FDI INFLOWS AND TRADE IN THE MENA REGION: COMPLEMENTARY-SUBSTITUTION ISSUES

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1. Introduction

The Euro-Mediterranean Conference of Foreign Affairs Ministers, held in Barcelona on 27th-28th November 1995, marked the starting point of the Euro-Mediterranean Partnership. The ensuing Barcelona Process represents a wide framework of political, economic and social cohesion between the European Union Member States and their Mediterranean partners of MENA region[1].

The global division of labour produces a new integration of trade and disintegration of production in the world economy in the presence of a spread of Foreign Direct Investment (FDI). Over the past two decades, Mediterranean Partner Countries (MPCs) have taken several steps to integrate into the world economy. Among them was the negotiation and signing of bilateral trade agreements with the European Union (EU). These agreements were primarily aimed at enhancing the access of Mediterranean exports to the EU markets. With the Barcelona Declaration of 1995, the EU-MED region moved to a new era of trade and economic cooperation. In fact, the Barcelona Conference aims at creating a Euro-Mediterranean Free Trade Area (FTA) by the year 2010, that will promote trade and Foreign Direct Investment flows into the region.

In many developing countries, policy-makers are highly concerned with FDI inflows. Such inflows are thought to represent the additional resources they need to improve their economic performance. FDI inflows are expected to increase a country's output and productivity, to encourage local investment and to stimulate the development and dispersion of technology (Sekkat and Varoudakis, 2003). To face this challenge, MENA countries cannot rely on their own forces alone: they need to deepen integration into the world

[1]. MENA (Middle East and North Africa) region includes: Algeria, Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, Turkey, United Arab Emirates, West Bank & Gaza, Yemen.

economy and to become attractive destinations for FDI as a means of receiving the resources for development they cannot generate on their own, also because their internal saving rate is too low.

In fact market-oriented reforms and opening up policy pursued by several governments have produced high economic growth and dramatic economic transformation; the openness of those economies to trade and especially to FDI was a driving force of their exceptional growth performance. Most of those countries have experienced such a rapid expansion of both FDI and trade that an examination of their linkages is motivated.

In international economic and business literature, the following two aspects of possible linkages between FDI and international trade are sometimes discussed:

a) whether FDI is a substitute for, or a complement to, international trade;
b) whether FDI causes international trade or the other way round.

Inward FDI in developing Mediterranean countries is supposedly expected to soar as a result of the Euro-Med partnership. This investment boom, however, is far from certain (Martin, 2000).

The paper is organized as follows: Sections 2 and 3 briefly introduce the literature on the substitution-complementary issue and on the casual link between FDI and trade; Section 4 focuses on the existence of tariff and non-tariff barriers in MENA region; Sections 5 and 6 respectively explore trade and FDI inflows; Sections 7 and 8 investigate the reasons of failure in attracting FDI; Section 9 illustrates the theory on the complementary linkage between FDI and trade in MENA region; Section 10 applies the previous conclusion to MENA service sector and Section 11 concludes.

2. FDI and trade: substitution-complementary issues

In previous literature there are several models which analyze the substitution-complementary issue. The Heckscher-Ohlin-Samuelson model suggests that international trade can substitute for international mobility of factors of production including FDI. For instance, by exporting capital-intensive commodities in exchange for labour-intensive commodities, a capital-abundant country indirectly exports a net amount of capital in exchange for a net amount of labour. Even under the assumption that factors are perfectly immobile between countries, factors do migrate between countries indirectly through exports and imports of commodities.

Based on the assumption that countries are symmetric in terms of size, factor endowments and technologies, and that there are trade barriers and transport costs, Brainard, Horstman and Markusen develop models in which the choice between horizontal FDI and international trade depends on the trade-off between *proximity* and *concentration*. If a firm is near to the investment host country, it will have an incentive to overcome barriers to trade by launching FDI in the foreign market; otherwise concentration advantages, such as increasing scale economies, outweigh proximity advantages and so on, there will be more import and export flows instead of FDI. Therefore, there can be a substitution relationship between FDI and trade (Brainard, 1993; Horstman and Markusen, 1992; Markusen, 1984).

The opposing view is that FDI and trade are complements. Helpman and Krugman (1985) illustrate that the degree of specialization is a positive function of relative factor endowments. If there are substantial differences in factor endowments, the capital-abundant country tends to export services into the labour-abundant country in exchange for finished varieties of a differentiated good and a homogeneous good. Thus, FDI generates complementary trade flows from the labour-rich country (Helpman, 1984; Helpman and Krugman, 1985). Also Stern (1997) summarizes the arguments about the complementary nature of inward FDI and the trade of the recipient host country. FDI and exports from the host country may be complementary, particularly if the foreign interest is secured through the establishment of foreign invested enterprises. Inward FDI brings with it the expertise of the foreign partner in selecting and promoting exports on international markets. In this way FDI enhances the recipient country's export performance (Stern, 1997).

3. Causal link between FDI and trade

The second issue of this analysis focuses on the precedence and timing of the relationship between inward FDI and exports; the results have relevant policy implications and a central importance to development planning and strategies. In fact, if there is a definitive unidirectional causality from export expansion to FDI, then some credence is given to an export-led growth strategy. If the causative process is in the opposite direction, then the implication is that the inflow of FDI is a prerequisite for the expansion of host country's exports.

Kojima analyzed the "*interactive path of FDI-enhanced trade and economic growth*" (UNCTAD, 1995): FDI are trade creator because they are directed to industries in which the host country has a comparative advantage; it is expected to stimulate exports (Kojima, 1973, 1978).

Some economic models suggest that many firms in manufacturing follow the traditional step-by-step sequence of servicing foreign markets: they trade in a foreign market in the first instance because trade is easier and less risky than FDI. After learning more about social, political and economic conditions, home country firms may establish producing subsidiaries in the foreign market through FDI. Thus, exports precede FDI inflow because at first foreign investors use their exportations as a tool "to test the ground" before investing directly (Liu *et al.*, 2001; Johanson and Wiedersheim, 1993; Nicholas, 1982; UNCTAD, 1996).

4. Tariff and non-tariff barriers in MENA region

The process of liberalization undertaken by Mediterranean countries and the removal of restrictions on capital movements allowed western firms to enter a market of 300 million potential consumers. However there are some important preliminary statements to make about tariff and non-tariff barriers still existing, before analyzing the overall economic impact of the Barcelona Declaration.

The evolution of tariff barriers was characterized by a downward trend for the past 20 years in the MPCs, as in all the developing and advanced countries, but slower than in the other regions during the last decade, so that the MPCs is one of the most protected regions in the world today (Tab. 1). In the early 1990s, while growth in global trade accelerated and developing countries significantly reduced their customs duties in order to insert themselves into global trade, the Mediterranean partners took the opposite track by raising their own. Thus, tariffs in the MPCs are still significantly higher than in other developing countries (Handoussa and Reiffers, 2002).

Nevertheless, the continuous reduction of tariffs within the framework of multilateral negotiations led some countries to protect themselves through a wide range of non-tariff barriers: for example, through quantitative restrictions (such as import quotas, voluntary export quotas, licenses, prohibitions, etc.), governmental participation to trade and uncompetitive practices (such as subsidising exports and local industries threatened by imports), technical barriers to trade and sanitary measures (Handoussa and Reiffers, 2002).

Tab. 1 – Trends in average tariff rates, 1980-1999 (%)

%	80-82	83-85	88-90	93-96	97-99
Algeria	44,4	21,7	23,8	24,8	24,2
Cyprus		17,1	10,4		8,4
Egypt	47,4		33,5	28,1	20,5
Israel	8,0	6,9		8,3	7,5
Jordan	13,8	14,2	12,2	16,0	
Lebanon				5,0	9,8
Malta				6,1	7,6
Morocco	54,0	27,0	24,0	25,7	22,1
Syria	14,8	14,8	11,0	21,0	
Tunisia	26,4	27,2	27,4	30,0	29,9
Turkey		24,7	22,7	26,7	8,2
MPCs*	23,8	18,0	16,6	18,2	15,9

Note (*): all tariff rates are based on unweighted averages for all goods in *ad valorem* rates, or applied rates whichever data are available in a longer period.

Source: WTO (1990-2000) CD-Rom database and Trade policy Review, Country Report, Various Issues; UNCTAD (1987 and 1994), *Handbook of Trade Control Measures of Developing Countries*; World Bank (1994 and 1996) "Trade Policy Reform in Developing Countries since 1985", in *World Bank Discussion Paper*, No. 267; OECD, Institut de la Méediterranée.

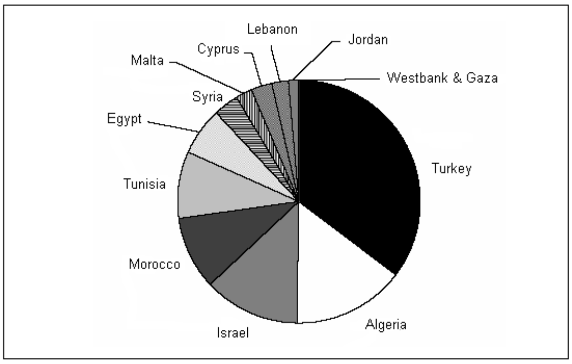
The establishment of complementary free trade areas among the Mediterranean countries is only just beginning. The Barcelona Declaration built on earlier cooperation between the EU and the MPCs, which included a unilateral opening of EU markets mainly for industrial products from the Mediterranean countries by the end of the 1970s. However, most Mediterranean countries started opening their markets for industrial products from the EU only recently. Only a few Mediterranean countries increased their market share of world exports to the EU from 1995 to 2003, while the EU's market share in the Mediterranean area remained fairly constant (Backer, 2005).

5. Imports and exports between MPCs and EU

The development of goods and services trade in the broader Euro-Mediterranean region is a central element for the reinforcement of regional integration.

The EU is the main trade partner of the Mediterranean countries and represents 52% of their trade (exports and imports) (Handoussa and Reiffers, 2001). In 2003 Turkey accounted for more than 1/3 of Mediterranean exports and imports with the EU. Algeria, Israel, Morocco and Tunisia together represent almost half of EU-Mediterranean trade (Algeria 15%, Israel about 13%, Morocco and Tunisia almost 10% each). Egypt, Syria, and to a lesser extent Malta, Cyprus, Lebanon, Jordan and the Palestine Territories shared the remaining 20% (see Fig. 1) (Backer, 2005).

Fig.1 – Share in total EU trade, 2003 (%)



Source: European Commission (2004), "External and Intra-European Union Trade", *Statistical Yearbook*, data 1958-2003, Luxembourg.

Although the region, abstracting from oil, scores one of the lowest ratios of export to GDP among all region of the world but Sub-Saharan-Africa, Tab. 2 underlines a positive commercial trend from Barcelona Declaration (Sekkat and Varoudakis, 2003). Trade in goods between the EU and Mediterranean countries has markedly increased over the last 10 years.

Tab. 2 reports total exports and imports between MPCs and the EU. Exports from Morocco to the EU nearly doubled after the ratification of Barcelona, increasing from USD 2.9 billion in 1995, to USD 5.4 billion in 2002. Imports have also uniformly increased from USD 4.7 million in 1995, to USD 7.8 billion in 2002. Israel, Jordan, Algeria and Egypt are in a similar situation. In Tunisia, Lebanon, Syria, export growth rates are smaller than in the previous countries but significant. With the exception of Jordan, from

1995 there was an overall increase in trade between the EU and MPCs (Neaime, 2004). In the last 5 years the international situation was favourable to the development of trade. Global trade in 2000 soared by 8%, against 4% in 1999 and 0% in 1998. Their exports rose by 17.3% and their imports by 12.3% in 2000, against 4.3% and -2.6% in 1999 (Handoussa and Reiffers, 2002).

Tab. 2 – Export and import of MPCs to UE (1994-2002)

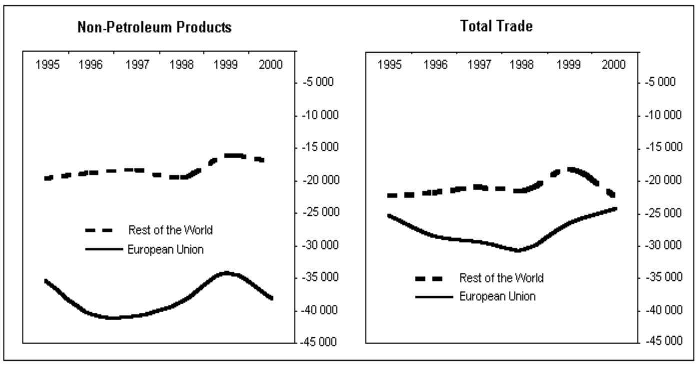
Export (USD million)								
Year	**Israel**	**Jordan**	**Morocco**	**Tunisia**	**Algeria**	**Egypt**	**Lebanon**	**Syria**
1994	4832.00	58.42	2559.31	3723.65	6104.89	1527.27	104.55	1979.14
1995	**5957.20**	**89.97**	**2918.23**	**4539.44**	**6067.03**	**1577.43**	**161.74**	**2262.30**
1996	6570.70	121.65	2917.56	4417.82	6658.70	1612.73	204.69	2441.90
1997	6796.00	109.66	2838.53	4408.02	8718.29	1621.28	163.28	2100.84
1998	7191.30	97.55	2716.88	4589.97	6405.67	1195.80	182.67	1454.88
1999	7650.20	86.05	5429.53	5940.91	8146.48	1237.20	175.83	2108.64
2000	8563.50	50.03	5100.70	4712.81	13755.40	2984.84	142.13	2868.94
2001	7652.70	87.52	5161.95	5276.65	12962.20	1301.04	245.37	3356.36
2002	7278.90	164.67	5465.76	5276.72	12243.30	2770.90	161.93	3454.02
Import (USD million)								
1994	12671.4	1199.48	4054.42	4728.02	5730.83	3836.85	2936.32	1931.83
1995	**14717.1**	**1226.85**	**4776.17**	**5643.31**	**6394.31**	**4562.85**	**3204.57**	**1619.72**
1996	15487.6	1359.13	4469.18	5599.52	5692.80	4711.26	3293.37	1726.29
1997	14858.9	1335.68	4100.38	6108.71	4929.77	5030.91	3538.83	1268.54
1998	13335.4	1252.23	4634.64	6217.13	5396.59	5977.52	3275.79	1268.75
1999	14386.4	1153.75	7745.39	7493.96	5157.92	5728.02	2877.52	1169.27
2000	15466.2	1414.6	7813.44	6074.99	6158.26	7978.05	2741.96	1779.81
2001	13933.0	1374.37	5799.99	6773.46	7374.65	3753.65	3014.38	2047.92
2002	13554.3	1562.93	7852.21	6778.14	8366.71	6569.07	3096.19	2130.29

Source: IMF (2002), *Direction of Trade Statistics*, Washington.

In 2003 the value of EU exports to the Mediterranean countries amounted to EUR 81.4 billion. That was almost 61% more than in 1995, the year of the Barcelona Declaration. Over the same period EU imports from the Mediterranean area grew by almost 109% to EUR 67 billion. The fact that imports from Europe grew more strongly than exports can be attributed to the EU's unilateral market opening for industrial products at the end of the 1970s, which eliminated significant trade barriers and made Mediterranean exports more susceptible to market forces (Backer, 2005). Since the implementation of the partnership, at the end of the year 2000, the trade deficit in MPCs was still in the range of USD 43 billion against a total trade value (exports and imports) of about USD 250 billion. This amount slightly improved since 1995 amounting to 58% at that time (Handoussa and Reiffers, 2002). Oil products contributed to stabilizing the trade deficit: with the exception of oil products, the deficit is about 50 billion Dollars (Fig. 2). In order to finance this deficit, the MPCs depended on private investments, banking credits and public financing.

Referring to the Maghreb economies in the short-term, it is widely agreed that the Euro-Mediterranean Free Trade Area will induce a deterioration of the trade balance in all three countries and a net loss of jobs (particularly as the implementation of Euro-Med goes hand in hand with deeper structural adjustment and privatization programmes, reducing the size of the public sector and so contributing to unemployment) (Tapinos *et al.*, 1994; Rutheford *et al.*, 1995; Kébabjian, 1995; Deardorff *et al.*, 1996; Tovias, 1999). This conclusion remits to FDI as a possible solution.

Fig. 2 – MPCs trade deficit with the EU and with the rest of the world



Source: COMTRADE (2001), Institut de la Méditerranée.

6. FDI inflows in the MENA region

The Barcelona Declaration encourages the promotion of FDI as a complement to domestic investment and stresses the importance of creating favourable investment conditions. *A priori*, the net relationship between trade, one of the Declaration's main targets, and FDI is not clear. FDI can be an instrument for market entry, thereby substituting trade. In previous Sections we have analyzed the trade flows from UE to MPCs and *vice versa*; in order to study the complementary-substitution issue between trade and FDI, in parallel we are going to study the FDI inflows trend in MPCs after the Barcelona Declaration.

The Mediterranean countries have been relatively successful in attracting FDI flows over recent years. Compared with 1992-1997 annual average, FDI inflows in the Mediterranean countries more than doubled in 2003 to USD 9.927 million (Tab. 3).

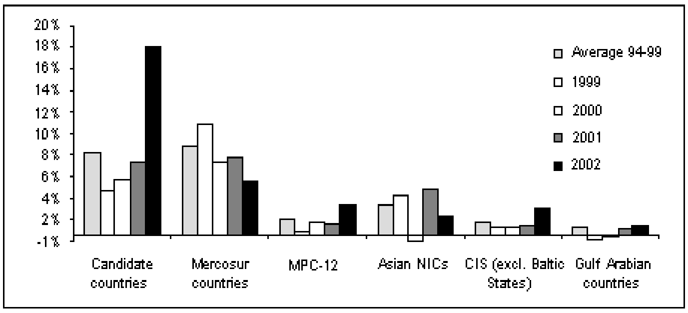
Tab. 3 – FDI inflows by host region and economy, 1992-2003 (USD million)

	1992-97 p.a. avg.	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2001-03 p.a. avg.**
Algeria	93	501	507	438	1,196	1,065	634	965
Egypt	820	1,076	1,065	1,235	510	647	237	465
Israel	1,069	1,887	3,111	5,011	3,549	1,721	3,745	3,005
Jordan	67	310	158	787	100	56	379	178
Lebanon	52	200	250	298	249	257[a]	358[a]	288
Morocco	551	417	850	215	2,825	481	2,279	1,862
Palestinian Territory	154	218	189	62	20	--	--	--
Syria	108	82	263	270	110	115	150[a]	125
Tunisia	457	668	368	779	486	821	584	630
Cyprus	150	264	685	804	652	614	830	699
Malta	126	267	822	622	281	-428	380	78
Turkey	750	940	783	982	3,266	1,038	575	1,626
Total	*4,243*	*6,830*	*9,051*	*11,503*	*13,244*	*6,387*	*10,151*	*9,927*
Developing economies	118,596	194,055	231,880	252,459	219,721	157,612	172,033	183,122
Africa	5,936	9,114	11,590	8,728	19,616	11,780	15,033	15,476
North Africa	1,926	2,904	3,032	2,918	5,490	3,631	5,784	4,968

Source: UNCTAD (2004), *World Investment Report*.

However, the Mediterranean countries' share of FDI flows to developing countries remained low (5.4% on average in 2001-2003), but in the early 1980s MPCs attracted 15.8% of foreign direct investment destined to developing countries (this rate decreased because of the boom of FDI in developing economies, while FDI inflows in MPCs in absolute terms grew) (Radwan and Reiffers, 2005). Destination of EU FDI flows in 2002 was marked by an increase of the Mediterranean countries share as a percentage of total extra-EU FDI flows. The MPCs took 2.8% of extra-Community FDI flows (1% in 2001), confirming the upward trend observed since 1999 (Fig. 3) (Quefelec, 2004). Overall, the European Union's FDI positions in the MPCs (Cyprus and Malta not included) increased more than threefold between 1994 and 2001.

Fig. 3 – Destination of European FDI flows by geographic zones as % of total extra-EU FDI



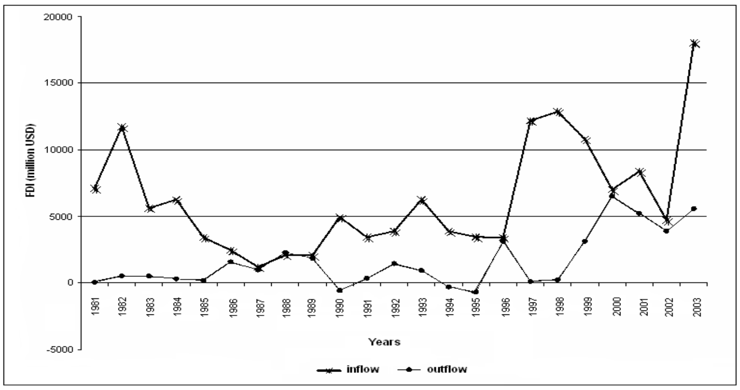
Source: Quefelec (2004).

The UNCTAD Inward FDI Performance Index – for the period 2001-2003 – shows that the MENA region is far behind any other developing region except South Asia (UNCTAD, 2004).

MENA countries are still poorly integrated in global production sharing networks, as reflected by the small share of MENA countries in global FDI flows and trade. Despite its size (population of 430 million) and total GDP (USD 1,198 billion), the MENA region seems to have difficulties in drawing foreign investors (Divarci *et al.*, 2004). The region receives only 1/3 the foreign direct investment expected for a developing country of an equivalent size (Abed, 2003).The ratio of net FDI flows to GDP only reached 0.9% in average in the 1990s, against 2.5% in Africa, 3.8% in East Asia and 4.5% in Latin America. Moreover, contrary to the other regions where FDI flows increased during the 1990s, the progression was very small in MENA (6.3 % in average per year, against 17% in Africa, 10% in East Asia, 22% in Latin America and 13% in South Asia) (Sekkat and Varoudakis, 2003). In the last few years, the Mediterranean Partners (MPs) have received on average USD 8 billion of FDI, that is little more than what Poland alone got (Radwan and Reiffers, 2005).

Outward FDI remains below the inward FDI level. Outward FDI level from the MENA region is below 1% of world outward stock and below 5% of developing countries' outward FDI stock for the period 1980-2003. Among the MENA countries Bahrain, Saudi Arabia, Turkey and the United Arab Emirates are the most important countries as source of outward FDI. Especially Saudi Arabia is one of the emerging investors abroad (UNCTAD, 2003).

Fig. 4 – FDI flows to and from MENA region



Source: UNCTAD, Hand book of Statistics online database, www.stats.unctad.org

The Mediterranean countries' capability to attract FDI was not spread equally. Turkey more than doubled its annual average FDI inflows in the period 2001-2003 compared with 1992-1997. In the same reference periods, inflows tripled in Israel, Jordan and Morocco, quadrupled in Cyprus and reached ten times their average 1992-1997 level in Algeria (Tab. 3). In 2003 Israel and Morocco were the principal recipients of FDI inflows (Tab. 4). In 2001, Cyprus, Israel and Turkey accounted for nearly 3/4 of European FDI positions in the MPCs. Those 3 countries also received in 2002 more than 3/4 of European FDI going to the MPCs.

Tab. 4 – FDI inflows by host region and economy, 1992-2003 (% of total)

	1992-97 p.a. avg.	1998	1999	2000	2001	2002	2003
Algeria	2.2	7.3	5.6	3.8	9.0	16.7	6.2
Egypt	19.3	15.8	11.8	10.7	3.9	10.1	2.3
Israel	25.2	27.6	34.4	43.6	26.8	26.9	36.9
Jordan	1.6	4.5	1.7	6.8	0.8	0.9	3.7
Lebanon	1.2	2.9	2.8	2.6	1.9	4.0	3.5
Morocco	13.0	6.1	9.4	1.9	21.3	7.5	22.5
Palestinian Territory	3.6	3.2	2.1	0.5	0.2	--	--
Syria	2.5	1.2	2.9	2.3	0.8	1.8	1.5
Tunisia	10.8	9.8	4.1	6.8	3.7	12.9	5.8
Cyprus	3.5	3.9	7.6	7.0	4.9	9.6	8.2
Malta	3.0	3.9	9.1	5.4	2.1	-6.7	3.7
Turkey	17.7	13.8	8.7	8.5	24.7	16.3	5.7
Total	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*
Developing economies	2,795.1	2,841.2	2,561.9	2,194.7	1,659.0	2,467.7	1,694.7
Africa	139.9	133.4	128.1	75.9	148.1	184.4	148.1
North Africa	45.4	42.5	33.5	25.4	41.5	56.8	57.0

Source: UNCTAD, World Investment Report (2004).

7. Economic policy failure in attracting FDI

In the 1980s, many MENA countries have shifted their import substitution policy to export-led growth that can be seen as a more open and attractive environment for FDI. MENA countries have performed many liberalization reforms in order to encourage FDI inflows. These reforms include tax and custom duty breaks, relaxed foreign ownership restrictions, and implemented privatization and capital market reform programmes (Eid and Paua, 2003; UNCTAD, 2004).

Despite some progress in economic policy, essentially in the 1980s for macroeconomic stability and in the 1990s for structural reforms, MENA countries have failed to attract much FDI. This can be due to several factors: the lack of economic reforms, a lack of physical infrastructures (Sekkat and Varoudakis, 2003), political and economic instability and negative government attitudes towards foreign investors, a weak enabling environment for privatization-related FDI and a total lack of effective investment promotion (Alessandrini, 2001), together with limited domestic markets, the absence of real South-South regional integration process and of an adjustment process of their legal framework to international standards (Radwan and Reiffers, 2005).

For enhancing domestic economies it is necessary not only to create the conditions to attract FDI, but also to spur private investments and consumption. The need to increase domestic savings and efficiency of investments before looking for foreign capitals is a notion displayed in a study by the IMF (Bisat *et al.*, 1997). This study remarked that Total Factors' Productivity (TFP) in Arab countries has remained at a very low level between 1971 and 1996, even during the oil boom of 1973 and 1979, when investments were heavily financed with external contributions. The experience of those years shows that efficiency of local investments and improvement of domestic savings are more important than the quantity of investments in starting the cycle of growth, and that structural reforms in the national budget and in the banking system are necessary (Minasi, 1998). Then, once the TFP and domestic saving take off, internal investments could be increased through FDI, without risking to depend on the latter for future growth. In other words, partner countries should not repeat the error to rely mainly on FDI to finance their growth, as they could find themselves alone as soon as economic conditions of foreign investors deteriorated.

The reason for the poor export and FDI performance in the region has been also related to prolonged application of inward-looking strategies based on import substitution (Nabli and De Kleine, 2000). That is why, during the 1980s, a number of developing countries engaged in a process of economic reform, involving a more outward orientation of their economies, the lowering of trade barriers, privatization of many industries and reform of the foreign-exchange market. The goal was to create a friendly climate favourable to trade and investment. MENA countries followed this process, but at different speeds (Nabli and Veganzones-Varoudakis, 2003).

Neither has the Barcelona Process regenerated the interest of European investors. The Mediterranean share of European direct investments (including intra-Union investments) was in 2000 slightly inferior (0.55%) to what it was in 1995 and much lower than the 1997 level. Such a development is, however, attributable to European wariness towards emerging markets rather than to disaffection for the Mediterranean area. Indeed, Eastern Europe or candidate countries do not compete with the MPCs. In 1995, European investments destined to the MPCs amounted to 11.7% of the investments directed towards Central and Eastern Europe (12.0% of investments into candidate countries).

In 2000, these ratios were respectively established at 32.0% and 31.0% (Handoussa and Reiffers, 2002).

Actors in the Euro-Med Partnership are all aware that South-South integration represents a key element for the success of the region as a whole, notably because it can create economies of scale that will compensate for the small size of individual domestic markets and will promote investment flows into the region. But, in spite of this awareness, trade between MPCs has not developed sufficiently to be considered anything more than marginal: intra-regional trade among MPCs remains marginal (Handoussa and Reiffers, 2002). It is argued that in the case of the three Central Maghreb countries, Algeria, Morocco and Tunisia, only the creation of a horizontal free trade area between them, as opposed to the creation of parallel bilateral free trade agreements between each individual country and the EU, as it has been done so far, could boost FDI levels within the region. A second possible line of action would be to turn the Euro-Med into a true Partnership for investment, taking concrete measures to foster FDI in the Southern and Eastern Mediterranean countries (Martin, 2000).

8. Determinants of commercial policy efficiency in attracting FDI

The study of the role and efficiency of economic policy in attracting FDI concerns also commercial incentive policies and it depends from the precedence and timing of the relationship between inward FDI and exports and from the existence of a complementary or substitutive link between FDI and trade.

Makdisi *et al.* (2000), Dasgupta *et al.* (2002), Nabli and Veganzones-Varoudakis (2003) showed that, although some reforms have been undertaken by the majority of MENA countries, these reforms have generally been insufficient. While trade and foreign exchange liberalization in the MENA region has been more effective than in Africa, it has most of the time lagged behind Latin America and East Asia. The main cause of this is a deficit in trade and foreign exchange liberalization process (Makdisi *et al.*, 2000; Dasgupta *et al.*, 2002; Nabli and Veganzones-Varoudakis, 2003). It can be calculated that FDI flows to the region could have been 2.3% of GDP (instead of 1.2%) during the 1990s, if trade and foreign exchange liberalization had reached the level of East Asia (Sekkat and Varoudakis, 2003). Moreover if exports other than oil were higher, and were made in a better investment climate, domestic private investment in traded goods and services would be much higher; and the FDI inflows that the region could expect would be several times what they are today. Based on this assumption, exports precede FDI inflows (World Bank, 2003).

Blomstrom and Kokko (1997) examined the effects of trade liberalization on FDI. They showed that trade liberalization and a reduction in investment restrictions have different effects on FDI. The effects of trade liberalization depend on the motives for incurring FDI. There is the tariff-jumping argument in which trade and factor mobility (including FDI) are viewed as substitutes. The other view is that the main determinant of FDI is the exploitation of intangible assets. Trade liberalization is likely to decrease intra-regional FDI flows if the tariff-jumping argument is valid, because exporting from the home country becomes more attractive than FDI as a way of serving the regional market. But if the motivation behind FDI is the exploitation of intangible assets, then a reduction in trade barriers can enable multinationals to operate more efficiently across international borders (Blomstrom and Kokko, 1997).

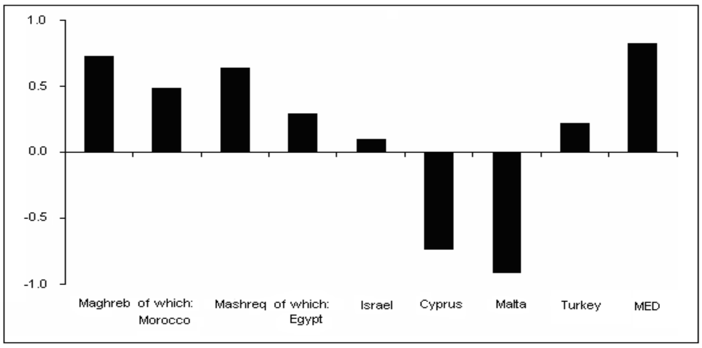
9. FDI and trade: complementary correlation in MENA region

So far we mentioned a model based on the assumption that exports precede FDI inflows but it is also true that deregulation of domestic and foreign investment is critical to enhancing export activities. There is evidence of a considerable unexploited trade potential between EU and Mediterranean countries, but trade liberalization in the Mediterranean countries needs a complementary strengthening of the private sector and business environment (Backer, 2005). The Barcelona Declaration stresses the relevance of improving the domestic business climate as a basis for investment, both domestic and foreign. In general, EU exports and FDI towards the Mediterranean countries are positively and strictly correlated in those cases in which FDI is predominantly driven by a delocalization of the production chain according to cost criteria rather than by market-seeking aspects (Backer, 2005). In fact, the overall effect of FDI on trade depends mostly on investment strategy. For instance, labour-seeking FDI quite often has a pro-trade effect on both the home and host countries. Resource-seeking investment also gives rise to growing levels of cross-border trade, with many resource investment schemes characterized by rising imports of machinery from the home country and a corresponding increase in exports of raw materials from the host one. Efficiency-seeking FDI has a similar effect. On the other hand, market-seeking FDI in large markets for the purpose of satisfying domestic demand is linked to import substitution, and thus can have an anti-trade bias, as it reduces the need for imports.

The increase of international trade in the Mediterranean region after the Barcelona Declaration testifies that foreign investors follow the traditional step-by-step sequence of servicing these markets: in the first phase of commercial relationship development they test the ground exporting before investing directly through FDI (in fact MPCs imports grew more quickly than MPCs exports, whereas there was an increase of FDI, but it was significantly smaller compared with the FDI inflow growth rate of other developing countries). The Mediterranean region has a great potential in attracting FDI, but several issues have to be tackled to settle the full integration process with European partners. Thus, the unsuccessful take off of foreign investments is due to this kind of obstacles rather than to the presence of a substitution relationship between FDI and trade. In fact, the correlation of EU exports and EU-FDI towards the Mediterranean countries over the period from 1995 to 2003 is positive for all current partner countries (Fig. 5). Yet the data for Cyprus and Malta, which were available only from 2000 to 2002, showed a negative correlation indicating high outflows during that period (Backer, 2005). Therefore the correlations are difficult to interpret in these cases. The correlation is close to 0 for Israel and Turkey because of large FDI swings. EU exports and FDI towards the Maghreb and Mashreq, as well as towards the whole Mediterranean area, are positively correlated. This indicates that, overall, EU exports and FDI are complements, and that features such as intra-firm trade probably prevail over export-substituting FDI. This seems to point to a more advanced degree of EU-Mediterranean integration, where FDI as a market entry instrument has become less important.

The complementarity of these two economic instruments and the not total dependence of MPCs from European FDI, could contribute to not separate them from the rest of the world economy without increasing dependence on imports from EU. Moreover, the exclusive predominance of FDI might create a vicious circle, where foreign investors open up firms in the South just to benefit from lower wages and produce semi-finished items, in order to re-export them to Europe for further treatment. In this way, all the value-added is produced in Europe. In other words, the risk exists that free trade and the imposition of European legal standards create a drive for *relocation*, instead of *integration* and *cooperation* (Minasi, 1998).

Fig. 5 – Correlation on EU exports and FDI to MENA region



Source: European Commission (2004), "External and Intra-European Union Trade", *Statistical Yearbook*, data 1958-2003, Luxembourg.

10. Removing trade barriers and inefficiency in MENA service sector to accelerate economic development: positive correlation between trade and FDI inflows

Inefficient domestic production of services behind trade and investment barriers acts as a tax on the production of goods. The liberalization of services may be necessary for industrial sectors to be able to fully benefit from the direct opportunities that are made available by the removal of trade barriers (Brenton and Manchin, 2003).

Most of the MENA countries have to develop their basic telecommunications infrastructure if they want to accelerate economic development. Developing the infrastructure can be achieved by shifting from public to private ownership, by liberalization of industry entry and by increasing the scope of foreign ownership (Safadi and Togan, 2000).

Countries which have improved the performance of trade-related services (transport utilities, finance and telecommunications) seem to have achieved substantial increase of their exports and FDI inflows (Sekkat, 2002). On the one hand, improved regulation and competition in trade-related services could strengthen the export response to trade liberalization by reducing the cost of exporting. On the other hand, creating efficient trade-related services may enable local producers to better coordinate their activities with intermediate input suppliers located in high-income countries and, hence, may make the countries more attractive to foreign direct investment. In turn, the latter could help upgrading their technological base, by improving their position in vertically integrated production networks.

Within the services sector particular attention is often given to financial services due to the role they play in directing investment flows to the most productive uses and, in so doing, providing for growth of output and incomes. If liberalization of financial services leads to higher savings and investment and/or more productive use of capital, then a higher level of per-capita income will result (Brenton and Manchin, 2003).

Despite recent initiatives, MENA region is far from a situation in which services do much to promote trade and investment. The MENA area is among the low performing regions of the world in terms of telecommunication services (Sekkat, 2002). Moreover, the share of EU exports of services was only 13% of the total, while EU imports of services represent a share of 20%. Except for the cost of local calls, all the indicators of telecommunication services performance in the region are among the lowest in the world. Taking the two results together sheds light on the well documented observation that the MENA region is lagging behind other regions in the world in terms of manufactured exports and FDI inflows as shares of GDP. Trade liberalization in service industries, such as transport, insurance and finance, can play a prominent role in stimulating both trade in services as well as goods and FDI inflows (Deardorff, 2001).

11. Conclusions

A growing literature has begun considering trade and FDI not as two separate and distinct functions, since the two are more inter-related than autonomous. Over the past decade, global FDI has become increasingly associated with the creation of integrated international production networks of firms, whereby companies spread their activities regionally or globally across various production sites.

While FDI is often thought of as a substitute for trade, the reality is that FDI can both substitute *and* complement trade. Our research has investigated this issue referring to MENA countries and EU partnership.

In spite of the EU-MED Agreements, the share of FDI received by MENA countries is very small both in absolute terms and relative to the size of their economies. Two explanations are possible: one is related to the nature of the MENA region as being a newcomer to the international market of capital flows; the other is related to the substitution issue between FDI and trade. This paper suggests that the weak FDI record of the region can largely be explained by the lack of economic reforms rather than to the presence of a substitution relationship between FDI and trade, a linkage which is denied by a European Commission study (2004) cited in Section 9.

What about trade? Trade in goods between the EU and Mediterranean area has markedly increased over the last 10 years but MENA countries score one of the lowest ratios of export to GDP among all regions of the world, but Sub-Saharan Africa, and imports from Europe grew more strongly than exports. The Euro-Med Agreements have not increased the trade shares of the Southern Mediterranean partner countries in EU markets because of many reasons, which include the EU's unilateral market opening for industrial products at the end of the 1970s, the restrictions on trade in agriculture, services and labour, the lack of harmonization of standards, and the stringent rules of origin for some manufactured goods that have high export potential, such as textiles and clothing. The unsuccessful growth of MENA exports can partially be due also to the anti-trade effects of market seeking FDI inflows.

Trade is thus likely to be a key source of growth in the MENA region in the next decade and beyond. With gains in trade intensification and major improvements in the investment climate, a significant improvement of private domestic investment and FDI is expected.

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