OVER THE HORIZON: A NEW LEVANT

EXECUTIVE SUMMARY

Complementarities between Egypt, Turkey, Jordan, Lebanon, Iraq, Syria, and the Palestinian Territories are significant, pointing at substantial potential welfare gains from increased trade and investments and economic integration. This group of seven countries, defined as the “New Levant” for the purposes of this study, appears to be well positioned to benefit from dynamic gains of integration given the geographical proximity to major markets. Furthermore, similarities in stages of economic development, resources endowment, or factor costs generate high potential to benefit from competitiveness and complementarities. The volume and structure of trade and investment flows among the New Levant countries indicate that there are large untapped potentials for deeper and wider integration in the sub-region. This report discusses how to tap these large potentials for mutual benefit.

Economic integration is one key means to benefit from regional opportunities. Most of the countries in the sub-region have some common challenges, including: (i) limited diversification of production and exports, (ii) weak regional and global economic integration through trade and investment, and (iii) large youth unemployment. Coordination among the Levant countries could help address common economic and social development issues. Despite some progress toward economic integration, albeit with political disruptions, there exists the potential for great benefit from further collaboration. An economic zone is an ultimate outcome for the medium to long term, but in the short term—given the current political situation—tangible results can be reached through sub-regional cooperation in specific areas. Economic integration is the first-best scenario, but, the current political situation could further hurt the overall economic relations and political barriers to reform could go beyond the current turmoil. This means turning to second- or third-best reform scenarios, which are reachable in the short-term in competitive sectors where public and private sectors in the region are willing to act together for the welfare benefit of the people.

A critical need to reduce regional uncertainty and revive investment and economic activity within the region—and thereby increase macroeconomic stability—provides strong motivation. Governments in the region are aware that there is an opportunity cost of not benefiting from untapped potentials. Although ongoing political and security issues in the sub-region have weakened integration efforts, the New Levant countries, both individually and collectively, have a clear interest in deepening economic and regulatory ties within the region, especially in view of the security dividends implicit in closer cooperation on the economic front. The Arab countries already have a trade agreement among themselves but through deeper integration with Turkey and the rest of Europe, these countries can better integrate into global and regional value chains that exploit their comparative advantage and take advantage of preferential treatment.
Increased trade and investment flows among the Levant countries can help promote growth and structural change in the region, thereby paving the way for the most efficient use of the region’s resources, value addition, human capital, and diffusion of technology. Trading partners can benefit from complementarities and competitiveness through regional trade integration. As Turkey, Lebanon, or Jordan climb up the ladder of their dynamic comparative advantage, more labor-intensive industries can potentially move to lower wage countries such as Syria and Egypt. These developments have already started in the textile and garments sector, in particular in Syria before the start of the 2011 upheavals. Conversely, higher wage countries such as Lebanon and Jordan can benefit from technology spillovers from Turkish investors in exchange for providing access to regional market and distribution networks.

Egypt and Turkey are potential growth poles for the sub-region with possible spillover effects

Egypt and Turkey are poised to form substantial growth poles for a more open economic space in the sub-region. During the last decade, Egypt has experienced a promising rise of trade in goods with Turkey and other regional partners. Egypt provides an important connection to Arab markets, especially while conflict continues in Syria. At the same time, Turkey provides a large and geographically close potential market for Arab countries’ goods and services. Turkey is a successful example of combining trade liberalization with economic reforms to generate robust economic growth and development. All countries can benefit from exploiting economic complementarities in the sub-region through specialization in their most productive sectors, integrating further in foreign direct investment (FDI) and value chains, and importing low-cost consumer and intermediate goods from the region. Egypt and Iraq are well placed to attract capital investments from Turkey due to competitive labor costs. The gains from capital investments can be particularly high if domestic and international firms cooperate in joint ventures.

However, despite growth in goods trade, Egypt and Turkey are still under-trading in the region relative to fundamentals suggesting an untapped potential for both countries to deepen their trade integration. The gravity trade model developed for this report suggests a significant untapped potential for Egypt and Turkey to deepen their trade integration in the region. For both countries, actual realized trade flows are lower than predicted by trade fundamentals in the model, which is an indication of under-trading. Regional bilateral exports to these two countries are also less than what is expected given their economic structures. In fact, Jordan, Lebanon, and Tunisia are under-exporting to both countries. Also, another interesting finding is that Egypt does not over-trade with any regional partner. In contrast, the results show that Jordan and Iraq are over-trading (both in exports and imports), and Iran and Iraq are over-exporting to Turkey.

In addition to Egypt-Turkey prospects, there are significant economic complementarities and trade and investment potentials among other Levant countries

Intra-group trade among Egypt, Jordan, Lebanon, Syria, Iraq, and Turkey has increased substantially in the past 10 years.¹ Primary trends in regional trade flows show that intra-group trade among these countries increased seven-fold from US$4.2 billion in 2000/02 (three year average) to US$29.7 billion in 2008/10. This significant increase in intra-group trade partly reflects the improvement in the policy environment so far. Regional trade flows have responded positively to previous liberalizations of trade regimes. Export growth took place both on the intensive margin (exporting more of the same product) and extensive margin (exporting new products) as indicated by both increased value and number of products exported by all countries. Turkey had the largest increase in intra-group trade both in terms of value (over 13-fold) and number of products (six-fold) from 2000-02 to 2008-10. In terms of value increase, Lebanon

¹ Data on the Palestinian Territories are not available.
ranks second at about 11-fold, Syria ranks third at over eight-fold, Iraq ranks fourth at three-fold, and Jordan ranks fifth at over two-fold.

Despite this high growth, there is still significant untapped potential in terms of bilateral trade flows in the Levant. The combined share of Turkish exports to Jordan, Lebanon, Syria, and Iraq accounted, on average, for only 6.6 percent of total Turkish exports in 2008/10. Likewise, exports of Mashreq countries to other Arab countries, including the Gulf, are much more significant than exports destined for Turkey; Lebanon has the highest share of exports destined for Turkey at 4.2 percent, exceeding the value of Lebanese export destined for Iraq or Jordan. But there are substantial differences even among the Arab countries. The high bilateral export shares between Syria and Lebanon, respectively, as well as the high share of Syrian or Jordanian exports to Iraq stand out; in contrast, bilateral trade between Jordan and Lebanon is still relatively limited.

Similar to potential in higher regional trade flows, there is a great opportunity for expansion of foreign direct investments. FDI inflows are currently concentrated in real estate, construction, tourism, and oil sectors. The Gulf Cooperation Council (GCC) countries were by far the most important investors into Arab countries. Total investments from the GCC between 2003 and 2010 represented 75 percent of total FDI inflows for Lebanon, 69 percent for Jordan, 61 percent for Syria, 59 percent for Egypt, and 46 percent for Iraq. FDI from GCC countries into Turkey accounted for nine percent of Turkey’s total FDI inflows. In the oil importing countries with strong GCC links, such as Lebanon and Jordan, the share of FDI in GDP increased considerably. For instance, the share of FDI in total gross fixed investment is high by international comparisons in Jordan and Lebanon where it was over 40 percent on average between 2005 and 2010, compared to 10 percent in Syria. Regional FDI flows within the Levant remained relatively low between 2003 and 2010 except for Turkish FDI flows into Iraq. But, it is important to note that GCC will remain as a potential source of capital to the entire Levant region.

The potential for intra-group trade has increased since 2001 and has reached levels comparable to regions that have a history of successful multilateral trade agreements. To assess how well the export structure of one country matches the import structure of trading partner, trade complementarity indices are estimated at the aggregate level. The results show that, in particular, the prospects of Levant countries to increase exports to Iraq and Turkey improved substantially. The increase in the export potentials to Turkey reflects that these countries’ manufacturing exports tended to diversify into products that Turkey imports. The substantial increase in export potential to Iraq reflects the stark increase in the number of goods that Iraq imports since the second Gulf war. The analysis also shows that Jordan and Lebanon have a relatively good potential to export to Iran and Libya. The potential to export to Tunisia increased for almost all countries. The findings show that trade complementarities among Levant countries are relatively high and comparable to index levels among countries that historically formed successful regional trade agreements. The six founding members of the European Economic Community (EEC) had an average trade complementarity index of 53 when they signed the agreement; the free trade area between Canada and the U.S. had a founding value of 64. The index for the Eastern enlargement (Bulgaria, Hungary, Poland, Czech Republic, and Slovak Republic) of the European Union (EU) was 61. As a comparison, Turkey, Egypt, Jordan, Lebanon, Syria, and Iraq are relatively well positioned for a regional trade agreement with trade complementarity indices of 40-50 on average.

The structure and specialization of countries’ exports baskets are changing

The Levant countries are specializing in different products within traditional as well as modern manufacturing industries. Revealed comparative advantages (RCA) show that apart from Iraq, recent export performances reveal a diversification from traditional sectors towards new, potentially higher value added sectors in all Levant countries. Nevertheless, traditional sectors (i.e., food, textiles, garments and footwear, and mineral goods) are still dominant in the sub-region. There appears to be direct
competition for regional and world markets shares in traditional export sectors among Lebanon, Turkey, Jordan, Syria, and Egypt. Product level export performances suggest a pattern whereby regional manufacturing for several products in traditional industries shifted from Lebanon and Jordan to Egypt and to a lesser degree Syria between 2000 and 2010. In contrast, Turkey maintained strong export performances in predominately traditional products and industries, and even expanded its share in world markets in some cases. Egypt experienced strong export growth in predominantly low technology industries. Nevertheless, the industry level export data also suggests potential for increased intra-regional trade, in part for manufacturing sectors that have a higher potential for productivity.

**Jordan maintained a strong export performance in several chemical products including medicaments.** Jordan is successfully exporting medicaments; these are mostly generic drugs with relatively lower profit margins but recently the pharmaceutical firms in Jordan are attempting to move up the value chain by developing patents. Between 2005 and 2009, Jordanian firms faced increasing regional competition from low cost generic drugs produced in Syria. Jordan has an RCA exporting pharmaceuticals. Turkey is a large potential market for Jordanian pharmaceuticals, which are already exported to Lebanon.²

**However, the overall degree of export sophistication has not moved significantly towards higher value goods in terms of knowledge or technology content**

**The overall degree of export sophistication in Arab countries has shown some progress over the last decade, however the performance is weak.** The export baskets of Jordan, Lebanon, Syria, and Egypt have slowly started to become somewhat more sophisticated. However, compared to exporters in Turkey and fast-growing East Asian countries, Arab firms show only weak export diversification towards higher productivity products.

**There are potentials for firms in the Levant to diversify into higher value added industries through economic complementarities**

**Country-specific diversification potentials complement each other.** The product space analysis presents potential economic complementarities in more detail at the industry and product level. Turkey is the most diversified country in terms of manufacturing in the region as well as a potentially large source of demand, foreign investment, or productivity (technology) spillovers. Products manufactured in the relatively lower wage countries—Egypt and Syria—experienced a strong increase in competitiveness in similar industries, with the potential to benefit strongly from more trade and investment integration with Turkey. In particular, there are large potential gains from knowledge and technology spillovers through integrated production chains with Turkish manufacturers; the latter could, in turn, benefit from low local wage costs and duty- and quota-free access to Arab markets. Jordanian and Lebanese exports were already fairly diversified in the 1990s, in particular in core manufacturing industry clusters, but diversification has stagnated since. Both countries must specialize in higher value-added manufacturing niches to escape regional and international cost competition in traditional export sectors. Nevertheless, in manufacturing industries there are significant potential gains from trade and investment integration between Jordan, Lebanon, and Turkey. Iraq has the least diversified export basket; it is highly concentrated in petroleum products. Tunisia’s export structure is more diversified than Egypt’s or Syria’s, while its manufacturing exports focus on the European market where Tunisia will potentially compete with Turkey.

**Significant economic complementarities and trade and investment potentials in the sub-region will provide welfare benefits for all countries involved**

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² However, there exists a domestic Turkish pharmaceutical industry, which primarily targets the domestic market and appears to be de facto protected by non-tariff barriers from Jordanian products.
The benefits of expanding economic ties in the Levant will be significant for all countries in the sub-region. To assess the medium-term economic effects of reforms aimed at deepening of trade relations in the sub-region, a computable general equilibrium (CGE) model is developed for the purposes of this study and consideration is given to four scenarios emphasizing different aspects of trade relations among Egypt, Iraq, Jordan, Lebanon, Syria and Turkey: (i) the removal of tariffs on agricultural goods and processed food; (ii) reducing the restrictiveness of non-tariff measures (NTMs); (iii) liberalizing transport services in the zone, resulting in reduced trade transport costs; and (iv) services trade liberalization within the zone. As it becomes established, the benefits of establishing a zone will increase with the deepening of the commitments. In all cases, the trade effects for some sectors are expected to be sizable. Levant countries are estimated to gain in welfare terms under all policy scenarios.

Potential welfare gains accrue to all countries under the scenarios of deepening economic integration, but the impacts on aggregate welfare and export volumes of reforms are estimated to be larger in the case of services liberalization. The welfare gains from services liberalization will represent the lion’s share of all gains associated with the four reform scenarios. With a cumulative welfare increase of US$12 billion (11 percent increase in welfare), Egypt is expected to benefit the most in absolute terms, while Iraq will likely gain the most in relative terms as its welfare rises by almost 17 percent or US$2.5 billion, followed by Syria (11.6 percent increase), Jordan (6.5 percent increase), and Lebanon (3.3 percent increase). Turkey will garner close to US$10 billion, which due to its large size translate into 1.7 percent increase in per capita income. Nearly all of these gains are a result of deeper integration through services trade.

The impact on exports varies by country, sector, and reform instrument, and is sizable for some sectors. In Turkey, reforms will either have no effect, or in the case of services liberalization will have a small negative impact, on aggregate exports. Services liberalization in Turkey’s trade with Levant partners is expected to affect the construction sector. The productivity boost expected in construction will stimulate domestic activity in Turkey, but not exports. In the other Levant countries, the impact on aggregate exports will be positive under all scenarios, but the magnitude of the effect will be sizable only in the case of services liberalization. Agricultural liberalization and improved transport logistics will boost bilateral exports of farm and processed food products among Levant countries. Reducing the restrictiveness of NTMs will increase exports of farm, petroleum, resource-based, and metal products from Turkey, manufactures from Jordan and Lebanon, and crude oil, petroleum, and manufactures from Syria. Services liberalization will improve the supply response and encourage services exports from Jordan, Lebanon, and Syria. The effect on Iraq’s exports will be negligible.

There is high potential in the Levant to integrate further through services trade, and liberalization in the services sector is critical for all countries to benefit from potential welfare gains.

The centrality of services to the economic structure of the Levant region offers a compelling motivation for devising a cooperation agenda aimed at facilitating expanded services trade and the adoption of competition-enhancing regulatory regimes. There is a clear preponderance of the service sector in the Levant in both aggregate output and employment terms. During the last decade, services exports exhibited the fastest growth in Jordan, Lebanon, and Syria. Jordan and Lebanon have large services sectors and show strong export performance. Services trade in the Levant has been dominated by travel, transport, and other services but exports of communication, financial, and insurance services witnessed more rapid change over the last decade. Prospects of competitiveness are also favorable. The Levant countries have revealed comparative advantages in at least one services sector. Egypt, Iraq, Jordan, Lebanon, Syria, Turkey, and the Palestinian Territories have a comparative advantage in the export of travel services. In

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3 The model excludes the Palestinian Territories because of lack of data.
addition, transport services stand out as a sector where Egypt, Jordan, and Turkey possess a revealed comparative advantage in exporting. Besides travel services, Lebanon has comparative advantages in the financial sector, along with construction and computer services exports.

**However, Levant countries are not benefiting fully from regional opportunities because of restrictiveness of services trade policies.** Egypt stands out for the high level of restrictiveness of its applied regulatory regimes in services. Lebanon has the highest level of restrictiveness in cross-border supply. All Levant countries have highly restrictive regulatory regimes governing the temporary mobility of services providers. The sub-region is characterized by the paucity of mutual recognition initiatives aimed at facilitating the mobility of skilled professionals. Egypt and Turkey stand out for the high level of restrictiveness of their applied regulatory regimes in movement of natural persons. When compared globally in services regulation, the sub-region ranks among the world’s most restricted in services trade, with an aggregate level of restrictiveness across all sectors and modes of supply.

A major issue emerging from the restrictiveness of services regimes in the Levant concerns the preference of governmental authorities to retain a considerable degree of policy autonomy and regulatory discretion. Even in areas that are free of explicit restrictions, de jure openness may not always imply or translate into a commensurate degree of de facto openness. Across different sectors, the allocation of new operating licenses remains unduly discretionary in many countries. A key reform issue is therefore how regulatory discretion can be reconciled with the need to have clear rules for service providers.

There is a clear need for greater multilateral efforts towards services liberalization in the region. For a deeper regional integration in the services trade, the Levant countries should make significant cooperation and liberalization efforts. As measured in this report, intra-regional integration of services markets will be (net) welfare-improving for all Levant countries. While liberalization of services offers direct benefits much like it does for goods trade, the policy literature suggests that more pervasive systemic benefits are likely to stem from the positive impact of services liberalization on manufacturing productivity. The benefits from services liberalization for the Levant countries will certainly be larger than those deriving from goods trade liberalization. These issues need to command greater attention among regional policy makers.

Throughout the Middle East and North Africa (MENA) region, policy makers confront a number of common challenges calling for collective action initiatives and the supply of regional public goods able to tackle the region’s most pressing needs. Several such challenges appear amenable to service-centric responses and policy reforms including the need to promote greater market integration across a range of service industries through efforts aimed at enhancing investment climates and initiating the progressive dismantling of key obstacles to trade and investment in services. In the services realm, cooperation in the Levant entails the possibility of preferential negotiations with the Gulf Cooperation Council (GCC) and an intensification of efforts under existing regional agreements. Expanded service exports are most likely to arise from higher quality regulatory environments. For this to occur, Levant governments must strive to improve the quality of regulatory institutions and endow them with adequate resources and requisite competencies.

**Liberalization of trade in financial services would help Levant countries take advantage of regional opportunities**

An analysis of financial services trade in the sub-region reveals that Lebanese and Jordanian financial institutions have the potential to grow further. Development of cross-border financial services activities exhibits a rather more asymmetric picture than that of merchandise trade activities between Turkey and MENA region countries. There are eight fully licensed MENA-origin banks now operating in Turkey.
These banks are headquartered in Lebanon, Jordan, Libya, and the GCC. It is especially noteworthy that Lebanese and Jordanian financial institutions are the most active in regional activities. The activities of these banks demonstrate trade-in-services opportunities from increased regional economic activity for those economies of the region that have relatively less natural resource endowment. These banks also play important intermediary role between the large capital pool in the Gulf area and the biggest economy of the region which has a considerable current account deficit. All of these observations reveal substantial and multi-dimensional benefits accruing to all sides from enhanced economic linkages between Turkey and MENA region.

**Proceeding with necessary financial sector reforms as well as maintaining of macro-financial frameworks which are conducive to support the reform process is essential.** Financial institutions of the region provide fairly adequate payment related services such as foreign exchange and fund transfers services to support the current trade volumes. However, financial sectors lack depth and breadth virtually all across the region. The systems mainly consist of commercial banks because non-bank financial services are underdeveloped. Consequently, financial backing of trade transactions is weak. The lack of cross-border financial intelligence services and effective contract enforcement mechanisms also render proper risk assessment very difficult, if not impossible. Thus, provisioning of cross-border trade credit becomes scarce as well. It should also be noted that financial prices in many countries are hardly market determined. Although the mechanisms employed to set these prices provide some sort of stability, possibility and/or probability of relatively large discrete movements in key financial prices bring about another element of risk for financial market participants.

**There is a clear need to focus on the energy sector to stimulate private sector growth and to benefit more from regional economic opportunities**

**The demand for energy, especially in the electricity sector, is high in the region; however there are bottlenecks in expanding the capacity of electricity generation.** A range of electricity interconnection infrastructure exists among the grids of Mashreq countries (Iraq, Syria, Lebanon, Jordan, Egypt and The Palestinian Territories), Maghreb countries (Libya and Tunisia) and outlying countries (Turkey and Iran). Tunisia (along with Algeria and Morocco) is interconnected to the European grid and operates synchronously with them. Mashreq countries and Turkey have been trading electricity for over a decade and a half, though the volume of trade is far below the potential. The main bottleneck is a shortage of power in most of the Mashreq countries and the inability to add capacities based on gas, which, during the past decade has become scarce and much higher priced than before due to the rapid growth of international exports of middle eastern gas at highly attractive prices. Rapidly rising electricity and gas demand in Egypt has rendered the only two existing regional gas pipelines (the Arab gas pipeline and Arish-Ashkelon gas pipeline), practically unutilized.

**The Mashreq countries need to compete in the international market place for gas.** The sub-region needs additional transmission lines to relieve local bottlenecks for cross border flows and also it needs to sharply improve its ability to operate the grids synchronously in a sustained fashion through upgrades of grid codes and regulatory arrangements. Gas trade infrastructure, by way of liquefied natural gas (LNG) import terminals exist in Turkey, are being constructed/pursued in Jordan, Egypt, Lebanon and Syria, and are planned in Iraq. These will support the growth of LNG trade. The Mashreq region has large gas reserves, and 94 percent of these reserves are in two countries, Iraq and Egypt. However, both Egypt and Iraq face significant constraints in expanding their gas production capacity to meet the demand. For Egypt the constraint is the size of its gas reserves, and for Iraq the constraint is its implementation capacity. Iraq has the potential to develop as a major supplier of pipeline gas. A positive development is the discovery of offshore gas for Lebanon. It is estimated that the technically recoverable hydrocarbon reserves in the Levant basin region covering 83,000 sq.km in the Eastern Mediterranean (Lebanon, Israel, Cyprus, Turkey, Egypt and Syria have territorial stakes in this region) at around 1,689 million barrels of oil and
122.4 tcf (3.5tcm) of gas. Significant natural gas discoveries have been made in the offshore areas of Israel (especially in the Leviathan field), and in 2010 a U.S. hydrocarbon exploring company confirmed the commercial viability of the gas deposits. Lebanon planned to divide its offshore area into blocks and carry out international rounds of biddings to award exploration and production contracts.

**Connectivity can be improved through ICT and transport services**

*There are complementarities to be realized from trade in information technology (IT) services in addition to the benefits of enhanced information and communications technology (ICT) services as an enabling platform for trade in other sectors.* There is a large opportunity for telecommunications services trade. In some of the Levant countries, FDI in telecommunications has represented up to 40 to 50 percent of all FDI in the past few years. Also, there is a strong opportunity for the mobile app and software markets to grow beyond national borders and create greater value added at a regional level, benefiting from larger economy of scales. However, the region is lagging behind the world in crowdsourcing, which could otherwise have a great potential for job creation through ICT-enabled trade of professional services. There is limited scope for trade in hardware, or to develop a hardware industry for export purposes.

*In addition to being an important sector of the economy, ICT, and broadband in particular, is a powerful enabler of trade development.* Wallsten (2007) estimates that a 10 percent increase in broadband penetration is associated with an increase in exports by over four percent. Countries traditionally identified as superior benchmarks in terms of trade performance have international communications prices that are up to ten times cheaper compared to some of the Levant countries. Turkey is the leader in the region, with international communications charges about 11 times cheaper than Tunisia. A reform path similar to the one followed by Turkey in telecommunications is a condition for higher trade development and integration in the sub-region. IT is an enabler of complex supply chain integration. The region can benefit from enhanced business process outsourcing that apply specifically to the textile and automobile manufacturing industries if appropriate reform is introduced in the telecom and broadband sector.

*Government policies are needed to enhance investment in telecom infrastructure and to reduce prices.* A low-cost, high-speed Internet infrastructure is important to facilitate integration. There is a great potential to be realized from enhanced interconnectivity among the Levant countries. To reach this goal, countries in the sub-region need to strengthen competitiveness in telecommunications, following the examples of Jordan and Turkey. The removal of existing entry barriers would create a favorable environment for regional and sub-regional investment in broadband infrastructure. This would translate in a rapid decline of the price of international communications. Lebanon could take the opportunity to move to 3G and 4G services. The migration to broadband in a liberalized environment will be an essential priority for the Levant region, but will involve the management of a political and economic transition.

*Current air passenger traffic levels in the region are low, however higher growth rates have been observed in recent years in selected regional markets, suggesting that fast growth is possible. Indeed, air passenger markets in the Middle East are changing rapidly.* Turkey, which aspires to serve the region as a hub, has seen rapid growth in air passenger traffic, within the region and with the rest of the world. Turkey is in fact already emerging as a *de facto* hub with striking increases in traffic in recent years with all countries in the region, including Iran. This growth has occurred despite the fact that Turkey still has more restrictive bilateral air services agreements with many countries of the region than those countries have with each other. Turkey is not a member of the plurilateral arrangement that governs air passenger traffic between most of the Arab states: the Inter-Arab Freedom of the Air Programme of the Arab Civil Aviation Commission (ACAC). Instead, World Trade Organization (WTO) measures suggest that Turkey’s bilateral passenger traffic arrangements with these countries are quite restrictive.
Moreover, the ACAC agreement seems to not have lived up to its potential and has been less liberal in practice than its formal terms would suggest.

**More liberal policies are associated with more passenger traffic, but this relationship is substantially weaker in plurilateral arrangements like the ACAC.** A gravity model was estimated for the purposes of this work analyzing the links between bilateral traffic and policy while controlling for other determinants of traffic. A set of empirical models of air passenger traffic was used in order to better understand the relationship between air transport policy and international traffic. WTO index measures of policy commitments in both bilateral and plurilateral air services agreements were used, and measures were related to ICAO data on air passenger traffic. The results suggest that there are significant gains (in terms of higher likelihood of direct flights and the magnitude of passenger traffic) to be had from establishing and fully implementing a regional open skies agreement.

**Tourism services should be part of regional trade arrangements to recover and reform the sector**

*In tourism services, beyond the already existing links, there is a case for further integration in the sub-region and the promotion of complementarities to develop a more complete tourism offer.* Coordination among the Levant countries can improve competitiveness and increase the attractiveness of the sub-region by providing a wider range of tourism offerings and packages and contribute to boosting tourism receipts by increasing the amount of spending per tourist, and diversifying the origin of the tourists. Possible sub-regional cooperation could focus on different themes, such as infrastructure and transport, regulation of the hospitality sector (norms, quality), ease of transit and movement of people (visas, open sky agreements), and training. A regional tourism cluster could make use of the tourism complementarities and promote tourism in the region. The promotion of complementarities would help to develop the diverse tourism offers that are sought after by the new generation of tourists.

*There is a need for reforms in the tourism sector especially after the Arab Spring disruptions.* The tourism sector in the Levant took a sharp hit as a consequence of the Arab Spring and economic instability in Europe. Between 2010 and 2011, tourist arrivals decreased by 32.4 percent in Egypt, and Syria’s tourism sector’s contribution to Gross Domestic Product (GDP) declined by US$1 billion. To recover from the crisis and to benefit more from complementarities, efforts are needed at the sub-regional level. The facilitation and growth of the tourism sector in the Levant requires the removal of obstacles. This includes tourism services, but also a range of other services critical to tourism, such as transport, energy, ICT, or financial services. While most countries have unilaterally removed obstacles to trade in the tourism sector, there remain a number of restrictions on all modes of tourism services supply. Domestic reforms alone will not suffice to increase the countries’ competitiveness in the tourism sector. Tourism should be part of the regional trade agreements’ priorities for action and adequate instances should be put in place to promote it.

**Trade in services and foreign direct investments require mobility of the skilled labor for a deeper economic integration**

*The Levant countries have highly restrictive regulatory regimes governing the temporary mobility of services providers.* There is strong evidence showing that labor market restrictions are imposing a much greater burden on the global economy than the remaining trade restrictions. The gains from integration—in goods, capital and people—are based on harnessing economic advantage from differences in endowments. While General Agreement on Trade in Services (GATS) Mode 4 suppliers are typically subjected worldwide to the most acute regulatory hurdles, the level of restrictiveness in the Levant countries attests to a region of highly fragmented labor markets, weak employment performance, and high unemployment (particularly among skilled youth), reflecting in turn a structural mismatch between labor market needs and the supply of skills emanating from tertiary educational institutions throughout much of
the region. The Levant, like MENA more broadly, is characterized by the paucity of mutual recognition initiatives aimed at facilitating the mobility of skilled professionals. Egypt and Turkey stand out for the high level of restrictiveness of their applied regulatory regimes in movement of natural persons. For a deeper regional integration in the services trade, the Levant countries should make significant cooperation and liberalization efforts on labor mobility issues.

Demographic forces provide “arbitrage” opportunities for the Levant where skilled labor can move as part of services trade or FDI skills-transfer to facilitate economic integration. The Mediterranean area is in a critical stage in terms of regional integration of labor markets. Many countries in Europe are facing rapidly aging populations that will be accompanied by shrinking labor forces in the next decade. Even though most of them have entered their own demographic transitions with declining fertility rates, most countries of Southern and Eastern Mediterranean still have relatively young and educated populations who are facing bleak labor market prospects. These current diverging patterns are creating unique welfare enhancing “arbitrage” opportunities for the region where skilled labor can move as part of services trade or FDI skills-transfer to facilitate economic integration. Given the geographic proximity and historical migration trends, there are potential demographic benefits of increased mobility between Europe and within the Levant.

Labor mobility should be managed within a regional framework where the sending and receiving countries coordinate their policies and actions so that efficiency gains are maximized for all parties involved while the potential distortions and disruptions are minimized. Regional cooperation helps creating opportunities for better-managed cross-border labor movement. Coordination is crucial to construct a viable legal framework which will achieve multiple objectives: (i) It would help to prevent concerns about undocumented migration which is one of the main sources of political opposition in Europe to any relaxation of migration restrictions, (ii) it would lead to stronger protection of the migrants’ rights, including social protection and pensions; (iii) it would lower all transactions and implementation costs required to establish and maintain labor mobility agreements which can be significant if done unilaterally. Despite the technical and conceptual limitations of the GATS Mode IV, it remains the only collective action response to labor migration governance issues. It is therefore worth preserving and empowering this mechanism; one way to do so would be to move the focus towards “contract-based” movement of service suppliers rather than employment-based movement. The advantage of contract-based movement is that it would help make temporariness more credible as contracts would be time bound and between firms; in addition it would allow workers to be hired based on competence and performance.

There are significant barriers to trade in the Levant, not allowing countries to reach their potentials and to benefit from regional economic opportunities.

With global economic liberalization and reduction of tariff protection, the potential for non-tariff measures to act as trade barriers has increased in the last decade. NTMs are policy measures and do not have necessarily a trade protectionist intent, and can be introduced to achieve other policy objectives such as to preserve human health or the environment. In fact, NTMs can promote trade by providing consumers with information, limiting transaction costs, facilitating comparison and reducing uncertainty. Therefore, not all NTMs are barriers, and the challenge with NTMs is to make them the least trade restrictive while achieving other important policy objectives.

NTMs may have the potential to create market access barriers especially for companies from developing markets. For instance, compliance with the technical requirement of destination countries can necessitate investment in production facilities, in design, and in packaging of the final product. Demonstration of compliance with the technical requirements often calls for certification either because exporting countries do not have internationally recognized certification bodies and laboratories or because
the destination countries do not recognize international certificates. Pre-shipment inspection and other formalities are frequently associated with time delays that can be substantial in developing countries due to lack of infrastructure and qualified personnel. The private sector often complains about the related procedures, delays, cost, and corruption. Suppliers of fresh vegetables and fruits are particularly vulnerable since the shelf life of their product is very limited.

**Most of the NTMs in the MENA region materialize in the form of sanitary and phytosanitary measures or technical barriers to trade depending on the sector.** The first type of regulation is important in the food sector, affecting 60.5 percent of the product lines that belong to this category. The impact of technical barriers to trade (TBT) ranges from 15.1 percent of the product lines in the food industry, and 49 percent in the chemical sector. In addition, pre-shipment inspection is important in the food sector affecting 30 percent of the product lines. Egypt’s NTM pattern resembles the average of the region. Sanitary and phytosanitary (SPS) measures affect 72.1 percent of the product lines in the food category. However, the relevance of TBT is higher in Egypt than the average of MENA, ranging from 54.7 percent of the product lines in the food industry to 99.1 percent in the base metal category. Syria’s NTM structure reveals high regulations in food and chemicals. SPS is important in Syria’s food sector affecting 78.2 percent of the product lines; while TBT is relevant in the chemicals sector corresponding to 73.1 percent of the product lines. The impact of NTMs in Lebanon is very low. The effect of SPS in Lebanon’s food sector is below the average for the region, 11.7 percent. TBT is mainly imposed in chemicals (24.4 percent), and textiles and footwear (30.9 percent).

**Among the trading partners, the sub-region’s exports are highly exposed to NTMs in China and the EU.** The Levant countries’ exports to the European Union are primarily affected by TBTs. The coverage ratio ranges from 77.1 percent of exports from Jordan to almost 100 percent of exports from Iraq, Syria, and Egypt. Among the trading partners, almost all of sub-region’s exports to China are subject to many forms of NTMs. 100 percent of the exports from Turkey to China are affected by regulations such as SPS, TBT, price and quantitative controls, and anti-competitive regulations. The exposure of Turkish exports to TBT in Europe is also high accounting for 87 percent of the exported products. The impact of NTMs on Egypt’s exports to Lebanon is negligible; but TBTs have a large effect on Egypt's trade with the EU. Charges, taxes, and other para-tariff regulations, as well as pre-shipment inspection in Tunisia affect 43 percent of Egypt’s trade flows. More than 90 percent of Syria’s exports flowing into the EU, Egypt, and China are vulnerable to TBT regulations. Charges, taxes, and para-tariff measures impact 46 percent of Jordan’s exports to Egypt.

**Dealing with market access barriers such as NTMs is not an easy task.** There are, however, certain policies that countries can implement to deal with this issue. First, countries can follow an offensive strategy to improve market access through bilateral negotiations focused on particular products or sectors. This can consist of mutual recognition of standards and certifications or preferential treatment. Under mutual recognition, each government has sovereignty over its own technical regulations but a limited ability to project those policies onto its trading partners. Third, countries can choose the standards of their trading partners on products for which there is a huge market potential. However, this may impose additional costs to local producers that are not exporting to the countries whose standards were adopted. It is important to involve the private sector to identify areas where negotiations can lead to favorable outcomes for developing countries. In addition, since many of problems are related to implementation at the border, a trade facilitation agenda aimed at speeding up the clearance process and avoiding duplication of requirements can also help to reduce NTMs.

**The MENA region suffers from high trade costs mostly due to supply chain inefficiencies and weak trade facilitation framework, including transport services and customs procedures.** A way to assess the integration of countries is to refer to trade costs. Trade costs represent the price wedge between domestic consumption and trade with another country. Bilateral trade costs capture the obvious impact of distance.
but also the effect of the “thickness” of the border of each of the countries: trade facilitation, trade policy, connectivity, and logistics. The cost of trade between neighbors is typically twice as high among MENA countries as compared with those in Western Europe. Trade costs are consistently higher for agricultural products. On the other hand, Turkey has had a declining trend of its trade costs with its partners, reflecting the increased competitiveness of Turkish economy. Turkey has its lowest costs with EU countries and Israel. However, trade costs with Arab countries, even adjusting for distance, are typically 80-100 percent higher, including with the nearby Arab countries in Western Asia.

**Trade facilitation and logistics issues constitute important barriers to deeper integration of countries at a sub-regional level.** These factors affect the competitiveness of the Levant countries. The major issues are deficits in logistics performance and facilitation bottlenecks. Infrastructure is a less significant issue in the region compared with constraints related to trade processes and the low quality of logistics services. In addition, the transit traffic has been especially affected by the absence of active cross-border cooperation, resulting in very heavy and delay prone control systems at borders between Arab states. Together with inefficient trucking industries, the associated transit regime causes significant impediment to sub-regional integration and to the improvement of trade competitiveness. Although there is some development in customs modernization in the sub-region, differences in customs reform targets of individual countries, depending on whether control or implementation techniques are influenced by EU practices or not, might create a problem for cross-border harmonization in the Levant. Apart from the GCC, which is already a single market, little has been done to facilitate cross-border trade between neighbors and along trade corridors.

**The Levant countries are particularly weak in logistics performance for customs, infrastructure, and the ability to track and trace consignments.** An empirical investigation of World Bank indicators of logistics performance suggests that countries in the region have sub-par logistics systems, but they do not lag too far behind expected levels of performance. A cross-country model of logistics performance for the Levant region suggests that, on a 5-point scale, the sub-region lags expected logistics performance by 0.25 points. This average level of underperformance obscures some important heterogeneity, however. Iraq has logistics performance measures that lie well below the model prediction. Egypt also lags significantly, but not to the same degree. A more detailed assessment of the logistics performance measures indicates that the sub-region is especially weak in three of six categories of logistics performance: customs, infrastructure, and the ability to track and trace consignments. Egypt and Iraq underperform across most all areas of logistics performance. Tracking and tracing is an area of weakness in almost every country in the sub-region. Lebanon is unusual in that it scores well above the model prediction in one sub-category—logistics competence. More broadly it appears that Lebanon outperforms its peer countries in that category.

Although current regional trade agreements generated some positive impacts, they were unable to remove obstacles

**In addition to their bilateral free trade agreements (FTAs), the countries in the sub-region participate in a number of regional integration arrangements.** Turkey's role is important in current dynamics. Furthermore, the EU is an important partner affecting the overall picture and the potential incentives. Turkey joined the EU Customs Union in 1996. Egypt, Jordan and Lebanon concluded Association Agreements (AA) with the EU in 2001, 2002 and 2006, respectively, as part of the Euro-Mediterranean (Euro-Med) Partnership. Syria initialed an AA with the EU in 2008, but has not yet ratified it. With 12 other Arab countries Jordan, Lebanon, Egypt, and Iraq participate in the Pan-Arab Free Trade Area (PAFTA), entered into force in 1998. Jordan, with Egypt, Algeria and Morocco established the Agadir Free Trade Area as part of the Euro-Med Partnership, which became effective in 2007. Also, Turkey, Syria, Jordan, and Lebanon initiated negotiations to establish the Levant Free Trade Zone (LFTZ) in 2010. The negotiations were suspended after political disruption in Syria.
Despite slow progress in implementation, trade agreements have generated some positive impacts for regional trade. Most of the preferential trade agreements (PTAs) within MENA included negotiations to reduce the restrictive impact of NTMs on trade. Some MENA countries have made considerable progress towards this goal. The decline in NTMs has been most dramatic for agricultural products. Considering the great dependence of MENA countries on imported food and the increase in food prices over the past decade, this is a positive development.

However, the sub-region has yet to reap the full benefits of existing regional arrangements. There is scope for additional regional liberalization of trade policies. Despite steady advances made in liberalization of trade in goods, the achievements remain significantly below potential. Apart from Turkey, the Levant countries have failed to take full advantage of the network of trade agreements with both the EU and among themselves. In some cases this is due to the design of the agreements (shallow agreements). Others are explained by the weak implementation capacity of the signatories or lack of enforcement and implementation mechanisms accompanying the agreements. In particular, with the exception of Pan-Arab Free Trade Agreement (PAFTA) and Agadir, existing regional agreements cover essentially trade in industrial goods and target elimination of tariffs as binding legal commitments. As a result, the agreements have led to “shallow” integration. Exclusion of services and agriculture from integration undermined the trade promotion effects of tariff reductions. Furthermore, the complementary behind-the-border reforms regarding the business environment and investment climate were not included in the agreements as legally binding constraints—an important design flaw that adversely affected improvement of competitiveness particularly in the less developed countries.

An economic zone is an ultimate outcome for the medium to long term depending on the outcomes of the ongoing political upheaval.

When the political conditions permit, the “New Levant” countries have the potential to move forward towards a deeper regional integration. If political and security situations are normalized in the medium to long term, Turkey, Jordan, Lebanon, Syria, Iraq, Egypt, and the Palestinian Territories could start discussing a potential economic zone—a sub-group that is likely to form a deeper integration based on large economic potentials discussed in this report. A key requirement for successful regional integration in a variable geometry environment is the consistency of the integration policies adopted by the sub-groups. A variable geometry approach is preferred in strengthening regional integration, which allows sub-groups to move faster than the whole group or move to a deeper form depending on country-specific conditions. All countries (except for Iraq) are members of the Med12. Therefore, the Levant initiative could be part of the Barcelona process. It is important to find a solution to include Iraq to this potential zone as a preferential partner to increase the benefits of deeper economic integration in the sub-region. Currently, the EU Customs Union membership does not allow Turkey to establish a FTA with Iraq because it is not a Euro-Med member.

In the long-term, a Levant Economic Zone could consolidate the bilateral FTAs that Egypt, Lebanon, Jordan, and Syria have with Turkey, and improve market access for Turkey and Iraq to each other’s economies. Egypt, Lebanon, Jordan, and Syria already have bilateral FTAs with Turkey and, as members of PAFTA, benefit from free trade in goods amongst MENA countries. If political commitment is strong, opportunities exist to realize economic benefits by moving from “shallow” bilateral FTAs to “deep and comprehensive” integration within a common economic zone. If it is designed well and implemented

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4 Association Agreements (AAs), PAFTA, and Agadir include additional negotiations on elimination of NTMs pertaining to technical standards, SPS, trade facilitation as well as gradual liberalization of agriculture and services, competition policy, government procurement, investment, and capacity building. However, progress on these negotiations has been very limited.
effectively, the “New Levant” could play an important role in realizing the Euro-Med objective of a deep and comprehensive FTA between the EU and the Med12. It would also replace the bilateral FTAs among the Levant partners. Reforms can be anchored in trade agreements to help governments implement long-term plans.

However, even in the short-term, Levant countries could benefit from sub-regional cooperation in specific areas through public-private sector partnership

The reform process should start with improving the existing agreements with parallel behind-the-border policy measures. A deeper economic zone in the Levant will improve access of the signatories to each other’s market. However, this may not be sufficient to expand trade, diversify production, and accelerate growth in the member states. A wide-range of policy weaknesses and supply-side constraints in the member economies inhibit competitiveness and a strong supply response to improved market access. Substantial improvement in the complementary behind-the-border policies and harmonization of the business and investment climate will be necessary to take full advantage of better market access. Closer collaboration in these areas in the context of the broader Barcelona Process is essential. Improvement of the behind-the-border policies is particularly important for Syria, Jordan, and Lebanon to be able to raise their competitiveness.

The Levant countries should take unilateral measures to remove barriers to trade. Deepening and widening of integration will require improvement in the trade regime and trade facilitation in each country. The countries will need to undertake reforms unilaterally to remove trade barriers, especially customs procedures and NTMs. In a few particular sectors NTMs are significantly more restrictive on imports from Turkey than on imports from other sources. This is the case for Turkey’s exports of coal products to Tunisia, primary agriculture to Jordan and Syria, and resource-based manufactures to Egypt and Syria. Unilateral reforms and liberalization of selected sectors in the short-term can feed into overall long-term integration agenda.

The reforms associated with the formation of the Levant Economic Zone could promote domestic reform. Formulating clear rules and putting an effective implementation mechanism in place will be essential for the success of the “New Levant” as a sub-regional integration zone. The Levant countries should review a wide-range of policy weaknesses in member economies that could obstruct a strong supply response. For example, countries will need to improve national and cross-country infrastructure, implementation capacity in partner countries, as well as harmonize business and investment climate rules and regulations. Particular emphasis should be placed on advancing private sector development in the sub-region. In this content, the zone could be used as an engine for domestic reform.

There are lessons to be learned for MENA countries that have not yet signed FTAs with major partners, or who are not yet in the WTO system. While their trade policies are not triggered with pressure to “adjust,” these countries frequently have export sectors that are affected by policy changes elsewhere. For example, the trade policy changes are impacting significant exports of steel rebar, ceramic tiles, blankets, and cotton and synthetic yarn from Syria; cement, ceramic tiles, and steel rebar from the Palestinian Territories; and blankets, cotton textile products, and ceramic tile from Lebanon. Governments that undertake reforms to the trade regime almost inevitably face some pushback from domestic industries that struggle to adjust to new conditions of competition. For non-WTO member economies in the region, renewed effort should be placed on making the reforms necessary to complete the WTO accession process. Trading partners do not guarantee most-favored-nation (MFN) treatment to non-members; furthermore, non-members do not have access to the highly effective arbitration and dispute settlement procedures of the WTO system to protect their market access interests abroad. The initiation of the WTO accession process can benefit countries’ trade performance while triggering deeper integration.
While WTO member economies may have lower applied tariffs than WTO non-members in a number of instances, there is still much trade liberalization work to be done even among the WTO member countries in MENA. For example, Tunisia has bound relatively few of its tariffs, and Egypt’s tariff bindings continue to be extremely high. Because economies like Egypt, Jordan, and Tunisia also have relatively high MFN applied tariffs, their implementation of preferential tariff commitments through FTAs with Turkey and other major economies runs the risk of leading to trade diversion. One important way to address this concern is to continue to lower MFN applied import tariffs and to take on additional commitments to lower WTO import tariff bindings. As a general rule, the economies that are members in the WTO not only are relatively more open, but because there is also some external, multilateral oversight and agreed-upon surveillance over their trade policies through the WTO’s Trade Policy Review Body, and WTO committees and reporting requirements.

Eventually, the transformational nature of successful regional integrations provides expected benefits to countries in terms of growth, employment, and diversification. Almost all fast-growing countries, i.e., countries which have grown at average annual rates of seven percent or more for at least 25 years, integrated into the global economy during their high growth periods through increased trade and foreign direct investment. Integration into global value chains is likely to have contributed to high sustainable productivity growth in these countries based on a continuous process of international knowledge and technology flows channeled through trade, FDI, or international migration. For instance, Turkey’s GDP growth amounted to, on average, six percent per year from 2002 to 2011 when the country benefited from FDI from EU countries as well as trade integration into European value chains. A number of empirical studies demonstrate the importance of international trade flows to explain technology spillovers and productivity growth. Moreover, Baldwin and Forslid (2000) argue that trade liberalization improves the incentives to invest in new technologies through competition and better financial intermediation. Thus, trade integration provides mechanisms for international technology diffusion and can be a pivotal ingredient for economic development, in particular, when paired with economic behind-the-border policy reforms making domestic firms more competitive and domestic markets more attractive.

The private sector in the Levant is taking the lead in implementing short-term actions and long-term economic integration agenda in partnership with the public sector.

There is a clear interest from private sector representatives in the region to take the leadership role for addressing common challenges in the region. ‘The New Levant Initiative’ could provide a platform to private sector champions in the region to identify constraints that impede regional economic activities especially related to trade flows, labor and capital mobility, and offer solutions and actions through debate and discussion as well as consultation with authorities in their own countries. This initiative could activate a “Levant Private Sector Network” that institutionalizes a regional private sector lobbying group that brings together private sector firms in the region for the common purpose of advancement of economic integration of the sub-region. The World Bank is working closely with private sector and governments in the region to introduce a regional economic integration agenda with an aim to implement short- and medium-term actions. International and bilateral development partners will be able to assist Levant countries in implementing trade reforms either through facilitating the dialogue by bringing together the stakeholders, or providing technical assistance and policy recommendations and supporting implementation by providing finance and mobilizing resources.

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5 Estevadeordal, Freund and Ornelas (2008) present evidence to suggest that this may have been a strategy adopted by a number of economies in Latin America after their regional integration efforts led to adoption of a number of preferential trade agreements in the 1990s. After the adoption of FTAs, which would have otherwise resulted in large tariff preference margins, such economies subsequently lowered applied MFN tariffs toward imports from nonmembers in order to minimize the likelihood of costly trade diversion.