Republic of Lebanon
Office of the Minister of State for Administrative Reform
Center for Public Sector Projects and Studies
(C.P.S.P.S.)

Section I.1 - Introduction to the Macro-economic situation in Lebanon 3
A. Introduction to the macro situation and the expected welfare impact 3
i. Structural imbalance of the trade balance 5
The customs classification 6
Characteristics of Lebanese imports 6
Principal products exported by Lebanon 7
ii. Dissymmetry of the trading partners 9
iii. Characteristics of the trade flows with Europe 11
iv. Tariffs 14
v. Recommendations 15
C. Lebanese Private Sector: Institutional and Structural Obstacles 16
Section I.2 - Introduction to the Euro-Med. Agreement proposal with Lebanon 19
A. Major provisions of the Euro-Med Agreements 19
i. For the product industrial 19
ii. For the agricultural products 20
iii. Service trade 21
B. Rights of Establishment and the Rules of Origin 23
i. Rights of Establishment 23
Lebanon 23
Morocco and Jordan 24
ii. Rules of Origin 25
iii. Rules of Origin - NAFTA 28
Section II. Assessment of The Arab Free Trade Area (AFTA) and Overview of the Bilateral Agreements with Arab States 30
A. Arab Free Trade Area 30
B. Bilateral Trade agreements between Lebanon and Arab countries: Main Provisions 31
C. Syria 33
Section III - International experiences with the Euro-Med. Agreement 35
A. The Maghreb 35
B. Egypt 36
C. East and Central Europe 37
D. Regionalism 38
i. North American Free Trade Area (NAFTA) 38
Tariff Barriers 39
Non-Tariff Barriers 39
Investment Barriers 39
Services 40
Intellectual Property Rights 40
ii. Association of Southeast Nations (ASEAN) 40
Section V.1 – Mapping the Economy 41
A. Overview 41
i. Macroeconomic Situation 41
ii. Fiscal Situation and Policy 42
iii. Monetary Policy 45
iv. The Financial System and the Banking Sector 47
v. Foreign Direct Investment & balance of payments 48
B. Macroeconomic Analysis: Liberalization and The Expected Impact 49

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الجمهورية اللبنانية
مكتب وزير الدولة لشؤون التنمية الإدارية
مركز مشاريع ودراسات القطاع العام

i. The Fiscal Impact 49
ii. Welfare Impact 51
iii. Impact on Foreign Direct Investment (FDI) and the Balance of Payment 54

Section I.1 - Introduction to the Macro-economic situation in Lebanon

A. Introduction to the macro situation and the expected welfare impact

The end of the war in Lebanon brought the return of political order to the country. This together with a tight monetary policy, brought stability to the country's macro-economic policy. The government reduced the reliance on money creation to finance its budget deficit and increased its issuance of treasury bills. The post-war economic stability encouraged the inflow of foreign direct investment and the government, through the Central Bank, controlled the exchange rate and curbed the nominal inflation rates.

The high interest rates that helped bring capital inflows to Lebanon discouraged, however investors from creating new capital and investing in long-term projects. The negative impact of high rates of returns on treasury bills was large enough to stagnate the economy for the latter part of the 1990s. The high growth rates in GDP witnessed in the years following the end of the war soon dropped reaching 4% in 1997 and close to 0% in 1999. As GDP growth was mainly consumption driven, that is public sector consumption, the economy began to stagnate as soon as the government stopped stimulating the economy with public works projects.

The post-war monetary policy had a triple objective: curbing inflation, reducing the dollarization of the economy, and stabilizing the nominal exchange rate. The general price level in Lebanese Pound dropped to single digits whereas in US dollars the inflation rate remained constant through out the decade. Pegging the exchange rate to the US dollar remained a priority as the monetary authorities aimed to increase confidence in the national currency and the economy as a whole. The attempt to reduce the dollarization was partially successful and authorities now favor a drop in interest rates but believe however that the market should dictate rates and any change ought to be gradual.

Rebuilding the infrastructure and providing regular services have been the government's crucial contribution to the reconstruction effort. The acceleration of public capital expenditures, together with large and expanding current expenditures and the slow recovery of the revenue-generating capacity, has led to sizable fiscal imbalances. While the deficit fell from 16% of GDP in 1991 to 8% in 1993, it rose and remained thereafter, reaching 26% in 1997. As a result gross and net public debt as percent of GDP also increased surpassing the 100% mark in 1997 and reaching 140% by early 2000. To these ends, the 1998 budget involved both expenditure and revenue measures to initiate needed adjustments in order to ensure some medium term sustainability and underpinning a soft landing approach.

As for the external imbalances, and even though the size of the current account deficit is subject to measurement errors, there is no doubt on the improvements in foreign direct investments, financial inflows, and portfolio flows. The Lebanese economy is still in a net creditor position vis-à-vis the rest of the world as data indicate that by the end of 1997, assets exceed liabilities by a factor of two.[1]

[1] IMF Occasional Paper 176, 1999.

Signing a regional trade agreement with the European Union (EU), Lebanon's number one source of imports and foreign direct investment, is expected to have significant implications on the Lebanese economy, both for the short and long term.

About 50% of Lebanese imports come from the EU and taxes on international trade made up in 1998 61% of total tax revenues. This fiscal dependence on trade raises alarming speculation on the fiscal impact of joining the Euro-Med. free trade area. Measuring the exact fiscal impact has not yet been fully estimated given the lack of data which questions the reliability of any econometric model. A number of descriptive and empirical studies have been conducted to estimate the fiscal impact, for Lebanon and the region, and the common conclusion for Lebanon is that the government needs to introduce new tax measures in order to absorb the drop in fiscal revenues.

Examining the welfare implication of the Association Agreement is dependent as well on the modeling technique and parameters used. The agreement is expected to increase the volume of trade among the member states (EU and Lebanon) but at the expense of the rest of the world, probably a more efficient source of import (i.e., trade diversion). A number of studies tried to construct models with the available data and quantified the welfare impact. The results varied according to the empirical simulation used and depended heavily on a number of calibrated parameters. The key parameters that have a first-order impact on welfare are the elasticity of substitution among competing import suppliers and between aggregate imports and domestically produced goods. The models depended, but to a lesser degree, on a few other parameters including the initial tariff rate and the tariff measurement used (i.e., simple average, weighted average, etc.).

Even though the welfare impact, as measured in economic models, is directly affected by changes in the price levels, there are indirect factors sometimes not captured well in the model that ultimately affect the economic welfare of a nation. An Association Agreement with the EU is expected to impact foreign direct investment and the overall Lebanese balance of payment, both of which will have welfare implications. Under a regional trade agreement, member countries are expected to increase intra-regional trade but also intra-regional investments. The "no-less favorable treatment" clause acts as an incentive for foreign direct investors and as a result increases the volume of intra-regional economic activities. The Association Agreement is also expected to increase other forms on flows such as financial and technical assistance monies and raise the credit ceiling for the joining member whose "credibility" improves as a result of entering into a regional trade area.

B. Lebanese Trade Patterns

Lebanon is currently negotiating with the European Union a Euro-Med. Partnership agreement which envisages amongst other things the progressive adoption of a free trade area between the EU and Lebanon over 12 years as from the entry into force of the agreement.
That involves the progressive reduction of the tariff barriers on imports from the European Union. Several consequences will result from this: on the perceived customs revenues and the tax impact, and on the national producers' competitiveness vis-à-vis the increased competition of the European products.
To evaluate the impact, it is therefore necessary to study the trade flows of Lebanon. The data on the exchanged products, the source of imports, and the possible substitutions between the origin of imports makes it possible to know better the consequences of the Euro-Med agreement.
In addition, another aspect of the agreement is to increase the competitiveness of the Lebanese firms via an increase in competition on the national market which would make it possible in the medium term to encourage their performances on exports. Indeed, Lebanese exports have been benefiting since the agreement from 1977 of the application of the system of generalised preferences set up by the EU. The exports of industrial products are thus free from customs duties.

i. Structural imbalance of the trade balance

Lebanon is a slightly industrialised country. That is reflected in particular by the development of the tertiary activities since the 1950s, the small size of the internal market, scarce natural resources,... It has therefore to import to satisfy local demand.
The depreciation of the Lebanese Pound which followed the hyperinflation crises of the years 1987 and 1992 allowed a temporary stepping up of exports. From the end of 1992, the government's monetary policy has been to ensure the stability of the Pound. Since 1993, the Pound has been appreciated in relation to the dollar US. The appreciation rate bordered the 3% a year at the beginning of the period but it stabilised this last year (1999).

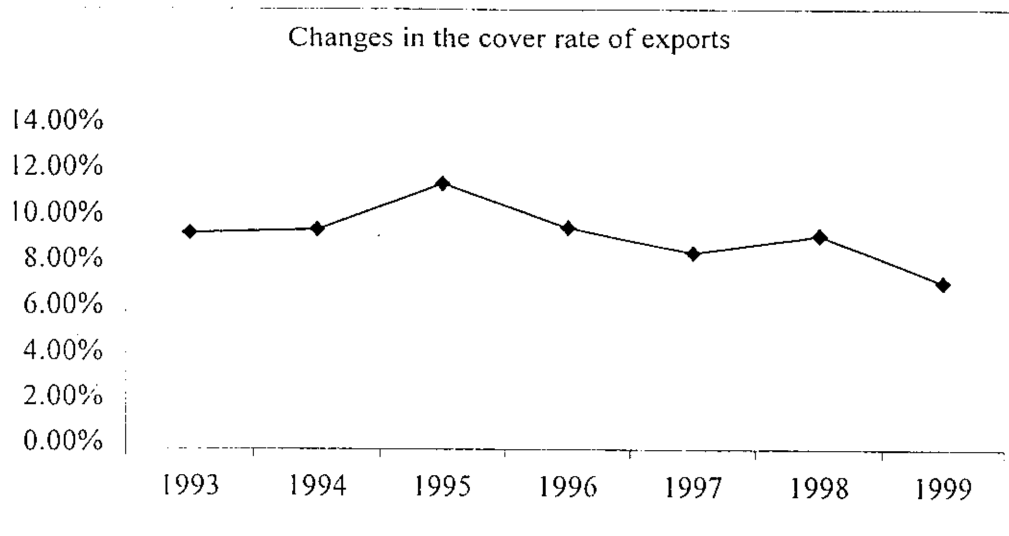
Development of the trade flows (thousands of USD)

	1993	1994	1995	1996	1997	1998	1999
Imports	4,939,499	5,921,400	7,152,047	7,559,127	7,456,574	7,055,190	5,880,734
Exports	468.159	569.972	829.695	733.124	642.282	660.949	429.160
Trade balance	-4,471,340	-5,351,428	-6,322,352	-6,826,003	-6,814,292	-6,394,241	-5,451,574
Cover rate of exports	9 48%	9 63%	11 60%	9 70%	8 61%	9 37%	7 30%

Source: Higher Council of the Customs

Imports increased regularly of 1993 have 1996 then decreased these the last two years reaching a maximum in 1996..That corresponds in particular to the needs connected with the rebuilding programme and with the boom of the construction that the country experienced after the end of the war. The reduction observed recently is the result of the deceleration of activities connected with the sector of construction and of the economic recession that the country is going through.
Exports after having increased until 1995 decreased to be on a level lower than that of 1993. Exports are penalised by the rise of the Lebanese Pound in relation to the dollar and in relation to the rise of the dollar in relation to the European currencies in particular.

The result is a structural deficit of the trade balance. The cover rate of exports is very low since it is, with an exception, still less than 10%.



Source: Higher Council of the Customs

The trade deficit is made up at the macroeconomic level by a surplus of the balance of capital. Lebanon was always able to finance this deficit with a capital inflow. The years 1983 and 1984 were the only exceptions.

The customs classification

The trade flows are classified from the customs classification. In 1995 the so-called harmonised system to replace the Brussels classification which prevailed before (2 300 articles). The tarification rests on the application of *ad valorem* taxes. The number of rates had fallen at the time of the change while the number of articles passed to more than 5 600. Coding includes 8 digits. The 6 first correspond to the classification universally adopted by the countries; the last 2 digits are left to the discretion of each country. In addition to the easy applicability of this system, it is also transparent. The system makes it also possible to calculate the impact of tariff dismantling.

However, in Lebanon, since its adoption, the customs tariff has undergone numerous modifications (more than 500 in 5 years). Moreover, specific rates were introduced and minimum perception rates were also integrated. The result is a complication of the tariff. The average tariff became difficult to determine, consequently, the impact of trade agreements cannot be determined so easily.

Classification includes 21 sections (cf. annex 4) symbolised by the first 2 figures of the classification. These sections are divided into 99 chapters, the 3rd and 4th figures are divided into sub-section (more than 1,100). The 7th and 8th figure determine the product (more than 5,600).

Characteristics of Lebanese imports

Imports are grouped into 6 categories, which account for more than 58% of imports. The structure of imports is relatively stable at the most aggregated levels.

Principal imports (% of the total)

Imports	1997	1998	1999
Electrical fittings	15.5	16.1	14.7
Vehicles	10.0	9.7	9.9
Mineral products	9.6	7.9	9.9
Chemicals	7.2	8.0	9.3
Foodstuffs and drinks	7.6	8.4	7.5
Jewels	7.8	7.2	7.4
Total	57.7	57.3	58.7

Source: Higher Council of the Customs

On a more detailed level, the same concentration is found since 13 headings - out of the 1 150 of the customs classification - count for approximately 40% of the total imports in 1999.

Principal products imported by Lebanon in 1999

Classification	*Products*	*Share*	*Effective tariff* *
27.10	Oil	8 32%	0 to 72%
87.03	Cars	7 34%	0 to 6%
71.08	Jewels (powders, non monetary uses)	6 65%	0 to 6%
30.04	Antibiotics	4 37%	0 to 6%
24.02	Cigars, cigarettes	2 22%	6 to 90%
01.02	Pure race reproducers	2 04%	50%
04.06	Fresh cheese	1 48%	0 to 105%
87.08	Parts of coachwork and accessories	1 43%	20 and 25%
72.14	Rolled , forgings, in free-cutting steel	1 31%	3 and 15%
84.71	Computers	1 00%	15%
84.15	Air conditioning equipment	0 93%	6 and 25%
04.02	Milk powder	0 91%	3 to 42%
10.01	Wheat	0 91%	3 to 6%

Source: Higher Council of the Customs

*: It is not the nominal tariff mail the tariff determined in the following way: customs revenues (LL)/Imports x 100

Lebanon does not have oil resources and thus has to import all petroleum-related products. The same holds true for vehicles and in particular cars. In the agricultural sector and of the agro-food, local production is definitely insufficient to meet domestic needs. The principal imported products are milk products (fresh cheese and milk powder) and wheat. The tariffs applied to the centre of the same category of products can be extremely variable (example of the fresh cheeses) because of the diversity of the products that it gathers.

Principal products exported by Lebanon

The value of exports differs of almost 20% between what is recorded at the Lebanese customs and the international commercial directories. Exported goods are underestimated. It is not known whether this under valuation applies in a uniform way to all exports or is restricted to a number of products and whether it depends or not on the destination of exports.

At the aggregated level, Lebanon exports mainly jewels, chemicals, metals, foodstuffs, electrical fittings, and textiles.

Principal exports (% of the total)

Exports	1997	1998	1999
Jewels	10.4	10.4	14.2
Chemicals	10.9	13.2	12.6
Metal metals and products	10.6	10.3	11.7
Foodstuffs	10.0	10.7	10.9
Electrical fittings	10.4	9.5	10.8
Textiles	12.2	10.9	8.1
Total	**64.5**	**65.0**	**68.3**

Source: Higher Council of the Customs

Disaggregating, the list of the principal exported products is obtained. Lebanese exports are concentrated on a small number of products since these 15 products count for more than 52% of the value of total exports.

Principal products exported by Lebanon in 1999

Classification	Products	Share
71.13	Jewels out of noble metals	12 17%
71.08	Jewels (powders, non monetary uses)	9 43%
76.04	Products in aluminium	7 67%
49.01	Books	4 18%
85.44	Wires for winding	2 66%
28.09	Diphosphore, phosphoric acid pentaoxide	2 27%
72.04	Waste and cast iron and steel scrap	2 09%
94.03	Furniture of office out of metal	1 68%
76.02	Waste and scrap of aluminium	1 60%
62.03	Complete costumes and	1 54%
34.01	Soaps	1 53%
84.18	Refrigerators	1 52%
74.04	Waste and scrap of copper	1 47%
21.06	Protein concentrates	1 45%
17.04	Chewing gum	1 36%

Source: Higher Council of the Customs

In addition to jewellery and metal products, the principal exports are: books, furniture, dressmaking, soaps and detergents, refrigerators and confectioneries. The number of exported products is restricted: 686 imported products against 1,150 and if one retains only those for which the export value is higher than USD 10,000, only 470 products are concerned.
The imports and exports disaggregated in chapter are listed in annex 1. The data before and after 1996 cannot be compared because of the change of classification which was performed. The most

important category remains the same over the whole of the period, however from one year to another flows are very volatile.

Disintegration by sub-chapter of imports and exports for 1999 is listed in annex 3. Imports and exports are differentiated according to their origin/destination: European union (EU), Member State of the Arab League (AL) and the rest of the world (ROW).

If we consider the most important categories, it is noted that trade is mainly inter-sectoral except for the sector of jewellery where we witness intra-sectoral trade. Indeed, exports and imports do not concern the same goods. In the sector of jewellery, the existence of demand for differentiated goods explains partly the observed trade flows.

ii. Dissymmetry of the trading partners

The study of the Lebanese trade flows shows a high dissymmetry between the trading partners. EU imports account for more than 46% of the total while exports are mainly intended for the Arab countries (39%).

Distribution of imports according to the source (thousands of USD) for 1999

Trading partners	*Imports*	*Distribution*
European union	2 751 709	46.8%
The Arab League	585 389	9.95%
Rest of the world	2 543 664	43.25%
Total	5 880 762	100%

Source: Higher Council of the Customs

Principal supplying countries of Lebanon

	1993	1994	1995	1996	1997	1998	1999
Italy	13 49%	14 20%	13 67%	12 85%	13 24%	12 49%	11 83%
France	9 12%	9 47%	8 04%	8 27%	9 51%	10 56%	10 36%
Germany	9 84%	10 65%	8 84%	9 04%	8 69%	9 43%	9 63%
The United States	11 27%	9 84%	11 16%	11 58%	9 18%	10 13%	8 72%
Switzerland	3 54%	3 68%	4 82%	3 62%	6 61%	6 87%	7 72%
Great Britain	4 72%	4 40%	4 12%	4 28%	4 38%	4 90%	4 73%
China	3 33%	3 28%	3 46%	3 09%	3 19%	4 07%	4 55%
Japan	4 10%	4 48%	4 16%	4 11%	4 05%	4 53%	4 51%
Syria	5 30%	4 60%	3 40%	4 32%	4 37%	3 98%	3 90%
Turkey	1 66%	2 33%	2 23%	2 43%	2 06%	2 76%	2 85%

Source: Higher Council of the Customs

Among the 10 principal supplying countries there are four EU member states for only one Arab country and that is Syria. Since 1993, Italy has been the principal source of Lebanese imports. The market share of the United States decreased in recent years to the profit of other EU countries, France and Germany in particular.

The import market share of Syria decreased in 1999 because of a reduction in value of imports at a time when a bilateral trade liberalization agreement entered into force envisaging the

progressive reduction of 25% of the tariffs on the industrial products over a 4-year period. However, the smuggling which exists between the two countries can introduce a slant into the analysis of this official report. According to economic theory, the reduction in tariffs on imports from a country should cause an increase in imports due to an increase in trade between the two countries and to a diversion of imports of similar goods from other countries. This effect checks itself in the case of Egypt where a slight increase in imports is observed following the adoption of a trade agreement similar to that concluded with Syria. The same is true with the Kuwaiti imports which increased by 46%.

With regard to exports, the principal destinations are countries of the Arab League and in particular Gulf States (Saudi Arabia, United Arab Emirates, Kuwait). However, a reduction in the value of exports to Gulf region, which resulted in particular to a fall in the share of total exports since 1996, is also observed. On the other hand, exports to the EU increased.

Distribution of exports according to the source (thousands of USD) for 1999

Trading partners	*Exports*	*Distribution*
European union	132 493	30.9%
The Arab League	167 629	39%
Rest of the world	129 037	30.1%
Total	429 160	100%

Source: Higher Council of the Customs

Principal customer countries of Lebanon

	1993	1994	1995	1996	1997	1998	1999
Saudi Arabia	13 27%	15 24%	11 07%	13 64%	15 09%	12 64%	10 26%
WATER	9 00%	17 97%	28 68%	23 43%	8 99%	9 78%	7 95%
France	6 02%	4 61%	5 99%	4 61%	7 15%	8 57%	7 61%
Switzerland	0 50%	2 29%	1 13%	1 45%	2 45%	3 26%	6 46%
The United States	4 29%	3 62%	3 75%	3 01%	6 00%	6 47%	6 15%
Great Britain	3 69%	1 93%	1 68%	1 57%	3 09%	2 92%	4 45%
Syria	12 23%	11 01%	8 37%	6 89%	5 84%	7 05%	4 36%
Kuwait	5 67%	5 63%	3 93%	7 64%	4 48%	4 24%	4 28%
Jordan	5 23%	3 99%	3 58%	4 91%	3 87%	3 66%	4 00%
Germany	1 55%	1 68%	2 21%	2 25%	2 17%	3 16%	3 65%
EU [1]	na	16.3%	22.8%	17.8%	22.9%	na	30.9%
The Arab League [1]	na	53.3%	44.2%	57%	45.6%	na	39%

Source: Higher Council of the Customs, [1]: Audi bank

As mentioned, Gulf States, mainly Saudi Arabia and the United Arab Emirates, remain the principal destinations of Lebanese exports. Exports to Syria strongly fell between 1998 and 1999 (- 46%). The trade agreement signed with Syria therefore did not have the expected repercussions. This can however be explained by the economic recession that Syria is currently experiencing. Similarly, Lebanese exports to Egypt decreased by 22.9% between 1998 and 1999 and exports to Kuwait decreased by 13%.

Note that the bilateral trade agreements signed with Syria, Egypt, and Kuwait which envisages tariff dismantling on the industrial products over 4 years, did not result in any significant increase in trade for the moment. Indeed, Lebanese exports to these two countries decreased. In addition, the increase in Egyptian imports is far from compensating for the reduction in Syrian imports. But it is premature to establish as of now a conclusion because the entry into force of these agreements is still recent and numerous other determinants intervene (relative exchange rate, economic situation etc).

These bilateral trade agreements aim to accelerate the process of liberalisation of the trade of industrial goods between Member States of the Arab League. The agreement signed in 1997 by 18 of the 21 member states of the Arab League institutes indeed the progressive adoption of a free trade area. This agreement, entered into force in 1998, envisages the uniform reduction in the tariff rates at an annual rate of 10% over a 10-year period. Certain countries decided to carry out more rapid tariff dismantling.
Previously, Lebanon had signed bilateral trade agreements with Sudan, Saudi Arabia, Iraq, and Jordan. However, these agreements had a more limited scope and were not fully implemented.

iii. Characteristics of the trade flows with Europe

In order to study the impact of the Euro-Med agreement at a commercial level, it is essential to examine the principal imported products, the market share of European imports, and the applied tariff rates.

Imports from the EU in 1999 (thousands of USD)

Classification	*Description*	Import	*% total import*	*Market share of the EU*
87.03	Cars	261.413	9 50%	60 55%
27.10	Oil	204.821	7 44%	41 88%
30.04	Antibiotics	203.200	7 38%	79 05%
01.02	Pure race reproducers	107.486	3 91%	89 59%
87.08	Parts of coachwork	50.746	1 84%	60 45%
04.06	Cheese	42.485	1 54%	48 75%
04.02	Milk powder	41.108	1 49%	76 47%
85.25	Emission appliances	39.900	1 45%	93 89%
71.13	Noble metals	38.412	1 40%	91 69%
85.44	Wires for winding	37.779	1 37%	90 92%
62.04	Suits	31.172	1 13%	71 45%
94.03	Furniture out of metal	28.392	1 03%	64 99%
21.06	Protein concentrates	27.057	0 98%	58 14%

These 13 sub-chapters account for more than 40% of imports from the EU. It is noted that except for oil and for cheese, the market share of the EU is higher than 50% and can reach 93%. The higher the share is the less is the effect of trade diversion (negative effect connected with the partial dismantling of the tariffs from an area of countries but which can be cancelled by unilateral dismantling of the tariffs whatever the origin of the products) is important.

In addition, the reduction of the tariffs does not concern agricultural products (e.g., live animals). The negotiations on possible liberalisation will be envisaged only as from 2002. Imports from the EU will remain taxed at the same rate.

The tariff rates used on these categories are among the most taxed. Thus for the milk products - cheese and milk powders - the tariff rates vary respectively from 3 to 20% and from 0 to 105%. The same is true for the protein concentrates which have tariff rates that can reach 108%.

As the customs revenues represent the first source of incomes for the Lebanese state (40% in 1999), the duty rates of customs were determined with the purpose of protecting local industries and generating revenues for the state. The introduction of the VAT, envisaged in 2001, and more generally of the implementation of the five-year plan of the Ministry of Finance should allow the gradual substitution of customs revenues by those generated by the VAT. The customs tariff would find then its first vocation to know the protection of certain industrial sectors but which generates distortions in the economy.

However, the profit of a reduction in the tariffs (fall in the consumer prices) could be lost if the commercial margin rate increases and compensates for the fall in the tariffs.

Exports to the EU are very concentrated as 20 sub-chapters account for more than 70% of total exports to the EU. Since the partnership agreement of 1977, the exports of industrial products have not been subject to a tariff at the entry on the European market. The agricultural products are separate in two categories: those subject to the quotas and others.

The products exported towards the EU hardly differ from the principal products exported overall. However, it is noted that jewels, principal export category, are not exported towards the EU. The share of precious metals and that of books are also modest. For these categories, the principal destination is the market of the Gulf.

high commercial margins. This practice is all the more important as the Lebanese law permits the exclusive representation which in essence allows monopolistic behaviour.
There is therefore a considerable risk so that the fall in tariffs is not reflected on the selling price if there was an increase in the margins. This would obviously reduce the positive effects directly connected with the adoption of a free trade area.

At the fiscal level, the loss of customs revenues at the end of the transitional period is equivalent to the weight of imports from the EU (46.5% in 1999). The share of the customs revenues in public income would fall from 40% to 18%.
The introduction in January 2001 of the VAT (single rate of 10%) which will be applied on all imports should compensate from the first year the losses of customs revenues given the temporal delay between its application and the date of the first dismantling.

The static effects of short term - creation and diversion - of trade are of contrary signs. However, in view of the characteristics of Lebanese foreign trade, the negative effect of trade diversion should be limited. Indeed, the average tariff and the current share of European imports tend to decrease the negative effect.

The costs of the adoption of a free trade area (losses of customs revenues, prevalence of the effect of diversion on the effect of creation of trade, losses of competitiveness of local industries) occur in the short run and are more easily quantifiable than the possible profits which will occur only in the long run and which are not easily measurable.

The positive effects of the agreement include the improvement of the government's credibility in terms of its economic policy, an increase in foreign direct investments, and the possible transfers of know-how. On a parallel level, the use of EU and international standards should allow a stepping up of Lebanese exports.

At the end of the process, a better allocation of the resources in the economy should be carried out with the development of the productive sectors having a relative comparative advantage in their sector at the expense of the sectors protected of competition by the customs duties.

v. Recommendations

- Simplification of the customs tariff and stability of the applied tariffs to ensure better transparency and simplification of the customs procedures.
- Simplification of the customs clearance procedures (one-stop shopping type).
- Adoption of the computerised system of customs at all the border posts.
- Setting in place or supporting structure reinforcement to the industrialists to promote exports (representations abroad, functioning design office, offices of advice in legal matters, of standards,... institution of guarantee of equivalent exports to the COFACE in France).
- Adoption of differentiated tarification for utility companies (electricity, water, telephone) in order to restore the competitiveness of Lebanese firms with respect to their foreign competitors in the Lebanese market and abroad.
- To increase controls concerning standards and to establish legal penalties in the event of non-observance (penalties, closure, etc.).
- To encourage the disbursement of appropriations in the medium and long term to the industrial sector in order to allow the modernisation of equipment in particular.
- Better statistical measurement of exports and imports of services.

C. Lebanese Private Sector: Institutional and Structural Obstacles

Douglas North (1990) presented a theoretical model to explain how state policies, through transaction costs, affect private sector's investment decisions and hence growth. Several historical, empirical, and case studies have established the causal link. The World Bank (1997) most recently conduced a comprehensive study based upon 3,600 firms in 69 countries. The main conclusion reached was that per capita income grew by 0.5% for countries with a weak state and poor policies against a 3% for countries with strong capabilities and good and transparent policies.

Measuring the institutional bottlenecks facing the Lebanese private sector is notoriously difficult. A survey conducted in 1998 by the Lebanese Center for Policy Studies (LCPS) of 250 firms covering agriculture, banking, manufacturing, and tourism sheds some light on the existing obstacles as perceived by the Lebanese firm. The sample was selected randomly but the survey considered firms from different sizes, especially medium to small, to reflect as much as possible the composition of the Lebanese private sector (most sampled firms with ten or less employees). *A priori*, the original sample did not discriminate by geographical location, sector, or other criteria.

The results of the LCPS survey could be summarized as follows. Close to 70% of the firms believe that the state does occasionally or never does have a well-defined policy. The degree of participation in decision-making or the degree of being informed as perceived by the private sector is the lowest when compared to the rest of the world.[4] The government credibility rate in Lebanon is slightly better than in the Former Soviet Union, otherwise, Lebanon scores the worst.

With regard to corruption and the frequency of paying bribes, the LCPS survey shows a rate of 60%, the second highest when we compare to the rest of the world as calculated by Brunetti, Kisunko, and Weder (1997). The frequency of paying bribes is highest in the banking sector (close to 100%) as opposed to an average of 60% for the rest of the surveyed firms. The frequency increases with the size of the firm and the study explains the correlation with the fact that big firms perform larger operations and manage more assets. Corruption is rampant in the issuing of permits and licenses, 51% of the surveyed Lebanese firms held back investment projects because of problems related to the compliance with government regulations. These regulations can be costly but most of all the cost remains unknown given the potentiality of corruption. Beside the banking sector, it is the uncertainty about the cost of regulation, not the cost itself that stops most private firms from investing.

With regard to the role of the judiciary, the picture is mixed. On one hand the judiciary is not seen as a major impediment, but, on the other, it is the least preferred mechanism for solving disputes. The process is long, expensive, especially to medium and small enterprises, which are by and large the largest group in the Lebanese private sector. Firms, across sectors or size, prefer to negotiate with an official or appeal to personal contact than to sue in court.

The LCPS study listed the obstacles to growth as ranked by the surveyed firms and the main obstacles were:

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[4] The figure for the rest of the world (Latin America, MENA region, etc.) was calculated by Brunetti, Kinsunko, and Weder (1997).

- Corruption;
- Bureaucratic procedures;
- Informal competition;
- Uncertainty;
- Tax regulations;

These in-rooted problems raise many questions on the ability and readiness of the Lebanese economic system to face international competition or to adhere to international regulations in light of the proposed Euro-Med. Agreement.

After reviewing the institutional constraints facing the Lebanese private sector, it is equally important to consider the internal or structural obstacles or advantages for each sector of the economy.

The agriculture sector employs 9.3% of the working population and make up 12% of GDP (Iskander 1999). Technological know-how is available and can significantly render agriculture profitable. Water is relatively abundant in Lebanon, and the potential to serve a large market exists.

On the other hand, agriculture in Lebanon has traditionally faced a number of basic constraints that have hindered its development. For one, agriculture spending does not exceed 1% of total spending. And although the contribution to the GDP is at 12%, total bank lending is not comparable with only a share of 1.5% of total credit given to the private sector. The sector suffers as well from insufficient vertical integration with a shortage in adequate storage facilities, grading, and packaging. To date irrigated land constitutes only 30% of arable land. The high proportion of small landholding constitutes a serious obstacle to efficient irrigation, mechanization and land reclamation. Lastly, agriculture is hindered by high market risks and the volatility of prices. These problems are added to the lack of sufficient market outlets and a lack of market information available to farmers.

Moving to the manufacturing industry, in 1999 the sector contributed an estimated 15 to 18% to GDP and accounted for 40% of total exports. There are 22,000 industrial firms, 95% of which are small or medium in size employing less than 10 workers whereas only 1% have a labor force above 100.[5] Many obstacles continue to impede the recovery of this sector and they include obsolete equipment, limited access to medium and long-term credit, high cost of financing, inadequacies in the infrastructure, elevated cost of public services, and the LCPS cited obstacle of an absence in a clear-cut government policy with regard to the promotion of industry.

On a lighter note, and according to the directorate of industry, 526 new factories were established in 1999 (compared to 451 in 1998) generating 3,886 new jobs and pumping LBP128bn in investments into the economy. Another significant development was the establishment of a National Scientific and Research Council with the purpose of conducting R&D for the development of the private sector, mainly the industrial sector. The trade agreements, signed or under review, might force some firms to shut down for the lack of a competitive edge, but they will also serve as a medium for the transfer of technology and know-how.

As for services, Lebanon has and continues to rely heavily on this sector, mainly tourism, banking, and education. The lack of credit might not be a major obstacle but this sector faces a number of structural constraints. The largest Lebanese bank, for instance, remains small when

[5] Source: Lebanon Invest Research Company, weekly bulletin no. 185 – July 17-22, 2000

compared to banks in the region either in assets or deposits. An alarming fact to deal with before the total liberalization of services. The policy of the Central Bank has been to encourage mergers and the consolidation of banks, still the end result remains below international standards. The increase in the capitalization requires an active stock exchange market and a public interest to invest in firms historically owned by families.

The issue of size is a problem facing also the hotel industry. Phoenicia's opening in mid 1999 was the exception. Prior to the reopening of Phoenicia, Lebanon had been unable to hold international conferences or to accommodate large groups of tourists. Economies of scale and size, be it for the service sector or any other sector, are correlated. Currently, small and medium size enterprises compromise 95% of the total. Globalization requires of Lebanon to "mass produce" and to "mass customize," both of which necessitate the establishment of larger firms and versatile service providers.

Stock Markets in Selected Arab Countries

	Lebanon	Bahrain	Jordan	Oman	S. Arabia
Total value of shares ($)	1.9bn	7.1bn	5.8bn	4.3bn	60.9bn
Trading rate	17%	31%	58%	105%	312%
No. of listed companies	13	41	152	140	72

Finally, the stock market in Beirut remains small and inactive. The figures are self-explanatory. This "economic agent" has only 13 companies listed on it as of December 1999 (AMF 1999) with a total market value for shares of $1.9bn only and a trading rate (velocity) of 0.17%. Only 5% of the total value of shares is allocated for commercial companies aside from SOLIDERE and commercial banks. Bahrain, on the other hand, its stock market has 41 listed firms with a total value of $7.1bn and a trading rate of 31%. Jordan has 152 listed companies and a trading rate of 58%.

Section I.2 - Introduction to the Euro-Med. Agreement proposal with Lebanon

The Barcelona Declaration of 1995 which was the outcome of the inter-Mediterranean conference held on the 27th and 28th of November called for an economic and financial partnership between Mediterranean countries and the European Union.

The Euro-Mediterranean partnership agreement is based on three pillars:

- Policy and safety: A closer co-operation is envisaged in the fight against illegal immigration, terrorism and racism. Support will be brought to democratic institutions, to the strengthening of the rule of law and civil society. Concerning migrations, the objective is to reduce migratory pressure while guaranteeing the protection of all rights recognised for the legal migrants.

- Social, cultural and human: The main focus is on the sector of health, of social development and on the exchanges between the civil societies

- Economic: The main pillar partnership agreement is economic with the adoption of a free trade area between the EU and Lebanon on the trade of the industrial goods.
Until now, the trade between Lebanon and the EU is governed by the association agreement of 1977. Lebanon benefits from the system of generalised preferences set up by the EU which envisages the application of a preferential rate on the imports of industrial products from certain developing countries. These agreements do not call for reciprocity by Lebanon.

A. Major provisions of the Euro-Med Agreements

The general objectives of the agreement are:

- the intensification of the political dialogue,
- the adoption of reciprocal free trade on the majority of industrial goods and at a later phase a preferential access for agricultural goods.
- the harmonisation of commercial regulations and the adoption of international technical standards,
- the adoption of conditions for the right of establishment and the supply of services,
- the increase in economic, social and cultural cooperation

The agreement ensures as well financial aid from the EU to help Lebanon in the implementation of the previous objectives. Concerning Lebanon, the principal measures are as follows:

i. For the product industrial

The agreement foresees that industrial products, the tariffs on industrial goods originating from the EU will be eliminated over a period of 12 years. The reduction will be done in a uniform way on all the goods concerned as from the third year. The textile products and clothing will follow the same tariff dismantling system.

- No new import duty or tax having an equivalent effect is to be introduced in the exchanges between the Community and Lebanon.
- The products originating in Lebanon are admitted duty-free and by the Community

• The Community maintains an agricultural element on imports of the goods originating in Lebanon (see annex 1)
Lebanon separates an agricultural element in the import duties in force of the products originating in the Community (annex 2). For the products of Annex 2, originating in the Community, Lebanon applies to the entry into force of the agreement laws of customs on imports and equivalent effect levies not higher than those mentioned in Annex 2.
The agricultural elements can be reduced when taxation applicable to a basic agricultural product is reduced or when these reductions result from mutual concessions relating to the processed agricultural products
• for the products of the list of Annex 3, the customs duties and others are abolished two years after the entry into force of the agreement

For the other products, the timetable is as follows:
-5 years after the entry into force, each right and tax is brought back to 92% of the base rate

-6	84%
-7	76%
-8	68%
-9	54%
-10	40%
-11	20%
-12	0%

In the event of serious difficulties, the applicable timetable can be revised by a mutual agreement but the timetable cannot be extended for the product concerned beyond the maximum period of 12 years. For each product, the basic duty on which reductions have to be performed is subject to the law put into effect on January 1st, 1997.

If after 1 January 1997, a tariff reduction is applied *erga omnes,* the reduced rate replaces the basic duty.

ii. For the agricultural products

Agriculture has always been treated with caution in association (and trade) agreements, often in the form of an exception to the general applied to industrial goods and services. Arrangements have combined continuous farm subsidies or postponement of trade liberalization in agricultural commodities. Current Association Agreements typically stipulate that import tariffs will be progressively eliminated, starting with capital and intermediate goods, later to be followed by consumer goods. But agriculture has been excluded from the overall framework and given a special status in the Marrakech agreement. According to the latter, the agricultural trade regime will be reviewed in the near future (2000 for Tunisia).

As a result of the 1977 agreement between Lebanon and the EU and the GSP (Generalized System of Preference), about 85% of Lebanese exports to the EU benefit from preferential treatment. In return, Lebanon is not required to apply reciprocal or any preferential treatment to EU exports. This reflects in the different levels of weighted average tariffs: 3% on Lebanese exports for 15% on EU exports to Lebanon. But Lebanon tariffs applied to EU products do not differ from average tariffs applied to products from the rest of the world and are relatively low compared to tariffs in the region.

For agricultural products, since 1997, import licenses are required by Lebanon for some agricultural. products, while for others an agricultural a calendar applies. The latest version of the draft Association Agreement (October 1996) specifies that Lebanese trade regime vis-à-vis the EU will be modified in two ways:

- All tariffs to EU products will be reduced to 0 over a transition period of 12 years, with no quantitative restrictions;
- Lebanese imports to the EU will be exempted from tariffs immediately.

Existing restrictions on trade in agricultural products could in principle remain in effect, as the current draft agreement does not contain provisions in this regard apart from the fact that negotiations would start 5 years after the enactment of the Association Agreement. But an agricultural protocol has been proposed by both Lebanon and the EU, as an appendix to Article 17 of the Association Agreement.

Examining in detail the proposed Euro-Med. Agreement with Lebanon we find that the text includes four short articles on agriculture and fishery products. Article 15, for instance, states the « Community and Lebanon shall *gradually* implement *greater* liberalization of their reciprocal trade in agriculture and fishery products. » The chapter on agriculture does not provide any mechanism or timesheet for the liberalization as was done for the industril products. The assemement will be done after the 1st of January 2002 and in light of that, the two parties will decide on the measures to be applied.

The reluctance to presently deal with the liberalization of trade in agriculture is complemented with a statement in Article 17 where the sensitivity of this sector is clearly stated and followed by a call for the Association Council to « examine on a regular basis, on a reciprocal basis, and *product by product the possibility* of granting each other further concessions. » Article 17 of the draft defers any further measures to liberalize agricultural and fishing products to 2002.

Article 62 proposes methods and ideas that could enhance economic cooperation with regard to agriculture and fisheries. Even though the article remains general in context, it touches on 14 sub-headings that will help increase the cooperation between the Community and Lebanon and in essence improve the state of the Lebanese agriculture sector. Among the aims of cooperation, as listed in Article 62, shall be to diversify production, reduce food dependency, establish closer relations between enterprises, support agronomic research, exchange of experience and know-how on rural development, strengthen the agricultural credit system, and develop the forestry sector.

iii. Service trade

Contrary to the agreements signed between the EU and some Mediterranean countries (e.g., Morocco, Tunisia, Jordan), services are included in the agreement between Lebanon and the EU. The two parties engage on the basis of granting the other party the most favoured nation treatment on all the services covered by the GATS except for air and maritime transport where the principle of access without restriction on the international market is applied.

The protection of the service goods is not done via the tariff or non-tariff barriers at the border but by internal regulations which can penalise the companies or foreign nationals. The incorporation of the sector of services in the agreement grants equal treatment to foreign companies.

According to the law in Lebanon :

Foreign labour: Foreigners wishing to work in Lebanon have to obtain a work permit in the Ministry of the Labour, requested by a Lebanese employer. They need also to obtain a residence permit. The work permits are valid for two renewable years. Certain occupations cannot be offered to a non-Lebanese. For example, as employees, foreigners cannot be frameworks in the banking sector, salesmen, pharmacists, etc. As employers, foreigners cannot exert in the sectors of construction, of jewel trade, of the shoe industry, the furniture factories, of the printing, of the publishing.

Land acquisition : Foreigners are not permitted to buy real estate exceeding the 10 000 m^2 for business purposes unless the majority of the actions belong to a Lebanese or to Lebanese companies.

Administrative framework: All companies have to be registered at the commercial Court of their respective district.

Supply of public services: If a company provides a public service, at least 1/3 of the capital of the firm has to belong to Lebanese shareholders.

Financial banks and institutions: The establishment of this type of institution is subject to a special licence accorded by the Central Bank of Lebanon which has a discretionary power for approval or refusal to grant this licence. The foreign ownership of a bank cannot exceed 2/3 of the capital. Foreign banks can open only one branch in a *Mohafazat.*

Insurance : Cross-border insurance service is limited. Companies have to be registered except with regard to the transport of imported goods. The amount of the reserves is higher than that required for the national companies.

Tourism : Licences by the ministry of tourism are required for the establishment of activities pertaining to this sector (hotels, restaurants, etc.).

Legal Services: They are subject to the reciprocity clause. Foreign lawyers can practice if they are registered at the bar association. A foreign firm can operate in Lebanon only through a local firm.

Maritime transport: Lebanese benefit from preferential conditions in Lebanese ports (lower taxes and expenses).

Liberalisation of Service is related to the liberalisation of the right of establishment.

Right of establishment (cf. at all following for more details)

The establishments of the EU will be entitled to the national treatment in Lebanon and the Lebanese companies will benefit from the most favoured nation treatment

Rights on the intellectual property (cf. at all following for more details)

Agreements will have to be signed during a 3-year period after the entry into force of the agreement.

Rules of origin (cf. at all following for more details)

Cumulation of the rules of origin is envisaged.

Finally, the proposed agreement with Lebanon includes 19 articles on possible economic cooperation between the EU and Lebanon. The agreement calls for cooperation on numerous levels including scientific, technical, and technological. Article 56 calls for cooperation in combating the deterioration of the environment and other related matters, Article 57 is about industrial cooperation, Article 58 on promoting investment, Article 64 on information technology and telecommunications, etc. The long list also includes transportation, energy, financial services, agriculture, tourism, customs, statistics, and combating drug trafficking and money laundering.

Title V on economic cooperation remains general in content, ambitious, but promising for both parties. Such cooperation clauses, be it economical, social (Title VI), educational (Title VI, Chapter 2), or financial (Title VII), are important to the developing countries given the need to assist them and better prepare their economies to face regionalism and international competition.

B. Rights of Establishment and the Rules of Origin

i. Rights of Establishment

Lebanon

The Euro-Med. Agreement (EMA) includes an important provision (Title III) on the liberalization of the right of establishment and trade in services. This is important as Lebanon's economy depends heavily on services.

Article 30 confirms the obligations of the EU and Lebanon under the General Agreement on Trade in Services (GATS), particularly the obligations to grant most-favored-nation (MFN) treatment in all services covered by GATS. The article states that the MFN treatment shall benefit companies, subsidiaries, and branches established in the respective regions. Exemptions do apply to a list of sub-sectors listed in Annex I.

Air transport, inland waterways transport, and maritime transport are exempted for the right of establishment. Firms supplying all other forms of transport are permitted a commercial presence in the other party's territory but in the form of subsidiaries or branches. It is with maritime transport that Lebanon might be most affected. However, Article 31 does state that the principle of unrestricted access to the international market shall apply with respect to maritime transport. Each party is also required to grant a treatment no less favorable than that accorded to its own ships, ships used for the transport of goods and passengers, and all related maritime activities such as the use of infrastructure, custom facilities, etc.

Article 32 notes that a branch of a company not incorporated in the territory of the first party is allowed to get established in the second party. As for the movement of natural persons supplying

a service, Article 32 states that the agreement does not prevent the parties from applying their laws and regulations regarding entry, work, and other labor related conditions.

As a specialized attorney in corporate law, Najjar (1997) reviewed the legal obstacles to the establishment of Lebanese business in Europe and concluded that there is a long way to go towards the total freedom of establishment. European citizens as well as firms are allowed to choose their place of establishment anywhere in the EU. However, the current regime governing the establishment of non-European firms in Europe is not uniform and subject to legislation by each concerned nation.

Morocco and Jordan

Reviewing the agreements with Morocco and Jordan with regard to the right of establishment adds some insight permitting us to compare and contrast and to determine whether the agreements are confirmative or tailor-made.

Starting with Morocco, Title III of the agreement deals with the right of establishment and services. In Article 31, the document reads that " the parties agree to widen the scope of the Agreement to cover the right of establishment of one Party's firm on the territory of the other and liberalization of the provision of services by one party's firms to consumers of services in the other." The Association Council (AC) will assess, five years after the agreement enters into force, whether the stated objective was met. The Agreement states that the AC will take into account the obligations of each Party under the GATS Agreement and the past experiences of implementation of reciprocal most-favored nation treatment. In other words, the Agreement does not impose the liberalization of the right of establishment on both parties. Instead, the AC will *only* " ... make recommendations for achieving the objective," and if certain conditions are not met (e.g., past experiences, GATS), the Agreement indirectly hints for the possibility of not implementing the right of establishment clause.

In the case of Jordan, Article 30 of Title III calls for the right of establishment for both parties but part three of the same article states that the provisions (listed in the above paragraphs) "cannot be used so as to circumvent a Party's legislation and regulation applicable to access to specific sectors or activities by subsidiaries or branches of companies of the other Party established in the territory of such first Party." Again, the clause leaves the gate open for legal and legislative obstacles for full implementation.

Article 34 of the Jordanian agreement touches on the employment of Jordanians (Europeans) in the firms established in Europe (Jordan) stating that the companies are entitled to employ or have employed by one of its subsidiaries or branches but in accordance with the legislation in force in the host country. This article does not add anything new to the movement of labor but simply gives the firm the right to employ foreign workers - from the other country - only if the law permits. This was the case with or without a regional agreement. A similar clause for Lebanon, if ever added to the latest Lebanese draft, would also have no value-added.

In actuality, Article 34 restricts the employment to "key personnel" where this group consists of senior workers, persons with uncommon knowledge, and intra-corporate temporary transferees. A senior employee could be the general manager, a middle manager with a supervisory role, or the head of the human resource department. A person with uncommon knowledge has to possess

progress" as specified in Article 6(1) of both agreements. To summarize, for products to be considered as originating in Jordan/Lebanon on one hand or the EU on the other, they have to be either wholly obtained or have undergone sufficient working or process in the country of origin.

The list of wholly obtained product includes for instance:

- Mineral water extracted from their soil or from their seabed
- Live animals born and raised there
- Products from live animals raised there
- Vegetable products harvested there
- Others.

On the other hand, products that are not wholly obtained are considered "sufficiently worked and processed" when a list of conditions (detailed in the Jordanina case in a 165-page annex II) are met. Article 7 lists as well eight major causes that would render a sufficiently worked or processed product insufficient (i.e., loses duty-free access). For instance, changing the packages, the slaughtering of animals, or the simple assembly of parts to constitute a complete product (very applicable to Lebanon) could all make the product lose its status of origin and thus its duty-free access to the EU or to Lebanon.

The diagonal cumulation of origin is applicable in the Lebanese agreement (Title 2, Article 3) and in most Euro-Med. Agreements for that matter. This is an important clause and continues to be a major subject of debate. The diagonal cumulation implies, assuming all conditions are met, that inputs originating from other Euro-Med. Partners would be considered as originating from either the EU or Lebanon. Inputs from Algeria, Morocco, Tunisia, Jordan, Israel, Cyprus, Malta, Turkey, the Palestinian autonomy, and Syria are all considered as originating in the Euro-Med zone. Hence, Lebanese producers need to prove that either the goods where wholly obtained in either one of the listed countries or the accumulated value-added from all these countries surpasses the minimum required. Note that Syria is not yet a member of the free trade zone and its inclusión on the list is an exemption granted for Lebanon given the bilateral trade patterns and the potential benefits to Lebanon.

The second paragraph of Article 4 in the Lebanese agreement adds a constraint to the applicability of the cumulation option. It states that products pass the rules of origin if and only if the value added created in Lebanon or the EU surpasses the value of the input acquired from the list of countries considered as partners in the Euro-Med. Zone.

For the cumulation of origin to be applicable, three basic conditions need to be met. A free trade zone has to exist between the "cumulating countries" – e.g., Lebanon and Jordan. Second of all, the same rules of origin should be applied amongst the countries that want to take advantage of the cumulation. The third condition is for the countries to be part of the Euro-Med. free trade area.

The Arab states have in fact already agreed to unify their general rules, even though countries such as Lebanon have some reservations on these rules, which are in actuality "imported" from European text agreements. The Lebanese government does not see the benefit of using rules and standards tailor-made to meet European interests for the purpose of inter-Arab trading. A portion of Lebanese exports to Arab countries is expected to lose duty-free access (within the Arab Free Trade Area) since most of the inputs used in their production come from non-Arab countries. Arab economies do not produce certain inputs (e.g., engines for refrigerators) that Lebanese firms need to produce the final product and exported back to certain Arab countries. On the other hand,

special skills with a high level of qualifications and be a member of an accredited profession. As for the intra-corporate transferee, the person has to be located in the country of the second party for a specific period of time and in the pursuit of a specific economic activity. In essence, given that medium skilled Europeans do not work in Jordan, and given the clause defining key personnel is very selective, the Agreement simply forbids non-elite Jordanians from working in their offshore branches. Will that also be the case for Lebanon?

Article 37 of the Jordanian Agreement refers to the cross-border supply of services. As is the case for Lebanon, the first paragraph states and with a passive tone that "the Parties shall *use their best endeavors* to allow *progressively* the supply of services by Community and Jordanian companies who are established in .... taking into account the development of the services sectors in the Parties." The following paragraph goes further stating that the AC shall "make recommendations for the implementation of the objective mentioned in paragraph one." The language used does not promise a full implementation of this article and no mechanism is mentioned on how to promote the cross-border supply of services.

ii. Rules of Origin

With respect to regional trade agreements, rules of origin set the standard for determining the level of regional content that must be embodied in a product to qualify for the trade benefits granted under the agreement.

The proposed Euro-Med. Agreement includes the so-called rules of origin. As it will be shown in the cases of Lebanon, Jordan and Morocco, the list of rules is extensive and very specific. In short, unless exports to the EU meet these specific rules, they would not be given preferential treatment. Moukrabel (1996) examined the implications of these rules on the Lebanese economy and concluded by stating that they have been tailor-made to meet the sole interest of the European partners. In most cases, the second Party – i.e., Lebanon – is required to wholly produce the commodity or to fully produce intermediate goods used in the production of exported commodities.

Investors from outside the EU, such as Korean or Taiwanese firms, are thus handicapped by these rules of origin. Losing business with such dynamic economies has serious negative repercussions on the Lebanese economy. Hoekman and Djankov (1996) state that the rules of origin make the use of EU inputs by Lebanon a prerequisite for Lebanese exports to benefit from EU duty-free access. They also claim that the effective liberalization of trade in manufactured products would only come from less restrictive rules of origin. Furthermore, the possibility for future cumulation of rules amongst member states may lead European multi-nationals to locate in countries with lower labor costs than Lebanon.

After reading these reviews on the rules of origin, it is important to examine the proposed draft on the rules and then compare the Lebanese case with Jordan and Morocco in order to make an informative judgement.

The technical definitions for the basic concepts on the rules of origin are the same across countries. Title II in the Lebanese proposed agreement or the protocol 3 attached to the Jordanian agreement define the concept of "Originating Products." Products (i.e., product being manufactured for final or intermediate usage) are considered originating in Jordan/Lebanon or the EU only if they are wholly obtained in that country. Similarly, materials (i.e., raw material, component, etc.) are originated in Jordan/Lebanon or the EU only if they are incorporated into a product obtained there. It is necessary as well that such material undergo "sufficient work or

this is not the case in-between European countries which are rich with all kinds of raw material and intermediate inputs.

The detailed rules of origin listed in the annex are similar to the ones provided in the 1978 Cooperation Agreement, which ack then were not strictly enforced. The EU, and with the new Association Agreement, has added an alternative option for each article listed in the 1978 Agreement expect for articles 62 to 80 which covers sectors such as textiles, where no changes were made since 1978. The EU has in essence made the rules more flexible and offered the member parties more ways to meet the rules of origin.

The EU has imposed paying customs on imported inputs from outside the Euro-Med. Zone even if the final product will be exported. Otherwise, the certified "original" product will lose duty-free access and will be subjected to the standard tariff rate. This clause essentially discourage Lebanese importers to do business with non-Europeans even though, *cetirus paribus*, the non-EU inputs are preferred. This clause does not appear in the agreements signed early on with the *Maghreb* countries, something the EU now believes was a mistake. Lebanon is calling for the removal of this article.

A proof of origin is required as stipulated in Title V of both agreements. Jordan and Lebanon also has to prepare a proof of origin for all of its exports. A movement certificate EUR.1 - the proof - is a prerequisite with the only exception of small packages sent from private persons to private persons or packages forming part of a traveler's personal luggage (Article 25 for Jordan, Article 26 for Lebanon). The EUR.1 and a side application are issued by the customs authorities of the exporting country and have to be filled by the exporter, who and at any time, can be asked to submit all necessary documents proving the originating status of the products concerned.

Articles 22, 23, and 24 define who is an approved exporter, what is the validity of the proof of origin, and how to submit the proof. For instance, the validity of the proof is for four months from the date of issue. The submission of the proof of origin may have to be accompanied by an import declaration and a statement from the importer to the effect that the products meet the conditions required for the implementation of the agreement. The supporting documents needed can also be numerous and difficult to get. Documents are needed to prove that the product has been worked or the material processed in the exporting country and these documents may be in themselves extensive and numerous. Proving a product to be wholly obtained might be easy, but legally proving a product to be sufficiently worked or processed if that product is the result of mixed production is a task in itself.

Finally, Article 32 discusses the verification of the proofs of origin, which would be carried out at random or whenever custom authorities deem necessary. Where disputes arise in relation to the verification procedures that cannot be settled between the custom authorities, the case shall be submitted to the Association Committee but the settlement of disputed will be carried out under the legislation of the receiving country.

The text and the rules of origins in the Moroccan agreement are not different in either content or implications. In some articles, the text is exactly the same, showing the proto type approach used by the EU. The only major difference with Morocco is the consideration of products and materials originating, specifically from Algeria and Tunisia, as originating in the EU. When the agreement was signed, the two named countries were the only ones to have signed or will soon sign the Association Agreement. The agreement with the *Maghreb* countries allow for the cumulation of inputs within the EU and these two countries. The procedures for certifying origin

are also similar to the case of Jordan with some minor differences that are dependent solely on the domestic laws applicable in Morocco.

Annex I of the Moroccan agreement is a 127-page document detailing the rules of origin with the specific conditions for a product or material to acquire a proof of origin. The annex offers specific examples such as in the case of "yarn of heading no. 5205 made from cotton fibers of heading no. 5203 and synthetic staple fibers of heading no. 5506 is a mixed yarn. Therefore – the example continues – non-originating synthetic staple fibers that are not manufactured from chemical materials or textile pulp may be used up to a weight of 10% of the yarn." The examples are numerous and the headings are in the thousands.

iii. Rules of Origin - NAFTA

Reviewing the rules of origin for Morocco, Jordan, and Lebanon, we observe little or no difference in the content and no special treatment accorded to one state over the others. Next we examine, and for comparison purposes, the rules of origin as conceived in the North American Free Trade Agreement (NAFTA).

Goods traded duty-free under NAFTA must contain substantial North American content. NAFTA rules strengthen, clarify, and simplify rules contained in the U.S.-Canada Free Trade Agreement (CFTA), and therefore, NAFTA rules supersede the CFTA rules.

The improvements are summed up below:

- Few NAFTA rules require cost accounting; those that do are based on simple formulas.
- Most NAFTA rules are based on simple, predictable tariff classification principles.

Many procedures governing rules of origin documentation, record keeping and origin verification are the same for all three NAFTA countries. The same NAFTA certificate of origin form is used by the Customs administrations in all three countries. In addition, Mexican, U.S. and Canadian Customs administrations will issue advance rulings, upon request, on whether or not a product qualifies for tariff preference under the NAFTA rules of origin. This removes a great deal of uncertainty from the exporting process.

HOW RULES OF ORIGIN WORK:

Each product has a rule of origin that applies to it. The rules are organized according to the Harmonized System (HS) classification of the product. There are two types of rules; both require substantial North American processing, but they measure it differently.

Rule Type	Description	Example
Tariff-Shift Rule	All non-NAFTA inputs must be in a different tariff classification than the final product. The rules state the level of tariff classification shift required. The rules may require that the non-NAFTA input be in a different HS chapter, heading or tariff item number. Most goods are subject to a tariff classification shift	Paper (HS Chapter 48) made from wood pulp (HS Chapter 47) imported from outside North America would qualify for NAFTA tariffs because the manufacturing process results in the required shift in HS chapter.

	requirement.	
Value-Content Rule	A set percentage of the value of the good must be North American (usually coupled with a tariff classification shift requirement). Some goods are subject to the value-content rule only when they fail to pass tariff classification shift test because of non-NAFTA inputs.	If perfume (HS# 3303), for example, fails the applicable tariff classification shift rule, it must contain 50-60 percent (depending on the valuation method) North American content in order to get preferential treatment.

Source: NAFTA official web site

The tariff-shift rule may be implicitly mentioned in the detailed Euro-Med. rules of origin but is not explicitly stated in the general rules as they appear in the draft agreements for Lebanon, Jordan, or Morocco. The value-content rule or concept is the one followed in the Euro-Med. agreements when determining the origin of the exported product.

Article 401 defines the « Originating Goods » by stating that a good shall originate in the territory of a Party where:

(a) The good is wholly obtained or produced entirely in the territory of one or more of the Parties, as defined in Article 415;

(b) Each of the non-originating materials used in the production of the good undergoes an applicable change in tariff classification set out in Annex 401 as a result of production occurring entirely in the territory of one or more of the Parties, or the good otherwise satisfies the applicable requirements of that Annex where no change in tariff classification is required, and the good satisfies all other applicable requirements of this Chapter;

(c) The good is produced entirely in the territory of one or more of the Parties exclusively from originating materials; or

(d) Except for a good provided for in Chapters 61 through 63 of the Harmonized System, the good is produced entirely in the territory of one or more of the Parties but one or more of the non-originating materials provided for as parts under the Harmonized system that are used in the production of the good does not undergo a change in tariff classification because

(i) The good was imported into the territory of a Party in an unassembled or a disassembled form but was classified as an assembled good pursuant to General Rule of Interpretation 2(a) of the Harmonized System, or

(ii) The heading for the good provides for and specifically describes both the good itself and its parts and is not further subdivided into subheadings, or the subheading for the good provides for and specifically describes both the good itself and its parts.

Provided that the regional value content of the good, determined in accordance with Article 402, is not less than 60 percent where the transaction value method is used, or is not less than 50

percent where the net cost method is used, and that the good satisfies all other applicable requirements of this Chapter.

As for the cumulation of inputs, Article 404 states that the production of the product is considered to have been performed in the territory of the parties provided that:

(a) All non-originating materials used in the production of the good undergo an applicable tariff classification change set out in Annex 401, and the good satisfies any applicable regional value-content requirement, entirely in the territory of one or more of the Parties; and

(b) The good satisfies all other applicable requirements of this Chapter.

For purposes of Article 402(10), the production of a producer that chooses to accumulate its production with that of other producers under paragraph 1 (previous paragraph) shall be considered to be the production of a single producer.

From the brief review of the NAFTA rules of origin, it is difficult to make a straightforward evaluation and thus compare with the Euro-Med. rules. In short, the main observation is that NAFTA appear to have more complex and difficult requirements to meet, probably given the volume and value of trade conducted within and with North America.

Section II. Assessment of The Arab Free Trade Area (AFTA) and Overview of the Bilateral Agreements with Arab States

A. Arab Free Trade Area

In February 1997, the Arab League launched a free trade program known as the Arab Free Trade Area (AFTA). It is an agreement aiming to implement a free trade area between the members of the Arab League by the year 2007. Initially 13 member states have agreed to join AFTA and they are: Lebanon, Egypt, Saudi Arabia, Jordan, UAE, Bahrain, Syria, Iraq, Oman, Qatar, Kuwait, Morocco, Tunisia, and Libya.

The executive program calls for tariff reductions over a ten-year period at a rate of 10% per year on products of Arabic origin, thus totally eliminating tariffs by the year 2007. In addition, member states agreed to bind their national tariff schedules as of December 31,1997. By September 1999, fourteen countries had applied tariff reduction schemes and fulfilled the tariff commitments. Member countries are however allowed to draw up a list of exempted industrial products and the exception is applicable only for the first years of the program. In the area of agriculture, the program offers member states the opportunity to suspend tariff reductions on some produce during the peak seasons. Each country is allowed to submit ten items for suspension, with a total exemption period of 45 months all items. So far, 10 member states have submitted a list of 30 fruits and vegetables (ERF 2000).

The AFTA program does call for a schedule to reduce non-tariff barriers. However, none of the member states have tackled these barriers. The program calls for the application of international rules regarding subsidies and anti-dumping measures but there was no explicit reference to the WTO agreements on that regard. AFTA does offer a set of rules of origin for duty-free treatment. The AFTA value-added requirement is set at 40%. The first method used to calculate the origin is

based on the local value-added approach. The alternative method relies on the net cost approach. There is an on-going effort for the elaboration of detailed preferential rules of origin for AFTA-made products. The new adopted rule allow for full cumulation of origin among member states.

AFTA is managed by the Council of Ministers of member countries and by a permanent executive body. AFTA has a functioning Secretariat that comes under the economics department of the Arab League. So far, the AFTA is believed to have accomplished a lot, at least in terms of setting up the framework. The program, and as mentioned, calls for across-the-board tariff reduction offering the advantage of transparency and ensuring that high tariffs are reduced faster than lower tariffs. Such a policy could have a significant effect on trade creation. The exception of certain industrial and agricultural products from tariff reduction remains the major shortcoming of the program. AFTA calls for some harmonization with regard to custom clearance procedures but it does not address the harmonization of a number of other major regulation such as certification procedures and product standardization as is the case with NAFTA or the Euro-Med. Agreements.

Linking AFTA with the Euro-Med. Agreements would further enhance market efficiency and allow AFTA countries to better face international competition from emerging world exporters in Asia and Eastern Europe. The cumulation of rules of origin for products made in the AFTA bloc may help create backward and forward linkages between member countries and increase the potential for trade. However, the expansion of cumulation to include Euro-Med. countries and the AFTA countries would be even more beneficial to member states and would help reduce the "hub and spoke." Most of the studies,[6] if not all, agree that expanding the free trade zone to include Europe and the Arab world is by far Pareto superior to just having one or the other.

In order to deepen the integration of AFTA, there is a need to extend regional liberalization to the areas of trade in services and labor. The existing program is limited to the liberalization of merchandise trade. There are no provisions on the free movement of services and the right of establishment. There is also as a need to harmonize the regulation of financial services as there is little integration among the financial institutions of member countries. Cooperation among AFTA countries to promote professional and technical labor mobility is desirable. From the point of view of efficiency, free movement of skilled labor enhances the efficiency of production and thus increases the competitive edge and comparative advantage of AFTA member countries.

B. Bilateral Trade agreements between Lebanon and Arab countries: Main Provisions[7]

Below is a listing of the major bilateral agreements signed with regional countries. Some of which have been ratified, others pending, and some are not comprehensive trade agreements. The impact differs across countries and from one agreement to the other. Assessing the impact is still premature as most agreements are less than 2 or 3 years old and have been put in effect around 1998 or 1999. The most important trade agreements are with the largest Arab state, Egypt, and with Lebanon's main export destination and they are Syria, Kuwait, and Saudi Arabia. A number of the agreements described below have a bilateral status but fall within the AFTA framework.

The expectations on the Syrian agreement are positive, as this market of 17 million will be opened to Lebanese exporters after decades of protectionism. As for Egypt, the recent treaty is

[6] Martin (2000), Ghaleb (1998), Hoekman and Djankov (1996), etc.

[7] Updated January 1999. Sources: Ministry of the Economy and Trade and "Free Trade and the Environment in Lebanon," Ministry of the Environment Report

expected to reduce the trade deficit for Lebanon since Egyptian products are cheaper than their European substitutes. Egypt is a market of 65 million people and together with Syria; the triangle area will constitute a major Mediterranean-trading bloc facing the EU. Below is a listing of the major provisions of the bilateral trade agreements between Lebanon and the Arab countries.

- Egypt (several agreements)

  - Free trade zone agreement, law 48, signed and ratified February 23rd, 1999.
  - Free zone agreement, dated September 10th, 1998 and effective January 1st, 1999. (Arab free trade zone)
    - ⇨ All products of Lebanese of Egyptian origin are exempted from all customs duties or similar taxes starting January 1, 1999. A list of goods and commodities are excluded from this rule.
    - ⇨ All products from Lebanese or Egyptian origin are subject to the same laws and regulations applicable to the national product, and is subject to the same taxes.
    - ⇨ Lebanese and Egyptian products are subject to sales taxes, according to the applicable law in each of the two countries.
  - Trade agreement, law 147, dated 1992 and calls for the development of commercial and economic relations. A list of tariff exemptions exists.
    - ⇨ Agreement is valid for one year, renewed automatically but Lebanon has not renewed it.
  - Prevention of double taxation, law 582, dated 1996 and enforced March 22nd, 1998. Agreement intends to prevent double taxation and tax evasion.

- Jordan (two agreements)

  - Trade agreement, law 186, dated October 10th, 1992 and ratified December 4th, 1993. Agreement lists the tariff exemptions in particular for agricultural products, and lists the tariff reductions mainly for industrial products. Agreement includes the definition of the rules of origin.
  - Free trade agreement dated July 18th, 1996. Agreement is pending awaiting the approval of the Jordanian government.

- Kuwait (several agreements)

  - Trade agreement, law 574, dated January 10th, 1996. Agreement regulated the importation of industrial and natural resources, it list the customs exemptions for agricultural, animals and natural resources, and for some industrial products.
  - Agreement to avoid double taxation. Initialized April 24, 1998.
  - Trade agreement, dated September 19th, 1998.
    - ⇨ It calls for a 25% tariff reduction every year on sectors such as oil, chemical, steel production, clothes, and paper productions
    - ⇨ Tariff exemptions for certain products.
    - ⇨ Effective January 1st, 1999. Fully implemented in 4 years.

- Saudi Arabia

- Economic and trade agreement, law 67/71, dated November 11th, 1971. Agreement lists products with tariff exemptions and reductions and calls for the facilitation of custom procedures and for the promotion of investments.
- Valid for one year, renewed automatically. Revised in 1997, signed by both parties and ratified but not effective, pending government approval.

- Tunisia

  - Trade and economic agreement, law 1758AC, dated April 16th, 1998.
  - Agreement calls for the avoidance of double taxation and the prevention of fiscal evasion. Ratified February 23rd ,1999.

- Morocco (two agreements)

  - Trade agreement dated May 29th, 1998 and is under study by the Lebanese Ministry of the Economy and Trade.
  - Trade agreement law 5199, dated 1973, calls for a free trade zone.

- Yemen

  - The trade agreement, law 1808AC dated March 24th,1998 awaits the approval of the Yemeni government.

- Sudan

  - Trade agreement, law 20/71, dated 1971.
  - Agreement includes a list of tariff reductions and exemptions.
  - Valid for three years and is renewed automatically. Ratified February 27th, 1971.

- Iraq

  - Economic agreement protocol, law 67/46 (71/19), dated April 9th,1967.
  - The agreement includes a national treatment for agricultural goods, animal goods and natural resources, a list of tariff reductions and exemptions, a definition of rules of origin.
  - Most favored treatment in sea transport and in using port facilities.
  - Valid one year, renewed automatically. Renewed in 1971.

- Bahrain
  - Trade agreement, law 8165AC, dated 3rd of November 1997 and agreed upon by both parties.

C. Syria

Trade with Lebanon's only friendly neighbor Syria is of paramount importance to both economies and to reflect that fact, several agreements have been signed between the two countries.

Over the last few decades, Lebanon and Syria have developed economies that are structurally complementary with contrasting specialization in production and economic activity. The differential in factor endowments between the two countries (e.g., size, arable land, human resources, natural resources) calls for economic cooperation and complementation. On the other hand, the two economies have followed, since independence, two separate paths: Laissez faire for Lebanon and command control for Syria. The divergence in systems renders the called for economic cooperation a difficult task to implement.

Trade agreements with Syria take on a higher level of importance once we consider the forecasted impact of such economic cooperation in light of the Euro-Med. Agreement. Take for instance the benefits attributed to the diagonal cummulation of rules of origin once Syria enters the Euro-zone after liberalizing trade with Lebanon. The positive impact is highlighted further given that almost half of Lebanon's imports from Arab sources come from Syria.[8]

As mentioned earlier, several agreements have been signed between the two countries. Below is a listing of those agreements and their major provisions.

- Trade agreement, law 12942, dated August 31st, 1998. Agreement calls for 25% reduction on industrial products over a four-year period. Agreement lacks implementation program.
- Agricultural tariff reduction agreement dated September 1999. Not yet ratified.
- Promotion of reciprocal investment protection: Clause enforced September 15th 1998.
- Avoidance of double taxation and prevention of fiscal evasion. Agreement signed January 12th, 1997 and ratified July 24th, 1997.
- Economic agreement, law 14461, dated 1970. Agreement lists products with tariff exemptions and with national treatment. Valid for one year, renewed automatically.
- Economic and social cooperation agreement, law 298, dated 1994. It sets the framework and agenda for developing a common market.
- Agricultural cooperation agreement, law 4373, dated 1993.
  - ⇨ Exchange knowledge and know-how
  - ⇨ Set up Cooperation Committee

The 1998 trade liberalization agreement on industrial goods is the outcome of the Cooperation and Brotherhood Treaty signed in 1993 and was agreed upon after two bilateral meetings on February 7th and November 2nd 1998. The agreement was put into effect on January 1st, 1999 and calls for a phased annual reduction of tariffs of 25%. The Syrian government has asked for a number of exceptions and the list of products includes: Porcelain, Ceramic, juices, tobacco, alcohol, and soft drinks. The exceptions are in fact a list of banned products.[9] More recently, Syria has allowed the importation of porcelain and ceramic products coming from Lebanon. In return, Lebanon did not provide a list of banned or tariff exempted products. The 1998 industrial agreement did not set up the mechanism to implement and enforce the agreement.

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[8] Figures from 1996. Source: Saidi (1998)

[9] Source: Ministry of Economy and Trade

Both industrial and agricultural agreements do not include any rules of origin given that the two countries follow the general rules of the AFTA agreement.

In September 1999, an agriculture agreement was signed and it called for a 50% reduction in tariffs effective immediately, to be followed by a 10% reduction over five years. To date, the two governments have not ratified the agreement.

The industrial liberalization agreement has faced numerous obstacles. The complementary nature of the economies of the two countries, though theoretically an advantage, has created numerous problems in the implementation phase of the trade agreement. To illustrate the differences, the economic system in Syria is based upon monopolies. In other words, a Lebanese businessman cannot export a product (e.g., Pepsi-cola) if the Syrian economy has only allowed a competitive product (e.g., Coca-cola) to be the sole supplier. The list of "unaccepted products" is long and Lebanon has asked for the elimination of such behavior.

Furthermore, Syria does not have the freedom of exchange. Exporters have to open an account with the only bank – The Syrian Commerce Bank – and deposit the foreign currency they collect from Syrian importers. With the same money, the exporters have to purchase Syrian products, as they cannot transfer earning back home. The administrative constraints gets more complicated as exported goods are categorized and for each category the same exporter has to open different accounts at the Syrian Bank.

The challenges are numerous but both parties appear to have the will to push for further cooperation and economic integration foreseeing the benefits of establishing a free trade area prior to the liberalization of trade with the EU. Lebanon needs Syria, among others, for its richness in natural resources, and Syria needs Lebanon for its human capital and expertise in the negotiations with the European Union.

Section III - International experiences with the Euro-Med. Agreement

Morocco and Tunisia have both signed a comprehensive integration agreement with the EU. These agreements consist of two essential elements – increased aid flows and technical assistance in exchange for reduction in trade barriers and other impediments to the flow of goods and investment over a period of 12 years. Agreements with about 10 Eastern European countries were signed in 1991, and the EU is actively negotiating with countries such as Egypt to strengthen the strategic trade alliance across the Mediterranean basin.

A. The Maghreb

Morocco and Tunisia have been the star performers of the MENA region in terms of growth. Between 1960 and 1994, Tunisia grew by slightly more than 5% per year and Morocco by more than 4.5%. Total factor productivity in both countries increased between 0.4 and 0.9 (1988-1994) and such improvements can be linked to structural adjustments (Page and Underwood 1996). It was thus likely to see both countries pioneer in liberalizing trade and joining the Euro-Med. Free trade area.

Traditionally studies of free trade agreements have focused on the welfare effects of trade liberalization. Rutherford et al. (1993) showed that the possible benefits on Tunisia and Morocco

are significant but not enough to imply rapid income convergence. The welfare gains were estimated to be about 1.5% of GDP in Morocco and 1.7% of GDP in Tunisia. The cumulative effect over a 10-year period would increase per capita income of about $25 per person in Morocco and $40 per person in Tunisia. The welfare gains would increase by another 1% of GDP if the two countries liberalized trade with the rest of the world. Note that the welfare gains are somewhat significant given that trade diversion is relatively small in both Morocco and Tunisia. It is small because more than 50% of Morocco's non-oil imports and more than 70% of Tunisia's already come from Europe.

The main beneficiaries from the EU free trade agreement is the consumer but it is also expected that Morocco and Tunisia would attract substantial direct foreign investments. FDI increased substantially in Morocco in the 1990's when the overall share of the MENA countries was stagnating. About two-thirds of Morocco's FDI originates in Europe, nearly a fourth from France alone while Middle Eastern investors make up 20% of Morocco's total. Tunisia's FDI have also grown in the 1990's, primarily as a result of investments in the energy sector.

Page and Underwood (1996) have a reservation on the expected magnitude of new FDI inflows. The experts agree with the view that macroeconomic stability and improved legislative are important to attract FDI but they stress the need for a change in the strategic perception of foreign investors. For the latter reason, Page and Underwood do not foresee major increases in FDI, as they believe that integration agreements do not substantially change investors' perceptions. Morocco and Tunisia's trade specialization patterns remain highly concentrated in resource-based sectors (e.g., energy, fishery) and trade agreements might help increase the volume of investments but the perceptions of the desirability of investments in these resource-based sectors will not change dramatically.

Page and Underwood (1996) do not expect growth in the total factor productivity (TFP) of MENA countries and Tunisia and Morocco, they add, do not differ much from other MENA countries. The estimated rate of TFP growth for Morocco is around zero and Tunisia's is less than 1% per year. Despite the potential for both economies to adapt existing international best-practice technologies to their economies, neither has realized rates of TFP change, which exceed those of European economies. In aggregate terms, no productivity-based catch-up is taking place.

B. Egypt

While unilateral trade reforms have been undertaken since 1989, Egyptian trade performance continues to suffer from a variety of technical and administrative non-tariff impediments. Elimination or reduction of these administrative costs could promote efficiency and growth over the medium term, particularly in conjunction with further liberalization of the tariff structure.

To study the intersectoral allocative effects of trade policy reform, along with the associated changes in economic welfare, Maskus and Konan (1997) constructed a computable general equilibrium model of the Egyptian economy. To summarize the results, a partnership with the EU is believed to provide some scope for welfare gains on its own and without the necessity of undertaking prior trade reform. The association bears potential to raise Egyptian welfare up to 0.3% of GDP in real terms. This finding is very important, at least from a policy-maker standpoint. It is however conceivable that a mixture of more limited trade reform and an association with the EU could generate yet higher welfare gains. Sectoral impacts of trade liberalization tend to favor output and employment expansion in service sectors relative to

manufacturing sectors. However, the reduction of non-tariff barriers trade costs could further expand trade, output, and employment in the merchandise industries.

Subramanian and Abd-El-Latif (1997) examine the impact of the Euro-Med. Agreement on the Egyptian Pharmaceutical sector. According to the study the most important external development factor affecting the Pharmaceutical sector is the WTO TRIPs agreement, which could alter the overall legal and economic environment. In Egypt, there will be shift from domestic companies and towards foreign-owned companies that specialize in R&D-based production. Having said that, the expected magnitude of the impact is small, as only a limited share of the current market will be affected by the increased international competition. The static impact of the TRIPs agreement will be negative for the Egyptian economy – owing to higher prices and the associated loss in consumer welfare. However the magnitude is small as the number of imitation-based Egyptian companies is also small.

The potential impact of the Association Agreement on the Egyptian textile industry was examined by Kheir-El-Din and El-Sayed (1997). Egyptian textile and clothing manufacturing and exports are mostly constrained by domestic factors rather than by external conditions such as market access. Egypt, and according to the study, appears to have a good export prospect in a wide array of products and these prospects seem to be higher in EU markets than anywhere else.

High tariff and non-tariff barriers have historically sheltered the textile industry. With increased liberalization resulting from the implementation of the Uruguay Round agreements and a free trade area with the EU, textile and clothing producers in Egypt will enjoy increased access to external markets. However, the major challenge remains the domestic liberalization and the restructuring within the system.

C. East and Central Europe

Looking back into Europe's complex system of trade relations. EU trading partners can be grouped in three levels. At the top level, there is a large number of countries enjoying preferential access to EU markets. The second level includes countries trading with the EU on the basis of most favored nation (MFN) clause, while finally, at the bottom-end, there is the rest of EU trading partners. At the beginning of the 1990's, Central and East European Countries (CEECs) were included at the bottom-end group, thereby trading with the EU on a lower basis than the MFN, while most southern Mediterranean countries (SMC), and especially Morocco, Tunisia, and Egypt belonged to the top end group.

Between 1991 and 1993, this ordering changed dramatically. Free trade areas were established between the EU and CEECs and the trade agreements had the nature of reciprocal regime and thus CEECs enjoyed a more generous access to EU markets than that enjoyed by southern Mediterranean countries. Note that the EU is much more important to CEEC countries than it is for SMC countries.

Table – CEEC and SMC Shares in EU's Extra EU Trade

	Imports				Exports			
	1993	*1994*	*1995*	*1996*	*1993*	*1994*	*1995*	*1996*
CEEC	4.6%	5.5	6.7	6.7	5.9	6.5	7.6	8.6
SMC	3.3	3.2	2.6	2.7	3.7	3.6	3.2	3.0

Source: Europa website (EU official website)

European Agreements (EA) between the EU and Poland, Hungary, Czech Republic, Slovak Republic, Romania and Bulgaria were signed in 1991 and 1993. The EA represent a fundamental transformation in economic relations between the East and the West blocs of Europe. An in contrast to the previous EC-EFTA free trade agreements, which excluded the agriculture sector entirely, the new EA provide substantial access for the Eastern countries and include the following provisions:

- Duty-free and non-tariff free access for all industrial products
- Enhanced access for agriculture products
- Intellectual property rights
- Commitment to harmonize legislation

The agreement covers two stages of five years each. An interim review of the status of the signatory countries is conducted in-between phases and in preparation for full reciprocal free trade and national treatment of companies at the end of the 10-year transition period.

Since 1996, countries such as Morocco and Tunisia began moving up within the top group as they realized the need for reciprocity in trade and signed new trade agreements with the Europeans. The next logical question to be raised is to what extent the EU-CEEC preferential trade agreements have harmed the competitive position of Southern Mediterranean (i.e., North Africa) countries vis-à-vis trade with Europe. The model introduced by Buigues and Mongay (1999) shows, and in a nutshell, that EU's trade agreements with the East have not harmed the EU-Southern Mediterranean trade. EU-CEEC agreements have improved market access between the two blocks but the corresponding increase did not come at the expense of trade with other EU trading partners, thus downplaying the much discussed trade diversion to CEEC countries. On the other hand, De Kleine (1996), and in the context of CEEC/SMC competition, believes that North African migrant workers will face stiffer competition from the former Eastern Bloc's relatively inexpensive and well educated labor force.

D. Regionalism

i. North American Free Trade Area (NAFTA)[10]

NAFTA is a comprehensive trade agreement that improves aspects of doing business within North America. NAFTA eliminates tariffs completely, and removes many of the non- tariff barriers, such as import licenses, that have helped to exclude U.S. goods from the other two markets, especially Mexico.

NAFTA ensures that investment will not be coerced by restrictive government policies, that U.S. investors receive treatment equal to domestic investors in Mexico and Canada. At the same time, NAFTA's extensive easing of cross-border services rules ensures that if U.S. companies do not wish to invest in another country to provide their service, they do not have to.

The intellectual property provisions negotiated by the United States ensure that the U.S. competitive advantage in high technology is fully protected. NAFTA provides for guaranteed access to lucrative government procurement contracts in Canada and Mexico.

[10] Source: Several NAFTA sites on the Internet

Tariff Barriers

Within 10 years of the January 1, 1994 implementation of NAFTA, all tariffs will be eliminated on North American industrial products traded between Canada, Mexico and the United States. A few tariffs on U.S. exports of agricultural products to Mexico will be phased out over 15 years. The agriculture sector is a sensitive sector across the world but with NAFTA a timetable exists for the liberalization of trade in agriculture products, something not available in the Euro-Med. Agreements, where the text remains too general.

As provided in the U.S.-Canada Free Trade Agreement (CFTA), all trade between the United States and Canada will be duty-free by 1998. Most U.S.-Canada trade is duty-free already. Prior to NAFTA, Mexican tariffs, which ranged from 0 to 25%, were 2.5 times U.S. tariff rates -- and about the same as (pre-CFTA) Canadian rates. Without NAFTA, international trade rules would have permitted Mexico to raise its tariffs as high as 50% without paying compensation. Under the NAFTA however, tariffs on all goods entering Mexico from the United States will be eliminated.

On January 1, 1994, Mexico eliminated tariffs on nearly 50% of all industrial goods imported from the United States, including some of the most competitive products in US markets such as machine tools, medical devices, semiconductors and computer equipment, and telecommunications and electronic equipment.

Non-Tariff Barriers

In addition to elimination of tariffs, Mexico will eliminate non-tariff barriers and other trade-distorting restrictions. The benefits are two-fold: 1) exporters are able to ship more of their products into Mexico; and 2) exporting is more cost effective since exporters will no longer have to deal with the uncertainty and administrative burden associated with obtaining an import permit.

NAFTA also eliminates a host of other Mexican barriers, such as local content, local production and export performance requirements, that have acted to limit U.S. exports. Local content requirements condition permission to sell a product on the incorporation of a mandatory percentage of local parts or labor. In other cases, companies must produce locally if they want to sell to the domestic market, or they must export a certain percentage of production. NAFTA eliminates all these requirements.

Investment Barriers

Prior to NAFTA implementation, Mexico could review all investment proposals to determine if they were in the national interest. Under NAFTA, Mexico may review acquisitions above an initial threshold of $25 million, phased-up to $150 million over nine years (adjusted for inflation and economic growth). Mexico will continue to prohibit foreign investment in certain "Constitutional" activities (e.g., energy, railroads).

NAFTA gives U.S. companies the right to establish firms in Mexico and Canada or acquire existing firms, but it does not encourage U.S. firms to go abroad.

NAFTA provides, at the option of the investor, for binding international arbitration of disputes between host governments and foreign investors that involve monetary damages or restitution of property that may arise if NAFTA rights are denied. This is an important development in U.S. trade relations with Latin America, as certain countries in that region have denied foreign investors such protection.

NAFTA investment provisions do not cover maritime, basic telecommunications, government - sponsored technology consortia and R&D programs, and exiting state and local measures. Like agriculture, the maritime sector remains an untouchable in most trade agreements including NAFTA and the Euro-Med.

Services

The U.S. - Canada Free Trade Agreement established the first comprehensive set of principles governing services trade. NAFTA broadens these protections and extends them to Mexico. Virtually all services are covered by NAFTA with the exception of aviation transport, maritime, and basic telecommunications.

Intellectual Property Rights

The NAFTA promotes export-driven growth in some of America's most competitive sectors, such as U.S. high technology and entertainment products, by providing the highest standards of protection for intellectual property available in any bilateral or international agreement. The NAFTA covers patents, trademarks, copyrights and related rights, trade secrets, geographical indications and industrial designs.

NAFTA, and unlike the Euro-Med. provides the mechanism to enforce and implement intellectual property rights. More specifically, the NAFTA:

- Requires each country to provide for the enforcement of the rights of authors, artists and inventors against infringement and piracy;
- Ensures protection for North American producers of computer programs, sound recordings, motion pictures, encrypted satellite signals and other creations, including rental rights for computer programs and sound recordings;
- Locks in the availability of patent protection for most technologies in Mexico, allowing U.S. firms to patent a broad range of inventions in Mexico.
- Resolves longstanding trade irritants for U.S. pharmaceutical and agricultural chemical companies by expanding the coverage of product and process patents and limiting compulsory licensing of patents.

ii. Association of Southeast Nations (ASEAN)

East Asia compromises the low and middle-income countries of East and Southeast Asia and the Pacific. During the last two decades the region has gained a great deal of prominence in the world economy and global trading system. Within East Asia, the Association of Southeast Nations (ASEAN) countries – principally, Indonesia, Malaysia, Philippines, Singapore, and Thailand – are among the most prominent countries in the next tier of countries following the development path of the newly industrialized countries.[11]

Although ASEAN was originally established in the 1960s for the purpose of strengthening political security in the region, economic cooperation has come to play a primary role in the activities of the Association. Economic policy dialogues are held periodically among members

[11] ASEAN also includes Vietnam and Sultanate of Brunei

and between ASEAN and its primary trading partners: the United States, Japan, and the European Union.

The early preferential trade agreements adopted in 1977 were unsuccessful in fostering significant expansion in intra-ASEAN trade. Nonetheless, and as a response to the global economic integration as reflected, for instance, by the North American Free Trade Agreement (NAFTA), ASEAN countries announced in 1992 their intention to form an ASEAN free trade area.

As outlined in the Singapore Declaration of 1992, beginning 1995 each ASEAN country is expected to reduce the level of tariffs on imports to a range of 0% to 5% by the year 2003. During the first five years of the plan, tariff levels are to be reduced substantially, a contrast measure to what is proposed in most Euro-Med. Agreements. The ASEAN plan does make provisions for safeguard measures in cases of "serious injury" to domestic producers and the scheme allows more protection for selected manufactures than for primary commodities and agricultural raw materials (DeRosa 1997). The ASEAN trade agreements are accused of being biased against agriculture with the objective of promoting more rapid industrialization.

An ASEAN trade simulation model was developed to empirically determine the medium-term macro and sectoral impact of the free trade area on the major ASEAN countries (DeRosa 1995). Using Viner (1950) terminology, the ASEAN free trade area is trade creating for most of the scenarios considered.[12] The bias against agriculture is reduced; specifically the terms of trade for agriculture relative to non-traded goods are widely improved. The potential expansion of agriculture exports is less under the existing free trade agreement than under a MFN liberalization scenario. The expected depreciation of the exchange rate works also in favor of the agriculture exports.

Liberalizing ASEAN trade relations on a non-discriminatory basis results in significant gains in welfare for the four natural resource-abundant countries and they are Indonesia, Malaysia, Thailand, and the Philippines. The model estimates the welfare improvement to be 2% for Indonesia and about 5% for Malaysia and the Philippines. Singapore is an exception with a decline in welfare by 2%, only under the MFN scenario. Along the same lines, the estimates show a growth in the wage rate regardless of the simulation or the assumed scenario. However, the wage increase is significantly higher when the MFN simulation is executed (DeRosa 1995).

Section V.1 – Mapping the Economy

A. Overview

i. Macroeconomic Situation

Since the end of the war, Lebanon has embarked on an ambitious program of economic reconstruction and stabilization. A rapid rehabilitation and enhancement of the infrastructure was an essential component of the government strategy. The government thus embarked on major capital expenditure programs and envisaged that the trend of large primary budget deficit would be reversed to a primary surplus.

The reconstruction increased the net public debt from 38% of GDP at the end of 1993 to about 97% in 1997 and by early 2000 the ratio was 140%. In light of these large deficits and the

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[12] The three scenarios cover the liberalization of selected manufactures, all manufactures, and all goods

associated rapid increase in the public debt, questions about the implications of the government fiscal policy stance on debt dynamics and macro stability have arisen.

As a result, the Lebanese government tried and is trying to deal with several major issues mainly focusing on the economic slowdown, public debt, budget deficit, the current account balance deficit as well as the high interest rates paid on the Lebanese Pound. The 1999 budget is not only austere but it also introduces a global fiscal reform. To date, the fiscal revenues represent 17% of the GDP and the tax to total revenue ratio remains below international standards. The government thus has a double objective: Correct the fiscal imbalances and stimulate economic activity.

Table - Major Macro Economic Indicators

Indicators	1998 (Total)	1991 (1st)	1999 (2nd)	1999 (3rd)	1999 (4th)	2000 (1st)
Deficit (LBP bn)	3,457	555	709	848	1,075	1,101
Primary Deficit (LBP bn)	105	-54	-84	-63	-16	259
Gross Int. Debt (LBP bn)	21,685	22,181	22,488	21,685	25,561	25,911
Trade balance ($ mn)	-6,399	-1,407	-1,273	-1,424	-1,425	-1,311
Net Inflows ($ mn)	5,681	1,368	1,163	1,532	5,795	1,180
Gross Inflows ($ mn)	5,912	1,368	1,189	1,538	1,732	1,180
Balance of Pay. ($ mn)	–487.5	-39	-110.3	108	307.1	-131

Source: Bank Audi Quarterly Reports for 1999 & 2000, Ministry of Finance Fiscal Budget Reports

At any rate, what do the figures show? The public finance policy during the first quarter of the year 2000 brought about excess in expenditures of LBP 1,100bn. Compared to the first quarter of 1999, the deficit to expenditure ratio went from 36.5% to 51.8%. The budget deficit and the servicing of the debt contributed to a 2.2% increase in the gross internal public debt reaching LBP 25,911bn by March 2000.

ii. Fiscal Situation and Policy

The Lebanese government had to cope with a growing deficit of the budget of the state between 1992 and 1997. Despite a strong increase in income, as the growth rate of expenditure was higher, there was an important increase in the deficit (+ 446%).

Lebanese income and public expenditure (in billion LL)

	1992	1993	1994	1995	1996	1997
Income	1.138	1.855	2.242	3.033	3.534	3.753
Income tax	513	1.220	1.440	2.000	2.869	2.893
Indirect taxes	467	987	1.172	1.706	2.549	2.443
Customs revenues	323	661	791	1.320	1.632	1.722
Property tax	N/A	177	197	222	260	291
Direct taxes	46	233	268	295	319	451
Income tax	N/A	201	240	228	257	375
Non fiscal income	626	635	802	1.033	665	860
Expenditures	2.219	3.069	5.379	6.342	7.732	9.662
Budget	-1.081	-? 1.214	-? 3.137	-? 3.309	-? 4.198	-? 5.909
Need for financing	-101	74	-? 8	36	805	233

Source: IMF 1999 occasional paper 179.

The increase in revenues is mainly due to the improvement of the collection of customs revenues. Indeed, for the same period, income and profit tax was lowered to 10%. Most recently, the various tax rates were increased.

The share of tax revenues out of total revenues went from 45% to more than 77%. The customs revenues are the principal source of tax income since 1992, they represented between 54% and 66% of tax revenues. Their contribution to state revenues stabilised around 45% between 1995 and 1997 only to decrease to 40% in the last two years.

The public deficit decreased by 41% between 1997 and 1998. The reduction in the deficit comes mainly from the increase in revenues and an increase in expenditure. The customs revenues count for 40% of state revenues.

Lebanese income and public expenditure (in billion LL)

	1998	1999
Public expenditure	7.807	8.454
Public revenues	4.449	4.868
Customs revenues	1.763	1.959
Public deficit	3.457	3.585
Customs revenues/Revenues	0.40	0.40

Source: Audi bank, 2000

Because of the budgetary significance of customs revenues for the state, it seems that the decisions on the levels of the applicable tariff rates were more justified by budgetary imperatives than by considerations on the protection granted via these rates to the various Lebanese productive sectors.

Weight of the customs revenues in public revenues (billion LL)

	1992	1993	1994	1995	1996	1997
Revenues	**1.138**	**1.855**	**2.242**	**3.033**	**3.534**	**3.753**
Income tax	513	1.220	1.440	2.000	2.869	2.893
Tax revenues/revenues (%)	45.08	65.77	64.23	65.94	81.18	77.08
Customs revenues	323	661	791	1.320	1.632	1.722
Custom revenues/tax revenues (%)	62.96	54.18	54.93	66.00	56.88	59.52
Custom revenues/ revenues (%)	28.38	35.63	35.28	43.52	46.18	45.88

Source: THE IMF, 1999.

If one considers 1998 and 1999, customs revenues provided 40% of state revenues. In 1997, more than 47.5% of imports came from the EU. If it is considered that the average tariff rate is appreciably the same whatever the origin of imports,[13] it is estimated therefore that tariff dismantling will have as a consequence a reduction in half of customs revenues (under the hypothesis that the commercial structure does not vary i.e. without effect of creation of trade or of trade diversion). Note however, dismantling will start only as from the third year after the entry into force of the agreement.

In addition, a five-year plan for the implementation of a tax reform was worked out by the ministry of finance. Application is planned to start by early 2001. It envisages in particular the introduction of a value-added tax which aims to replace gradually the customs revenues as a source of indirect taxes for the state. VAT will be applied uniformly whatever the origin of the product (local or imported) to a single rate of 10%. However, it will not replace completely the tariff structure, which will then serve to protect certain sectors of foreign competition.
According to the 2000 budgetary law voted in 1999, other measures were applied in order to increase tax revenues the state such as:

- Increase in the progressive tax rates of the taxes on wages. The maximum rate doubled from 10% to 20%.
- Increase in the progressive rates on industrial, commercial corporation taxes, and professions. The maximum rate jumped from 10% to 21%.
- Increase in the linear tax rates on profits of companies from 10% to 15%.
- Increase in the linear tax rates on income resulting from mobile capital from 5% to 10%.
- Increase in the linear rates on dividends from 5% to 10%.
- Increase in the progressive tax rates on inheritance assets. The maximum rate went from 10% to 16%.
- Increase in the progressive property tax rates from 10% to 13%.

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[13] Martin (2000)

All these measures are intended to reduce the budget deficit while decreasing the dependence on customs revenues. The time delay between the first tariff dismantling connected with the Euro-Med agreement and the implementation of these tax measures has to make it possible to partially compensate the loss attributed to the elimination of trade barriers with the European Union.

iii. Monetary Policy

The Central Bank carries out monetary policy through a number of instruments. The issuance of domestic currency treasury bills and bonds for sterilization of capital inflows was a primary instrument until 1997. Since then, the issuance of certificate of deposits (40 to 60 days maturity) and the intervention in the foreign exchange market have become more important instruments. The sterilization option is still utilized occasionally in order to accumulate foreign exchange reserves.

The Central Bank is yet unable to actively use the open market operation instrument as often done by the US Federal Reserve given the absence of a deeper secondary market in treasury bills. Similarly, the reserve requirement tool has not been used in recent years. Note that Lebanese banks must hold 13% of deposits in Lebanese Pounds in reserves at the Central Bank. No reserve requirement exists on deposits in foreign currency although the majority of deposits are in US dollars.

Table - Major Monetary Indicators

Indicators	1998	1991 (1st)	1999 (2nd)	1999 (3rd)	1999 (4th)	2000 (1st)
LBP/$ Rate	1,508	1,508	1,508	1,507.5	1,507.5	1,507.5
Net Reserves ($ mn)	6,414	6,520	6,293	6,751.7	7,607	7,265
Reserves/M3	44.4%	44.2%	41.1%	40.4%	43.2%	39.9%
Price Index inflation- (LBP)	1.57%	-0.30%	0.15%	1.09%	0.19%	0.43%

Source: Bank Audi Quarterly Reports for 1999 & 2000, Ministry of Finance Fiscal Budget Reports

The first quarter of the year 2000 was characterized by an accentuation of the cumulative effects of the monetary stabilization policy due-to the strengthening of the crowding out effect and the sterilization. The exchange rate of the Lebanese Pound to the dollar remained stable or fixed and the inflation rate (in Lebanese Pound) remained low reflecting the weakness of the demand.

The banks operating conditions were marked, in 1998, by the increase in the dollarization of deposits from 60 to 65%. As for the dollarization of lending the rate stood in the same year at about 89%. The monetary policy of stabilizing the nominal exchange rate and offering high rates of returns of treasury bills succeeded in the early 1990s to reduce the dollarization of the economy. However, the policy simulation was insufficient to reverse the weak economic fundamentals the Lebanese economy suffers from including, most of all, the lack of confidence in the currency and in the overall economic prospects.

Table – Dollarization of Deposits

Year	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*
Deposits in USD/Total	70%	61%	62%	56%	60%	65%

Source: Central Bank of Lebanon

Between the years 1995 and 1996, the dollarization index dropped and was accompanied by a reduction in the nominal rates on earned income. Aside from interest rates on US dollars which remained stable, a positive but weak correlation exists between the dollarization of the economy and the level of interest rates. This relationship contradicts the governmental policy of increasing demand on Lebanese Pounds with higher rates of return.

Table – Lebanese Interest Rates (%)

Year	**Income**	**Lending**	**Income($)**	**Lending($)**	**Inflation**	**Inflation($)**
1995	17.12	28.99	5.46	12.19	11.00	2.81
1996	14.70	24.67	5.62	11.27	6.70	2.93
1997	13.07	20.40	5.87	11.85	6.70	2.34
1998	13.11	20.26	5.93	11.63	4.40	2.34

Source: Central Bank of Lebanon

After dropping the rate of return on the 24-month treasury bills, the government and in close coordination with the banking community was able to reduce the lending rates in 1999. The current mainstream view is to push for more reduction but on a gradual and cautious basis even though, in theory, the economic benefits are significant with a lower lending rate on loans denominated in Lebanese Pounds.

Examining the general price level, and once we factor in the exchange rate, the figures show a constant inflation rate. This fact contradicts the general belief that the economy has been witnessing a decreasing inflation rate.

The figures and facts listed above reflect *mixed results for the Lebanese monetary policy* aimed at reducing inflation, dollarization, and increasing confidence in the domestic currency. The same monetary policy has been implemented since the early 1990s and the policy was successful in stabilizing the nominal value of the Pound without altering the level of foreign reserves. On the other hand, the inflation rate in US dollars remained constant and the dollarization in deposits and loans has not dropped significantly for most of the 1990s, in fact it has risen in the latter part of the decade.

On a different level, monetary policy aims at strengthening *the link between the monetary and the real sectors of the economy*. In that regard and to a certain extent, the policy has been able to improve the linkage and stimulate economic activity. Foreign-currency loans to the productive sectors extended with a 5% interest subsidy increased by $27.3mn at the end of June 1999, up from $8.5mn during the same period in the previous year. The sectors benefiting from the subsidized rates are agriculture, industry, and tourism but the agriculture's share was only $600mn whereas the share of the other two sectors was increasing significantly.

Table – Subsidized Loans in Foreign Currencies (in million USD)

Period	March 98	June 98	Sept. 98	Dec. 98	March 99	June 99
Industry	32.7	40.1	65.0	75.8	83.7	97.3
Agriculture	13.3	15.3	24.9	27.6	27.9	41.0
Tourism	7.3	8.2	9.4	10.9	11.2	11.8
Total	**53.4**	**63.7**	**99.3**	**114.3**	**122.8**	**150.1**

Source: Central Bank of Lebanon, 1999 2nd Quarterly Report / End of Period

Moreover, total loans benefiting from reserve requirement facilities went up by LBP 13bn from March to June 1999. Housing, industry, and tourism received respectively 23.2%, 37%, and 23.3%. Comparing to December 1997, the total credit almost doubled from LBP 263.6mn to 432.6bn in absolute terms, however the same three sectors enjoyed increasing funding whereas the percentage allocated to services (minus tourism) and electricity dropped.

Table – Credit Benefiting from Facilities in Reserve Requirements (Million LBP)

Period	Dec. 97	June 98	Dec. 98	March 99	June 99
Industry	68,537	93,982	146,826	152,805	160,435
Tourism	77,597	86,479	95,754	96,207	100,731
Housing	59,726	62,669	99,108	100,030	100,664
Agriculture	629	7,132	11,281	13,561	13,711
Electricity	16,183	16,183	16,183	16,183	16,183
Services	40,970	40,970	40,970	40,970	40,970

Source: Central Bank of Lebanon, 1999 2nd Quarterly Report / End of Period

iv. The Financial System and the Banking Sector

Commercial banks remain the most important financial intermediaries despite the progress in the development of securities markets in recent years. The structure of the financial system has been largely shaped by the conduct of monetary policy.

As of mid-1998, there were 71 operating commercial banks, of which 15 were foreign banks. Seven new banks were chartered since 1990 while a number closed or merged with existing ones. In fact, a law adopted in 1993 and expired in 1998, encouraged consolidation in the banking system. The number of specialized banks has doubled to eight over the last decade, however the importance of this sub-sector remains marginal. As far as concentration, the top eight banks account for about half of the sector's activity measured in deposits, assets, or loans. The concentration ratios, whatever the measurement index used, have remained constant through out the 1990s.[11]

Foreign banks essentially enjoy national treatment; even before the concept of most favored nation treatment was introduced. The foreign banks are however subject to tight constraints on foreign land ownership and can only open one branch. Government ownership in the banking

[11] Source: IMF Occasional Paper 176, 1999

sector is limited. The state owned, or had to cease the operations of collapsing banks but soon after the restructuring, it sold its shares or retained a very small percentage. The Housing Bank (Banque de l'Habitat) and Credit Libanais are examples of such experiences. In other words, the liberalization of financial services as a result of the proposed Euro-Med. Agreement would not significantly alter the existing structure. However, the overall liberalized environment will be inducive for more large foreign banks, to enter the market – possibly using Lebanon as a platform for the regional market – and as a result introduce tough competition that some local banks might not be able to survive.

v. Foreign Direct Investment & balance of payments

One of the main characteristic of the Association Agreements with the EU is the acknowledgement of the dynamic effects of investments, both domestic and foreign. The long transitory period of 12 years is intended to allow time for the implementation of adjustment measures and for the developing joining states to prepare for a competitive environment imposed by the globalization of markets. The domestic firm, protected by high tariff rates and custom duties, will have the time to implement adjustment policies and reap up the benefit of liberalization. The dynamics of investments are a crucial element in order to maximize the benefits of regional integration. Foreign direct investment, that in some countries such as Tunisia and Egypt make up 20% of total capital expenditure, will be essential in fostering the modernization and the social development of the host country.

The World Investment Report shows that southern Mediterranean countries received $6.3bn in 1997 (4.4% of developing countries' share). Egypt was the main host in the 1980s but has been replaced by Turkey and Israel in the 1990s. The level of FDI coming into Lebanon has been increasing and a fast rate since the end of the war. In 1997, and according to the World Bank Development indicators (see table below), the ratio of FDI to GDP was 1% compared to 0.1% for the MENA region. But since MENA receives between 0 and 2% of the world total, the comparison might not be justified. In addition, the level of the Lebanese GDP is small, and so if the economy were able to grow at normal rates, the 1% ratio would drop substantially.[15]

Table – Foreign Direct Investment in the MENA Region

	FDI % gross domestic investment		FDI % of GDP	
Country	*1980*	*1997*	*1980*	*1997*
World avg.	2.4	5.1	0.6	1.4
MENA avg.	-3.1	0.7	0.7	0.1
Lebanon	-	3.8	-	1.0
Kuwait	0.0	0.4	0.0	0.1
Oman	7.4	4.0	1.6	0.4
Tunisia	9.1	6.3	2.7	1.7
Egypt	8.7	-	2.4	1.2

Source: World Bank Development Indicators, 1999

[15] Source: World Bank Development Indicators, 1999

The 1998 FDI inflows increased 48% from the 1997 level and were mainly targeted to the commercial sector (45%), tourism (15%), housing (13%), and industry (12%), with 15% for the rest of the sectors.[16]

Lebanon is a small emerging economy that relies on the inflow of investments made by foreigners but also by Lebanese living abroad. The Association Agreement could play an influential role in stimulating and promoting FDI in Lebanon. In fact, in 1993, all foreign direct investment originated from Europe. The rate had dropped with the lifting of the US travel ban on Lebanon but the EU remains the number one source of FDI.

Net capital inflows, which include FDI, foreign aid, and other forms of money transfers, recorded in the first quarter of 2000 a surplus of $1,180mn against $1,368mn during the same period of 1999, partially offsetting the trade deficit, the balance of payments having registered a deficit of $131mn (against a deficit of $39mn in the first quarter of 1999). The deficit results mainly from a decrease in the Central Bank's net foreign assets, which decreased by $282mn. The total level of net inflows for the year 1999 stood at $5,795mn, $114mn more than the level for the year 1999.[17]

According to the 1999 Arab Investment Guarantee Corporation Report, 50% of total capital flows into Lebanon came from Arab countries.[18] Arab investments lead by Saudi Arabia, Kuwait, and the United Arab Emirates (UAE) targeted mainly financial services (40%) and real estate (30%) and non-Arab investments were also distributed to the latter two sectors with the respective shares of 35% and 30%. Paradoxically, most of the capital inflow is not directed to sectors the Arab Finance Corporation[19] considers as Lebanon's future and main comparative advantage and they are media, information and communication technology, and the pharmaceutical sectors.

B. Macroeconomic Analysis: Liberalization and The Expected Impact

i. The Fiscal Impact

In 1998, the EU share of Lebanese imports was 45%. The total value of imports for the same year was LBP 10718.9bn out of which 43% went for final consumption. The trade deficit stood at LBP 9632.5bn and collected custom duties at LBP 2,104.3bn. The European share of Lebanese imports remained around the 50% mark for most of the 1990s. These rates are also comparable to the rates of pre-war years. Furthermore, a large part of the trade deficit is a result of Lebanese-EU trading.

Table - Trade Balance with the European Union

	1991	1992	1993	1994	1995	1998
Import share	48	48	48	50	51	45
Export share	21	19	17	17	20	24

Source: Administration Centrale de la Statistique

[16] Inter Arab Investment Guarantee Corporation 1998 Report on Lebanon
[17] Source: Bank Audi Quarterly Reports (1999 and 1st quarter 2000)
[18] Capital flows from the Gulf countries was mostly in the form of grants and soft loans with a smaller share of FDI originating from Kuwait and the UAE.
[19] Arab Finance Corporation Reports (1999 & 2000)

The Lebanese fiscal (revenue) situation adds another dimension to the Euro-Med. Agreement with Lebanon. The ratio of taxes on trade out of total tax revenues was 61% in 1998, and 60% in 1996. Out of the total revenue collected in 1996, that share stood at 45% and 46% in 1998. Moreover, the 1994-96 average EU share of taxes on trade was 28.8%. In other words, the tax revenue share from the trade with the EU reflects the EU import share. This, in turn, reflects the abnormal fiscal dependence of Lebanon on trade with the EU.

Table - The structure of taxes in MENA[20] countries (taxes as a % of total revenues) - 1998

	Taxes on int'l trade	Tax on goods and services	Income and capital gain tax
Middle East average	13.84	12.02	13.08
Lebanon	46.18	3.94	7.26
Jordan	25.97	30.15	12.66
Kuwait	1.95	0.02	0.47
Egypt	9.98	12.94	16.47
North Africa average	18.5	15.15	14.41
Morocco	14.44	19.37	19.37
Tunisia	25.57	15.66	15.66

Source: Government Finance Statistics, 1998. IMF

The table above shows that Lebanon is an exception to the rule even in comparison to the countries of the region. The share of taxes on international trade is triple the Middle East average and more than double the North African average.

The two sets of data figures (tax and import structure for Lebanon) highlights the alarming implication as a result from the significant drop in fiscal revenues brought about by the liberalization of trade with the EU.

As mentioned, the fiscal position of Lebanon and of the MENA budget is in the negative. With the exception of Kuwait, a statistical outlier, Lebanon's fiscal situation is the worst.

Table - MENA fiscal budgets ($ million)

	1996	*1997*	*1998*
Arab Countries	-20.162	-12,182	-31,966
Lebanon	-2,672	-3,882	-2,552
Egypt	-884	-687	-832
Jordan	-209	-219	-506
Kuwait	-2,180	1,656	-1,214
Morocco	-1,218	-808	-661
Tunisia	-836	-805	-277

Source: World Development Indicators, 1999

Measuring the exact fiscal impact on Lebanon as a result of signing the Euro-Med. Agreement with the EU remains subject to discussion and remains heavily dependent on the parameters and

[20] Middle East and North Africa

the assumed hypothesis. There have been recent attempts carried out by the Lebanese government to alter tariff rates on intermediate goods in order to stimulate investment and kick-start the economy. These attempts have been welcomed by the private sector.

Fuleihan (1997) roughly estimates the direct and immediate loss in total revenue to be 25%. The figure appears to be determined from a simple mathematical calculation and not based on an econometric model. Ghaleb (1998) on the other hand set up a static computable general equilibrium model for Lebanon and found that 3.6% of base income (GDP) has to be raised or a corresponding 5.8% income tax hike is needed in order to keep the deficit stable in the case of a bilateral 50% tariff reduction between Lebanon and the EU.

As a first order approximation and taking into account the shares of tariff receipt from the EU imports in total tax receipts, Abed (2000) finds that the revenue impact is likely to be the most adverse for Lebanon and Algeria. The potential revenue losses are smaller for Tunisia, Jordan, and Morocco. When measured as a percent of GDP, it is Tunisia and Lebanon that are the most negatively affected. Note that the revenue loss is attribute to both the reduction in the tariff rate and the reduction in the tax base as a result of replacing non-EU imports taxed at higher rates with the cheaper EU imports (i.e., trade diversion).

Rutherford et al. (1993) tried to assess the direct and indirect fiscal impact on the Moroccan economy. The model estimated the potential revenue loss to be 3.3% of the long-run equilibrium GDP. A simpler and more direct approach was developed in IMF staff papers on Morocco and Tunisia. The model assumes a static relation between imports and GDP and the existence of no trade diversion. According to their calculations, revenue losses are estimated to gradually rise from 0.3% of the GDP in the first year to 2.6% by the end of the 12th year of the Agreement transition period. On the other hand, Devarajan et al. (1997) examined the direct and indirect impact but for a number of countries including Lebanon. The study estimated the drop in the revenue level for Lebanon to be 31.4%.

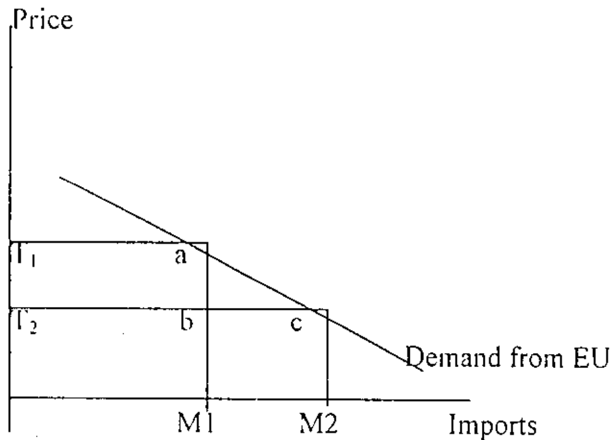
Whatever method or model used, the fact is that is Lebanon has to find an alternative source of revenues to replace the taxes on international trade. This is true whether Lebanon signs or does not sign a free trade agreement with the EU. A decision to introduce a value-added tax (VAT) has been taken and the Lebanese government is expected to start enforcing the VAT in 2001.

ii. Welfare Impact

Ever since Viner (1950) and the ambiguity regarding the relative strength of trade creation and trade diversion, economists have debated as to whether preferential trade agreements such as the EMA are desirable.

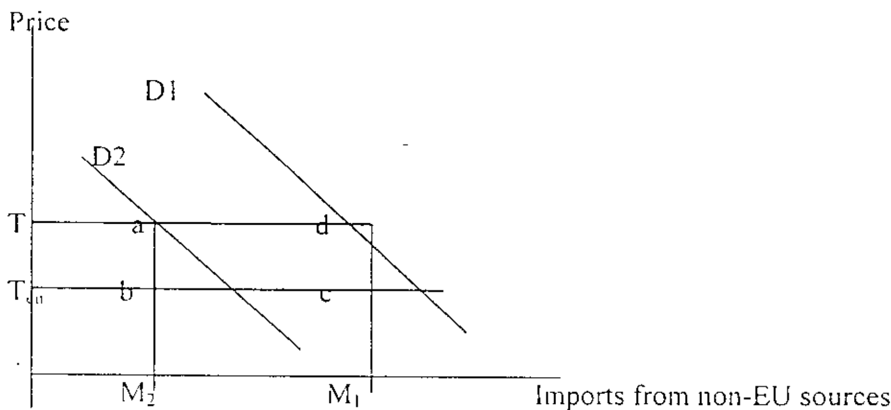
Assuming a country is a price-taker (small open economy), trade creation and diversion can be illustrated using a simple diagrammatic approach. Demand for imports from the EU is illustrated in the graph below. A tariff reduction from T1 to T2 increases the quantity of imports from M1 to M2. Given this straightforward tariff simulation, the tariff loss is reflected by the abT_1T_2 rectangle and the consumer surplus increased by T_1T_2ac. The net welfare gain is thus the difference between the tariff loss and the consumer gain which is the abc triangle.

Graph 1 - Trade Creation



The other Lebanese trading partners, who are discriminated against with the preferential trade agreement with the EU, will witness the demand for their exports to Lebanon decrease assuming that their products are perfect substitutes to European goods. In graph 2, the demand for non-EU imports shifts to the left as a result of a tariff reduction on EU imports, other things remaining equal. The shift in demand drives down non-EU imports (from M1 to M2) and reduces with it tariff revenues by the rectangle area of abcd. The loss in revenues is due to the fact that the loss of imports from non-EU sources would have been subjected to a higher tariff rate. This revenue loss attributed to a reduction in the tax base represents a welfare loss due to Lebanon. A further negative welfare impact could be expected if EU products were produced in a less efficient manner than their non-EU substitutes. In other words, the Lebanese consumer is buying a second-best product because it is now cheaper with the distortionary tariff reduction.

Graph 2 – Trade Diversion



The flatter the import demand curve (i.e., the more elastic import demand is) of graph 1, the larger the effect of trade creation and the larger the net welfare gain (i.e., larger abc triangle). The same result is true the higher the initial tariff rate on EU imports. Similarly, the higher the initial tariff rate on non-EU imports, the greater is impact of trade diversion. Trade diversion and creation are also positively correlated with the size of the elasticity of substitution parameter for

imports across regions and between imports and non-imports respectively. In other words, the higher the substitution between imports and domestic goods, the larger is the trade creation.

Analyzing the welfare implications of the Association Agreement for Lebanon is not easy. The agreements signed with other Mediterranean countries have not been fully implemented, allowing us to better estimate the costs and benefits. Studies have though been conducted in that respect but the findings have not been conclusive. Deardorff et al. (1997), for instance, find the equivalent variation (EV) welfare index for Tunisia to be from slightly negative to somewhat positive, and that the quantitative result depends on the model underlying assumptions. The authors expect in conclusion that Tunisia's welfare will be reduced in the short run later to increase.

At any rate, the Lebanese economy is relatively different than the economies of the region, thus it is difficult to assess the potential impact based upon a comparative analysis. Lebanon also has data deficiencies making it near impossible to numerically and econometrically analyze the impact. Note that some studies have been conducted with the available data but the authors recognize at the start the lack of data which remains a major drawback in their economic models.

The recent papers on the agreement with Lebanon have focused on three main issues.

- The fiscal implications associated with the establishment of a free trade area and the related loss of custom revenues
- The welfare implications through its effect on trade diversion and creation
- The competitiveness implications for the domestic industries of the changes in the effective rates of protection

The fiscal implications were addressed in the previous section. With regard to the welfare impact and following the establishment of a free trade area, trade between Lebanon and the EU is likely to increase (trade creation), but possibly at the expense of trade with the rest of the world (trade diversion).

On the import side, the elimination of tariffs will affect welfare through lowering import prices on EU goods. Ghaleb (1998), and after controlling for the level of state revenues, finds that the EV welfare index to be positive. Consumers will be better off through an increase in their welfare, while some producers will be worse off because they will not be able to withstand the increased competition. On the export side, the welfare effects could be small since Lebanon already enjoys free access to the EU market for most industrial goods since 1978 – and most Lebanese exports to the EU are industrial goods. This latter conclusion is shared by Martin (2000) and Ghaleb (1998) who computed two different general equilibrium models.

Martin shows that substantial trade is created with the EU (23% increase) but trade is also diverted from the rest of the world leading to an insignificant net increase in the volume of trade of 0.5%. Martin finds that there is a net welfare loss of 0.3% with respect to the base case expenditure level. Even though the direction of the welfare impact between Martin and Ghaleb is the opposite, the differential in the magnitude is small and varies depending on the simulation. The case-by-case comparison is not though justifiable as the models are constructed differently and the simulations also differed. Martin, for instance, constructs his production function from the revenue function, whereas Ghaleb relies on the standard functional forms with labor, capital, etc. as factors of production.

The results of all the econometric studies made on Lebanon depend heavily on two key parameters and they are: The elasticity of substitution among competing import suppliers and between imports and domestically produced goods. This fact is recognized by both studies and by Devarajan et al. in their 1997 study. The welfare impact also depends, but to a lesser degree, on a number of other parameters including the initial tariff rate imposed and the chosen tariff measure (e.g., simple averages, weighted averages, etc.). All three studies, take these remarks into consideration and run a number of simulations to test the reliability of their models. Ghaleb, for instance, runs his model with alternative parameters and quantifies the changes associated with the new assumed parameter.

Given the lack of data, the models are constructed to quantify the impact of a shock or test the significance of a certain parameter and not to replicate economic reality.

The third group of impact studies for Lebanon, though not numerous, have focused on the competitiveness of domestic industries in light of the changes in the effective rates of protection. The 1996 study of Hoekman has been the most extensive and has thus become the reference in that area of research.

While nominal tariff rates rank among the lowest in the region, Hoekman claims that Lebanese industries enjoy a high effective rate of protection (ERP) averaging 22%. The ERP varies across goods from 0% on grain to 84% on transportation equipment. The back-loaded tariff-reduction scheme as described in the Euro-Med. Agreement, will have a little impact on the ERP during the first five years. However, the effective rate will drop drastically in the last three years when about one-half of the tariff reduction materializes.

Hoekman believes that as post-war reconstruction nears completion, the price of non-tradables will decrease as a result of increased efficiency, improved services, and the removal of bottlenecks. With such major changes, Lebanon's competitiveness is expected to increase thus reducing the impact (or fear) from external competition brought about by the Euro-Med. trade liberalization agreement.

iii. Impact on Foreign Direct Investment (FDI) and the Balance of Payment

The Euro-Med. Agreement impact on the balance of payment, the level of FDI, and the financial credibility of a nation, play also a major role in determining the magnitude of the welfare, fiscal, or competitive impact on the Lebanese economy.

Liberalizing trade with the EU facilitates the inflow of foreign direct investment, which in turn helps in the transfer of new technology and know-how to Lebanon. Under a regional trade agreement, the member countries are expected to increase intra-regional trading but also intra-regional investments. As is the case for any member of a "club" who is offered certain benefits for the price of the membership, Lebanon is expected to attract more European FDI with the liberalization of the right of establishment and most especially in the services sector. The "no-less favorable treatment" clause in the proposed agreement is expected to boost FDI inflows and outflows but the magnitude of the FDI changes will depend on the implementation of this non-discriminatory concept. Assuming the proposed draft agreement is ratified, Lebanon will have to undergo major adjustments to attract foreign investors, probably at the expense of some domestic firms.

The numerous technical assistance projects listed in the *Measure d'Accompagnement* or the *MEDA* program are another medium for the transfer of know-how. The main purpose of the

MEDA is to support Mediterranean countries in their efforts to adjust prior to the full implementation of the Euro-Med. Agreement. The millions of dollars spent for the purpose of smoothing the adjustment process has a by product impact and that is the acquisition of new skills by Lebanese laborers.

The MEDA programs, up to 1999, included industrial modernization, direct fiscal aid, revising industrial norms and standards, rehabilitation of the public administration, and assistance in the reform of the fiscal situation. Additional money is promised under MEDA II for industrial modernization and fiscal reforms as well as technical assistance in the preparation to the accession to the WTO. The European assistance also covers non-economic programs with long lasting implications such as empowering women and protecting the environment.

The total budget of the EU for assistance programs has exceeded Euro 5bn over five years, and Lebanon's share was Euro 48mn for the year 1998. Over Euro 186mn have been committed to Lebanon since 1996 for economic-related projects and more aid is expected to come under the second phase of MEDA (Alawa 2000).

A trade agreement also boosts the credibility of the developing country on the world market and the country can benefit from such a new status to borrow on the international market or lure new investors. A regional integration agreement could offer a stronger mechanism for implementing economic reforms than the WTO. Regional agreements sometimes introduce binding commitments that have a positive impact on the credibility of a member country (Hoekman and Djankov 1996). A country perceived as more credible allows it to borrow more under favorable conditions and receive more aid, consequently improving the state of the balance of payment.

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