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Discussion Paper
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Enhanced Trade Integration with Europe: New Prospects of Growth and Development for Libya ?

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Abstract:

The paper deals with the prospects of economic recovery and growth of Libya after the suspension of the UN sanctions. Here the risks and chances of Libya's participation in the so-called 'Barcelona Process' are viewed. Based on the results of a similar study for Egypt and an empirical analysis of Libya's trade performance, the findings suggest that Libyan-EU trade is characterised on the one hand by a high gravity, but on the other hand by a strong dissimilarity, making economic integration difficult. Free-trade as a stand-alone measure would not be necessarily conducive to Libya, however, the secondary effects of free trade, fuelled by enhanced incentive to pursue courageous structural reforms could have important effects on an improvement of international economic competitiveness of Libya, a dire need with a view to the limited crude oil resources.

JEL-Classification: F15, O10

Keywords: European Integration, Free Trade, Gravity, Intra-industry Trade, Similarity of Trade

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1. Introduction

Libya's dependence on its oil export revenues has largely characterised the development process since the sixties. A number of different phases is to be distinguished: the policies of the Kingdom, the surplus re-distributive policies under the revolutionary government until 1981, the US trade boycott and the declining revenues during the eighties, the UN sanctions and further deteriorating growth prospects during the 90 and presently the opening-up of Libya after lifting the UN sanctions.

A lot has been researched about the importance of the oil revenues for Libya and there has been a consensus that the structural dependence on this asset is the national source of wealth but also a major factor of economic uncertainty. The paper deals with an initial discussion how the chance of economic liberalisation and and the recent efforts of re-integration after the end of the UN sanctions could be used to more sustainably absorb the oil revenues. The strategy of enhanced trade integration with the EU is at the centre of this paper. A major question is whether joining the Barcelona Process and the European Neighborhood Programme will be beneficial for economic development of Libya. Here the central issue of research is whether Libya could sufficiently benefit from free trade with the EU and if yes, which reforms have to be tackled by Libya itself. The bulk of liberalisation efforts would have anyway to be done by Libya itself, as under a free trade agreement the EU will just grant preferential duty-free access to industrial products from the Mediterranean free trade partners.

Addressing such an issue empirically requires the availability of sufficient national accounting data (a national Input-Output Table or a Social Accounting Matrix) to be used for estimated projections within an open macro-econometric model or for calibration of a Computable General Equilibrium Model (CGE).

S. Dessus and A. Suwa-Eisenmann (1999) have estimated the effect of the bi-lateral free trade agreement of Egypt on trade integration, diversification and growth. In contrast to our study, they could rely on a rather actual Social Accounting Matrix providing the necessary data basis for running simulations with a CGE model[1]. For Libya, the availability of data is rather limited. Neither an I-O table nor a SAM is available. Therefore, in this paper it is only possible to analyse the prospects of trade integration with limited descriptive statistics (i.e. the application of specific indices) and referring to overall interpretations associated with those indices. However, Dessus' and Suwa-Eisenmann's study on Egypt and its findings are likewise highly useful for Libya, so that it will be considered in our conclusions.

[1] Sébastien Dessus and Akiko Suwa-Eisenmann 1999, 'Trade Integration with Europe, Export Diversification and Economic Growth in Egypt', in Ahmed Al-Kawaz (ed.), *New Economic Developments and their Impact on Arab Economies*, Amsterdam: Elsevier

It is to be stressed that the primary results of our study are not very surprising, as they more or less repeat well-known assessments about the economic peculiarities of Libya and other rich rentier economies, hence, on the one hand, the message of our study might sometimes sound a bit truism-like. But on the other hand, an assessment of trade perspectives cannot ignore these fundamentals.

2. Development over the past 20 years

At present, Libya is at a turning point, both politically as well as economically. Since the lifting of the UN sanctions numerous impediments to trade and economic co-operation have been removed, hence there is scope for a growing developmental dynamic.

However, the well-known structural imbalances of the Libyan economy (the heavy dependence on crude oil exports) cannot be relieved in a short or medium time horizon. While there has been progress in other surplus-petroleum exporting countries, Libya has not gone through a significant structural change in terms of simultaneous export diversification and outward investment of surplus export revenues, both relieving the dependence on oil. One of the major reasons for that have been the political and economic isolation and the resulting restrictions in trade and economic co-operation, thus retarding any progress of structural change (Bergs 1999). In addition, Libya's relatively poor infrastructure and adverse climatic conditions, weaknesses in the macro-economic management, a bloated and costly public sector (around 60% of government spending is allocated for public sector salaries), large projects with questionable effectiveness and impacts (i.e., the "Great Man Made River" project), and various legal rigidities have posed impediments to foreign investment and to economic growth during the 1980s and 1990s (Bergs ibid.).

Revenues from the export of crude oil, which amount to approximately 95% of Libya's foreign exchange income and fuelling 75% of the budget, decreased already in the eightees after the trade boycott of the Reagan Administration against Libya, markedly revealing the risk of her heavy depencence on oil. During the ninetees, the UN sanctions against Libya further aggravated the economic crisis until the dramatic decline of oil prices during 1998. With higher oil prices since 1999, however, Libyan oil export revenues have grown from $5.8 billion in 1998, to $13.4 billion in 2003 and $12.9 billion in 2004 (forecast). As a result of growing oil export revenues, Libya's fiscal situation has now again improved. These positive trends coincide with the removal of the UN sanctions.

2.1 GDP and diversification

A rather strong diversification of the sectoral production has taken place in the last years, as the following table shows:

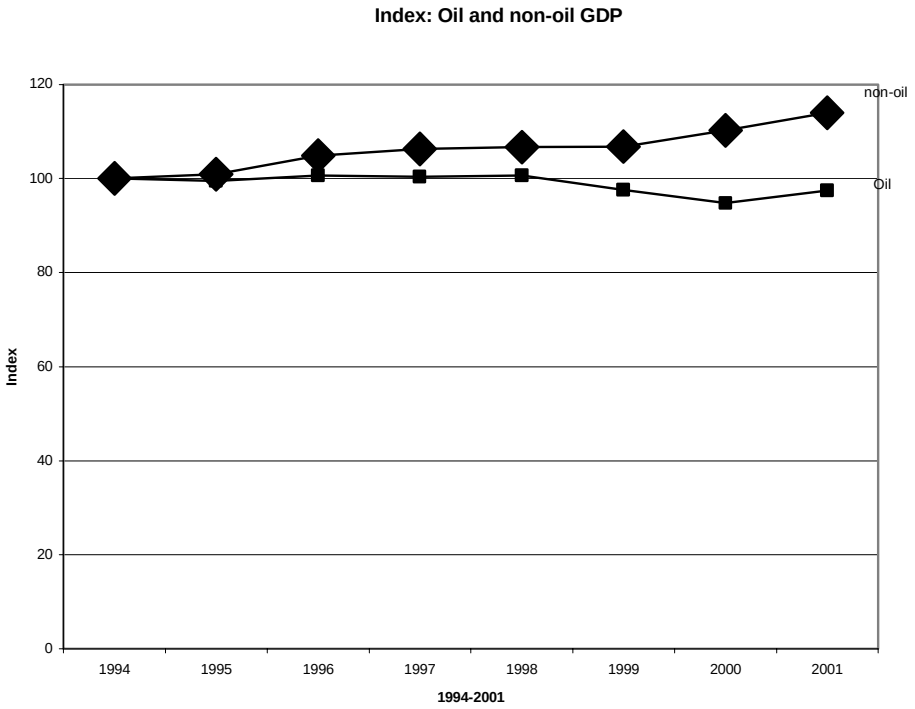
Table 1: Comparisons: Manufacturing and non-manufacturing value added

Indicator	Years	Libya	North Africa	Developing Countries
Manufacturing value added, average annual real growth rate (in %)	1981-1991	7.8	4.3	5.0
	1991-2001	6.7	4.3	5.1
Non-manufacturing value added, average annual real growth rate (in %)	1981-1981	-0.9	2.3	3.7
	1991-2001	0.7	3.8	4.3
Manufacturing value added per capita, in constant 1990 US$	1981	301	149	408
	1991	470	181	409
	2001	770	225	876
Manufacturing value added as percentage of GDP at constant 1990 prices	1981	3.8	11.2	21.0
	1991	7.8	13.0	20.9
	2001	13.9	13.7	21.1

Source: UNIDO, Reference Information – Country Page Libyan Arab Jamahiriya, August 2003 (www.unido.org)

Manufacturing output per capita is now 2.5 times higher than in 1990. Apart from manufacturing the contribution of non-oil value added in general (notably construction) has increased over the last decade, so that there is indeed some evidence of a slight overall diversification process, as the following index might illustrate.

Figure 1: Index of oil and non-oil output trends



Source: Central Bank of Libya: Economic Bulletin
The largest non-oil growth rates could be achieved in construction (6.7%) and manufacturing (3.5% p.a.).

In interpreting the above data it is necessary to note that although the manufacturing value added per capity is over-average for Libya related to North Africa and almost on a par with the developing countries, manufacturing in Libya is highly concentrated on few capital-intensive product groups (petrochemicals, aluminium and steel).

2.2 Balance of payments

The development of the balance of payments has been more erratic during the last decade after it was permanently negative between 1982 and 1989 and positive during the 1970s until 1981. On average, however, during the longer-run trend until 2003, the data suggest an improvement of the Libyan foreign trade position with a strong real appreciation of the dinar.

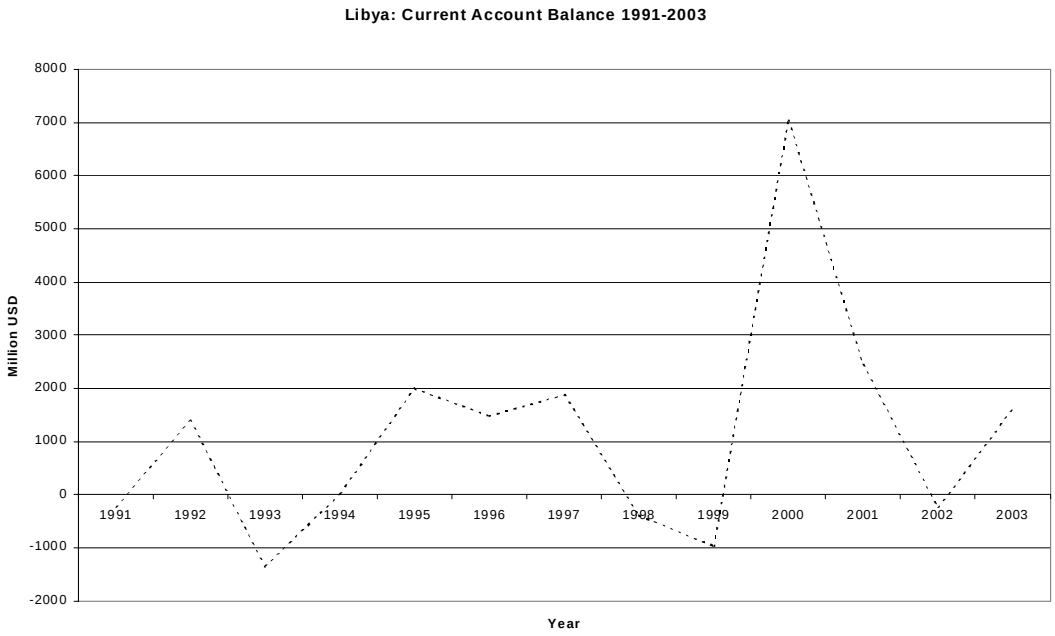


Figure 2: Libya: Current account balance 1991-2003

Sources: African Development Bank (1991-1999), IMF-Report 03/327 (2000-2003); (data for 2003 only as a IMF projection)

2.3 Fiscal balance

As regards the fiscal recovery and balance, the following chart reveals growing public revenues (also in terms of non-oil revenues). A substantial deficit (of around 12.6%) only occurred in 2000. In the other years they are either small or there were surplus fiscal balances.

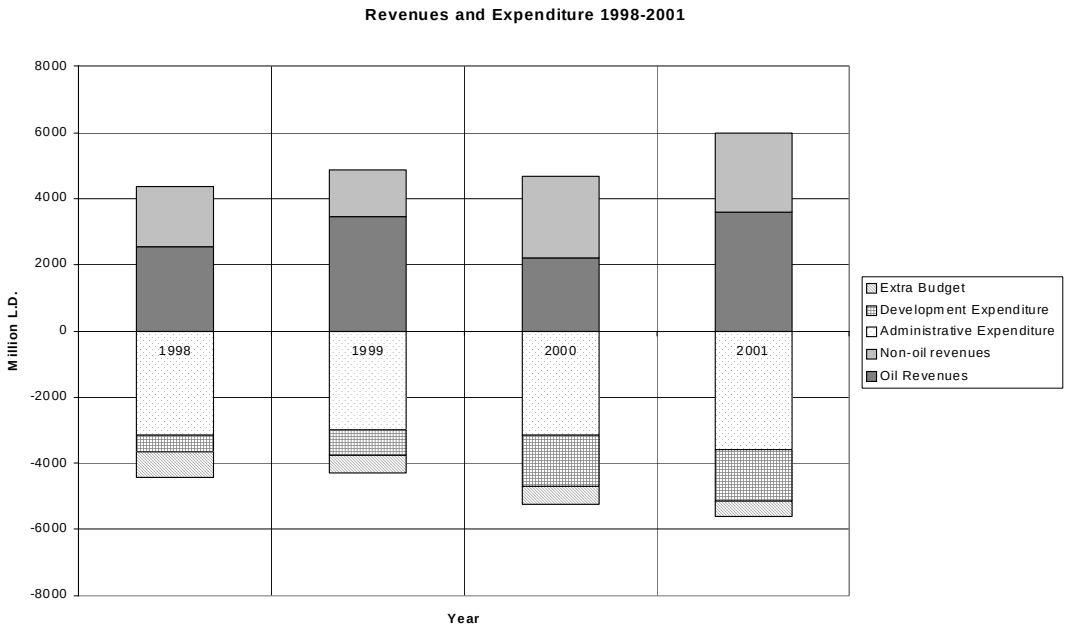


Figure 3: Revenues and expenditure

Source: Central Bank of Libya

By and large, economic trends have reversed after around eighteen years of decline and stagnation.

3. Libya at the turning point

Despite these recent signs of an economic recovery it must be borne in mind that Libya's structural rigidities (dependence on oil, low absorptive capacity of capital in the non-oil sectors) are likely to remain, furthermore underemployment is still rampant as the country's population grows rapidly (at 3.5 %) creating further imbalances on the labour market. The mentioned recovery process can therefore not be regarded as an indication of a sustainable development path.

Nevertheless, despite the enormous structural risks of the Libyan economy, the removal of the sanctions and the recent political and economic opening up of the country, coupled with the impetus of stronger economic growth within Libya's current business cycle, could render big chances for a re-orientation towards a more sustainable development in terms of prudent economic policies. A major asset of Libya, as compared to the neighbor countries in the MEDA area, is that it can better materialise the advantages of market proximity of the EU. Of course, the distinguishing factor can be seen in the crude oil reserves as Libya's major asset. In contrast to other neighbor countries, Libya is capable to contribute with substantial own investment activities improving perspectives for increased inter- and even intra-industry trade with the EU area - at least theoretically and in the longer run. Therefore, Libya's proximity to Europe (a direct neighbor to the EU) and the economic potential are to be seen as advantages compared with either the much poorer other EU neighbors (Egypt, Morocco, Algeria and Tunisia) or the rich but

more distant Gulf states. Assuming the validity of the gravity theory, i.e. trade volume between trade partners as a behavioral function of distance and economic performance:

$$T_{ij} = A\frac{Y_i Y_j}{D_{ij}},$$ [2]

the following distribution would suggest that Libya and (to some extent Algeria) are in an advantageous position to benefit from enhanced trade with the EU.

Table 2: Gravity distribution

	EU-neighborhood	**EU-distant**
High income	***Libya*** (Algeria)	Kuwait, SA, VAE ...
Low income	Egypt, Tunisia, Morocco	Yemen, Sudan, Mauritania, Mali

As shown by table 4, the trade volume T per capita (*P* = population)

$$T = \frac{M + X}{P}$$

is considerably higher for Libya than that for its neighbor countries, substantiating the validity of gravity in Libyan trade with the EU. Moreover, it is to be noted that through the UN sanctions during the 90s, the gravity effect on mutual trade with the EU and other trading partners has been largely suppressed, so that there is evidence for a substantial gap between potential and real trade volumes.

From the viewpoint of the EU, the Barcelona Process and the bilateral free trade agreements would strengthen growth and development for all Mediterranean partner countries.

3.1 The Barcelona Process, the Neighborhood Programme and the expected mutual advantages of trade integration

The Barcelona Process was launched in 1995 as a means through which the EU supports Mediterranean partners in their political, economic and social reforms while at the same time building a closer EU-Mediterranean partnership. In order to tackle the challenges effectively, the EU and the partners have created a multilateral regional framework, in which a new bilateral contractual relationship (the Euro-Mediterranean Association Agreements, combined with free-trade Agreements among the Mediterranean Partners) and a dedicated assistance programme (MEDA) support each country to progress on the way towards the Barcelona objective. The three main goals of EU Mediterranean policy are set out in the Barcelona Declaration: The creation of an area of peace and stability, the improvement of mutual understanding among the

[2] where T_{ij} is the value of exports from country i to j, D_{ij} is a measure of distance between them (or the respective capitals) and A is a constant of proportionality.

peoples of the region including the development of an active civil society and the creation of an area of shared prosperity through sustainable and balanced economic and social development, and especially the gradual establishment of free trade between the EU and its partners, and among the partners themselves, until 2010. This process should be accompanied by substantial EU financial support to help partners dealing with economic transition and the resulting social, economic and environmental challenges.

As regards trade integration, the latter goal of the Barcelona process is of particular importance, as here the explicit goal of an area of shared prosperity is spelled out.

All Mediterranean non-EU countries have joined the Barcelona process, except Libya. Only in April 1999, following the suspension of UN sanctions, Libya acquired an observer status in the Barcelona Process. The country was invited to become a full member as soon as the UN Security Council sanctions have been definitively lifted and once Libya has accepted the full Barcelona 'acquis'.

Full integration into the Barcelona process is the first step towards new relations with the EU, which include the negotiation of an Association Agreement. If it is achieved and once there are contractual arrangements with the EU, participation in European Neigborhood Programme will allow further development of the EU's relationship with Libya as for all other countries in the Barcelona process.

An important step forward has been the invitation to Libya to fully join the process in February 2004. In the Brussels meeting with Col. Qaddafi on 27 February 2004 Commission President Prodi underscored the importance of Libya in the Barcelona Process as 'an important political and economic player in bringing Africa closer to Europe, and structural cooperation with the EU could provide benefits in a wide range of fields - economic, cultural and political.' (Romano Prodi on 27 February 2004).

The specific goal of the free trade process is to create an area of linking the 25 EU countries, the EFTA countries and the Mediterranean partner countries. At a later stage around 40 countries and around 600-800 million consumers should make up one of the world's largest trading bloc.

The European Neighborhood programme (ENP) should have important economic implications as regards technical assistance and trade integration. Neighboring countries will also have prospects of access to the EU Internal Market based on harmonised legislative and regulatory procedures, the participation in a number of EU programmes and improved co-operative ties with the EU in general.

The reduction of tariff and non-tariff barriers to trade should ensure substantial efficiency gains and improve welfare through increased market integration. Further indirect effects, particularly on partner countries, are estimated even larger. By linking neighbouring countries closer to the EU, successful policy strategies and best practices can be transferred. There is the expectation that the ENP and particularly the proposed extension of the internal market, will considerably improve the investment climate in partner countries and will provide a more conducive environment for private sector-led growth. This again will trigger increased FDI influx, falling trade and transaction costs, attractive relative labour costs and reduced trade risk (cf.:

European Commission 2004, *European Neighborhood Policy – Strategy Paper*, 12.5.2004, Brussels).

4. When is free trade beneficial?

Now the important question arises, whether a free trade agreement within the Barcelona Process can be really conducive for Libya[3]. There is anyway scope for further enhanced trade due to the a substantial 'gravity' between Libya and the EU, but free trade as such is a different issue.

In general, agreements of trade integration (ranging from the lowest level of a free trade area up to the level of a monetary union) is most effective to partner countries the more they are similar in their level of development, their economic structures and the patterns of their business cycles (cf. Wagner 1998, p. 250 f.). Moreover, it is to be borne in mind that a free trade area can lead to trade distortions and trade diversion, if the tariffs between free-trade member countries and third countries remain different (Bela Balassa 1962, *The Theory of Economic Integration*, London, p.70). As regards free trade between the EU and the Mediterranean partner countries (specifically Egypt) the most important question has been put forward by Dessus and Suwa-Eisenmann: '… Can this agreement [Free Trade Area] promote the export diversification process by increasing the competitiveness of Egyptian products? Or will it produce negative effects if the economy is not able to re-allocate its resources towards the most productive sectors during the transition phase, because of insufficient factor mobility and trade diversion? …' (p.98).

In case of Libya, the peculiar effect of the oil sector on labour cost in other sectors with tradable goods is of particular importance. In order to foster EU-Libyan trade in non-oil sectors, the import prices for such Libyan products need either to be grossly reduced (most probably by substantial currency devaluation) or the labour productivity in these sectors in Libya would need to be extremely increased. None of these alternative strategies is useful or realistic – at least in the case of Libya; devaluation would even bring about considerable welfare losses due to increasing import prices (for consumer and capital goods) most probably reducing prospects of diversification in the non-oil sectors (instead of improving them). Labour productivity cannot be boosted in the short and medium run. This has been anyway the most serious bottleneck of the Libyan economy during the last 40 years. Thus, at a first glimpse, a free trade agreement with Libya seems to be questionable. Trade liberalisation will first have an impact on the small but growing manufacturing sector, leading to its decline. Imports from the EU will become more and more competitive and cheaper. Hence, a structural decline of the economy is associated with welfare gains due to decreasing costs, or with other words: a market-led structural adjustment process will trigger a simultaneous reduction of capital assets and a gain in welfare. The short-term effect will be painful but perhaps – under the assumption of perfect competition - beneficial in the longer run. The impetus of the impact on the manufacturing sector will be only relieved to some extent by the gradual liberalisation approach until 2010, giving some time for adjustment in manufacturing productivity.

[3] Libya has already taken important steps of multilateral trade liberalisation, e.g. the elimination of import licensing requirements. However tariffs still range between 0 and 425%, a relatively wide dispersion by international standards (cf.: IMF 2003)

Hence, there is no simple answer to the issue of free trade for Libya. Moreover, this question should be explored a bit more empirically, and there should also be a 'second glimpse' looking at the question of further possible, and indirectly positive, effects of a free-trade agreement within the overall partnership agreement in the context of *Barcelona*. Indirect effects, going beyond the primary effects of free trade, play an explicit and major role in the ENP.

Due to a lack of data the present situation and perspectives for Libya from conducive indirect free trade effects cannot be simulated. Therefore, in the following chapter, it is only possible to view the relationship between gravity, trade and competitiveness profiles and free trade descriptively and to draw conclusions, which go beyond those of direct effects, from secondary sources with a comparable research interest.

5. Trends of Libyan foreign trade

Per capita imports and exports reveal a strong trade exchange between Libya and the EU, at least if compared to other important North African countries and between African blocs, as the following two tables show:

Table 3: Trade with the EU : Libya compared to Egypt and Algeria (bn Euro)

Year	**Exports to the EU**			**Imports from the EU**		
	Libya	*Egypt*	*Algeria*	***Libya***	*Egypt*	*Algeria*
1999	**6.9**	2.4	7.8	**2.3**	7.9	5.2
2000	**13.0**	3.4	16.4	**2.5**	7.9	6.1
2001	**11.5**	3.1	16.0	**3.0**	6.9	7.5
2002	**9.5**	3.2	14.3	**3.1**	6.3	8.1
2003	**10.9**	3.4	14.6	**3.1**	6.0	7.8

Source: Eurostat (2003)

Table 4: EU-Libyan trade volume per capita in Euro (compared with Egypt and Algeria)

Year	***Libya***	*Egypt*	*Algeria*
1999	**1,673**	158	418
2000	**2,818**	173	723
2001	**2,636**	153	746
2002	**2,291**	145	720
2003	**2,545**	144	720

Source: Eurostat; (own calculation)

Consequently, the gravity assumption therefore holds for Libya. This is further substantiated if one compares EU-Libyan trade with the small volumes of intra-UMA trade and UMA-Africa in 2002[4]:

Table 5: Comparison of inter-regional trade volumes

Trade Partners	**Export + Import 2002**
Libya-EU	12.6 (bn Euro)
Intra-AMU	1.2 (bn US-$)
AMU-Africa	3.3 (bn US-$)

Sources: Eurostat (Libya-EU), African Development Bank: Intra-African trade be Economic grouping in 2002

5.1 Important indicators of competitiveness and market integration and the position of Libya

A major criterion for beneficial effects of trade and thus market integration is the level of competitiveness and similarity of economic structures. Here a number of different indices are applied. These are the the Balassa-Index and CEPII-Index of Revealed Comparative Advantage measuring the share of products in national export related to the share of the product at the world trade level.

The RCA index (Balassa and CEPII) sheds light on the competitiveness of a country and its trade sectors, but it is not capable to measure the level of market integration between two economies. Here the index on intra-industry trade (Grubel-Lloyd-Index) is useful. A further useful index to measure similarity of product structures in trade is the Finger-Kreinin-Index. With the data available for Libya, the RCA, the Grubel-Lloyd-Index and the Finger-Kreinin-Index are shown in the following tables.

5.1.1 The CEPII-RCA 2001

The CEPII-RCA[5] is defined as follows:

$$y_{ik} = 1000 * \frac{x_{ik} - m_{ik}}{Y_i},$$

where i is the country referred to and k the product group (*Y*, *x* and *m* denote GDP, exports and imports respectively). In case of Libya there is an extreme distribution as the following table shows. Except minerals (i.e. crude), all other product groups reveal a comparative disadvantage.

[4] cf. in this context also the ECB Monthly Report 10/2004 which includes a paper on Economic Integration of selected Regions outside the EU.

[5] Located in Paris, CEPII (Centre d'Études Prospectives et d'Informations Internationales) is a leading French institute engaged in research on international economic issues.

Table 6: CEPII-RCA-Indices 2001

	Libya	
Product group	**CEPII-RCA**	**Rank**
Minerals	356	1
Leather products	-4	2
Cons. Electronics	-8	3
Textiles	-12	4
Fresh food	-12	5
Wood products	-13	6
Clothing	-17	7
Electronic components	-25	8
Misc. manufacturing	-26	9
Chemicals	-26	10
Basic manufacturing	-33	11
Transport equipment	-39	12
Processed food	-67	13
Non-electric machinery	-73	14

Source ITC 2001 (www.intracen.org/menus/countries.htm)

5.1.2 The Grubel-Lloyd-Index and the Finger-Kreinin-Index

The Grubel-Lloyd-index shows the difference or similarity of goods exchanged in foreign trade:

$$GL = 1 - \frac{|X - M|}{X + M}$$

where X means exports and M means imports within any industry. It implies that for a given industry the index of inter-industry trade, GL, is at its maximum of 1, when exports in the related industry exactly equal the imports. On the other extreme, when an industry either has exports but no imports or vice versa, the index becomes zero.

The following table reveals the low similarity of exchange and thus the low market integration of Libya and the EU.

Table 8: IIT-Index for different product groups 2003

Product	**GL**
Food	0
Raw materials	0
Energy	0.05
Chemical products	0.6
Machinery	0.35
Miscellaneous	0.27

Source: Eurostat (own calculations)

Higher values are only achieved for chemical products and machinery, although it is to be borne in mind that the sectoral distribution is highly aggregated (the sorts of traded chemical products differ considerably) and that re-exported items (thus not being produced in Libya) make up a significant share (machinery).

Taking the measure of IIT on the level of the national economy, the following general index (in percentage) is used:

$$GL_{ij} = [\ 1 - \frac{\sum_k \left| x_{ij}^k - m_{ij}^k \right|}{X_{ij} + M_{ij}}] \cdot 100$$

where i and j represent the countries engaged in mutual trade and k the respective sector (cf. Grubel H. and P J Lloyd 1975). Since 1985, intra-EU-trade volumes have grown by 20-30%. Within the European Union the share of intra-industry trade in all trade is more than 55% (except for Greece, Ireland, Portugal and Finland).

Table 9: National Grubel-Lloyd-Index (Libya compared to new member countries and others)

Country	**Year**	**GL**
Libya*	2003	12.5
Czech Republic**	1997	56.6
Hungary**	1997	44.5
Bulgaria***	1995	24.6
Morocco***	1995	18.7

Sources for table Bergs 2004, Kaitila 1999 and Aturupane 1997
*own calculation based on Eurostat (aggregated)
** calculated by Kaitila (1999) at NACE 4 level
*** calculated by Aturupane 1997 at NACE 3 level

In case of EU-Libyan intra-industry trade, the volume is only at 12.5% in 2003, still even much less than the value for Morocco in 1995.

An even more significant picture can be drawn by the Finger-Kreinin-Index of similarity between country j and a reference country r:

$$FK_{jr} = \sum_i \min(s_{kj}, r_k),$$

where j is the country in question, s_{kj} sector k's share in exports of county j and r_i sector k's share of the reference country's exports. Taking the sum of the respective smaller shares, the index ranges between 0 and 1, whereby 0 means total dissimilarity and 1 total similarity of trade. The following table shows a comparison between Libya and selected other countries (Egypt, Belgium and Mali) in their similarity of trade with Italy (Libya's most important trade partner):

Table 10: Similarity of trade (Finger-Kreinin-Index)

Finger-Kreinin-Index 1990[6]	**Value**
$FK_{Libya\text{-}Italy}$	0.079
$FK_{Egypt\text{-}Italy}$	0.531
$FK_{Belgium\text{-}Italy}$	0.886
$FK_{Mali\text{-}Italy}$	0.230

Source: UNCTAD Handbook uf Statistics 2003

The results suggest that, although Italy is considered as Libya's most important trade partner, the sectoral trade structures of both countries are highly dissimilar. The value for Egypt is 6.7 times higher, the index for Belgium reveals a strong similarity of well-integrated EU economies. Even in the case of Mali (a low-income and EU-distant country) the index is significantly above that of Libya.

The above data and indices (chapter 5) give evidence that, on the one hand Libya's major trade partner is clearly the EU, but that on the other hand, the level of market integration and competitiveness in a broad range of products is still very low. EU-Libyan trade is strong, but highly asymmetrical – admittedly not a surprising insight. Direct and immediate positive effects from trade liberalisation with the EU – as a stand-alone measure - are therefore not to be expected. All product classes in table 6, from rank 2 downwards, will not be competitive under free trade with the EU and will be displaced by imports. But what about indirect and longer-run positive effects, as explicitly envisaged in the ENP? It is hard to give an answer for the Libyan case, but the message of the above mentioned study by Dessus and Suwa-Eisenmann on Egypt suggests that such effects should also be considered for Libya.

6. Lessons from Egypt and a second glimpse at Libya

In their study on Egypt, Dessus and Suwa-Eisenmann also critically question the alleged positive effects of a EU-Mediterranean free trade area on the Egyptian economy. However, their empirical analysis shows that there is reason to predict that a partnership agreement with the EU will stimulate diversification of the Egyptian economy in the tradable sectors. In a first step, they simulate a scenario where Egypt simply removes the import tariffs on EU manufactured products and in return Europe grants improved market access for Egyptian goods. There will be significant changes in the sectoral resource allocation, however, the welfare effects are of only minor significance. In a second step, the authors apply a Marshallian export externality capturing the possible dynamic effects from such a structural change[7]. The externality is most probably stimulated by the tighter economic co-operation within the partnership agreement, thus welfare effects are not to be expected by simple factor re-

[6] Composed of (i) food products, (ii) agricultural raw materials, (iii) fuels, ores/metals and (iv) manufactured goods. More recent data for Libya are not available.

[7] Here they refer to the well-known paper of Jaime de Melo and Sherman Robinson (1992), who argue that the neo-classical theory has been unable to explain the success of export-led growth and industrialisation implying rapid productivity growth in a number of developing countries. Therefore, in their theoretical model they decompose growth into the components factor accumulation, factor reallocation in favour of sectors with the highest levels of productivity and arising export and import externalities.

allocations but much more by the accompanying technology transfer streams and by increasing competitive incentives.

If there are clear and fair agreements for market access of Egyptian products and if agreements on standards, trade procedures and product quality are recognised, there will be a strong incentive for market-oriented reforms and productivity improvements. '… If this deeper integration takes place, and if Egypt is able to catch the benefits of the export promotion through an increase in the overall productivity, the outcome in terms of welfare and growth might even be higher than in the case of unilateral trade liberalisation by Egypt against all partners…' (p. 123). Dessus and Suwa-Eisenmann conclude that the real structural adjustment effort is not primarily based on the free trade agreement but on the necessity to diversify the economy and to reduce the dependence of crude oil revenues. In order to avoid an external crisis, a diversification is anyway required.

The same seems to apply for Libya, which is also faced by the risk of external crises, which it has already largely experienced during the 1980s and 1990s. Not only simple diversification, but a strong increase of manufacturing productivity is anyway needed, if Libya wants to lessen the dependence on its depletable crude oil resources – with or without free trade with the EU and the other partner countries in the ENP. This aim has been on the economic planning agenda since the 1960s. The perspective of free trade will however strongly enhance the pressure to pursue courageous domestic reforms in terms of a market-oriented re-allocation of the huge capital resources. Since the Libyan human resource capacities are still too small to absorb the capital economically in building up a modern and diversified economy, a far-reaching re-structuring and privatisation as well as enhanced economic co-operation in terms of FDI and/or business co-operation needs to be boosted very soon. An overall improvement of economic co-operation in terms of clear, fair and reliable mutual agreements, market-oriented reforms, legal security (cf. Bergs 1999) and a further encouragement of EU originated FDI in Libya will probably contribute to diversification and productivity improvements in Libya by incentive and further positive external effects[8]. Surplus export earnings (from oil) ought to be invested abroad (notably the EU) in sectors, where important knowledge spillovers for Libya (technology transfer) can be reaped.

Due to the less advantageous starting conditions compared to Egypt, which economy is more competitive in international trade, it is likely that the efforts of Libya need to be much more courageous. For Libya's pursuit of economic development, a free trade agreement within the ENP can only be a stimulating means, but not the end.

Such a broader view of purposes of trade agreements is also supported by John Whalley (1998) looking at regional trade agreements from an economic history perspective. According to him, countries do not only seek agreements in order to enhance traditional trade gains through improved mutual market access but also (and in some cases even dominantly) as a tool to strengthen domestic policy reforms, to

[8] It should also be noted that an intensified engagement of Libya in the EU research framework programmes or other programmes where Libya is entitled to participate (e.g. the INTERREG IIIB programme ARCHIMED, which from 2007 on will be part of the new Objective 3) could generate high social returns through networking externalities with only little money invested.

benefit from multilateral bargaining power and strategic linkages and to secure market access in the partner countries.

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