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The impacts of the proposed EU-Libya trade agreement

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Libya has not become a member of the Barcelona process or the Union for the Mediterranean. However, since the lifting of sanctions applied after the Lockerbie crisis, it has sought closer economic ties with the countries of Europe and more widely, and has entered into negotiations with the European Commission (EC) for an EU-Libya trade agreement. Although the Libyan leadership has shown little enthusiasm for a close relationship with the European Union, both parties might expect to gain economically from the proposed trade agreement. Analysing the potential details of the agreement can provide close insight into the nature and magnitude of these gains as well as possible losses and related social and environmental effects. In evaluating these potential impacts this paper makes use of the findings of a Sustainability Impact Assessment (SIA) study undertaken for the EC[1], along with other research conducted by the authors. A similar study for the other countries in the Euro-Mediterranean Free Trade Area was completed in 2007.[2]

Libya's rich endowment of oil and natural gas makes it an important trading partner for Europe and potentially for the rest of the region. In common with other southern and eastern Mediterranean countries it also has considerable potential for solar energy. The country relies heavily on imports of both manufactured goods and agricultural produce. Its agricultural capability is limited by severe water resource constraints, with concerns for the depletion of aquifers shared with its immediate neighbours. Libya has a growing fishing industry, which contributes to concerns over the depletion of Mediterranean fish stocks. It makes extensive use of migrant labour, and is also a conduit for immigration into Europe. These and other factors would be affected by the proposed trade agreement,

[1] www.iemed.org/anuari/2010/aarticles/George_Miles_Prudhomme_Libya_en.pdf (English), http://www.iemed.org/anuari/2010/farticles/Georges_Miles_Prudohomme_fr.pdf (French)

with potentially significant beneficial or adverse impacts in Libya, the EU and other Mediterranean countries.

Economy-wide effects

Most of the benefits that Libya and the EU can expect to gain from the proposed trade agreement arise from specific aspects under negotiation, rather than from the economy-wide effects of reducing trade barriers. In the SIA study the magnitude of the economy-wide effects was estimated using a computable general equilibrium (CGE) economic model[3], which was also used to give an indication of the indirect effect on capital accumulation, and the potential magnitude of impacts from trade facilitation (one of the deeper integration measures in the negotiation agenda). Two scenarios were examined. A 'modest' liberalisation scenario assumed a reduction of existing barriers (which are primarily non-tariff) of 90% for goods and 50% for services, while an 'ambitious' scenario assumed 97% for goods and 75% for services.

The results were roughly proportional to the degree of liberalisation postulated. For goods liberalisation the two scenarios were similar and gave similar impacts, whereas for services the impacts were significantly larger for the more ambitious scenario. In the EU the direct economy-wide effects are close to zero, since trade with Libya is only a small proportion of the EU's total trade. Within Libya, goods liberalisation is expected to give a small decrease in economic welfare, countered by a larger gain from services. For goods and services combined the overall direct effect was estimated to be a welfare increase of 0.4% for the modest scenario and 1.4% for the more ambitious one, accruing over a period of up to ten years. Although the economy-wide effect is bigger for Libya than for the EU, it is dwarfed by the impact on the Libyan economy of volatility in world oil prices.

The net effect on economic welfare is the result of significant increases in production in some sectors and decreases in others. Construction activity in Libya is projected to increase by up to 6%, while other services decline by up to 8%. There would be a small adverse effect on the overall unemployment level during the transition period, but this is not expected to be significant in national terms. Wages are projected to rise by about 5% in construction and fall by about 7% in commercial services. Growth of the construction industry would increase demand for migrant labour, which may exacerbate existing social tensions.

Significant concerns arise for Libyan manufacturing industry. The modelling scenarios project a rise in imports of over 30 percent of domestic production.

Agriculture, Fisheries and Processed foods

Unlike other countries in the region, Libya has little potential for increased agricultural exports to the EU because of severe water resource constraints. As measured by value at import prices, the country imports nearly half its food. The economic modelling results indicate that goods liberalisation would increase Libya's agricultural imports from the

EU by about 8% (mainly meat and dairy produce), with a corresponding small decline in domestic production of a little under 1%. The associated social and environmental impacts are expected to be small.

Larger impacts are expected for liberalisation of processed foods. Libyan imports are projected to increase by up to 16 per cent of domestic production. The exposure to greater competition would increase incentives for improving the productivity of the Libyan food processing industry, but the country is poorly placed to take advantage of economies of scale in expanding the industry to tap EU markets. Because of its water supply constraints Libya's agricultural production is insufficient to meet its own food needs, and is unlikely to become an economically competitive source for processed exports. It is therefore considered probable that liberalisation would lead to a long term decline of the industry, with increasing reliance on imports of both agricultural produce and processed foods.

Liberalisation of the fishery sector has potentially large environmental impacts, varying according to any conservation measures that might be adopted in parallel. Libya's domestic production supports over 95 percent of its consumption and is a growing export industry. The main export is bluefin tuna, exported mostly to Japan. The presence of large quantities of bluefin tuna in Libyan waters offers considerable opportunities for further expansion. If the trade agreement were to include duty-free and quota-free access to the EU market, then unless parallel measures to constrain production were implemented, Libyan production for export to the EU is expected to increase significantly, aggravating existing and severe overfishing.

The energy sector – oil, gas and solar

Libya's oil and gas industry is its main source of income, with the major share of exports going to the EU. The inclusion in the trade agreement of closer cooperation on financing and technology for the industry offers large potential benefits to the EU, both through greater energy security, and financial gains to the European energy and financial services industries. Libya would benefit from increased national income through expansion of the industry. There is significant potential for greater exports to other countries as well as to Europe, including the USA and China, but the shorter transport links to Europe tend to favour closer cooperation with the EU.

The principal issues of concern are the impact on climate change that would arise from maintaining Europe's dependence on imported fossil fuels, and the long term un-sustainability of Libya's oil and gas industry. While proven reserves are sufficient to maintain the country's national income at its projected level for about 50 years, most of the recent exploration by international oil companies has not borne fruit. Even if further exploration were to yield significant new finds, the industry cannot remain the pillar of the country's economy indefinitely, particularly if effective international measures are agreed upon to combat climate change. Further concerns arise from other environmental impacts associated with accelerated expansion of Libya's oil and gas industry. These

would add to existing pollution impacts and the degradation of biologically sensitive areas.

Libya also has major potential in solar energy. Its proximity to Europe again works in favour of close cooperation. The annual average solar radiation received in most of southern Libya is more than twice that in southern European countries, which is itself considerably greater than in northern Europe. It has been estimated that solar energy imports could make a major contribution to meeting Europe's energy needs. In contrast to Europe, southern Libya is sparsely populated and well suited to solar installations that could, if well designed, have minimal adverse social or environmental impacts. Similar considerations apply to the other Maghreb countries and to a lesser extent those of the eastern Mediterranean.

Key Services Sectors

Although Libya is only a small market, the EU would gain from obtaining greater market access for its services industries. Liberalisation also offers potential gains for Libya, along with significant risks.

The modelling study indicated that liberalisation of *financial services* could result in a contraction of the Libyan domestic industry of up to 8 percent, but with improvements in the sector's efficiency and its contribution to the growth of other sectors. The exposure to competition could be expected to stimulate efficiency in the domestic industry, alongside dangers that it could develop the same weaknesses as have been exhibited by many international financial services industries. The experience of financial crises in other regions, reinforced by the current global crisis, has demonstrated the dangers of financial liberalisation that is not supported by a strong regulatory and institutional framework.

The Libyan *telecommunications* sector has expanded dramatically since the 1990s, with plans for considerable further expansion. Privatisation of the state monopoly is not currently planned, but foreign companies have made major contributions to the development of a modern network. There is no clear evidence that a preferential agreement favouring EU suppliers would further benefit the sector.

Liberalisation of *construction services* offers potential for significant economic gains in both the EU and Libya, particularly if the agreement were to include increased mobility to Europe of Libyan workers. If liberalisation were restricted to professional staff it would still tend to stimulate trade in both directions, since Libya's construction industry is reasonably well developed, and has the potential to compete in EU markets as effectively as European companies compete in its own.

Liberalisation of *distribution services* would favour EU suppliers with highly sophisticated technologies and management techniques over the more traditional Libyan outlets. The number of small traders can be expected to decline significantly, with a smaller number of jobs becoming available in new outlets, and potential for a degree of

social unrest. The economic welfare gain from liberalisation comes mainly from lower consumer prices, particularly for higher income urban communities. Appropriately regulated liberalisation can be expected to stimulate the development of modern distribution companies in Libya.

Tourism has been identified by the Libyan government as a key growth industry, and steps have already been taken to encourage inward investment. However, the proposed trade agreement itself is not expected to make more than a minor contribution to the planned expansion of the industry.

Deeper integration

As well as aiming to reduce barriers to trade in goods and services the proposed trade agreement includes provisions for deeper economic integration, covering trade facilitation, investment, public procurement, competition policy and intellectual property rights.

Trade facilitation reforms aim to reduce the costs involved in the cross border movement of goods and services. Little information is available on the magnitude of these costs in Libya, although significant savings are likely to be possible, with consequent benefits to both Libya and its trading partners. However, many hurdles must be surmounted in undertaking reforms, including complex institutional and political issues. High trade transaction costs generally have many interrelated causes, which need to be tackled comprehensively for the reform programme to succeed. The proposed agreement with the EU is not expected to have a major impact, although the inclusion of technical assistance from the EU would help to facilitate more rapid action than would otherwise be possible. The benefits and risks of committing to reform within a trade agreement are unclear.

In negotiating any *investment* provisions in the trade agreement, Libya should consider how to balance attracting foreign investment appropriate to its needs and retaining control of industries it regards as strategic to its future development. Allowing greater freedom for investments in mergers and acquisitions would make no contribution to developing Libya's capital stock, while transferring the profit on the capital from domestic to foreign investors. The main benefit to the country would come in particular from investment in modernising its technological base, particularly if the technologies used by investing companies are taken up by local firms.

If the provisions for *public procurement* are restricted to increasing transparency the impacts are expected to be small. If they go beyond transparency to include national treatment for EU suppliers, the potential economic impacts are bigger but difficult to quantify. Little research has been done into the economic impacts of open tendering, even within Europe's own single market, and even less for developing countries. Much is often claimed for the benefits of including binding commitments in a trade agreement, but the evidence is not sufficient to make a convincing case.

Libya lacks comprehensive *competition law and policy*, as is common in developing countries that have yet to implement an extensive privatisation programme. There is a strong economic case for Libya to introduce and strengthen national competition laws and policies as it develops its privatisation programme, but with provisions that are specifically tailored to its own evolving needs.

The main benefit to Libya of including provisions for *intellectual property rights* in the trade agreement would be as preparation for WTO membership. In seeking membership of the WTO, Libya will need to implement the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs). However, the benefits of TRIPs apply mainly to those countries whose technological development has progressed to the stage where they need protection of their own innovations in global markets. This is not yet the case for Libya, which would benefit even less from the TRIPs-plus provisions that are common in Europe's bilateral agreements. Strong IPR protection could be advantageous for promoting the use of modern technology in Libya's infrastructure and its major current industries, notably the oil and gas extraction industry, while a degree of laxity in the early stages might help to facilitate diversification of the economy into other high technology sectors.

Conclusions and recommendations

The main potential benefits to both the EU and Libya from the proposed trade agreement come from closer cooperation in the energy sector rather than from the economy-wide effects of reducing trade barriers. The agreement may also have significant adverse effects that need to be taken into account. Although the net effect on economic efficiency is small in both Libya and the EU, it would be associated with structural changes in the Libyan economy that are considerably larger. In particular, liberalisation could lead to a long term decline of the country's manufacturing and food processing industries, unless accompanied by effective government intervention enabling these industries to respond positively to the increased competition from European suppliers. Financial and telecom liberalisation should both be approached with caution, and stronger regulation and appropriate phasing-in of reforms would be needed in order to mitigate potentially adverse effects in the construction and distribution services sectors. Further concerns arise over the potential impact of fisheries liberalisation on the sustainability of the entire Mediterranean tuna industry. Subject to the details of the trade agreement, it could add significantly to the risk of a collapse in stocks of bluefin tuna, and heighten the need for much stronger conservation measures by Libya, the EU, and other Mediterranean countries that exploit the resource.

Greater cooperation between the EU and Libya on trade facilitation measures is not expected to have large impacts, but the provision of technical assistance from the EU would help to strengthen Libyan efforts to address the inefficiencies, benefiting the country itself and all its trading partners. The other proposed measures for deeper integration would tend to benefit the EU more than Libya, with significant risks for Libya unless they were designed to meet the country's specific needs.

Closer cooperation on the development of Libya's oil and gas industries could be highly beneficial to both parties in the short to medium term, but would need to be accompanied by effective measures to strengthen environmental regulation. However, expansion of these industries would accelerate the long term decline of the resource, while reinforcing Europe's dependence on fossil fuels and its adverse impact on climate change. By contrast, closer cooperation in the development of solar energy could make a major contribution both to Europe's long term energy needs and to the long term prospects of the Libyan economy, while at the same time helping to tackle climate change. Since other Mediterranean countries have similar potential, a cooperative region-wide programme on solar energy development would be highly desirable. Such a programme is expected to take at least two decades to bear fruit, and should therefore be pursued as rapidly as possible.

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