms. And in many respects their initiatives are complementary. But there could also be serious problems. For example, if Arab countries use EU rules of origin in their regional arrangements, how could they become eligible for diagonal cumulation under US rules? Would the US recognize EU rules? Unlikely. Would Arab countries be expected to implement two differently sets of rules in the preferential agreements they sign among themselves? Similarly, would the standards they are required to use by the US agreement be compatible with those required by the EU? These tensions with the EU are particularly relevant because Arab countries typically have three or four times as much trade with the EU than they do with the US and if forced to chose, Arab countries would probably follow EU rules, thereby limiting the potential regional impact of a US agreement.

¹⁹ For a more complete discussion see Hoekman (2005)

²⁰ For an excellent analysis of the earlier agreements see Tovias and Ugur (2004).

What Economic Impacts Will MEFTA have? The relatively small value of bilateral trade between Arab countries and the US is also relevant when estimating the likely impact of the MEFTA. MEFTA will eliminate all tariffs on trade between the United States and the Arab Countries. To start thinking about its effects, therefore, it is helpful to consider the current levels of bilateral trade and the duties that are currently paid. While some Arab countries levy fairly high tariffs on US exports,-- on average the rate in 2003 was around ten percent --the US generally charges very small duties on Arab exports to the United States --just over half a percent in 2003. The predictable results of simulations using both partial and general equilibrium models of freeing this trade therefore are that (a) the impact is fairly small and (b) in most Arab countries imports from the US increase by more than exports to the US. Estimates of far less than one percent of GDP for the increase in welfare generated are quite typical in conventional simulations

However, capturing only the static effects of eliminating tariffs on goods may seriously understate the impact of the agreements. The additional effects of reducing non-tariff barriers and the liberalization of services trade and foreign investment should not be ignored. Simulations of these additional effects suggest they could be large.²¹ According to estimates using Tunisia and Egypt as examples, liberalization of foreign investment in services that is generalized to all trading partners could boost welfare by almost ten percent of GDP. (Konan and Kim 2004).

In addition, simulation models typically assume that the structure of trade will remain unchanged. They therefore capture only the responses induced to the goods that are currently traded. This has yielded quite misleading results. Kehoe, for example,

²¹ See Hoekman and Konan (2005).

evaluated the performance of so-called applied general equilibrium models on the impact of the North America Free Trade Agreement and found that these models “drastically” underestimated its trade effects, particularly in sectors in which originally there was little trade. Similarly, the International Trade Commission (USITC 2000) studied the potential free trade agreement between the US and Jordan and totally missed the explosion in that country’s exports of clothing to the US as a result of special trade concessions it was granted by the US. As Jordan and more recently Egypt’s experience with the QIZ demonstrates, however trade agreements *could change the trade structure* by inducing new export products and thereby generate effects that conventional modeling will ignore. Jordanian exports to the US increased from \$72.8 million in 2000 to a stunning \$1.267 billion in 2005 and the exports were so large that the bilateral balance of traded shifted from a Jordanian deficit of \$239 million in 2000 to a surplus of \$624 million in 2005. Similarly Egyptian QIZ exports to the US have grown very rapidly between 2004 and 2006.

Most significantly, however, the models fail to consider the effects these agreements could have in altering the trade regimes and regulatory policies in Arab countries. The more recent US agreements with Arab countries are extremely comprehensive. They require members to assume obligations that in many respects go much further than the WTO. There are provisions freeing all foreign direct investment and all services, with exceptions listed (negative list). There are agreements with respect to policy transparency, government procurement rules and practices, the operation of customs, and enforcement of intellectual property protection and labor and environmental

laws. WTO rules for sanitary and phyto-sanitary standards and technical regulations are included in the agreement and the provision.

If Arab countries adopt and implement these provisions with respect to the United States there could be fundamental changes in the nature of their trade regimes. Improvements in the operation of customs, the transparency of policy, procedures used for government procurement, the laws for intellectual property and other regulatory practices such as standards based on science will change the system not only for US trade and investment but for all foreign and domestic firms who trade in these countries.

Opening services trade to foreign investors will heighten competition, which could generate important improvements in productivity. These key potential benefits from US agreements are by their very nature difficult to measure. But there are reasons to believe they could be considerable, provided the appropriate complementary domestic policy steps are taken. But these benefits will require domestic leadership that takes advantage of the opportunities that are created. In this respect, however, the deep nature of the US agreements is a great advantage.

Most of these benefits could be achieved by countries that individually sign deep bilateral FTA and complement them by domestic reforms. If such reforms and liberalization are achieved by some Arab countries individually, their neighbors will automatically benefit from their more open regimes even absent formal regional arrangements and with the United States. Thus as long as individual countries implement these agreements the overall initiative seems worthwhile even if the difficulties of eventually consolidation are considerable.

An important concern in Arab countries relates to the inclusion of issues such as labor and environment in these agreements. In these areas, however, the specifics of the agreements need to be examined carefully. The agreements do not require adherence to *specific* environmental and labor standards.²² Instead, the countries commit in general terms to promote workers rights and protect the environment and the agreements emphasize the *enforcement of domestic environmental and labor laws* and not weakening environmental laws or reducing domestic labor protections in order to encourage trade or investment.

Moreover when it comes to enforcement, the agreements stress that “the parties retain the right to make decisions regarding the allocation of resources to enforcement with respect to labor (or environmental) matters determined to have higher priorities. To be sure, these obligations are backed by the Agreements’ dispute settlement procedures and cases can be brought where enforcement failures affect trade. However, if one party is found guilty of such infractions, and fails to come into compliance, the other side may not be entitled to retaliate using trade protection. If either country is found by a panel to be in violation of its enforcement obligations it can be subject to a monetary assessment. Moreover, such an assessment cannot exceed \$15 million and the funds are not necessarily paid to other party but may instead be used to help improve compliance. In sum, concerns that these provisions could be used to deny countries benefits are likely to be exaggerated.

Recommendations: By itself, under current conditions the impacts of most individual agreements and even an overarching MEFTA are likely to be modest for three

²² The Moroccan agreement, for example states that the Parties “shall strive to ensure” that its labor laws are enforced and consistent with the right of association, the right to organize and bargain collectively, the prohibition on forced labor, a minimum age of employment, and acceptable work conditions.

reasons. First, the current trade and investment links between the United States and the Middle East are relatively weak. Second, the regulatory and business environments in many Arab countries continue to impede the global integration of these economies. And third, the negative political fallout from US intervention in Iraq and the friction between Israel and its neighbors far outweighs the political benefits the US could obtain from the initiative. Nonetheless, the MEFTA initiative provides both the US and its Arab partners with opportunities to take additional measures that could yield much greater benefits. While trade agreements provide opportunities; they do not guarantee results. They can contribute to positive economic and political outcomes but need to be accompanied by other policies and actions by the private sector.

United States. For the United States, the principle challenges are sustaining the initiative politically; keeping the focus of the initiative on trade and investment issues; improving some of the specific rules of the agreement; introducing mechanisms that will facilitate integration among its Middle Eastern partners; and achieving a political settlement of the Arab-Israeli conflict.

Paradoxically, the United States will reap greater political benefits if, to a greater degree than it has done so far, it keeps MEFTA on a strictly economic track. MEFTA should be focused on maximizing the economic benefits it can bring to Arab countries. The criteria for MEFTA membership should be the capacity to implement and benefit from the agreement. The use of MEFTA as a bargaining chip to induce internal political reforms and changes in other policies, however well intentioned, is likely to backfire. This is likely to be difficult though in an environment in which Democrats who oppose trade agreement, are especially likely to bring political considerations into the debate.

Particularly in the more recent agreements, the US has appropriately insisted on Free Trade Agreements that achieve much deeper integration than the WTO requires of its members. This approach entails liberalization of all merchandise trade including agriculture, services (with exceptions) and foreign direct investment, and credible dispute settlement provisions. The depth of the MEFTA agreements ensures that the agreements are not merely symbolic; it also promotes their use as an anchor for domestic reforms. The agreements should not be watered down in an effort to attract more reluctant members. It is better to have comprehensive bilateral and sub-regional agreements, than weaker agreements to which all countries subscribe.

However improvements could be made with respect to the more protectionist provisions of the agreements relating to restrictive rules of origin and excessive intellectual property protection. The US should not be imposing intellectual property rules that cannot be justified as measures to stimulate innovation in Arab countries and can only be justified as measures to maximize the income of US pharmaceutical and other companies. MEFTA has recently run into security concerns that have been provoked by the Dubai Ports affair. The agreements need clearer national security exception provisions that prevent opponents using national security as a pretext for rejecting the agreements.

Since the number of agreements has now reached a critical mass, more attention also needs to be paid by the US as to how they can be integrated. In particular, a mechanism for diagonal cumulation needs to be developed to allow value-added in any of the countries to be combined to meet rules of origin requirements. Ideally this would be done on the basis of the relatively straight forward the rules of US-Israel agreement. The

US should also work with the EU to craft common rules of origin or mutual recognition of each others rules. Consideration should also be given to developing regional, rather than bilateral dispute settlement mechanisms.

Given its political objectives, the US should make a separate FTA agreement with Palestine a high priority. The current coverage of the West Bank and Gaza under the US-Israel FTA is inadequate and does not meet Palestinian needs for increased international engagement and domestic institutional reforms. In particular, the failure to cover investment is a serious gap. To be sure, the US currently faces difficulties in dealing with the Hamas administration, but eventually a US-Palestine FTA is a key building block for a MEFTA that lives up to its potential.

Finally, a comprehensive MEFTA arrangement is unlikely absent an acceptable settlement of the Arab-Israeli conflict. The US is unlikely to sign a comprehensive agreement with the region that does not include Israel. It is difficult, however, to imagine several Arab countries agreeing to a comprehensive arrangement that does include Israel. The political interest that the US has in the region provides unique opportunities for those seeking to use agreements as a stimulus to reform. But from the region's standpoint, it should also be acknowledged that the political nature of the US interest creates problems as well as opportunities. It is not easy to adopt policies for domestic economic reform and increased international integration in the first place. Whatever the long run payoff may be, reforms and trade liberalization create losers as well as winners. In this context, it is only too easy for opponents to wrap their opposition in nationalist and religious flags. The debate over free trade is becomes particularly difficult and charged when it is conflated with the debate over relations with the US and/or Israel.

Arab Opportunities. Arab countries that have signed agreements with the US should use them as an opportunity to undertake additional reforms in their domestic policies to improve the business regulatory environment; undertake additional measures to improve their international competitiveness, enhance Arab regional integration by extending the MEFTA provisions and coverage to each other; coordinate negotiations with the US and promote trade and investment liberalization with extra-regional trading partners. Finally, countries that have not signed such agreements need to carefully weigh the implications of participation and where these are deemed positive prepare carefully to be in a position to join.

The agreements themselves improve domestic regulatory policies by requiring measures such as greater regulatory transparency, better government procurement procedures, technical and health standards based on science, improvements in customs procedures, and better intellectual property enforcement. Countries should build on these measures to reduce the excessive red tape associated with domestic and foreign business transactions.

Simply signing MEFTA is insufficient. To exploit its potential, domestic based firms need to be competitive. Private firms need to change their corporate strategies to confront competitors both at home and in the United States. Governments too, need to adapt their policies to encourage domestic and foreign investors to take advantage of the improved access to the US market.

The fact that several countries in the region are willing to make the extensive commitments required by US FTAs suggests that there is scope for deeper integration agreements in the region based on the provisions. GAFTA and Agadir for example are

limited to trade in goods. MEFTA breaks new ground for many countries by including extensive obligations in services, foreign investment, standards, and dispute settlement. agreements should also be used as a means of developing regional integrative institutions.

Countries that have signed agreements with the US independently need to think about coordinating their negotiating strategies with respect to how these agreements can now be linked. Strategies for achieving diagonal cumulation and perhaps broader participation in dispute settlement are examples.

The agreements should be used as a basis for negotiating other bilateral and plurilateral agreements with trading partners outside the region. By signing an agreement with the United States, countries indicate a more general commitment to deeper, comprehensive international integration. Any country willing to adjust to free trade and investment with the largest developed economy could surely make similar adjustments in its trade and investment with other countries.

Countries that have not yet joined need to weigh their options carefully. Some countries in the region are not yet at a stage where they can assume the kinds of obligations required by these FTA and some might decide the costs of doing so are greater than the benefits. But, inevitably the laggards will experience pressures to enhance their reforms to match those in neighboring countries.

The US approach is standardized. Once they are eligible the US gives countries a take it or leave it choice. This means they need to understand the fine print of the agreement. The agreements have not been crafted to exploit individual country weaknesses but it does mean that countries need to do their homework and understand the full nature of the obligations they are assuming. Trade expertise is essential.

In sum, while the agreements create enhanced opportunities for economic benefits, at the end of the day, the payoffs to these agreements are highly contingent on governments and the private sector taking other measures.

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