Towards modernization of the Pan-Arab Free Trade Area Agreement

Summary

The present document investigates the reasons behind underperformance of the Pan-Arab Free Trade Area (PAFTA) agreement, through examining hindrances to its full implementation and its internal limitations. The document compares the provisions and content of selected key chapters of the agreement with other relevant trade agreements, with a view to identifying necessary changes and potential ways forward for PAFTA modernization. Indeed, the agreement should be modernized in order to foster free movement of goods, services, capital and persons across the region, in a world that is quite different from that when the agreement was first put together.

The document focuses on the following components: (a) rules of origin; (b) non-tariff barriers; (c) dispute settlement mechanisms; and (d) inclusion of services, movement of capital and labour, intellectual property rights and competition policies, among others, under PAFTA. It shows that what was done so far on these issues is insufficient to provide the necessary discipline to move quickly, safely and at affordable cost goods, services, ideas, capital, and technicians. A modernized PAFTA would permit development of production networks, by enhancing doing business in the Arab region, providing assurances for tangible and intangible assets, improving local business conditions, and advancing regulation harmonization and convergence.

The Committee on Trade Policies in the States Members of the Economic and Social Commission for Western Asia is invited to review the proposals made in the present document and make comments on the way forward.
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Introduction

1. Economic integration schemes aim at facilitating and fostering structural transformation within member countries, with a view to improving effectiveness of allocation of available resources; developing new comparative advantages; strengthening competitiveness; enlarging the market available to firms that can then benefit from economies of scale and technological transfers in upgrading and widening their production base. Under the right circumstances, trade agreements should lead to trade creation among their members, while minimizing trade diversion and deflation. In the end, the goal is to foster economic growth, improve living standards and discourage conflicts through creating an area of shared prosperity.

2. These desirable outcomes were at the core of the Pan Arab Free Trade Area (PAFTA) agreement, signed in 1997 and fully implemented in 2005. Initially, the agreement covered trade in goods. Trade in services and movement of capital were subsequently addressed after 2005. In 2006, eighteen of the twenty-two countries of the League of Arab States joined forces and numerous ex ante studies have been produced evidencing PAFTA’s great potential to help its members achieve expected development goals, building on existing historic, social and cultural ties.

3. Twenty years later, the vast majority of empirical investigations indicates that the achievements of PAFTA continue to fall short of expectations, especially when compared to its contemporaries, such as the North American Free Trade Area (NAFTA), established in 1995; the European single market, launched in 1992; and the free trade agreement (the AFTA), signed among countries of the Association of Southeast Asian Nations (ASEAN) in 1992. Among the many reasons advanced, the main one is the narrow focus on goods at the onset.

4. This parliamentary paper shows that it is not only urgent to fully implement the PAFTA agreement, it is also necessary to modernize it to make it relevant to the reality of regional economic integration and globalization. ‘New generation’ agreements cover tariffs and non-tariff barriers, services, investment, intellectual property, government procurement, and coverage of such agreements is expanding. Some agreements also tackle the issue of competition policies and their harmonization among members so as to create a level-playing field. Emphasis is often put on policy cooperation and convergence, with a view to reducing the potential market-segmenting effects of policies.

5. The first section of the paper describes the changing reality of economic integration since the PAFTA agreement was signed, largely driven by creation and extension of global and regional value chains. It shows that, in this context, PAFTA offers limited support to the integration of Arab economies at both regional and global levels. Based on recent trends in the design of regional trade agreements and on comparisons of contents of several relevant trade agreements, the second section of the paper proposes avenues for modernizing the PAFTA, for it to become an effective instrument in developing regional value chains and intra-Arab integration, as a stepping stone to further globalization. The third section concludes.

I. THE CHANGING NATURE OF ECONOMIC INTEGRATION AND THE LIMITED IMPACT OF PAFTA

6. Economic integration drivers evolved dramatically since the 1990s. Three types of cost condition economic integration: trade costs (moving goods across borders), communication costs (moving ideas) and face-to-face costs (moving people). Trade costs were reduced following the steam and industrial revolution.

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1 The agreement comprises 14 founding members: Bahrain, Egypt, Iraq, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, the Sudan, the Syrian Arab Republic, Tunisia, and the United Arab Emirates, subsequently joined by Algeria, the State of Palestine and Yemen.

2 The data sample used in this section covers the period 1997-2017. When available data for 1995-2017 were used. The sample was divided in two sub-periods: 1997-2006 and 2007-2017. This choice is coherent with the enter into full force of the PAFTA as tariffs were eliminated as of end 2005. It also coincides with the start of the global financial crisis.
At the time, successful development strategies consisted of building a whole value chain on the national territory and selling final goods overseas.

7. Following the Information and Communication Revolution, communication costs plummeted, and it became possible to trade ideas or tasks internationally, which led to fragmentation of the production process and emergence of global value chains. Then regionalism rose, as firms that have the knowledge tended to set up factories in different regions to supply each regional market, using inputs from within the region.

8. Against this background, investment became an alternative to building a factory to supply the foreign market, but also as a complement to trade (in parts and components). Choice of location by foreign firms became increasingly dictated by quality of logistic services and characteristics of local business environments. Thus, the development process of host countries became tied to their capacity to ensure smooth and safe flows of goods, services, capital, know-how, and people across borders. These elements define the new economic integration nexus.

9. The PAFTA agreement, designed and signed in the 1990s, reflects the concern of the time, which was essentially with moving goods across borders, but was not substantially updated to match the new reality of the goods/services-investments-intellectual property rights economic integration nexus. It still promotes shallow integration (trade in goods), while deep integration is needed for Arab countries to develop regional value chains and insert themselves in global value chains.

10. Beyond that, the agreement lacks full implementation. So far, Arab countries (a) have alleviated tariffs, as agreed in the PAFTA agreement, but not completely, (b) have not strengthened the chapters/provisions regarding non-tariffs barriers, and (c) have not established credible enforcement mechanisms.

11. As a result, trade costs are the highest in the Arab region3 and integration performance of Arab countries bilaterally, regionally and globally is still far below that of other countries with similar features, as evidenced in the ESCWA Assessing Economic Integration report series. In 2017, non-oil intra-Arab trade accounted for 13.1 per cent of total trade; intra-GCC trade for 9 per cent of the total, and intra-Arab Maghreb Union trade for 2.1 per cent of the total.4 These figures are quite far from that of intra-trade in ASEAN (23.2 per cent), and EU-27 (63.1 per cent). Further, ESCWA analyses show that the PAFTA did not provide a fallback to Arab countries when global trade plummeted after the global financial crisis in 2008, nor was it a stepping stone to globalization of Arab countries.

12. ESCWA carried out several studies to assess the prevalence, role and economic cost of non-tariff measures (NTMs) in the PAFTA region, represented by four countries for which data are available for 2012: Egypt, Lebanon, Morocco and Tunisia.5 It was estimated that, on average, more than 40 per cent of all imported products are covered by NTMs (figure 1a and b). Overall, the intra-PAFTA trade environment is relatively more restrictive than trade with Europe, as 97 per cent of the goods imported from PAFTA partners are subject to at least one NTM, against 57 per cent of imports from Europe.

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4 Still these figures include re-exports activities.

13. On average, each product is subject to up to 12 different NTMs in Tunisia, while the vast majority of imports (85 to 90 per cent) is affected by a maximum of nine NTMs in Morocco, 6 in Egypt and 4 in Lebanon. Hence, the average additional cost on imports is quite high, ranging from 22 per cent in Egypt to 45 to 50 per cent in Tunisia, 33 per cent in Lebanon, and 44 per cent in Morocco. Economic costs of NTMs is especially high when sectors supplying productive inputs are affected, as they hinder the emergence of regional value chains and participation in global value chains.

14. The situation weighed on the welfare enhancing and supporting effects of PAFTA. A reduction of NTMs, in particular of quotas and quantitative trade restrictions, would sizably boost the positive impact of intra-PAFTA and extra-PAFTA economic integration on the economic growth of member countries. Estimation for Morocco and Tunisia shows that their nominal GDP would increase by 0.6 per cent and 0.8 per cent, and exports by 1.2 and 1.8 per cent, respectively. A comparison with the impact of tariffs shows that NTMs have a greater impact on economic performance.

II. AVENUES TOWARDS MODERNIZATION OF PAFTA

15. The limited impact of the PAFTA is often explained by structural elements such as reduced trade complementarity, poor diversification of exports, similar and insufficient productive capacities and discrepancies among Arab countries in policies providing support to local production and subsidies to inputs (AAEIR, 2017⁶, 2015⁷). Conflicts and recurrent political tensions are taking their toll. However, the situation can also be attributable to weaknesses in the design and implementation of the PAFTA agreement itself, such as (a) inappropriate rules of origin; (b) pervasiveness of non-tariff barriers; (c) absence of effective dispute settlement and enforcement mechanisms, which undermines the credibility of the agreement, and (d) lack of coverage of crucial issues, such as services, investment and labour movement, given the new nature of the economic integration process and the upcoming digitalization of the world.

A. RULES OF ORIGIN

16. Rules of origin (RoO) are NTMs. They are basically criteria used to determine where the product was made, in order to identify which goods can be granted free access to a given area. They further allow determining anti-dumping or safeguard duties and regulating quotas. Moreover, they are a key element of regional trade agreements (RTAs), intended to encourage and maximize intra-regional flows, i.e., create trade while avoiding trade diversion and deflation.

17. ESCWA has shown that the RoO of PAFTA have been reducing the gains that firms could have accrued from accessing and using intra-PAFTA produced inputs free of duty. This has an especially deterrent effect on

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economic integration in a world dominated by fragmented production. Hence, non-preferential market shares of partners have grown at the expense of PAFTA members.

18. Furthermore, it is sometimes argued that PAFTA has not borne the expected fruits because of lack of relevant local production capacities, especially for inputs. However, the direction of causality may point the other way, since lack of productive capacities may in fact be due to PAFTA’s RoO that, being too restrictive, prevent creation of an Arab market for products, which discourages potential suppliers.

19. The principal difficulty with Arab RoO is the cumulation regime. As a regime-wide rule, a pan-PAFTA cumulation of origin system authorizing PAFTA countries to use productions originating from each other as if they were domestically produced would be preferable. For now, Arab countries are members of various trade agreements, the last to be created being the African Continental Free Trade Area (AfCFTA). The consequence of the spaghetti bowl of overlapping Arab RTAs is the creation of complex, heterogeneous and diverging RoO regulations and procedures across RTAs that have become a trade barrier along the whole supply chain and have undermined the development of intra-Arab trade. RoO across RTAs need to be made coherent and propitious to intra-Arab trade development.

20. Several other changes could be made to further increase the impact of a pan-Arab cumulation regime. In order to reduce the cost of complying with RoO for firms that use inputs that are not available, or not available in sufficient quantities, within the region, the PAFTA could include tariff preference levels, whereby trading partners can claim RTA benefits or can be granted the right to import inputs from third countries after having acquired a specific quantity of the same input produced within the region. Such a measure would be subject to the establishment of a short supply list identifying inputs that can be imported under these circumstances. Regarding produce-specific rules, members would benefit from opting for a ‘single transformation’ rule, along the lines of that included in the Africa Growth Opportunity Act for some countries and goods, and de minimis foreign content rules for large sets of products (as opposed to product-specific rules), eventually reduced to a single de minimis foreign content rate.

21. Such a move would establish a level-playing field for PAFTA countries and better serve development goals, as it would remove the de facto discrimination caused by export structure differences among members. Another advantage is that such rules and procedures are coherent with what can be found in other settings and would facilitate negotiations with third countries or in a multilateral setting.

B. NON-TARIFF MEASURES

22. Within the PAFTA region, tariffs have been largely reduced, but NTMs remain prevalent. These comprise a large set of policy instruments, very varied in nature; some addressing legitimate concerns and aiming at protecting consumers, while others add pointless extra layers of regulatory and procedural requirements. In general, and whatever their goal, NTMs negatively affect trade through the additional economic costs they impose on firms.

23. There is a large array of options to lower non-tariff barriers to trade. Updating and setting regional NTMs, such as environmental and health-related standards, and planning for a gradual convergence towards international standards and best practices, would not only make compliance feasible, but also encourage PAFTA countries, including LDCs, to improve the quality of their products.

24. Targets could be unwarranted sanitary and phytosanitary (SPS) restrictions not based on science, unjustified technical barriers to trade (TBT), and other ‘behind-the-border’ barriers, which impose unnecessary costs on PAFTA partners. NTMs that permit rent-seeking behaviour, such as import licenses, could be replaced by tariffs. This would advance transparency, while increasing governmental financial resources that could be used to strengthen long-term economic growth capacity by improving the quality of available production factors (education and health) or to invest in infrastructure or innovation. Such a strategy would have sizeable and sustainable distributional effects.
C. DISPUTE SETTLEMENT MECHANISMS

25. Dispute settlement (DS) mechanisms are key elements of any trade agreement. First, because they determine the effective enforcement of the trade agreement, they condition its overall credibility. Such mechanisms can be used to signal the degree of commitment of RTA members to the agreed elimination of tariffs and other trade barriers, and that they will not recourse to any unilateral action that may infringe/violate the agreement. Secondly, whenever RTA members differ in economic size and political power, properly designed DS mechanisms can ensure a fair and equitable treatment of both parties, which reinforces the will of the members to work collaboratively and, over time, to extend the scope of the agreement. Thirdly, these mechanisms condition the governance quality of the enforcement of the agreement, since they contribute to a more coherent implementation of the agreement by facilitating its understanding and interpretation. Thus, DS mechanisms influence participation of member countries and the private sector, the quality of their interactions, and the trade and welfare outcomes of RTAs.

26. An effective and efficient DS mechanism is one that (a) discourages infringement of the provisions of the agreement by making perceived costs greater than potential benefits, (b) encourages discussion and negotiation over the use of protectionist measures, and (c) recourses to sanctions as a measure of last resort. Moreover, the procedure itself should be efficient and effective, i.e., (a) its costs, in particular in terms of time, should be minimal, (b) the coverage of the provisions of the agreement should be as wide as possible as to avoid some provisions being perceived as relatively less important and member states commitments towards them relatively less strong, (c) the quality of arbitration should be high enough for the decisions made to be fully accepted by the parties and (d) means for effective enforcement should be available.

27. A comparison of the DS provisions of the PAFTA with the ones included in the most recent trade agreements signed by developing countries and between developing countries, on one side, and DS provisions of the European Union, on the other, highlights the limits of the former. The one paragraph regarding DS included in the PAFTA does not involve any provisions, rules, procedures or time frames. Moreover, most DS arrangements in RTAs have evolved over time, but not in the case of PAFTA.

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Source: Authors compilation.

Note: Euro-Mediterranean agreement (Euro-MED), Association of Southeast Asian Nations (ASEAN), South African Development Community (SADC), North American Free Trade Agreement (NAFTA), ASEAN (Association of Southeast Asian Nations)-Australia-New Zealand Free Trade Agreement (AANZFTA), Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).
28. For now, PAFTA’s DS process focuses on disputes among its members regarding potential infringement of privileges established under the agreement. Investment, standards, market access for agricultural products and other issues that appear in modern RTAs are lacking in PAFTA, the DS chapter is very limited in terms of substantive provisions and coverage. One of the most pressing issues relates to RoO and re-export activities of some Arab countries that lead to entry to the PAFTA market of products manufactured in China under preferential status, which undermines the emergence of intra-Arab value chains and distorts competition. Lack of an effective and efficient dispute settlement mechanism often leads Arab countries to fill a WTO complaint. Not only is this procedure lengthy, it also is accessible only to Arab WTO members and hence does not meet the needs of all Arab countries.

29. The PAFTA agreement does not have any explicit clauses regarding investment, although sub-agreements were developed, such as the Investment Promotion and Protection Agreement and the Investment DS in Arab Countries, both signed in 2000, which were followed by the 2013 Amendment to the 1980 Arab League Investment Agreement. The 2013 amendment improves protection and treatment of Arab investors (i.e., fair and equitable treatment, right to freely transfer capital and revenues after fulfilment of legal obligations and in a convertible currency recognized by the IMF, right to a fair compensation in case of expropriation, right to employ professionally skilled labour, expanded investor-State dispute settlement mechanisms). However, there is still a need to enhance transparency in investment arbitration and of the role of various actors such as the Cairo Regional Centre for International Commercial Arbitration, and to ensure greater consistency among regional, bilateral and domestic investment policies and rules.

30. Currently, Arab countries have signed more modern RTAs on DS with third parties, such as the United States of America and the European Union but also the ACFTA with African countries, the tripartite agreement or the Common Market for Eastern and Southern Africa (COMESA), than among themselves. A DS mechanism for commercial disputes could be drafted based on the clauses of these agreements, building on the experience accumulated by Arab countries so far and best practices developed by partners. To start with, a standard guarantee package that would shield investors from unjustified expropriation or unfair treatment, especially when governments change political direction, would include provisions on admission of investments and guarantees of fair and equitable treatment, and guarantees concerning free transfer of payments, as well as against arbitrary and discriminatory treatment. Arab firms should also be granted the same rights and benefits as other Arab local firms (national treatment) or third country firms (most-favoured-nation treatment). Such a package would also clarify whether all firms of RTA members would be treated the same way and, if not, what differences would be permissible.

31. Regarding transparency and effectiveness, a clear code of conduct should be adopted. A list of pre-approved arbitrators should be put together to reduce the time needed to appoint a special arbitration committee, like in the EU-Chile agreement. To this end, specific guidelines could be added referring to the qualifications of and terms of references and operational procedures for arbitrators. A specific and clear time frame for each step of the procedure should also be set. The time frame could be adjusted to the nature of the dispute and shortened in the case of trade or perishable-goods related disputes, for instance.

32. In order to strengthen credibility of the agreement, transparent enforcement mechanisms should be included. The defending party should have to clarify how it intends to comply with the administrator decisions. However, given the heterogeneity of economic situations in the Arab region, it should be possible for parties to negotiate mutually acceptable compensation awards, along the lines of the EU-Chile agreement. Further, provisions for ‘suspension of benefits’ in case of non-satisfactory compliance could be included in the agreement.

D. Services

33. Services are the fastest-growing sector of the global economy and play an important role in growth and development of countries. They are an important and increasing contributor to Arab countries’ GDP.8 ESCWA, 2017. Assessing Arab Economic Integration: Trade in Services as a Driver of Growth and Development. Available at https://www.unescwa.org/publications/assessing-arab-economic-integration-trade-services-growth-development.

8 ESCWA
analyses show that full liberalization of service sectors (financial, telecommunication and transport) could lead to sizeable gains in output, productivity, trade and employment in the PAFTA. Although services are not included in the PAFTA, work on an agreement on liberalization of services was initiated in 2004 and, after 12 years of negotiations, the ‘Beirut round’ was concluded in February 2017, with the commitment of nine countries: the United Arab Emirates, Saudi Arabia, Qatar, Oman, Morocco, Lebanon, Egypt, Yemen and Sudan.

34. For now, services trade restrictiveness indices remain highest in the Arab region across sectors, whatever the mode of supply. Arab countries would benefit from identifying a number of service sectors for early regional liberalization, as a preamble to initiating a dialogue at the regional level to re-examine the addendum to the PAFTA agreement signed recently, with a view to broadening its coverage and improving its applicability. Steps should be added that would lead gradually to expanding coverage to trade in services with third countries. In this regard, Arab countries could benefit from the experience of other countries and from their involvement at the WTO and in other RTAs that include services, especially with Europe and the United States. A key element of the revised PAFTA would be ensuring convergence of Arab standards towards those of developed countries.

35. The political economy of services liberalization differs widely among Arab countries. It is thus crucial to start by evaluating at the sectoral level the costs and benefits of the liberalization schemes envisioned, so that measures to weather the distributional consequences can be set up.

E. MOVEMENT OF CAPITAL AND WORKERS

36. Although trade integration remains limited in the PAFTA, capital and labour flows have always been intense and may offer greater potential than traditional trade. International and intra-regional investment is vital for exchange of knowledge, wage increases and economic growth. As said before, the changed nature of economic integration and investment issues has become an important part of modern trade agreements.

37. Going beyond the Amended Arab League Investment Agreement, fostering FDI within the PAFTA would enhance the business environment and perceptions of investors of its quality. Today, Arab countries suffer from a lack of stability and security, foreign ownership restrictions, dominance of the public sector in business and economic activity, lack of transparency and weaknesses in implementing the rule of law.

38. As discussed before, a first step would be to include in the PAFTA agreement provisions establishing credible dispute settlement mechanisms that would effectively protect investors rights and contract enforcement. DS provisions condition trust in regulators and contribution of the private sector to economic integration and development efforts. Another improvement would be for members to put together a regional legal framework for private investment, along best international practice, with emphasis on on fostering harmonization, cooperation and consolidation of national investment frameworks.

39. However, to be successful, such an initiative has to be holistic. Beyond investment, a successful regional approach will depend on coverage of adjacent issues that affect sustainability and gains of the process, although definite answers are not available for each and every one of them. As an example, lessons can be learnt from the aggressive capital-income tax competition in the European Union. Seeking full harmonization of tax and non-tax incentives across the PAFTA is not advisable, but adopting a cooperative approach would be a plus.

40. Another key element are policies regulating movement of persons among members. Visa restrictions that affect movement of investors and the right to employ professionally skilled labour also condition outcomes from investment or services. Related provisions are now generally included in the investment chapters of RTAs.

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41. Finally, a modernized PAFTA should include provisions for protection of intellectual property rights. Negotiations are still ongoing, but the issue will be included in the African Continental Free Trade Area (AfCFTA), which is a strong potential competitor to PAFTA as an Arab investment destination. A first step would be to commit to WTO-TRIPS standards.

III. CONCLUSION

42. This parliamentary paper showed that, in the 1990s, there was an untapped potential for further trade integration among Arab countries that the PAFTA could have helped harnessing had it been fully implemented and gradually revised to reflect changes in the nature of the integration process. Although a comprehensive mapping is beyond the scope of this paper, options to modernize PAFTA have been offered on issues pertaining to rules-of-origins, non-tariff barriers, dispute settlement mechanisms, services, investment, and flanking policies, such as labour-movement and competition policies.

43. That being said, any economic integration agenda for the PAFTA moving forward has to take into account the prevailing network of trade agreements that include non-Arab partners, and also the consequences of the conclusion of mega-trade agreements, emergence of major players affecting the integration game tremendously, and the role of the private sector that largely drives the economic integration process.

44. ESCWA is committed to helping PAFTA countries coordinate their efforts and policies. It is also ready to offer technical assistance to help member states expand the PAFTA agreement and put in place country policies that help member states harness the full potential of integration as a lever for improved competitiveness, economic growth, job creation and enhanced standards of living.

45. To this end, monitoring the implementation of the PAFTA is essential for improving effective enforcement. ESCWA has developed a monitoring and evaluation system for economic integration in the Arab region that covers the PAFTA. A platform will be set up for policymakers and stakeholders to access relevant information. In the future, Member States will have the possibility of notifying changes in rules and regulations, and an indicator could be developed to track progress of countries towards implementation of various agendas and convergence of regulatory environments.

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