

**CAN THE EU ANCHOR POLICY REFORM IN THIRD COUNTRIES?  
AN ANALYSIS OF THE EURO-MED PARTNERSHIP**

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Word Count: 8,900 (excluding abstract)

*EU Politics*, vol. 5, no. 4 (2004), pp. 395-418  
(Printed version available)

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### **Abstract**

The emerging literature on ‘anchoring’ draws attention to non-conventional benefits of regional integration arrangements, which include increased policy credibility. Nevertheless, this literature tends to view the anchoring of policy reform as an exogenously-given option for a reforming country. We demonstrate that anchoring is an endogenously-determined choice, which may guarantee neither optimal levels of policy reform nor effective anchoring unless the relevant contracts are both complete and incentive-compatible. We examine the economic pillar of the Euro-Med Partnership (EMP) to ascertain the extent to which its contractual provisions satisfy these conditions. Our findings suggest that EMP leaves too much room for discretion and does not internalise the positive externalities associated with policy reform. These findings enable us to elaborate on why the EU cannot be expected to function as an effective anchor for policy reform in its trading partners.

## **CAN THE EU ANCHOR POLICY REFORM IN THIRD COUNTRIES? AN ANALYSIS OF THE EURO-MED PARTNERSHIP**

### **Introduction**

‘Anchoring’ is a policy design issue that arises because of the time-inconsistency of optimal policy choices. Kydland and Prescott (1977) have demonstrated that time-inconsistency can be avoided by adherence to domestic rules. If domestic rules cannot be enacted due to political constraints, the time-inconsistency problem can be resolved by selecting an external anchor that would tie the policy-maker’s hands.

In the last decade, the debate concerning the causes and consequences of external constraints on governments has become more diverse. One strand focuses on the motives for and consequences of agreements with the International Monetary Fund (IMF). For example Vreeland (2001, 2003) demonstrates that governments concluding IMF agreements are those who find it difficult to pursue structural reforms because of resistance from powerful domestic interest groups. This finding, however, must be considered in conjunction with those indicating that compliance with IMF conditionality has been limited. (For a review, see IMF, 2001).

Another and more recent strand examines the causes and consequences of increased legalisation in international relations. Goldstein et al (2004) lead a team of international relations and political economy scholars in a special issue of *International Organization* to discuss, *inter alia*, the proliferation of legally-binding multilateral and regional agreements, the extent of compliance with these agreements, and the long-term implications of legalization for international relations. Some findings, for example those of Abbott and Snidal (2004), suggest that governments may be induced to prefer legalization because the latter increases the credibility of policy commitments and reduces transaction costs.

The third strand, which is more closely related to the content of this article, examines the extent to which regional integration agreements (RIAs) between developed and developing countries can anchor policy reforms in the latter. In this context, François

(1997) states that the North American Free Trade Agreement has benefited Mexico by ‘binding’ Mexican reforms and reducing the risk premium on inward capital flows. Galal and Hoekman (1997a: 3; 1997b) are also optimistic that association agreements within the Euro-Med Partnership (EMP) will enhance the credibility of the Mediterranean governments’s (MGs) commitment to policy reform. Specifically, they state that the free trade area agreements ‘can act as an anchor for government policy’ and signal to investors that ‘the government is unlikely to reverse its liberalization policies in the future.’

In this article, we aim to contribute to the ongoing debate by examining the likely impacts of the association agreements (AAs) and EU aid conditionality in the EMP context on policy reform performance of the Mediterranean countries (MCs) that are not EU members. Specifically, we aim to establish the extent to which the EMP contracts may or may not increase the credibility of the MGs’ commitment to policy reform. The credibility of the commitment is measured as the level of compliance with EMP contracts.

The article is organized in two sections. In section 1, we first review the literature on the relationship between external constraints (including anchors) and reform performance in reforming countries. Then, we use a model of exchange to demonstrate that the agreements concluded by an anchor-sponsoring entity (the EU) and an anchor-seeking government (the MG) are endogenous outcomes of strategic interaction between the two and that they do not necessarily ensure an optimal degree of compliance by a reforming MG. In section 2, we pursue two objectives. First, we identify the conditions that must be satisfied to achieve an optimal degree of compliance. Then, immediately after each condition specified, we examine the free trade and aid provisions of the EMP in order to establish the extent to which the latter satisfies the relevant condition. We conclude by pulling together the main findings and comment on the EU’s capacity to act as an effective anchor for policy reform in non-member countries in general.

## **1. Anchoring Policy Reform: A Political Economy Model**

The regional integration version of the ‘anchoring’ literature tends to conceptualise anchors as *exogenously given* commitment devices. What is involved here is that a reforming government chooses to tie its hands with the aim of minimising the risk of deviations from the drive towards trade liberalisation and structural reforms. Our contention is that a reforming MG would not necessarily choose an exogenously-given and binding regime that would tie its hands in a number of trade- and governance-related policy areas. This is obvious from the fact that a reforming government decides on the anchor to be chosen on the basis of prior bargaining with the anchor-sponsoring actor/entity. To the extent that this is the case, the outcome (i.e., the nature of the anchoring device) would be influenced by the political economy of the reforming country and the nature of the exchange between the latter and the EU as an anchor-sponsoring actor.

The political economy of a reforming country may have two opposing effects on its choice of anchor. On the one hand, and as Vreeland (2001 and 2003) demonstrates, a strong domestic constraint may induce a reforming MG to opt for an external anchor in order to overcome domestic resistance to reform.<sup>1</sup> Vreeland’s findings suggest that the larger the number of veto groups in the reforming country are, the more likely it is that the reforming government would seek and conclude agreements with the IMF. In other words, IMF conditionality emerges as a useful anchoring device when domestic resistance to policy change is high. On the other hand, and as Vreeland himself and a large number of studies reviewed below demonstrate, the willingness to conclude agreements with the IMF does not necessarily entail compliance. Therefore, we are faced with the question as to whether reforming countries may be inclined to choose anchoring mechanisms that would be ineffective in ensuring compliance.

Similarly, the nature of the exchange between anchor-seeking and anchor-sponsoring actors may also have opposing effects on anchor choice. To understand why this may be the case, we need to bear in mind that policy reform has some public good characteristics. The benefits that follow policy reform accrue not only the reforming country but also to the anchor-sponsoring actor. Benefits for the reforming country

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<sup>1</sup> The domestic resistance to reform is stronger the more the government’s survival depends on the distribution of protectionist rents and satisfaction of ‘veto group’ demands. On government-interest group relations in general, see Olson (1982). On the negative effect of veto groups on policy change, see Tsebelis (1995).

are straightforward: less policy capture by vested interests; reduced distortions in the domestic economy; higher levels of growth/employment, reduced risk premiums required by international creditors; larger foreign direct investment inflows, etc.<sup>2</sup> Benefits for the anchor-sponsoring actor are no less significant: reduced negative spill-over effects through migration, terrorism or political instability associated with underdevelopment in the reforming country; improved access to the reforming country's market as a result of reciprocal trade liberalisation; increased scope for direct investment flows, etc.<sup>3</sup>

Because of the positive externalities associated with policy reform, the anchor-seeking government would be inclined to link the level of reforms to the contributions that the anchor-sponsoring entity would provide. In fact, it is in the interest of the reforming government to secure the maximum level of contributions and deliver the minimum amount of policy reform, which entails short-run costs. The short-run costs range from weakening political support for the reforming government to adverse effects on income distribution. In contrast, the anchor-sponsoring actor would be motivated to maximise the level of reforms to be realised by the reforming country and minimise its contributions towards the cost of such reforms. Stated differently, the anchor-sponsoring actor would be in favour of stringent anchoring (or conditionality) and minimum level of compensation payments.

These dynamics have been examined widely in the existing literature on IMF conditionality and legalisation of inter-state relations. For example, research findings on IMF conditionality suggest that conditionality has not been effective in securing the expected level of policy reform in recipient countries. One indicator is recipient non-compliance. The rate of non-compliance between 1973-97 is reported by Moussa and Savastano (1999) as 54.5 percent. Interestingly, non-compliance has increased as the IMF has become more experienced in designing and negotiating conditionality.

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<sup>2</sup> We assume that policy reform (i.e., trade liberalisation and structural reforms) produces long-term benefits for MGs. This assumption is based not on hard evidence (which we cannot review due to space limitation) but on revealed MG preferences in favour of international agreements that require such reforms.

<sup>3</sup> This specification is in line with EU preferences revealed in Barcelona Declaration. On the expected benefits of the 'Barcelona process' and the EMP, see Xenakis and Chrysochou (2001).

For example, non-compliance increased from about 50 percent in 1970s to about 72 percent in the 1990s.<sup>4</sup>

Another indicator can be gleaned from Mosley (1987), who finds out that negotiations with the World Bank have generally resulted in unstable compromises – mainly because the tightness of World Bank conditionality tended to be inversely related to the borrowing country's bargaining power. Consequently, conditionality was relatively more punitive on 'weak' countries in need of World Bank lending, but relatively more lenient on 'strong' countries where structural reform rather than lending was necessary.

A third indicator relates to mismatch between IMF structural adjustment credits and the policy environment in recipient countries. Recent work demonstrates that IMF credits tended to favour policy environments that are too weak and to diminish in policy environments that are sufficiently good for funds to be effective. As a result, either disbursement/implementation remains inefficient (Collier and Gunning, 1999); or credits contribute to growth only in countries that are already committed to reform and macroeconomic stability (Burnside and Dollar, 1998). Similar findings led Dollar and Svensson (2000) to conclude that international financial institutions (a subset of anchor-sponsoring actors) have essentially been picking up winners rather than increasing the recipient's commitment to reforms.

More recent studies on the legalisation of international relations also come up with similar findings. For example, Goldstein et al (2004) point out that compliance with judgements of international tribunals or World Trade Organisation (WTO) decisions has been uneven and that unilateral actions continue to take place. This hypothesis is supported by the findings of the case studies in the special issue of *International Organization* referred to above. For example, Goldstein and Martin (2004) conclude that legalization has had only limited effects on national compliance and international co-operation in the area of international trade, despite the fact that legalisation in this policy area has been the most extensive. Goldstein and Martin relate this finding to

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<sup>4</sup> Non-compliance is measured as failure to disburse (or withdraw) at least 75 percent of the total IMF loan under a particular arrangement.

the possibility that legalisation may not enable policy makers to circumvent domestic politics. In fact, the authors argue that the impact of legalisation on compliance is mediated through domestic politics – the very factor that the proponents of anchoring expect to be circumvented.

These findings are not surprising. They are related to the endogenous nature of the international agreements that reforming governments conclude with anchor-sponsoring governments or international institutions. Because of the heterogeneity of the interests and because of the positive externalities associated with policy reform, parties to anchoring arrangements may conclude agreements that are sub-optimal for three reasons. First, heterogeneity of interests requires a high degree of discretion to be enjoyed by both anchor-seeking and anchor-sponsoring actors. That is because discretion enables either party to avoid compliance with existing agreements when compliance is considered to be undermining a vital (national, institutional or regional) interest. Secondly, the positive externalities associated with policy reform are conducive to sub-optimal supply of reforms. This is likely to be the case because the anchor-sponsoring actor would prefer to benefit from the positive externalities without contributing to the cost of policy reform. To the extent that the anchor-sponsoring actor engages in such free riding, the reforming government would reduce the supply of reforms. Finally, the anchor-sponsoring party would be reluctant to contribute to the cost of reforms on the grounds that reforms are essentially an issue for the reforming country and that the benefits of reform accrue mainly to that country.

For these reasons, in the specific context of the EMP, a reforming MG would be inclined to minimise its commitment to reforms and maximise side-payments by EU. This is in order to: (i) facilitate the construction of alliances with domestic actors/groups who would benefit from EU concessions; and (ii) ensure that the EU internalises the positive externalities associated with policy reform. In contrast, the EU would be inclined to minimise side-payments but maximise the extent of compliance with the agreements to be concluded. That is why it is necessary to derive the implications of these considerations at an analytical level that captures the strategic bargaining between the two parties.

We model bargaining between a reforming MG and the anchor-sponsoring EU as an exchange involving two goods: (i) anchoring facility with side-payments; and (ii) policy reform. Policy reform by MG has some public good characteristics in that it reduces the risk of migration and security threats that the EU would face if MGs did not embark on policy reform. In addition, policy reform will be supplied after the EU and MG have agreed on the terms of exchange. Given its public good characteristics and the timing of its supply, policy reform will be supplied optimally only if all beneficiaries contribute to the cost of supply in line with the benefits they would derive.<sup>5</sup>

On the other hand, the good supplied by the EU (i.e., anchoring facility with side-payments) is a composite good. Some of its benefits (e.g., access to the EU market and aid) are rival and excludable. However, other benefits (e.g., the credibility bonus derived from adopting the EU *acquis*.) are non-rival, non-excludable. Unlike reforms, however, the EU *acquis* already exists and its adoption by MG does not increase its cost for the EU. Given these conditions, the EMP could be a sub-optimal anchoring arrangement – as can be seen in Figure 1 below.

(Insert Figure 1 here)

The model consists of two sides' offer curves for two goods with public good characteristics. While the EU offers anchoring facility with side-payments, the MG offers policy reform. EU and MG offer curves are  $O_e$  and  $O_m$ , respectively. Each offer curve depicts the levels of 'exports' that each party is willing to offer in return for given levels of imports. Suppose that both parties agreed to a contract envisaging exchange at point A. Suppose also that the terms of trade are known and given by the gradient of line OT. Then the level of exchange at is optimal for three reasons. First, point A lies on both offer curves, so that any movement along  $O_e$  or  $O_m$  towards the

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<sup>5</sup> The classical contribution to the theory of public good is Samuelson (1956). An accessible treatment is in Boadway and Bruce (1984). For a literature review, see Oakland (1987).

origin will make the EU or the MG worse off. Secondly, at A the marginal rate of substitution in consumption (MRSC) is equal to the marginal rate of transformation in production (MRTP), as given by the slopes of the indifference curves  $I_m$  and  $I_e$  that are tangent to each other. Finally, at A,  $MRTP = MRSC = \text{Terms of Trade (gradient of OT)} = \text{world prices}$ , so resource allocation is efficient.

However, A is not Nash equilibrium, from which neither party has an incentive to deviate. For example, MG would be better off if it could trade at B rather than A. Diagrammatically, this is obvious because the indifference curve at B ( $I_{m2}$ ) is higher than that at A ( $I_{m1}$ ). The substantive reason as to why MG would be better off at B can be seen from the improvement in its terms of trade. At B, MG is importing a higher level of anchoring facility plus side-payments ( $F_b > F_a$ ) in return for less exports of reform ( $R_b < R_a$ ). This is nothing but an improvement in MG's terms of trade.

Therefore, there are incentives for MG to shift on to a new offer curve such as  $O_{m2}$  that intersects with the EU's offer curve at B. The new offer curve indicates that MG has introduced restrictions on imports of anchoring facility and forced EU to increase side-payments in order to counterbalance the effect of reduced demand. Hence, MG's terms of trade improve and those of the EU worsen. At this stage of the game, the EU has two options for improving its welfare: (i) inducing or forcing MG to repeal the restriction it has imposed and return to point A; or (ii) taking an action that would improve its own terms of trade. If the contract is incomplete (i.e., if EMP does not provide for credible sanctioning against non-compliance), the first option is not available. Then EU will have to retaliate by reducing side-payments and improving its own terms of trade through a rightward shift in its offer curve, say to  $O_{e2}$ . Now EU's welfare-maximising level of exchange will be at C, where its offer and indifference curves ( $O_{e2}$  and  $I_{e3}$ ) are tangent.

At C, however, MG is worse off compared to B. Then, MG can be expected to retaliate by a new round of restriction. This strategic interaction leads to two possible outcomes: either no trade at all at point O or a sub-optimal level of trade at any point between O and A. In a seminal article, Johnson (1953) demonstrates that the Nash equilibrium for such a game will be restricted trade rather than no trade. That is because the benefits of restricted trade dominate the loss that each party will incur

when trade is suspended. So, the Nash equilibrium for the EU and MG will imply a positive level of anchoring facilities and reforms, but this level will be sub-optimal compared to the level at A.

## **2. The EMP's Anchoring Capacity: Can It Be Improved?**

The analysis above suggests that bargaining between the EU and MGs does not necessarily lead to optimal anchoring in the EMP context. In this section, we will examine the provisions of the AAs and aid conditionality to ascertain the extent to which this is the case and what the EU can do to emerge as an effective anchor for policy reform in its Mediterranean partners.

### *2.1 Completeness of the agreements*

The analysis above suggests that, to function as an effective anchor, the EMP should leave minimum scope for discretion. Otherwise, discretion would make the agreed and *ex ante* optimal levels of reform and anchoring unsustainable. This is because discretion enables any of the parties to free ride on the efforts of the other. Hence, it would unravel any agreement *ex post*, irrespective of whether the EU and MGs begin with optimal contracts.

Therefore, the first condition (C1) that the EMP must satisfy in order to function as an effective anchor can be stated as follows: *agreements under the EMP must be as complete as possible to prevent biased interpretations and/or ex post non-compliance.* Now let us examine the extent to which the AAs and aid agreements under the EMP satisfy this condition.

Association Agreements (AAs) within the EMP are inter-governmental instruments to which the rules of international public law apply. They can be suspended by one of the parties only if an 'essential element' is not respected by the other. This 'essential element clause', however, refers to compliance with the principles of the UN Charter, such as human rights and political freedom; but does not extend to 'the principles of a market economy'. This exemption demonstrates the extent to which either party can

violate the AA's economic-commercial provisions without incurring the cost of suspension. It is also important to note that AAs' trade provisions can be suspended only by *unanimous* decision of the Council (Flaesch-Mougin, 2000: 83).<sup>6</sup> So, it is easier for MGs to suspend the agreement by invoking the 'essential element clause' than it is for the EU. This asymmetry further reduces the credibility of the EU's threat aimed at securing compliance by MGs.

In addition, AAs provide for the settlement of disputes by bilateral consultations within the Association Council (AC) - a body that monitors implementation and decides by unanimity. Given that the AC is composed of EU and MG representatives, the unanimity rule implies that the AC's role as an enforcer would be highly limited. Of course, there is always the possibility to retaliate, since AAs are based on the principle of reciprocity. Should an MG (or the EU) fail to comply with tariff dismantling schedules for industrial products, the EU (or the MG) can always react tit-for-tat by re-establishing the most-favoured-nation duties (i.e. the usual Common Customs Tariff) on imports originating in the partner.

Tit-for-tat reactions may enable either party to avoid impasse that could be caused by unanimous decision making within the AC, but it does not ensure completeness of the agreement. Consider a situation where an MG fails to comply with AA provisions. A tit-for-tat reaction by the EU may be costly for the non-complying MG, but it cannot ensure the continuity of the agreement. In other words, the EU may well suspend the concessions upon the MG's failure to comply, but it cannot prevent the MG from withdrawing from the agreement. Moreover, tit-for-tat measures are not specified and linked to specific implementation failures. As a result, there is a significant element of discretion inherent in tit-for-tat reactions. Given such discretion, a MG can always accuse the EU with violating the AA or being too excessive/unjust in its reaction – even if in that particular case the EU's tit-for-tat reaction were appropriate.

Similar problems exist in another economic component of the EMP, namely the MEDA Programme under which the EU grants bilateral aid 'to accompany the reform of economic and social structures' in Mediterranean countries (MCs). This is

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<sup>6</sup> This is why it is now so difficult for the EU to consider trade sanctions in the form of suspending the AA with Israel.

provided for in the Council Regulation 1488/96 of 23 July 1996 (the MEDA Regulation), which covers all eligible MCs under a unified framework (see Philippart, 2001; Guggenbuhl and Theelen, 2000; Clara Mira Salama 2002). Slightly less than €1 billion per year, drawn from the EU's own budgetary resources, are distributed on a bilateral basis among 8 MGs, all of which belong to the Arab world. Turkey, as a candidate country, is a beneficiary of MEDA funds but it also receives aid under the 'Pre-Accession Strategy'<sup>7</sup>. In addition to the annual €1 billion drawn from the EU budget, the European Investment Bank (EIB) provides 1 billion Euros for MCs in the form of loans.

The MEDA Regulation explicitly aims to promote good governance in MCs and 'progress towards structural reform'. These aims are additional to the trade liberalisation provided for in the AAs. In addition, the MEDA Regulation provides for Council decisions on the basis of qualified majority if 'an essential element' for the continuation of the support measures is missing. The Council, acting by qualified majority, can take 'appropriate measures' upon a proposal from the Commission. Therefore, the EMP's MEDA component may be closer to a complete agreement compared to the AAs. However, even the MEDA Regulation is still far from fulfilling the requirements for complete contracting.

One reason is that the Council may not be able to act by qualified majority. Given the differences in foreign policy priorities of the member states, it is doubtful that sanctions could be imposed against MGs without a consensus incorporating Spain, Italy, Portugal or Greece who, compared to other member states, tend to place a higher premium on EU-Mediterranean relations. The other reason as to why the MEDA Regulation may fall short of a complete contracting is that the indicative amount earmarked for an MG is linked not only to its country's need, but also to the amount earmarked for other MGs. As Philippart (2001) has indicated, each MG is told on an indicative basis the total amount it is likely to receive, but it is not told what other MGs would be receiving. As a result, the nine MGs compete for one pot of multi-annual financial resources (€3,435 million for MEDA I of 1995-1999 and

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<sup>7</sup> Israel is not entitled to receive bilateral aid, in view of its own development level. Programmes and relations concerning three candidate countries (Cyprus, Malta and Turkey) are monitored by DG Enlargement and not by DG External Relations.

€5,350 million for MEDA II of 2000-2006). So allocations are only provisional and this leaves scope for introducing conditions *ex post*. These conditions may be presented as necessary to ‘take into account’ each country’s reform performance, but they may actually reflect *ad hoc* changes caused by changing EU priorities. Any such discretion would weaken compliance with the contracts because an individual MG does not exactly know if, how and how much it would be rewarded or penalised.

Perhaps one should not read too much into what is hypothetically presented above, because in practice the disbursed and earmarked amounts were more or less the same. The surprise has come with the implementation of MEDA II, adopted in 2000. The EU has decided *ex post* to support the Palestinian Authority beyond what was expected initially and to the detriment of other eight MGs (Mira Salama, 2002). A more damaging example of discretion relates to the practice of earmarking MEDA funds for purposes other than those initially contemplated. For instance the Commission has recently suggested using bilateral MEDA funds to assist Arab countries to contain illegal migration to Europe rather than to undertake reforms that would eventually reduce migration pressure. (See, Commission of the EC, 2002: 6).

The analysis above demonstrates that the AAs and the MEDA Regulation leave ample scope for discretion by both parties. Given this scope for discretion, governmental and societal actors in both the EU and MCs will be motivated to force deviations from the commitments codified in the AAs and the MEDA Regulation. That is because these actors would expect their lobbying/pressure for non-compliance to bear fruit given the scope for manoeuvring that exist for their policy makers. The lobbying/pressure for non-compliance is likely to be higher in the MCs because the latter bear the largest portion of the reform costs and their governments are characterised by a higher degree of vulnerability to interest group pressure. Therefore, as they stand, AAs and the MEDA Regulation may not be conducive to a high degree of compliance by MCs – i.e., the economic pillar of the EMP may not be an effective anchor for policy reform.

## 2.2 *Incentive compatibility of anchoring arrangements*

The second condition that the EMP must satisfy for effective anchoring can be derived from the incentive compatibility of the EMP contracts. As Hurwicz (1973) has demonstrated, contracts are incentive-compatible only if they take into account the welfare-maximising behaviour of the agents involved. To assess the incentive-compatibility of the EMP, we need to focus on the production of the goods traded in Figure 1.

As indicated above, the exchange between the EU and MGs involve policy reform by MGs in return for anchoring facility plus side payments by the EU. These ‘goods’ have some public good characteristics and are produced sequentially. Whereas the anchoring facility (i.e., the trade and trade-related policy regime that the reforming MG would adopt) exists before the EMP contracts, policy reform and side payments occur after the conclusion of the EMP contracts. Under these circumstances, the EU enjoys an inbuilt competitive advantage because it incurs only the cost of side payments (i.e., market access and aid) without any extra cost associated with the exporting of its trade liberalisation regime. The MG, however, suffers from an inbuilt competitive disadvantage because it incurs the cost of reforms as well as reciprocal market access extended to the EU.

This asymmetry in competitive advantages does not eliminate the potential for welfare gains from an optimal anchoring arrangement. However, it increases the probability of non-compliance by the MG. In other words, and as demonstrated in Figure 1 above, the MG is likely to restrict the supply of reform at each level of side payments by the EU. This would have the effect of increasing the MG’s terms of trade and decreasing those of the EU. Faced with this risk, the EU can reduce the probability of unilateral action by the MG by increasing the level of side payments. An increase in EU side-payments makes the MG’s offer curve steeper (i.e., improves the MG’s terms of trade improve).<sup>8</sup> Improved terms of trade would reduce the incentive for the MG to engage in unilateral action. The overall result is that the initial contracts would be more incentive-compatible for the MG and reduce the risk of non-compliance.

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<sup>8</sup> The steeper the MG’s original offer curve ( $O_{m1}$ ) is, the more likely it is to intersect with EU’s offer curve ( $O_{e1}$ ) nearer point B in Figure 1. In other words, the distance between A and B will be reduced and there will be less incentive for MG to violate the contract that envisages exchange at point A.

Then, the second condition (C2) for an efficient EMP design can be stated as follows: *unilateral EU side-payments to MG must be large enough to reduce the cost of reforms and reflect the level of positive externalities associated with reforms in MCs.* Now let us examine the extent to which EU side payments (i.e., financial assistance and market access) under the EMP satisfy this condition.

The objective of EU financial assistance is to help MCs to adjust to the free trade conditions contemplated in the EMP. The avowed intention is to promote (further) economic reform by linking aid to reform performance. In political economy terms it seems natural that the linkage reflects a political compromise among the 15 EU member states, rather than among the 27 members of the EMP. In addition, the MEDA is an EC regulation - not part of AAs providing for industrial free trade between EU and MCs. It is important therefore to note that, legally speaking, the EU 'carrots' (MEDA assistance) and the MC's commitment to eliminate industrial tariffs on EU-originating products are not directly linked. At the most, the link is indirect.

Suppose that a MG implements trade liberalization in accordance with timetables inscribed in the AA. There is no explicit guarantee that MEDA assistance will then increase accordingly. In other words, there is what can be described as asymmetric conditionality. Whereas the EU can condition its increased MEDA assistance to the implementation of the AA provisions, the MG is not in a position to ensure that disbursements under MEDA or EIB loans reflect its reform efforts. There is also inconsistency of time frames: MEDA calendars are administratively linked to the EU's overall multi-annual financial programmes and not to the reform timetables provided for in the bilateral AAs.

Concerning short-run costs to be borne by MCs, the only component that seems to be amenable to fairly reliable evaluation is the amount of fiscal revenue foregone as a result of eliminating customs duties on imports from EU. This is an important issue particularly for Lebanon and Tunisia, but also for all remaining Arab MCs. In Morocco's case, it has been estimated that revenue loss would represent more than 3 percent of GDP at the end of the 12-year transitional period. The equivalent figure for Tunisia would be 6% (Mira-Salama, 2002). Other sources indicate that revenue losses as a share of total tax revenues would be 19% for Algeria, 16% for Tunisia, 12% for

Jordan, 10% for Morocco, 8 % for Egypt and 7% for Syria (Nienhaus, 1999: 509). There are also other empirical studies produced by international institutions such as the World Bank, the IMF or some NGOs and academic independent researchers evaluating trade, employment and welfare effects of the association agreements (see, for example, FEMISE, 2000; Ghesquiere, 1998; Havrylyshyn, 1997).

However, what is far more important for MC leaders but much more difficult to assess are the short-run costs and risks associated with implementation of trade liberalisation and other policy reforms. For instance, how to gauge the risks involved in having to replace customs duties by new taxes, such as VAT? How will the business community react to that? What about political parties and the public at large? Evidence from the case of Malta, where the introduction of VAT led to the downfall of the pro-EU conservative government in 1996, shows what might be at stake. What about cutting public expenditure, such as food consumption subsidies? Is that not likely to lead to riots, as was the case in Egypt (1977), Tunisia( 1978, 1984), Morocco (1981, 1984), Algeria (1988) and Jordan (1989). (See Richards and Waterbury, 1996: 268).

Despite measurement difficulties, however, we can rank-order the MCs in terms of their standing on the reform ladder and the level of EU assistance they receive. Table 1 below is presented for this purpose. The MCs' standing on the reform ladder is based on a composite index consisting of their ranks in the following areas where World Bank data is available: trade as percentage of GDP (trade openness), net private capital flows (indicator of macroeconomic stability and good governance); foreign direct investment as percent of GDP (indicator of good governance and protection of property rights), private fixed investment as percentage of gross domestic fixed investment (indicator of private sector involvement); and stock market valuation (indicator of the depth of the capital market). Obviously, the composite index thus defined may not be a reliable indicator of the country's standing on the reform ladder. That is mainly because some components of the index are influenced by country size – in addition to its reform achievement. Nevertheless, the resulting index can still be taken as a meaningful indicator of reform because the size effect work both ways: while it makes the country seems less open (hence lower on the

reform ladder) in terms of trade/GDP ratio, this bias is counterbalanced by an upward bias implied by the stock market capitalisation figures.

(Insert Table 1 here)

A quick glance at Table 1 clearly reveals that the per capita MEDA assistance received is not closely related to the level of reforms achieved by end of 1999. The weak correlation is an indicator of EU's inability to act as an effective and credible anchor for reforms in MCs – in both *ex ante* and *ex post* conditionality terms. If MEDA assistance was conditioned on *ex ante* reform promises, lack of correlation means that MCs that kept their promises were not rewarded accordingly. If, however, MEDA assistance was conditional on actual performance, lack of correlation implies that MCs failing to undertake reforms were not penalised. Of course, one can argue that Turkey is an outlier because of the Greco-Turkish disputes that led to the Greek veto of financial aid to Turkey. However, this is an exception that proves rather than disproves the discretion/uncertainty involved. It strengthens the impression that MEDA assistance seems to be highly sensitive to foreign policy considerations, concerns about immigration risks, or straightforward favouritism. (On the contrast with what was expected by Bretton Woods institutions, see Alonso-Gamo et al., 1997: 35).

### *2.3 Discounting rates and the effectiveness of the EMP anchor*

The third condition for ensuring that the EMP functions as an effective anchor is derived from an implicit assumption that underpins the model in Figure 1. The model assumes that the future benefits of anchoring reforms are not discounted. This assumption implies that the EU and MGs have the same discount rate of zero. This assumption, however, is not realistic. Existing signals suggests that the EU tends to emphasise the long-term benefits of the partnership, which are specified as improved competitiveness/efficiency, stable macroeconomic environment, stable institutions, etc which are conducive to economic and political stability and security in the region. MCs, however, tend to be concerned about short-term benefits such as improved market access, financial aid, immediate flows of foreign direct investment, etc. These signals indicate that MCs discount the future more heavily than the EU.

As Cramton (1985: 172) has indicated, bargaining games tend to produce inefficient results when the buyer's discount rate is higher than that of the seller. If the buyer's discount rate is higher, the future value of the exchange is declining fast for the buyer. Given declining future value, the exchange must take place sooner rather than later. Otherwise, the exchange may not take place at all. Under this condition, bargaining does not lead to an improvement on the *ex ante* outcome that dominates the outcome of sequential bargaining. According to this finding, lengthy bargaining on reciprocal trade liberalisation and side payments is inefficient in increasing the probability of implementing the EMP contract. Then, the *third conclusion (C3)* about the EMP's design can be stated as follows: *the EU must come up with front-loaded side-payment offers, which must be as close as possible to the eventual offers and increase as the MG's future discount rate increases.* This condition also has some parallelism with the findings of Kennedy (1995), who demonstrate that side-payments by developed countries have increased the probability of successful completion of the Uruguay Round.

When examined in the light of this condition, it can be seen that the EMP has not resulted in new and significant EU trade concessions to MCs. Previous cooperation agreements already provided for duty-free access for MCs' industrial exports (since 1 July 1977). In fact, the only trade-related concession made by the EU was elimination of a few remaining restrictions on textile and clothing imports. However, this concession came at a time when the EU had already agreed to phase out the Multi-Fibre Arrangement (MFA) restrictions against other developing countries by 2005. This was a result of the 1994 agreement on textiles and clothing during the Uruguay Round negotiations.

The Commission, in its initial proposal of October 1994, *did* ask member states to make some offers in the agricultural domain but, the Barcelona Declaration of November 1995 did not contemplate free trade in agricultural goods at all. Generally, bilateral AAs state that five years after the agreements were signed, negotiations on agriculture shall take place, but no time limit is set about when they must be concluded. In addition, EU tends to detach agricultural concessions from MC's overall liberalisation effort. Instead, it insists on reciprocity at sectoral level. True, at the EMP level, there

is some discussion about reforming the common agricultural policy (CAP) with respect to goods significant for MCs. However such reform would not result from the EU's need to accommodate the trade interests of MCs but rather those of the United States and Latin America, a *sine qua non* for the 'Doha Round' and EU-Mercosur negotiations, respectively, to succeed.

Secondly, the EU failed to come forward with meaningful concessions with respect to rules of origin and cumulation. In a document prepared for the Barcelona Conference, the Commission was willing to consider the possibility of cumulating value in different MCs for the purpose of defining the origin of products benefiting from duty-free treatment in the EU (Commission of the EC, 1994). However, diagonal cumulation (as this particular form of cumulation is called) has not been put in place seven years after the EMP was launched. In fact, it is not likely to be introduced at all because since then the Commission has changed its mind about the form of cumulation it wants to introduce. In 2001, the Commission accepted, in principle, that MCs should be incorporated in the Pan-European cumulation system (which includes Eastern European countries). If implemented, this could potentially be a huge bonus for Eastern Mediterranean countries in particular - where input complementarities seem more prevalent than the Maghreb.

However, a document prepared for the meeting of Euro-Mediterranean Foreign Ministers in Valencia in April 2002 leaves no doubt that the Pan-European system of cumulation will take a very long time to introduce – if it is introduced at all. That is because the system would require: (a) agreement of all current members of the pan-European system (including CEECs); (b) amendments in the association agreements; and (c) MCs concluding free trade agreements with identical rules of origin. (See, Commission of the EC, 2002).

It is obvious that pan-European cumulation would be a more generous regime than the one contemplated previously, but it will take much more time to implement in view of what is said above. The whole idea may be turned into a joke if, at the date of implementation, most-favoured-nation (MFN) tariffs applied by the EU become

redundant as a result of the coming Doha Round.<sup>9</sup> Cumulation makes sense only insofar as there is a sufficiently high preference margin justifying the time and money to be spent by Mediterranean industrialists in order to comply with (cumulated) rules of origin - e.g. maintaining separate stocks according to their origin, separate accountancy systems, lawyers' fees, etc. In addition, and even if cumulation became applicable and remained meaningful, it would no longer be related to the original aim – which is inducing and anchoring policy reform in MCs.

This apparent lack of front-loaded EU concessions must be considered in conjunction with incentives for MGs to deviate from the reform commitment. Table 2 below demonstrates that almost all MCs for which data is available (except Algeria and Syria) have been constantly running deficits in their trade with the EU. In addition, the trade deficit tends to increase over time (Youngs, 2001). According to FEMISE (2000), MCs' trade deficit with the EU increased from 46% of their total trade deficit in 1992 to 58% in 1997 and 60% in 1998 - amounting to US\$30 billion in 1998 instead of US\$12 billion in 1992. Under these conditions, it is highly likely that import-competing Mediterranean producers would intensify their pressure on MGs to frustrate their commitment to reform. Instead of providing meaningful concessions that would enable MGs to strike alliances with exporter-oriented producers, the EU has basically left its partners to fend for themselves.

(Insert Table 2 here)

The evidence above suggests that the EMP is designed in a way that contradicts the third condition indicated above. For a reforming MC, the partnership seems to imply having to deliver trade and other economic reforms *now* without getting any tangible trade concessions from the EU even in the foreseeable future. Under this condition, the EMP becomes an essentially short-term bargain - whereby MCs benefit from *increased MEDA grants and EIB loans* and not long-term benefits of economic reform, which the EMP was supposed to 'anchor'.

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<sup>9</sup> The average CCT on industrial products is currently less than 4 percent (Pelkmans and Brenton, 1999:104).

The underlying assumption of the EU is that its increased financial assistance can compensate for the absence or market access concessions. However, the amounts of aid needed to extract MCs from their current predicament are both very large and unavailable.<sup>10</sup> There is no political will in the EU to have the equivalent of the Marshall Plan for these countries. Some numbers shall help illustrate this point.

Using 1999 as a benchmark, the EU had committed itself to distribute to each of the citizens of the 9 relevant MCs (representing a population of 224 million people) about €9, half of it in the form of loans from the EIB.<sup>11</sup> But even if the aid programs are streamlined, as is the case for MEDA II, it is unrealistic to believe that €9 per year per capita can be instrumental in reforming or transforming economic reality (Telo, 2001: 182; Escribano and Lorca, 2001: 54). The argument that MEDA can be interpreted as a ‘signal’ to foreign investors would be too far-fetched<sup>12</sup>. As a point of reference, let us bear in mind that the US has been transferring each year US\$ 2.2 billion (i.e. €2.5 billion) to Egypt alone since 1979. This is more than three times the annual average of MEDA assistance to the whole region under MEDA II and, to date, US assistance has had little effect on policy reform in Egypt or inward FDI.

## Conclusions

The analysis above reflects serious shortcomings in the economic pillar of the EMP as a potential anchor for policy reform. On the one hand, AAs and the MEDA assistance framework are essentially ‘incomplete’ contracts that leave substantial scope for discretion by the EU or by MCs. On the other hand, AAs and the MEDA framework reflect an EU preference to avoid ‘public bads’ associated with economic underdevelopment and political stability in MCs, but they do not reflect an EU commitment to the cost of avoiding such public bads. This is in conflict with the theory

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<sup>10</sup> This point has been underlined by many scholars. See, for example, Marks (1996 : 16); Romeo (1998: 30-31).

<sup>11</sup> This is less than 1% of GDP. In practice, the amounts actually disbursed were much smaller mainly for administrative reasons. By way of comparison, Portugal and Greece have received support from the EU over the last 5 years equivalent to 2.7% and 3.7% of GDP.

<sup>12</sup> On the contrast between MEDA and pre-accession strategies for Central European candidates, see Bevan et al. (2001).

of public goods, which predicts that the latter will be under-supplied unless all potential beneficiaries contribute to the cost of their supply.

That is why economic concessions that the EU offers for the establishment of a ‘zone of shared prosperity’ through a ‘real partnership’ are not only insufficient but also too back-loaded to entice Mediterranean politicians to ‘tie their hands’. In our opinion, the attractiveness of the EMP as an anchor for policy reform in MCs could have been increased if the association agreements had contained more tangible and immediate trade concessions - especially in agriculture, processed food and with respect to rules of origin (as proposed more than a decade ago by Tovias, 1992: 125-7). By the same token, we also think that the reliance on financial assistance is a misguided strategy for two reasons. First, the contractual framework is neither ‘tight’ nor ‘fair’ enough to ensure that MGs embark on and remain committed to policy reforms. Secondly, and even if the ‘completeness’ and ‘fairness’ conditions are satisfied, the impact of financial aid on policy reform is ‘fungible’. To the extent that this is the case, financial aid boils down to income transfers rather than anchoring policy reform (on this, see Cook and Sachs, 1999: 437). The opening of new export markets through EU concessions, however, reduces the domestic pressure on the reforming MGs directly and allows Mediterranean politicians to strike alliances with export-oriented producers.

In the light of these findings, we conclude by arguing that the EU’s capacity to act as an effective anchor for policy reform in non-member countries is highly limited. The limitation is due to three factors that render the endogenously-determined anchoring arrangement sub-optimal. The first fact is discretion. Both the EU and its trading partners (with the exception of candidates for EU membership who are faced with tighter conditionality and greater rewards) tend to prefer a high degree of discretion built into trade and co-operation agreements. As a result, the risk of non-compliance (i.e., the risk of anchor failure) is high.

The second factor that weakens the EU’s anchoring capacity is the limited amount of side-payments (especially market access) that the EU is prepared to offer in return for policy reform by its trading partners. The EU’s side-payments can be increased only if EU governments, like reforming governments, can find a way out of their current

vulnerability to pressure from their own veto groups such as agricultural lobbies or industrial producers who have to compete with imports from trading partners.

The third factor that contributes to the weakness of the EU as an external anchor is the EU policy-making process itself. In this process, national governments are essentially veto players who, like veto players at the national level, are able either to capture the rule-setting body or to stall decisions in policy areas deemed to be 'sensitive'.

Therefore, the EU's approach to policy reform in its trading partners is highly likely to be influenced by changing foreign policy preferences of some member states or by changes in the compositions of the member states through enlargement.

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Figure 1: Optimal and Sub-Optimal Levels of Policy Reform and Anchoring

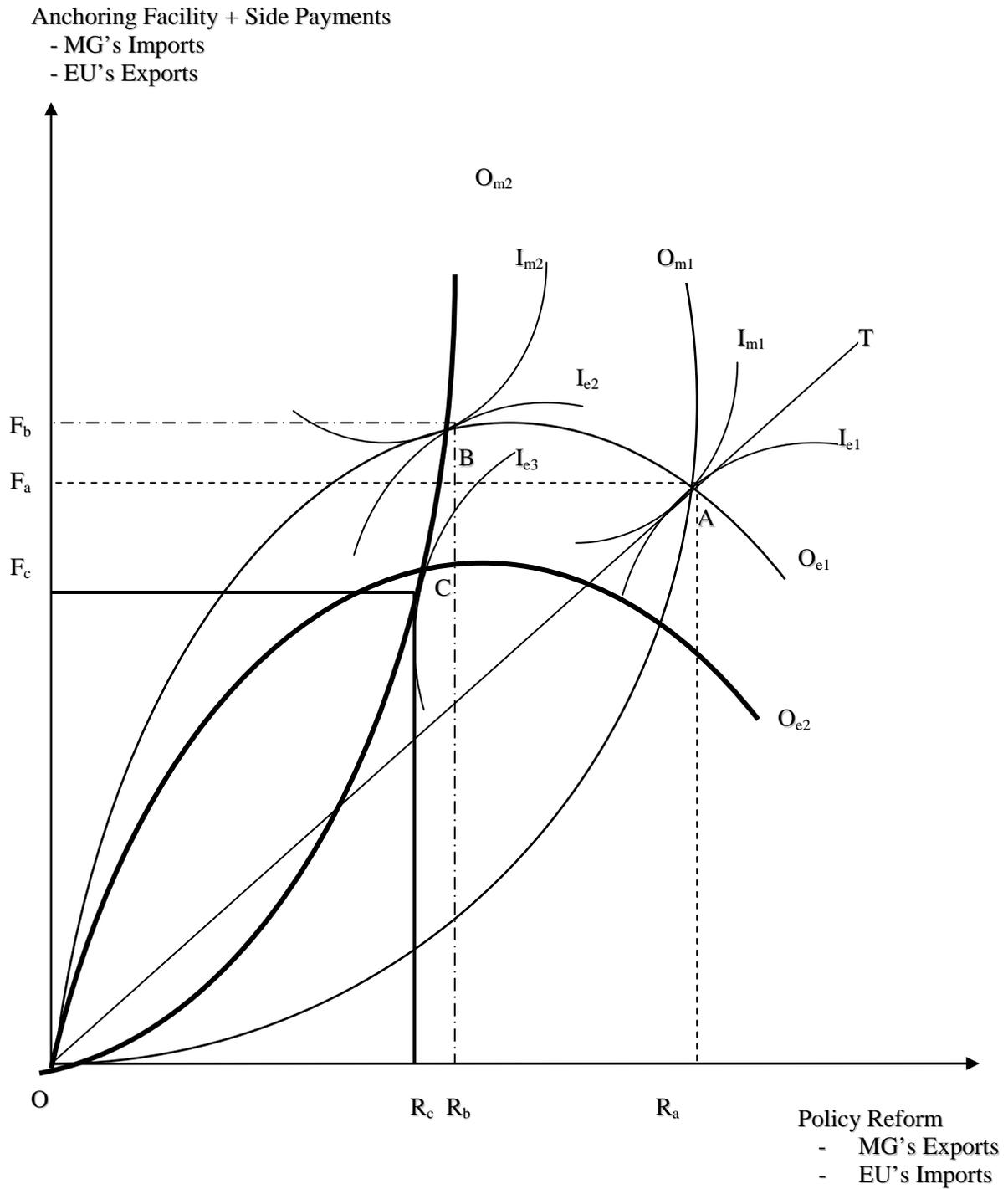


Table 1: Reform v. MEDA Assistance Ranking

Country	Reform rank(1)	MEDA rank(2)	MEDA assistance(3)
Algeria	1	1	1.40
Morocco	2	5	6.01
Syria	3	3	1.66
Egypt	4	4	2.84
Tunisia	5	6	11.61
Jordan	6	7	14.30
Turkey	7	2	1.50

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Note:

(1): Higher reform rank indicates higher level of reform by the end of 1999.

(2): Higher MEDA rank reflects higher per capita MEDA assistance received.

(3): MEDA commitments in Euros: per capita per year, 1995-1999.

Source: World Bank Atlas (2001) for components of the reform index; Philippart (2001) and DAC (2000) for MEDA rank and assistance.

Table 2: Trade balance of MCs with the EU

	1987	1992	1997	1998
Algeria	1347	3859	3889	1712
Egypt	-2691	-1483	-3410	-4781
Jordan	-832	- 937	-1129	-1046
Morocco	-561	- 758	-1265	- 840
Tunisia	-431	-1545	-1438	-1664
Syria	-331	576	811	-24
Turkey	-954	-2723	-12621	-10631

Source: FEMISE (2000: 105)