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Economic developments and prospects in Mediterranean Partner Countries

Executive Summary

The year 2005 marks the tenth anniversary of the initiation of the Euro-Mediterranean Partnership through the Barcelona Process. While progress has been achieved, economic performance in Mediterranean Partner countries (MPCs) over the past ten years has not yet met the objectives set out in the Barcelona Declaration. Divergences in living standards between MPCs and the EU have grown, and the unemployment rate—which currently averages over 15 percent for the Mediterranean region as a whole—risks increasing further unless growth performance can be improved on a sustainable basis.

The weaker-than-anticipated performance over the past decade reflects a number of structural impediments that are only progressively being removed: partial and fragmented integration into the world economy, geopolitical uncertainties, weak governance, poor economic diversification, dependence on large and inefficient public sectors, and large public sector deficits.

Despite these impediments, however, recent developments are more encouraging and prospects for the region have improved. Stronger global economic conditions and robust oil markets over the past few years have gradually lifted growth in the countries of the region to 4.5% in 2004 on average[1]. These factors, combined with stronger workers' remittances, politically-induced grant flows in some countries, and a recent pickup in tourism, have contributed to an improvement in the external current account position of the region, which has shifted into a surplus over the past four years, though some countries still display sizeable deficits.

At the same time, some progress on policies and reforms has been made in MPCs, although to varying degrees. Overall, it is apparent, however, that the macroeconomic environment has become more stable, as evidenced by lower and more stable inflation.

Recent improvements in policies and structural reforms appear to have helped strengthen the regional investment climate and have contributed to a progressive increase in private capital flows to the region since 2001. This, in conjunction with the stronger external current account positions has led to a substantial rise in foreign exchange reserves, which have increased by over 70 percent since 2001, albeit, in some cases, from very low levels. The robust overall external position places the region in a good position for enhancing structural reforms, although incentives for doing so may have declined.

[1] The analysis in this paper covers all MPCs that are part of FEMIP. Hence the regional averages include Turkey.

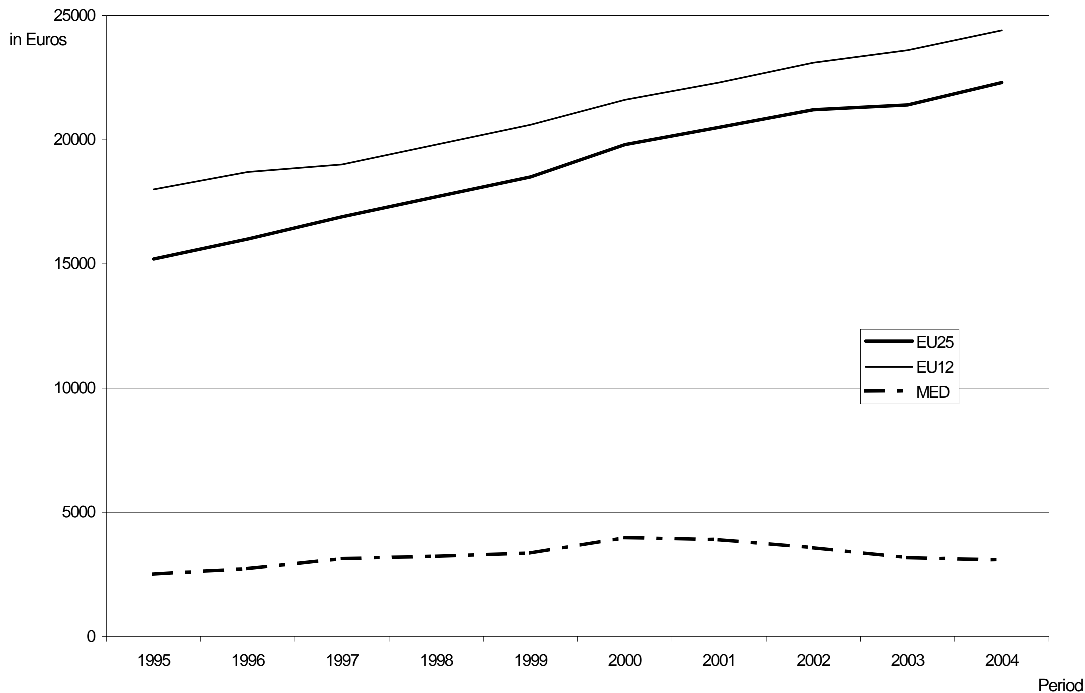
It is therefore imperative that MPCs take the opportunity afforded by a stable macroeconomic environment and strong external positions to advance reform efforts and further strengthen the investment climate. While requirements differ from country to country, the region taken as a whole would benefit from reforms aimed at strengthening private sector activity, further integrating the region into the world economy, strengthening fiscal positions, deepening financial markets, improving governance, and adjusting the role of the state in the economy. Reform efforts will need to be accompanied by strong social support mechanisms as well as a strengthened Euro Mediterranean partnership.

Economic developments and prospects in Mediterranean Partner countries

Economic performance has not met expectations

Ten years after the Barcelona Process economic achievements in MPCs are short of expectations. Perhaps the most telling evidence of this is the growing disparity in living standards between countries in the EU and those of its southern neighbors. Indeed, whereas per capita incomes in the EU have continued to rise over the past ten years, those of MPCs have been stagnant (Figure 1).

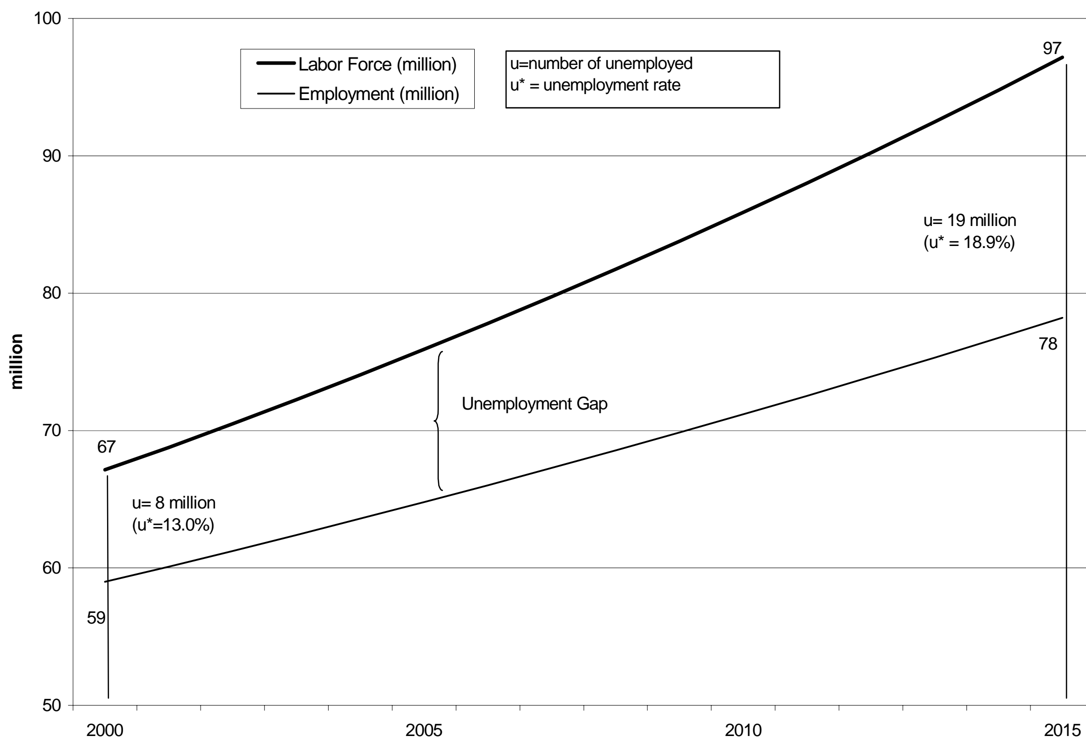
Figure 1: GDP per capita in EU and MPC Countries, 1995-2004



Source: IIF, Eurostat.

At the same time, regional job prospects have not improved over the past decade. Growth in MPCs has been insufficient to absorb labor market entrants and unemployment rates—particularly among the youth—remain very high. Migration and associated workers' remittances have provided a safety valve, but this will not resolve the problem. On current trends, the number of unemployed in the region would reach nearly 20 million people by 2015—corresponding to an unemployment rate of 19 percent—up from 8 million people in 2000 (Figure 2). Underlying these estimates are relatively low participation rates of about 35 – 40 % and thus there is a large portion of the working age population that does not engage in the labor market, partly discouraged by the lack of job opportunities.

Figure 2: Labor Force, Employment and Unemployment Perspectives in MPC Countries, 1995-2015[1]



Source: ILO, EIB estimates.

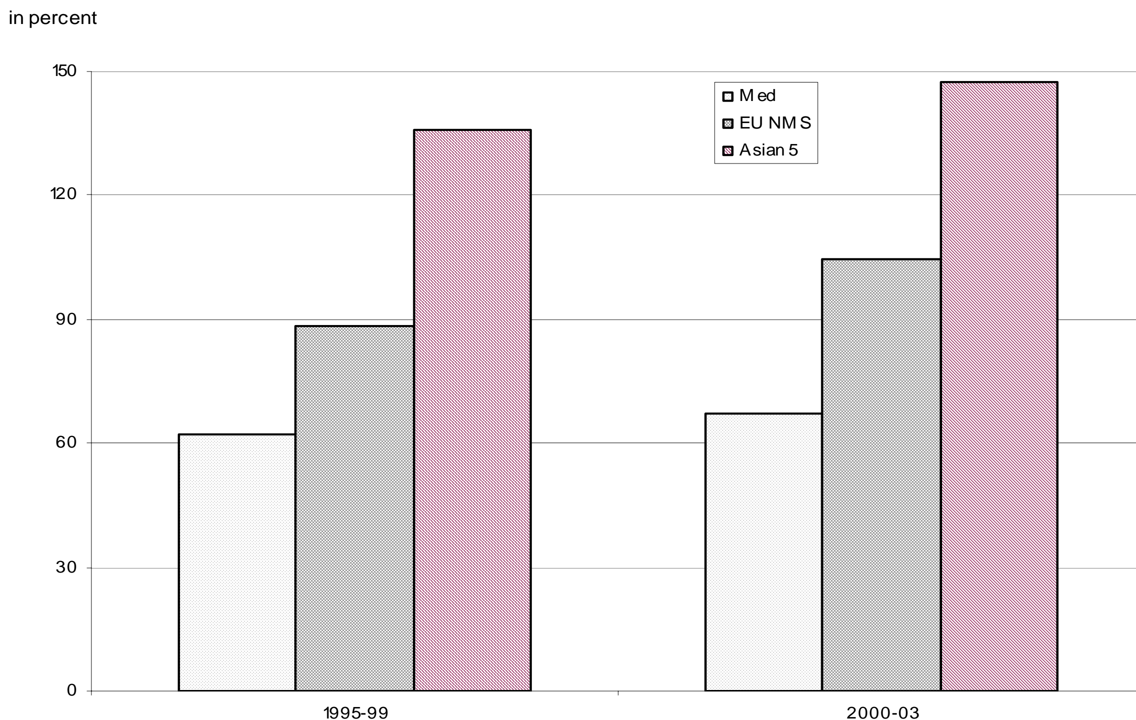
[1] Does not include Lebanon.

Disappointing performance reflects inherent structural impediments

While the MPCs are a heterogeneous group, and each country needs to be evaluated individually, the overall weak performance in the region over past ten years can be explained by a number of factors.

In the first instance, economic integration into the world economy remains partial and fragmented. Progress toward trade liberalization has certainly been made, notably in the context of Association Agreements with the EU, as well as through regional and bilateral initiatives. However, important sectors—such as agriculture and services—remain insulated, though negotiations are now under way in both these areas. Furthermore, the region could benefit from agreements to reduce non-tariff barriers, as well as from a more multilateral approach toward trade liberalization in order to minimize trade diversion. Overall, MPCs' economies are becoming more open, but they lag significantly behind other more dynamic economies (Figure 3). Trade openness indicators for the region have increased to over 65 percent on average annually since 2000.[2] This compares to an annual average of over 100 percent for the EU New Member States (NMS) and nearly 150 percent for high growth Asian economies over the same time period[3].

Figure 3: Trade Openness in Selected Countries, 1995 –2003



Source: World Bank.
EUNMS: EU new member states.
Asian 5: Indonesia, Malaysia, South Korea, Singapore and Thailand.

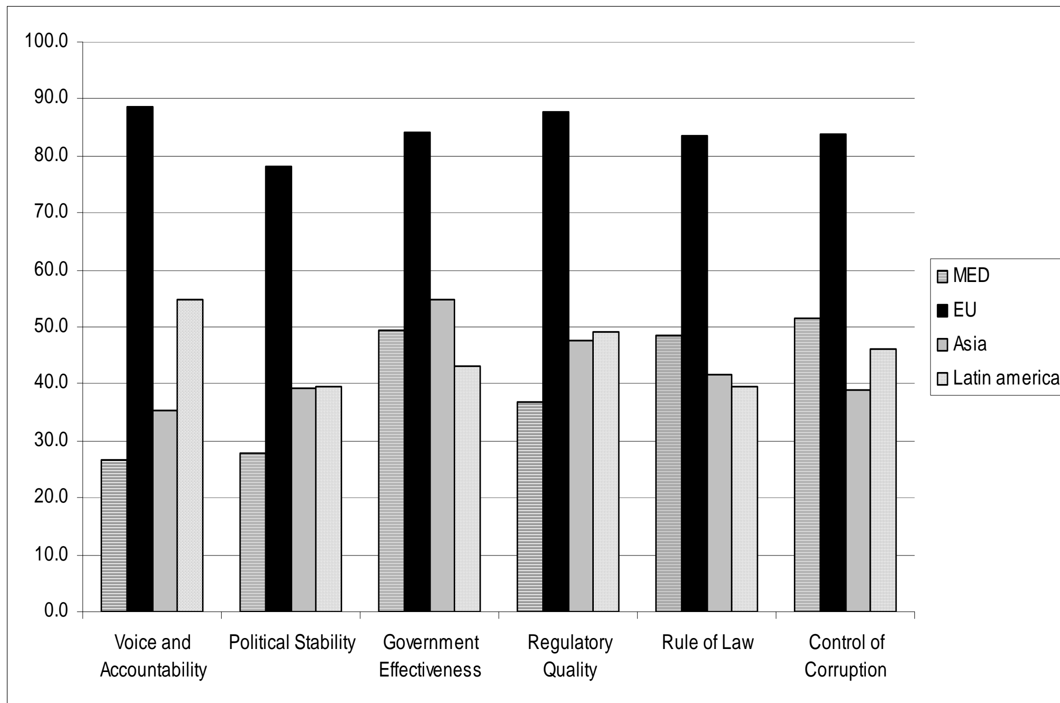
Meanwhile, MPCs differ noticeably in terms of their degree of capital account liberalization, although the region as a whole remains relatively closed in terms of capital controls that are imposed. Even countries like Morocco and Tunisia, which have achieved

[2] Trade openness is defined as the sum of exports of goods and services divided by GDP.
[3] High growth Asian economies considered are Indonesia, Malaysia, Singapore, South Korea, and Thailand.

progress in opening up their economies, and that have a clear policy goal to achieve greater international financial integration, retain a number of capital controls on investments, capital market securities, money market instruments, and credit operations. An issue here is the speed of warranted capital account liberalization in face of domestic financial sectors that still require reform and consolidation.

Geopolitical uncertainties and weak governance have also hindered stronger economic development. With regard to the former, the September 11 attacks in the US, the ongoing Israeli-Palestine conflict, political unrest in Algeria, as well as regional terrorist attacks in Egypt, Tunisia and Morocco, have had adverse consequences for regional tourism and foreign private capital inflows over the past five years. More generally, governance indicators produced by the World Bank show that the MPCs lag significantly behind the EU in all aspects of governance (Figure 4)[4]. In addition, MPCs compare unfavorably with other regions—such as Latin America and Asia—on a number of governance indicators, including notably voice and accountability, political stability and regulatory quality[5].

Figure 4: Governance Indicators 2004



Source: World Bank.

[4] The World Bank compiles governance indicators for the six dimensions of governance indicated in figure 4. The source of the data is very comprehensive: several hundred individual variables measuring perceptions of governance are drawn from 18 different agencies, including international organizations, political and risk-rating agencies, think tanks, and nongovernmental organizations.

[5] A distinctive feature of the region is long-lasting regimes with internal tensions.

At the same time, MPCs remain by and large poorly diversified and growth has been constrained by large public sectors[6]. Many countries in the region are dependent on one or a few sectors, and as a result their economies are vulnerable to cyclical movements in key sectors or exogenous shocks. Furthermore the region's heavy dependence on large and inefficient public sectors has deterred private sector activity, as a result of crowding out, and because employment has been diverted to the public sector from more growth prone private sector businesses.

Meanwhile, despite some budget consolidation in recent years, public sector finances represent a significant fragility in the region. With the exception of Algeria, gross public debt stocks are above 50 percent of GDP in all countries in the region, and a number of countries—including Turkey, Israel, and Lebanon—have debt to GDP ratios above 80 percent. Reducing debt levels and addressing large structural fiscal deficits therefore remains a key challenge for most countries in the region.

However, favorable cyclical conditions have strengthened MPCs more recently

Despite some of these inherent weaknesses, there has been an improvement in economic conditions in MPCs over the past few years, reflecting primarily cyclical conditions. In particular, improved global conditions and robust oil markets since 2002 have helped strengthen regional growth. Growth in the MPCs over the past three years has been on an increasing trend, rising to 4.5 percent in 2004[7]. Growth was particularly robust in Algeria, Jordan, Lebanon, Tunisia, and Turkey, which benefited from a surge in private investment and consumption.

Favorable oil market conditions, stronger workers' remittances, politically-induced grant flows, and a recent pick up in tourism have also led to an improvement in the overall external current account position for the region, which shifted into a small surplus (0.3 percent of GDP) for the 2001-04 period. This is in contrast to the 1995-2000 period, when the annual current account to GDP ratio registered a deficit of over 2 percent of GDP on average. The improvement in the regional current account position since 2001 is even more pronounced if Turkey is excluded. Strong economic recovery in Turkey over the past couple of years has been supported by a surge in domestic spending, which has swelled imports and widened the current account deficit to 5 percent of GDP in 2004.

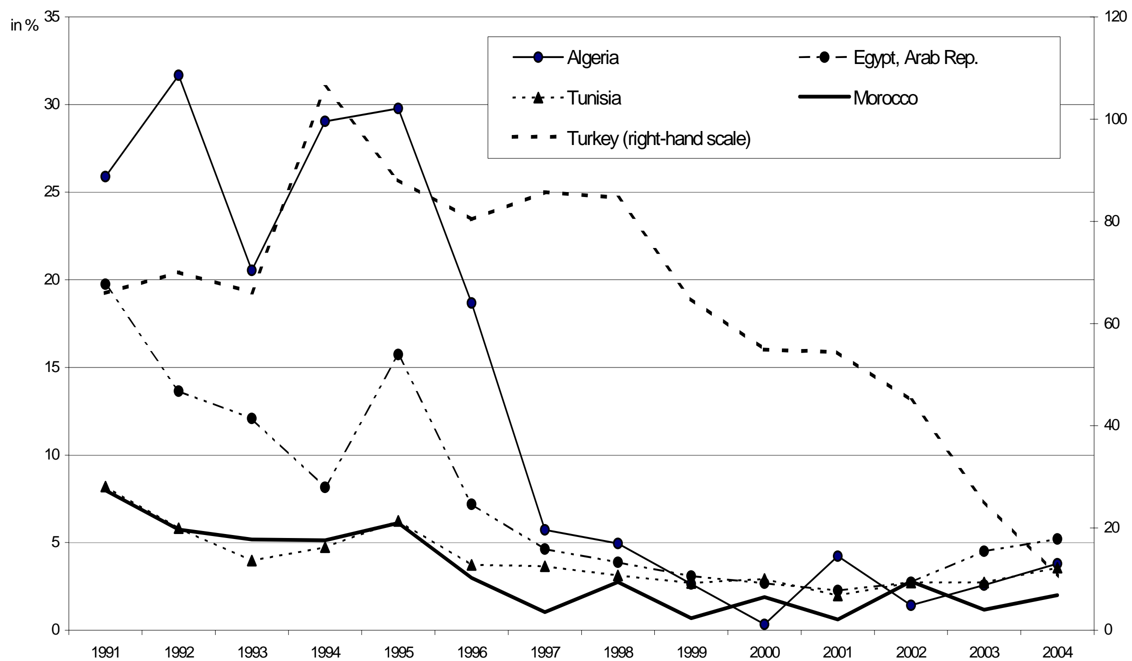
And some progress on policies and reforms have been made

At the same time, a number of countries in the region have improved macroeconomic policies and have engaged in more serious structural reforms, resulting in a more

[6] The share of public sector expenditure in GDP is over 30 percent, significantly higher than other regions such as East Asia and Latin America, which tend to have ratios below 20 percent.
[7] This number represents a simple average.

favorable investment climate. Thus, while each country in the region is setting its own agenda, MPCs are generally moving towards improved macroeconomic policies, focusing on fiscal reforms, enhancing monetary and external policies, and advancing structural reforms. As a result, the macroeconomic environment has become more stable, with noticeable declines in inflation throughout the region (Figure 5). Only Egypt has seen somewhat of a pickup in inflation over the past couple of years, reflecting the feed trough effect of the recent devaluation of the Egyptian pound.

Figure 5: Inflation, 1991-2004 in Selected MPC Countries



Source: IIF.

On the policy front a number of countries in the region have undertaken fiscal reforms in recent past. Algeria has improved fiscal transparency and has set aside an oil stabilization fund. Egypt is engaged in far reaching tax and customs reforms. In Jordan, budgetary measures aimed at boosting tax revenues and controlling current expenditure have strengthened the fiscal position significantly. Meanwhile, Morocco is developing a strategy to reduce the size of its structural budget deficit in cooperation with the World Bank and the IMF.

Countries in the region are also focusing on improving monetary policies—by providing greater central bank autonomy and strengthening the operational framework—as has recently been the case in Morocco and Tunisia. Furthermore, many countries in the region are engaging in financial sector reforms with the aim of strengthening market

mechanisms. In Egypt, the government has begun implementing a financial sector restructuring program to tackle the deterioration in commercial bank performance, while Morocco is similarly engaged in a restructuring of its specialized state-owned banks. Israel is implementing a multi-faceted program to improve the efficiency and competitiveness of capital markets. Many countries in the region are also taking steps to strengthen financial sector regulation and supervision. While financial sectors in countries like Syria and Algeria lag well behind those of other countries in the region, Algeria has recently taken steps to strengthen payments systems and improve prudential regulation and supervision.

Regional advances have also been made on the structural reform front. In addition to the aforementioned trade agreements, countries such as Tunisia and Morocco have been engaged in upgrading their industrial sectors with a view to strengthening their competitive edge. A number of countries—including Egypt, Morocco and Jordan—are also engaged in customs reforms.

Conscious of the burden imposed on growth by large public sectors, countries in the region have also placed increasing emphasis on developing private markets. Privatization efforts in the region have been mixed—with a number of programs in the region having effectively stalled—although some success has been achieved in recent years, notably in Morocco and Jordan. Efforts have also been made to provide incentives to private sector operations in a number of countries. Thus, for example, in Algeria, the passage of the new hydrocarbon law, which aims at opening up the sector to private investment, is a promising development. Similarly, in Morocco, important advances have been made toward improving the functioning of labor markets, streamlining investment procedures, and initiating judiciary reforms.

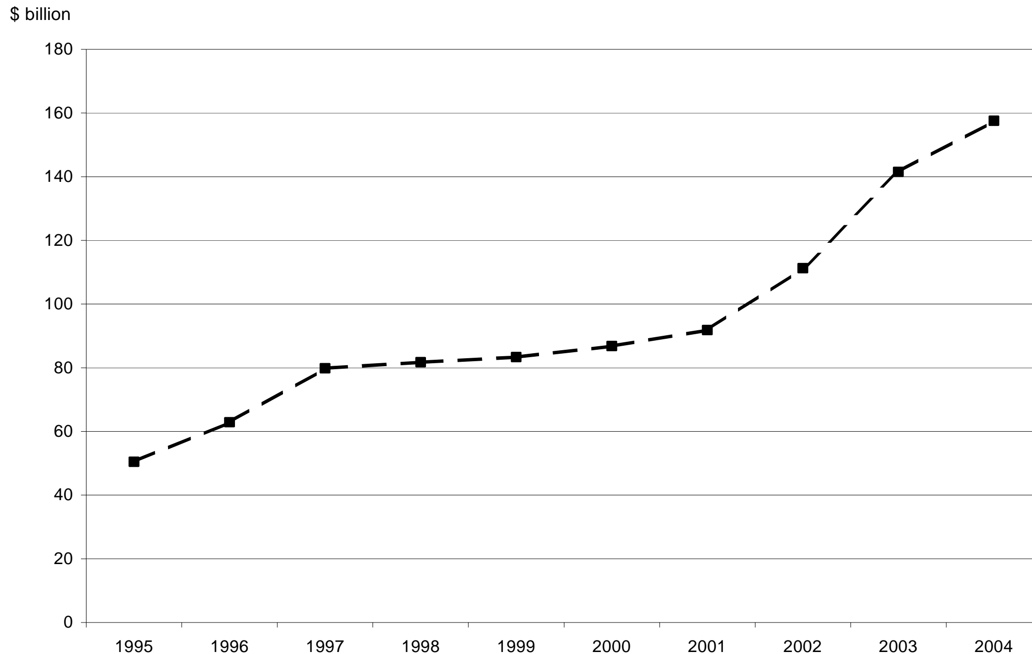
Recent improvements in macroeconomic policies and structural reforms have helped to strengthen the investment climate somewhat (despite continued geopolitical uncertainties), and have contributed to a progressive increase in private capital flows to the region since 2001, both debt and equity. These have reached over 4 percent of GDP in 2004, reflecting significant private inflows to countries like Turkey, Morocco, Tunisia and Jordan. Private capital flows also remained substantial in Lebanon, reflecting, inter alia, investments into the real estate sector and inflows of regional savings. With the notable exception of Lebanon, which has benefited from international financial assistance under the Paris II agreement, official flows to the region have been on the decline since 2001.

The region is now in a strong position for advancing reforms

The stronger external current account positions and increase in net private capital inflows in the region since 2001 are reflected in a substantial rise in foreign exchange reserves (Figure 6). Between end-2001 and end-2004, foreign exchange reserves in the region

increased to nearly US$160 billion (over 70 percent)[8]. The current robust external position places the region in a good position for enhancing structural reforms, although incentives for doing so may have declined.

Figure 6: Foreign Exchange Reserves, 1995-2004[1]



Source: IMF.
[1] Does not include Syria.

MPCs need to capitalize on current propitious environment

Mediterranean countries will need to capitalize on recent reform efforts and strong external positions. Improving economic fundamentals and long run growth prospects will require deeper integration into the world economy and sufficient access to financing and investment. This only makes sense if more progress on improving the macroeconomic environment and structural reforms is made. While requirements differ from country to country, the region taken as a whole would benefit from progress on a number of outstanding issues.

In general, the region needs to raise its growth potential to improve living standards and effectively combat unemployment. This can only be achieved by facilitating private

[8] Apart from Algeria, however, foreign exchange reserves in the early part of this decade were at modest levels, representing on average five months of import coverage.

sector activity, which in turn requires an efficient and reliable operating environment and well functioning institutions. MPCs therefore need to advance reforms that will improve the business climate. To this end, countries need to put in place transparent and enforceable legal systems that enforce property rights; strengthen financial systems to develop better access of the private sector to capital markets; and raise education standards to facilitate labor market entry and the contribution of the labor force to economic prosperity. Efforts are also required to rationalize the public sector and advance the privatization agenda, particularly in countries where progress has stalled.

But for long-term prospects in the region to improve substantially further efforts are needed to foster integration into the world economy. A more multilateral approach to trade liberalization could be useful to minimize trade diversion and negotiating costs. Additional efforts are also required to reduce non-tariff barriers and take pro-active steps to advance reciprocal agreements on a progressive opening up of sectors that remain protected. Capital account liberalization could also strengthen the region's growth prospects, and individual countries need to consider the potential benefits that could be reaped from integrating their capital markets further into the global economy. For many countries in the region, this requires further efforts toward macroeconomic stabilization and financial sector reforms, including with regard to regulation and supervision.

The most pressing regional issue on the macroeconomic front remains fiscal consolidation. Most countries in the region need to strengthen their fiscal positions, both through revenue enhancing measures and expenditure rationalization in order to lower public debt burdens. In addition, the adoption of medium-term budgetary frameworks and fiscal rules could help anchor expectations and limit the scope for discretionary spending. MPCs could also build on progress made recently in some countries in the region to strengthen monetary policy frameworks with a view to ensuring a low and stable inflationary environment.

Clearly reforms in the MPCs will need to be supported by targeted social support mechanisms in view of the weak social performance indicators and the potential short-term dislocation that reforms can generate.

Equally important will be the need to continue to find ways to promote and strengthen the Euro Mediterranean partnership. The EIB and other Euro area partners are already heavily engaged in the region, but additional support both through financial means and via technical assistance are needed to help boost the reform process and to facilitate the further integration of MPCs into the world economy.

Statistical Annex
Statistical Economic Indicators in the Mediterranean Countries: 1995 – 2004

Real GDP Change										percent
Algeria	3.8	3.7	1.1	5.1	3.2	2.2	2.6	4.1	6.7	5.9
Egypt, Arab Rep.	4.7	5.0	5.5	4.5	6.3	5.1	3.5	3.2	3.1	4.3
Israel	8.5	4.5	3.3	3.3	2.6	7.5	-0.9	-0.8	1.3	4.4
Jordan	3.9	1.3	3.1	3.0	3.1	4.1	4.2	5.0	3.2	5.2
Lebanon	6.5	4.0	4.0	3.0	1.0	-0.5	2.0	2.0	3.0	4.0
Morocco	-6.6	12.2	-2.2	7.7	-0.1	1.0	6.3	3.2	5.5	3.3
Syria	5.8	4.4	2.5	6.8	-3.6	0.6	3.8	4.3	2.6	1.8
Tunisia	2.3	7.1	5.4	4.8	6.1	4.7	4.9	1.7	6.1	5.3
Turkey	7.2	7.0	7.5	3.1	-4.7	7.4	-7.5	7.9	5.8	8.0
West Bank and Gaza	:	:	:	:	8.9	-5.4	-15.0	-14.5	4.5	3.0

Inflation									percentage	change
Algeria	29.8	18.7	5.7	5.0	2.5	0.3	4.2	1.4	2.6	3.8
Egypt, Arab Rep.	15.7	7.1	6.2	4.7	3.8	2.8	2.4	2.4	3.2	5.2
Israel	9.9	11.3	9.0	5.4	5.2	1.1	1.1	5.7	0.7	-0.3
Jordan	2.3	6.5	3.0	3.1	0.6	0.7	1.8	1.8	2.3	3.0
Lebanon	10.6	8.9	7.8	4.5	0.2	-0.4	-0.4	1.8	1.4	2.0
Morocco	6.1	3.0	1.0	2.7	0.7	1.9	0.6	2.8	1.2	2.0
Syria	8.0	8.2	1.9	-0.8	-3.7	-3.9	3.0	1.0	1.5	2.0
Tunisia	6.3	3.7	3.7	3.1	2.7	3.0	1.9	2.8	2.7	2.7
Turkey	92.5	80.4	85.7	84.6	64.9	54.9	54.4	45.0	25.3	12.0
West Bank and Gaza	:	:	:	:	5.5	2.8	1.2	5.7	4.4	2.5

General Government Deficit									percent of GDP	
Algeria	-1.4	2.9	2.4	-3.8	-2	9.7	3.4	0.2	5.1	5.7
Egypt, Arab Rep.	-1.2	-1.3	-0.9	-1.0	-3.0	-3.9	-5.6	-5.8	-6.2	-6.5
Israel	-4.1	-4.4	-2.7	-3.7	-4.2	-2.1	-4.1	-4.5	-6.4	-4.8
Jordan	-4.1	-2.9	-2.5	-10.0	-7.3	-7.4	-6.9	-8.1	-11.8	-10.6
Lebanon	-18.4	-21.7	-27.6	-13.7	-14.1	-23.7	-17.3	-16.7	-14.5	-12.9
Morocco	-5.6	-3.4	-3.4	-4.6	-1.8	-6.4	-5.7	-4.6	-5.4	-5.7
Syria	:	:	:	:	0.7	1.6	2.4	1.9	-1.9	-1.6
Tunisia	-4.5	-4.9	-3.9	-2.5	-2.3	-3.3	-2.8	-2.4	-2.8	-2.7
Turkey	-3.7	-8.5	-7.5	-7.6	-11.6	-11.6	-18.1	-14.2	-10.6	-10.3

Foreign Exchange Reserves									months of import cover	
Algeria	1.6	3.6	7.6	6.2	3.9	9.7	15.0	16.0	20.2	19.5
Egypt, Arab Rep.	10.5	10.6	10.9	9.9	9.1	7.1	6.9	7.6	8.0	6.9
Israel	2.5	3.2	5.7	6.4	5.6	4.9	5.5	5.9	6.2	5.4
Jordan	4.5	3.6	4.7	3.8	5.8	6.3	5.7	7.2	8.8	7.6
Lebanon	7.1	8.8	8.4	9.3	12.5	9.6	4.6	5.4	9.8	9.0
Morocco	3.4	3.7	4.0	4.2	5.2	4.2	7.6	8.4	9.7	9.5
Syria	:	:	:	5.2	4.7	5.5	6.0	7.2	6.8	6.6
Tunisia	2.0	2.4	2.5	2.2	2.7	2.1	2.1	2.4	2.7	2.9
Turkey	3.4	3.7	3.6	3.8	5.1	4.0	4.2	5.2	5.0	3.8

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Current Account Balance									**percent of GDP**	
Algeria	-6.1	1.8	7.2	-1.9	0.0	16.3	12.9	7.8	13.4	15.0
Egypt, Arab Rep.	0.6	-0.3	0.2	-2.9	-1.9	-1.2	0.0	0.7	2.4	5.0
Israel	-5.2	-5.2	-3.2	-1.1	-1.5	-1.5	-1.8	-1.7	0.1	-0.2
Jordan	-3.8	-3.0	0.4	0.3	5.0	0.7	-0.1	4.4	11.1	1.9
Lebanon	-37.5	-36.8	-36.9	-35.9	-30.5	-29.0	-20.4	-13.1	-12.4	-12.3
Morocco	-3.6	0.1	-0.3	-0.4	-0.5	-1.4	4.7	4.1	2.9	1.8
Syria	:	:	:	-0.3	0.6	5.4	5.9	6.7	3.2	3.2
Tunisia	-4.3	-2.4	-3.1	-3.4	-2.2	-4.2	-4.3	-3.5	-2.9	-2.6
Turkey	-0.7	-1.3	-1.4	1.0	-0.7	-4.9	2.3	-0.8	-3.4	-5.0
External Debt									**percent of GDP**	
Algeria	76.7	71.8	65.2	64.4	58.2	46.1	41.1	40.5	35.3	26.7
Egypt, Arab Rep.	54.8	45.9	37.9	33.1	31.1	27.9	27.5	33.1	35.5	39.2
Israel	49.4	46.8	53.5	56.0	59.9	55.5	57.0	64.6	64.0	60.0
Jordan	110.1	109.8	112.6	100.9	105.9	92.9	86.1	89.2	85.5	74.2
Lebanon	49.3	56.1	65.4	68.5	75.4	78.9	73.5	81.6	100.3	93.7
Morocco	70.4	60.3	60.8	58.2	57.4	54.9	47.5	44.8	39.1	34.6
Syria	:	:	:	131.6	126.4	110.9	103.6	99.6	96.5	98.6
Tunisia	60.2	57.0	57.8	57.9	56.6	57.2	59.4	64.2	62.3	56.6
Turkey	43.5	44.8	47.6	48.9	57.1	62.1	78.5	73.3	64.4	57.6
Debt Service ratio, paid							**% of exports of goods and services& income**			
Algeria	47.7	42.3	42.4	49.8	39.1	21.2	21.5	18.8	16.1	13.0
Egypt, Arab Rep.	14.1	13.2	11.2	9.8	10.2	10.3	9.3	12.4	12.0	10.7
Israel	17.1	16.5	18.5	20.1	17.7	15.1	20.3	18.4	18.2	11.9
Jordan	45.0	27.2	22.1	23.1	21.6	26.2	17.7	19.1	19.7	14.5
Lebanon			147.7	169.7	160.5	145.8	62.1	55.5	58.4	37.6
Morocco	37.3	34.1	32.7	25.8	23.8	21.1	20.9	21.6	22.5	18.5
Syria	4.3	3.7	9.1	6.5	6.4	4.5	3.2	2.9	3.6	3.6
Tunisia	20.5	21.2	19.2	18.9	19.5	21.7	15.0	16.9	14.7	16.6
Turkey	35.6	28.0	28.7	35.4	45.6	45.7	66.9	60.0	43.5	32.1

Source: IIF and IMF.