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Natural resources: a key challenge in regional integration of the Middle East and North Africa region

Greater trade integration within Middle East and North Africa region is expected to happen through the completion of the Pan-Arab Free Trade Agreement. However, recent studies suggest that when resource rich and resource poor countries give preferences to each other, as in PAFTA, the resource rich country is very likely to suffer from trade diversion. Our recent empirical research states that it has happened in PAFTA. This could explain why resource rich countries may be reluctant to deepen further this type of agreement.

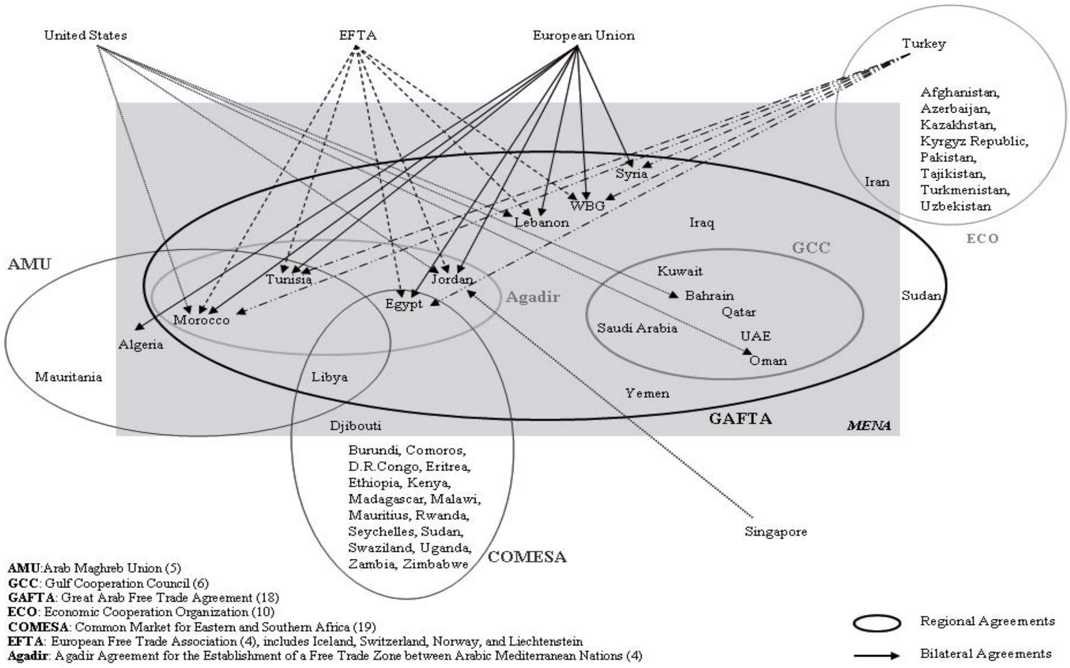
Regional Integration in MENA: many attempts, few results

Regional integration is reshaping the world and the Middle East and North Africa (MENA) region has implemented several regional trade agreements those last fifteen years. Regional integration schemes among MENA countries provide an ideal case study to test for the importance of trade diversion in agreements involving resource-rich and poor members. Half a century after the creation of the Arab League in 1945-aiming at intensifying regional trade in the region- MENA's spaghetti bowl of regional integration agreements has little to envy to those in Latin America or Sub-Saharan Africa (World Bank, 2008). In spite of the numerous regional trade agreements, the extent of intra-regional trade is only a tenth of total trade, and is below what a standard gravity model (which explains bilateral trade using distance between partners and the economic size of the two partners) would predict (Miniesy *et al.*, 2004 or Péridy, 2007)[1].

Several reasons could explain this low trade integration. As recently analysed by Chauffour (2011)[2], public sector governance and participation, accountability and transparency, and rents and privileges may impede the region's capacity to export. But it could also be the result of poor production complementarities: within Agadir or Gulf Cooperation Council (GCC) agreements countries have similar resource endowments, production capabilities, and export structure. They may find it difficult to use regional integration as a means to establish patterns of specialisation and diversification. However, in PAFTA, grouping resource rich and resource poor countries, it is the difference in resource endowment that could impede trade integration.

1. R. S. Miniesy, J. B. Nugent & T. M. Yousef (2004) ,"Intra- regional Trade Integration in the Middle East: Past Performance and Future Potential", in *Trade Policy and Economic Integration in the Middle East and North Africa: Economic Boundaries in Flux*, ed. H. Hakimian & J. B. Nugent, London: Routledge.
N. Péridy (2007), Toward a Pan-Arab Free Trade Area: Assessing Trade Potential Effects of the Agadir Agreement, The Developing Economies 43(3): 329-345.
2. J. P. Chauffour (2011), Trade Integration as a Way Forward for the Arab World. Policy Research Working Paper 5581, The World Bank, Washington, DC.

Figure 1 – Preferential Trade Agreements in the Arab World



Source: MENA Economic Developments and Prospects: Regional Integration for Global Competitiveness, (2008), World Bank.

Natural Resources: a brake on regional integration

The link between resource abundance and regional integration has been subject to an extensive literature. The *World Trade Report* (2010)[3] details how many integration schemes in the developing world disintegrated in the seventies when the oil price shocks accentuated the dichotomy between those which were commodity net importers and had to bear a rising import bill and those who were net exporters. Indeed, this led many governments from net resource importing countries to decide against the further liberalisation of intra-regional trade and instead to concentrate on earning revenues in trading extra-regionally. On the other hand, net resource exporters have often abruptly abandoned domestic policy reforms after enjoying resource windfall gains and thus injected some further erratic volatility into an integration scheme.

A matter of redistribution....

Natural resources are often viewed as a natural and strategic capital stock which should be at the exclusive disposal of national purposes and not be opened to access for member countries in an integration scheme. Hence, as Fouquin *et al* (2006)[4] stressed it out, such conduct could be a curse for deep integration which requires some asymmetric burden-sharing between rich and poor countries and perhaps even an inter-country redistribution of wealth. Nevertheless, it also could be a blessing if resource revenues enable the resource-abundant country to finance such redistribution and take more risks in implementing long-term integration time-tables. Natural resources would be then a major asset in forming regional coalitions and may encourage resource abundant countries to claim a driver seat of regional integration once they are prepared to co-shoulder some burden of partner countries (see Venezuela nowadays).

...through trade diversion?

A recent theoretical study by Venables (2011)[5] suggests that when resource rich and resource poor countries give preferences to each other, the resource rich country is very likely to suffer from trade diversion. If the preferential trade agreement is signed by a natural resource abundant country and a natural resource poor country with a small but developing manufacturing sector, then the introduction of tariff preferences will probably lead to some trade creation in the

3. World Trade Report (2010), Trade in Natural Resources, World Trade Organization, Geneva.
4. M. Fouquin, R. Langhammer & R. Scweickert (2006), Natural Resource Abundance and its Impact on Regional Integration: curse or blessing?, Paper presented at the ELSNIT Conference in Sao Paulo.
5. A. Venables (2011), "Economic integration in remote resource-rich regions' in Costs and benefits of economic integration in Asia", R. Barro & J. W. Lee (eds), Oxford University Press.

resource-poor country. It will benefit from a privileged access to markets inside the agreement and will be able to import more natural resources from the resource-rich country. There is little scope for the resource poor country to suffer from trade diversion if the resource abundant country is specialized in the natural resource good. On the other hand, the resource rich country may suffer from a significant amount of trade diversion as the resource poor country benefiting from the preferential access can increase its exports of manufacturing goods to the resource-rich country, hence the resource-rich country substitutes imports from the relatively more efficient rest of the world towards the regional partner.

Policy implications

So far, resource-rich countries have hardly ever been driving forces for establishing regional integration nor facilitators of deeper integration once they are part of such schemes. Firstly, poorer resource-rich countries may be aiming at developing a domestic industrial sector. This provides a disincentive for these countries to join regional integration agreements, as trade creation would imply that goods produced by less efficient domestic firms in the industrial sector would be replaced by cheaper imports from partner countries. In addition, to help develop their domestic commodity processing industries, resource-abundant countries may often restrict natural resource exports. However, regional integration may help resource-abundant countries diversifying their export basket and break into the chain of global manufacturing production.

Are natural resources impeding or fueling MENA integration

In our recent empirical research we explore[6] the extent to which MENA various integration schemes (AGADIR, GCC, PAFTA *etc.*) have led to trade creation and trade diversion. Middle East and North Africa region contains both resource rich and resource-poor countries. As argued in Venables (2011) the proximity of resource-rich and resource-poor countries gives an opportunity to even wealth distribution within the group of countries via regional integration. Indeed, the resource-poor countries sitting next to resource-rich ones have a strong incentive for preferential trade liberalization with its resource-rich counterparts, as a way to get access to the rents in the resource-rich country. However, this can be done at the cost of trade-diversion in the resource-rich country, and a loss of efficiency in imports.

The Pan-Arab Free Trade Area (PAFTA in force in 1998) is particularly interesting as it involves eight resource-poor countries and twelve resource-rich countries according to the World Bank's classification[7]. Other agreements such as the Gulf Cooperation Council (GCC) in force in 2003 only involve resource-rich countries and AGADIR in force in 2004 only resource-poor countries. Thus the same forces behind trade diversion are not at play.

Using a classic gravity model explaining bilateral trade patterns of each MENA country during the period 1990-2009 we measure the trade creation (increase in imports from partners) and trade diversion (decrease in imports from rest of the world) following implementation of preferential trade agreements (in the region but also with Europe and other partners).

For AGADIR and GCC, we do not find a statistically significant impact on intra-regional trade. This can be partly explained by the fact that all AGADIR and GCC countries are part of PAFTA and entered into force after PAFTA. So the advantages in terms of intra-regional liberalization that AGADIR and GCC offer may be limited. But the reason could also be that countries in those two regional trade agreements (RTA) are too homogenous in resource endowments and production capabilities, hence the RTA did not lead to specialisation and diversification.

We find strong evidence of increases in intra-regional trade in PAFTA and in other agreements signed between MENA countries and partners in the rest of the world, such as Euromed. However, evidence of trade diversion is only found in PAFTA.

We then explore whether Venables (2011) prediction is verified in PAFTA and find that indeed the main source of trade-diversion in PAFTA was due to the replacement of imports of resource-rich countries from the rest of the world by imports of resource rich countries from other PAFTA members. Resource poor counties suffer no trade diversion.

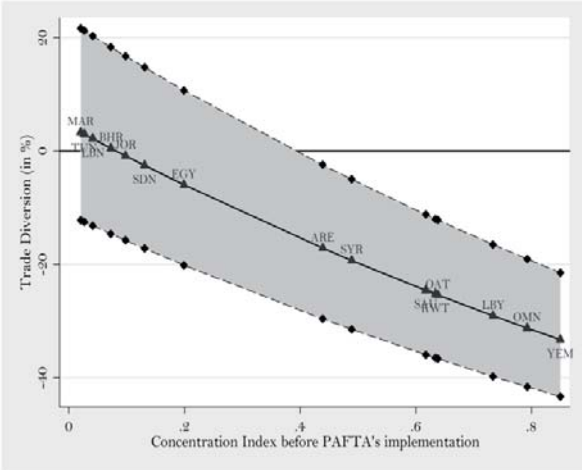
As predicted by Venables (2011) trade diversion in PAFTA seems to be concentrated in resource rich importers. These are generally countries that export only a few products and with a highly concentrated export bundle. Interestingly, these countries have also significantly increased their exports of non-oil goods to resource poor countries, but these increases were not accompanied by trade diversion in resource poor countries.

The figure below provides an idea of the size of trade-diversion for the different PAFTA countries according to the export concentration which is a good proxy for natural resources abundance (as well as the standard error of the estimate for each country). When we measure concentration using the Herfindhal index, resource poor countries (such as Morocco, Lebanon and Tunisia) do not suffer from trade diversion and then benefit fully from the PAFTA

6. C. Carrere, J. Gourdon & M. Olarreaga *et al.* (2012), "Regional Integration and Natural Resources: who Benefits? Evidence from MENA", *CEPII Working Paper*, no 2012-09, May.
7. According to World Bank's classification resource poor countries in PAFTA include Tunisia, Morocco, Lebanon, Jordan, Egypt, Sudan, West Bank of Gaza and Djibouti. Resource rich countries can be divided into two sub-categories. GCC Oil exporters include UAE, Saudi Arabia, Qatar, Oman, Kuwait and Bahrain. Developing Oil Exporters include: Yemen, Syria, Iran, Iraq, Libya and Algeria.

Figure 2 – Predicted non-fuel trade diversion given the pre-PAFTA Concentration index value

Herfindahl



	Trade Division %
Morocco	3.35
Tunisia	3.02
Labanon	2.23
Bahrain	0.55
Jordan	-0.78
Sudan	-2.49
Egypt	-5.93
UAE	-17.10
Syria	-19.26
Saudi Arabia	-24.52
Kuwait	-25.19
Qatar	-25.35
Libya	-29.01
Oman	-31.19
Yemen	-33.23

Source: Authors'calculations.

agreement (they experience only trade creation). Saudi Arabia, Qatar, Kuwait, Oman, Libya, Yemen and United Arab Emirates all have levels of trade diversion that are statistically different from zero with an average decline in imports from the rest of the world above 15 percent.

This may appear surprisingly low given that their increase in imports from other PAFTA countries is on average 107 percent in our results. But to assess the relative importance of these flows one also needs to consider the difference in the base. Given that initial imports from the rest of the world of imports are at least five times of imports from other PAFTA countries; this suggests again a fully trade-diverting PAFTA for resource-rich members.

Policy implication for MENA

Putting together our results suggest that the main beneficiaries from PAFTA are resource poor countries that experienced only trade creation and benefited from the trade diversion of resource rich countries at the expenses of the rest of the world. This means that PAFTA has helped redistribute income from resource rich countries to resource poor countries within PAFTA. It also explains why resource rich countries may be reluctant to deepen further this type of agreements. Indeed, there are certainly more efficient means of redistributing income to resource poor countries in the region than through trade diversion. However non-economic objective, such as the reinforcement of the resource-rich country hegemonic power could be one reason why resource-rich countries will enter this type of agreements.

Hence, while further intra-regional trade integration is an important avenue for enhancing diversification of resource poor MENA countries, resource-rich countries have no strong incentive for further preferential regional integration from a purely economic standpoint. Future discussions of regional trade agreements should take this into account. In this context, trade liberalization on an MFN basis may be the best option to further global integration.

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