FEMISE

FEMISE REPORT ON THE EURO-MEDITERRANEAN PARTNERSHIP

2013

TOWARDS A NEW DYNAMIC TO SUSTAIN THE ECONOMIC AND SOCIAL BALANCES

Illustration de Alain Soucasse

Coordinators
Ahmed Galal, Economic Research Forum, Egypt
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January 2014

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TABLE OF CONTENTS

PREFACE
Alain Henry, Director of Studies and Research
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What is the present economic and social situation in the south of the Mediterranean?

The 13th Femise Annual Report on the Euro-Mediterranean partnership has become a much awaited reference in providing the answers to this question. In these times of social and political transition, the publication of a robust economic analysis based on precise data, that is both classical and original, and that takes into account the specificity of each country, offers a crucial source of reflection for those who are interested in the region's development.

Whereas events have been occurring at a breathtaking pace over the past three years, playing havoc with established notions, this 2013 edition takes a step back to look at a situation that is difficult to decipher. In economic terms, the data analysis confirms the dynamics and weaknesses that have prevailed in recent years. Certain of these had already been identified, such as insufficient gains in productivity, but the current political transition has not yet managed to overcome them. Other weaknesses were less apparent, such as unemployment amongst graduates, the unbearable nature of which was revealed by the crisis. Beyond the specificities of each country, for which this Report holds a wealth of essential information, the latter sheds light on the burdens that are preventing the Mediterranean countries from taking off: youth unemployment, insufficient levels of high productivity activities, the lack of qualified labour, the insufficient level of innovation, territorial imbalances in particular between cities and rural areas, gender inequalities and beyond that, social inequalities, demographic pressure, etc.

The former regimes had promoted a so-called "social contract" among international partners, but this turned out to be rather dubious: the creation of infrastructures and public sector jobs in return for an authoritarian state. This "contract" was a specific adaptation of the authoritarian bargain model: to lead passive populations towards a future of happiness under the firm hand of their country's leaders. This message was sold to international economic partners, whilst the latter above all enjoyed greater trade liberalisation (more competition, fewer trade barriers, etc.). On the one hand, this implied abandoning freedom for the promise of a better future; on the other, with regard to the outside, discreet silence in exchange for good trade. Amongst others, this unleashed an inordinate amount of corruption and a focus on low added value production, to the detriment of a true industrial policy. The sham caved in, although it did leave behind a certain number of achievements (longer life expectancy and higher rates of school enrolment), but also economic weaknesses. The Report draws up a detailed and documented inventory of the current situations.

The proposals put forward by the Report are presented with intentional reserve. They would, however, lead us strongly to believe that it is time to break free of the views of the global economic doxa, to develop new public policies that draw their lifeblood from human resources and the very foundations of these societies.

The authors underline that it is now time to build, within each country, a 'social contract' that is worthy of its name, calling upon the social energy of new driving forces for the economy. These projects should be embodied in public policies. A mechanistic vision of economic drivers remains insufficient to develop in this direction, states the Report. Heterodox measures are required. Indeed, more often than not, the international economic authorities call upon a handful of sacred principles: the supremacy of contract law, the unwavering virtue of competition, the imperfection of public regulations, etc. But at a closer look, these economic principles are little more than a "belief", that exceeds the boundaries of economic theory. Admittedly, these principles are in line with a political vision that does truly exist elsewhere, in American society for example. Yet they cannot be imposed everywhere according to the same terms.

In the south of the Mediterranean, the new authorities are facing an intense demand for social protection. No long term economic policy can ignore this. Meanwhile– as the governments are well aware – national and foreign investors must once again be offered the possibility to plan ahead. This also requires stronger social cohesion. The new economic policies must establish greater equality (with regard to the application of rules for example), allow women to play a far greater economic role, develop innovation, leave room for local initiatives, rely upon decentralised management, etc.

The new governors must therefore map out routes towards modernisation with which their societies can identify. This 13th Report encourages the creation of public policies that are not inspired by economic credos, but rather by a deep-rooted understanding of local situations. Such an approach will also demand that donors lead a more comprehensive analysis of the societies at hand, based on a cross-disciplinary approach, including not only economics but also geography, demography, socio-anthropology, history, management, agronomy, educational sciences, etc. This Femise Report forms a precious basis for their reflection.

The French Development Agency is therefore delighted to have supported the works of this 13th Report. The original nature of the data and the analyses presented strive to find solutions to current extensive challenges and uncertainties, and to help support innovation in public policies.

INTRODUCTION

As this thirteenth Femise Report on the situation of the Mediterranean partner countries (MEDs) of the EU goes to press, there is an increasing feeling that the Arab spring has cooled significantly, some even go so far as to talk of a lengthy winter. The intention of this report is to examine, beyond the different political procrastinations, where the development process of the MED countries and their integration within the regional and global economy truly stands.

As the global crisis set in and the unrest in the Arab world continued, some economists developed the idea that the so-called middle income bracket countries, to which the Mediterranean countries belong, were at threat of being trapped in a grey zone that prevents them for joining the high-income countries. The position of Femise is that regardless of the current political debates and management challenges they must face within a still relatively lifeless global environment, the governments must establish the elements of a strategy that will transform the growth regime in order to move beyond this middle zone.

The present report looks at this difficult balance between, on the one hand, the need to control macroeconomic equilibriums whilst ensuring that the populations maintain their standards of living accompanied by greater social justice and, on the other hand, the need to devise a strategic vision for a new, more dynamic and more inclusive growth model.

Over the past fifty years, many countries have rapidly entered the group of so-called middle-income countries.

Amongst these, few have succeeded in achieving the status of high-income country [1]. The remaining are confined within what Gill & Kharas (2007) were the first to define as the "middle-income trap". This middle-income trap corresponds to a development stage at which the countries have succeeded in increasing their revenues, through the development of a low-wage industry and the increase in productivity. This was as a result of the following: a reallocation of resources and revenues from agriculture to industry, while maintaining agricultural prices fixed at a relatively low level; the introduction of imported technologies and the adoption of an extensive growth model. This was followed by wage increases which eroded competitiveness, especially whilst actual exchange rates remained relatively high.

These countries can therefore no longer compete with lower wage countries which, meanwhile, have entered the international market. Moreover, they can no longer compete with richer countries in the production of higher added value products as their position in the chain of value is too low. Meanwhile, these countries face new challenges in terms of social cohesion and growing imbalances (in particular territorial), whilst a large proportion of their population lives in poverty.

The points identified in the recent literature (cf. in particular, Flaaen et al., 2013, Aiyar et al., 2013, Eichengreen et al., 2013, Agenor & Canuto, 2012, Felipe, 2012, Nungsari & Zeufack, 2009) are as follows: the insufficient structural transformation of these economies which have not managed to develop high productivity activities in industry or services, the lack of skilled labour and an insufficient level of innovation. To these obstacles, unanimously identified by all authors, must be added more specifically in the case of Mediterranean countries: considerable youth unemployment, particularly amongst graduates, insufficient territorial cohesion meaning strong disparities in terms of income and opportunities, all in a context of uncertain forecasts which in turn affect three decisive sources of income: foreign investment, migrant remittances and tourism.

The MED's relative situation was clearly progressing before the crisis

Up until 2009 it can be said that the macroeconomic situation and international openness had generally been successful. The implementation of stabilisation programmes in the eighties and nineties had improved the macroeconomic situation of all countries of the region. A number of indicators demonstrated the progress achieved: (i) growth rates were close to those of other regions of the world (4.6% on average for MEDs since 2000, vs. 3.2% for Latin American countries, 6.0% for non-EU member Eastern European countries, 5.8% for ASEAN, 5.9% for BRICS) although the relative growth of income per capita was lagging due to the continued strong demographic growth, (ii) inflation rates were relatively low (6.2% on average for MEDs between 2000 and 2008 vs. 8.4% in Latin America, 5.8% in ASEAN, 26.4% for non-EU member Eastern European countries, 6.9% FOR BRICS), (iii) a decreasing budget deficit in MED representing 6.5% of GDP on average in 1998-2001 vs. 5% of GDP in 2002-2008, (iv) their attractiveness to foreign investments had progressed considerably reaching an average of 4% of GDP between 2000-2008, a figure comparable to that of other regions of the world.

Two weaknesses prevailed:

(i) **an official unemployment rate** of 12% before the crisis and disproportionate with respect to young people (except for Israel, vs. 7.5% for Latin America, 3.6% for ASEAN and 9.6% for BRICS) in a context of low labour force participation and the presence of a highly developed informal sector, considered in some countries to reach around 40% of GDP.

(ii) **a trade balance** that deteriorated regularly and was difficult to balance out with services (particularly tourism), remittances (particularly from migrants) and FDI.

Generally speaking, living conditions have improved considerably over the past 30 years: life expectancy has risen, for the entire region, from 62.6 years in 1980 to 74.4 years in 2011, placing the region ahead of BRICS, ASEAN, and non-EU Eastern Europe; the infant mortality rate also dropped significantly.

Regarding education, the rate of school enrolment progressed in primary (on average, practically all children in the region currently attend school), in secondary and in higher education. The literacy rate also grew, rising from 56% in the mid eighties to 81% towards the end of the 2000-2012 period. These results illustrate the efforts made in this direction and the obvious progress achieved. We may note, however, that the literacy rates of Mediterranean countries remain lower than those of other regions.

Moreover, to their credit, Mediterranean countries have succeeded in reducing the level of poverty. On average, Mediterranean countries have, alongside Eastern Europe, the lowest percentages of the population beneath the international poverty line. Indeed, only 1.8% of people have less than 1.25US$ per day to live with. Also, the intensity of poverty [2], estimated at around 0.3%, shows that the daily income of people living below this poverty line is very close to 1.25US$. Similarly, the Gini index, which measures the degree of income inequality, shows that Mediterranean societies are by comparison (with non-EU member Eastern European countries) not less egalitarian than those of other regions of the southern hemisphere.

However, a large proportion of the population remains in a vulnerable situation. Indeed, when the 1.25US$ line is raised to 2US$ per day jour, the proportion of poor people rises from 1.8% to 10.3%. Moreover, the use of a specific poverty line for each country takes the average percentage of poor people in the Mediterranean region up to 15.8%.

This progress led to a past growth that appears to have been quite favourable to poor populations. However, it seems to be lacking in inclusivity, insofar as a large part of the population remains without job opportunities and as it has not managed to include women in the field of productive economic activities. Moreover, the mean indicators do not take into account the fact that imbalances between regions and within regions have tended to deepen. Lastly, the fact that the growth lacks inclusivity and general productivity Is clearly linked to what is denounced as the "authoritarian bargain model", a centralised authoritarian system characterised by a strong collusion between the economic elites and political power (cf. Femise Reports 2011 and 2012). Moreover, in order to survive, in most cases this model implied restricting a certain number of freedoms.

The current need to manage short term issues whilst initiating a long term strategy based on a new growth model and a new social contract.

The key issues of the pre-crisis period are therefore clear and form a sort of permanent challenge that, regardless of circumstances, must be met if the MEDs wish to escape the middle income trap in the long run.

The crisis and events have led to the deterioration of macroeconomic indicators since 2008. The present report takes a detailed look at the situation in each country at the end of 2013 and illustrates the common challenges that most MEDs must face today. It is essential that the most affected countries benefit from the support of the international community in order to maintain the aforementioned achievements. All of the transition processes have experienced this intermediate situation and have required a considerable amount of support from the international community. .

As compared to the transition processes observed in the Eastern countries during the nineties, however, Mediterranean countries have a dual specificity: firstly they do not enjoy the prospect of joining a powerful zone bringing sufficient financial means (their anchorage to the EU via association agreements does not provide the same outlooks as those of membership); secondly, the population's sensitivity to poverty makes it impossible to accept a considerable and lengthy deterioration of all social indicators due to institutional reform, as suffered by countries such as Poland, whilst awaiting the rebound.

This necessarily leads them, in particular Egypt and Tunisia, to adopt direct social measures that are heterodox as compared to the heavy artillery of macroeconomic management (creation of jobs in the public sector, higher wages, maintaining of subsidies with an effort to build on efficacy); all of these are measures that mechanically deepen the budget deficit and put pressure on prices and the trade balance.

Here we support the point of view that the current environment calls for these policies to be continued and supported. But as shown, once again, by other transition processes, the duration of this intermediate stage can be reduced if it takes place within the framework of a strategic vision that is largely accepted by the population. Here the situation is complex as MEDs must simultaneously deal with: (i) political transition, which in certain countries involves strong social instability, prevents anticipation, puts a stopper on investment and risk taking; (ii) low external demand from Europe, their main client, thus reducing their outlets and migrant remittances; (iii) a strong increase the price of basic food stuffs and oil (for importing countries). It is not surprising, therefore, to note a deterioration of all macroeconomic indicators studied in the present report which, if it is to continue, will be difficult to absorb and will in turn lead to the deterioration of structural indicators.

Essential political changes but which must go hand-in-hand with a shared social and economic vision

The political situation of Mediterranean countries is not homogeneous. Some have progressed in the establishment of more transparent, more efficient and more participative institutions, although having achieved different stages (Israel, Turkey, Morocco, Lebanon), others are at the beginning of the transition process (Egypt and Tunisia), whereas Syria is in the throes of internal turmoil. This situation, along with the stalled peace process, in turn weakens the political situation of Lebanon and Jordan. We may therefore consider that the large majority of Mediterranean countries are in a phase of political transition, but at very various stages. This political transition globally means breaking the ties of collusion between politics and the economy, reducing the influence and power of the elites, breaking the arbitrary power of the authorities, public services and/or the military over individuals and companies, setting up a fair and independent justice system, respecting individual rights, allowing greater citizen participation, having governments that are open, transparent and that can be held legally accountable for their actions. The traditional "social contract " according to which the population (or at least a part of it) traded in political freedom for public employment and free access to all public services (health, education, etc.) must be redefined. This transition is a lengthy process that cannot adopt a linear pathway and that generally goes hand-in-hand with political instability and social turmoil.

The resort to a democratic project might turn out to be incantatory if it is not clearly supported by credible facts based on a shared vision. As an example, it wasn't until the end of the nineties that the opinion polls in Poland showed that the majority of the population no longer missed the former system. Along the same lines, a recent survey carried out amongst young people below the age of thirty in the region of Marrakech showed that 70% of these young people state that security (followed by employment for 68%) is their prime wish , whereas only 20% put freedom first [3]. Everything points in the direction of a possible return to more authoritarian powers if freedom and democracy are not seen to act as the levers of a new leap forwards.

In this context of growing trouble, the governments of transition countries are, paradoxically, less active on the economic side. Although over the past 20 years the dominant philosophy could be summed up as follows: "Economic reforms first, political reforms later", since the Arab Spring, the aphorism seems to have been reversed. The countries' authorities have focused on political reform and managing the economy seems to have taken a back seat. It is this re-balancing that appears necessary today and that requires the leading of political and organizational change in relation to a long term vision of economic and social development that draws the lessons from the voices of the people who have made themselves heard.

Propose a dynamic approach based on innovation and a new social contract aimed at young people in particular.

Beyond the progress to be achieved in the different aspects of macroeconomic management and the institutional and business environment, dealt with in this report, a vision is proposed herein that aims at significant changes in the growth model based on a new social contract. Its content is, firstly, to base growth dynamics on innovation and technological progress rather than on the accumulation of capital and the reallocation of production factors consecutive to the opening up of markets, secondly, to target youth as an essential part of this vision.

Innovation is considered here in the broad sense as according to Schumpeter "as any idea leading to economic activity". This means encompassing technological innovation and creative innovation and proposing changes in public policies regarding research, culture, education-training and company creation.

At the core of the knowledge economy, innovation can only develop if the four traditionally established pillars – institutions, research, education-training, ICT- evolve towards developing the creativity of society as a whole and transforming this creativity into economic value. Working towards an innovative society does indeed correspond to a vision that is forward-thinking, as large countries such as India, South Korea and Brazil have so clearly understood.

But the will to change the growth regime must go hand-in-hand with a new social contract that puts the spotlight on young people. It is essential to enable their access to universal knowledge of the highest rank, to allow debates on all cultures and to facilitate risk taking and mobility in a climate of open innovation. They must also learn to develop the opportunities they are given, in particularly by bringing them into the decision-making process and by facilitating company creation. Finally, this approach, which qualifies what we call an inclusive model, must come with an access to better shared opportunities regardless of geographical location.

This last part of the social contract means that territorial imbalances must be addressed.

Strengthen social cohesion by reducing territorial imbalances.

The present work does not presume to deal with the difficult question of the content of decentralisation. On a more modest note, it presents the nature of territorial gaps, their links to disparities in income and opportunities and proposes some guidelines for further reflection. Regarding territorial gaps, we underline: (i) that due to its geography, 90% of the population of Mediterranean countries live in 10% of the administrative territory, with very strong disparities in the density of occupied areas, (ii) that urbanisation in the Mediterranean is relatively high as compared to other developing regions, (iii) that the region suffers from "macrocephaly" i.e. the excessive weight of the main city, meaning in particular that external benefits in terms of infrastructures and services are not correctly disseminated throughout the entire urban fabric, (iv) that migration to cities occurs without clear employment outlooks, showing that urban migration is not due to a transition towards an industrial model, but most probably to a gravitation towards the catchment area. This lack of concordance and therefore of employment leads to the urbanisation of poverty and marginalization, with increasingly blatant disparities within a small area, within the city itself in which "local poverty traps" are created.

If to this we add demographic pressure along with (geographical) land and water scarcity, there is a major risk of seeing the appearance, on the one hand, of regions that are clearly lagging behind and, on the other hand, of urbanisation developing hand-in-hand with poverty, on the outskirts of the traditional urban fabric (slums, etc…).

These characteristics explain the increased income gaps between territories in an environment where the national income gap has changed little (the GINI coefficient went down from 1995 to 2000 and then rose again). The detailed analysis made within this report underlines that:

Firstly, income gaps are very high and, to a lesser extent, follow population polarizations without there being a general downwards trend in the spatial distribution of wealth. To the contrary, for half of the Mediterranean countries, in particular for Morocco, Tunisia and Turkey, we may even note an increase in these gaps between 1995 and 2005.

Secondly, when we look beyond the income/wealth gaps, at elements which more directly determine the capacities and opportunities of individuals, in particular health, education and employment we note: (i) that for all of these indicators, the differences within the country are stronger that between the countries themselves; (ii) that the different forms of inequality are not of the same intensity, depending on the indicators or countries observed. Although income gaps are generally the strongest of inequalities, gender, place of residence and age also play highly significant roles. However, spatial disparities can vary considerably between countries. Regarding this aspect, the smaller Machrek countries logically display lower spatial imbalances; (iii) the importance of gender varies significantly according to the indicator and we may also note that gender inequalities are now low regarding education, but very high regarding access to employment; (iv) far from being in conflict or substitutable, the different forms of imbalances add up, creating extreme opportunity differences between individuals within different regions. This is particularly the case for higher education or employment, with probabilities for individuals that are diametrically opposed according to where they live, their gender, age and family income.

The implementation of systems to correct this situation is obviously, therefore, a key part of the new forward looking social contract.

The present report discusses the possibilities available in the light of international experience and the initial conditions applied to SMEs. Although it is clear that no model can be applied as such, a number of points deserving more in-depth discussions are highlighted.

The first is that progress must be made towards greater decentralisation that will allow a greater participation of the population, more at the local level no doubt.

The second is that the decentralised levels selected must benefit from true autonomy; this raises the difficult issue of relationships between deconcentrated and decentralised responsibilities.

The third is that particular care must be given to the training of local staff, to their status and their autonomy with regard to the central authorities. All of which is currently lacking, as is the existence of procedures by which to analyse any actions undertaken.

The fourth is the choice of the priority functions for decentralization. The choice should be based on international experience in these different areas. Thus, for example, it would appear that “blind institutions” operating homogeneously throughout the country are preferable in the fields of health and secondary education, whereas mixed solutions would be preferable for primary schools, with teachers benefitting from a civil service status and the town being responsible for managing the school. Similarly, if the local creation of companies is to be developed along with the dissemination of innovation, the regions must see their scope of economic action extended and supported by a decentralized financial framework… The only purpose here is to show the complexity and interest of this decisive question in modifying the social contract in the envisaged direction. It is obvious that this question could be the object of a large-scale public debate at the national level which would focus people’s attention and demonstrate the will to move towards the now much needed new social contract.

The first part of this report will broach these questions under the title “Maintain the socio-economic balance and offer a vision”; the second part will deal with the detailed situation of the different Mediterranean countries in 2013, i.e. Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Turkey and Tunisia.

Notes

1. Countries are generally considered (cf. World Bank) according to three major classifications: Low income (≤ 975$), Lower-middle income (between

976 and 3855$) and Higher-middle income (between 3856 and 11905$) and Higher income (≥ 11905$). Amongst the Mediterranean countries, 4 are ranked in the lower-middle income bracket (Egypt, Morocco, Syria and the Palestinian territories), 5 are amongst the higher-middle income bracket (Algeria, Jordan, Lebanon, Tunisia, Turkey) and 1, Israel, is ranked amongst the higher income countries.

2. The Poverty Gap corresponds to the ratio (poverty line – median income of the poor population/poverty threshold.

3. See results of the OCEMO youth survey 2013.

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Part 1.

Maintain the socio-economic balance and offer a vision

Sub-section 1.

Understand the relative dynamics
To propose a vision for the future

The objective of this first sub-section is two-fold. Firstly, to provide a clear picture of the situation in the Mediterranean region, as compared to other countries, in terms of growth, social indicators and integration within the global economy. Secondly, we attempt to identify the main problems facing the region's economies and which interfere with their relative position.

I. The weakened position of Mediterranean countries

What are **the economic, social and international dynamics** that have characterised the region over the past decades?

I.1. Successful macro-stability until 2010 but with insufficient growth rates.

The implementation of stabilisation programmes in the nineties helped to improve the macroeconomic situation within all countries of the region. Table 1 shows that inflation rates were amongst the lowest in developing and emerging countries, with an average rate of 6.2% between 2000 and 2009 and 5.2% since 2009. Similarly, before 2009, fiscal balances improved throughout (cf. Graph 1). The recent deterioration of the region's macro-economic situation was triggered by the economic crisis, the soaring prices of foodstuffs and energy products and political and social instability linked to the Arab Spring. Prior to these events, the macroeconomic environment of the Mediterranean countries was quite satisfactory.

Internally, however, these countries are characterised by (i) relatively low growth rates, compared to other developing and emerging regions, with a GDP growth rate that has never exceeded a decennial average of 2.7, (ii) extremely high unemployment rates, a very low level of participation, particularly of women and (iii) a highly developed informal sector despite the lack of data for the entire region. In some countries, it is considered to represent around 40% of the GDP.

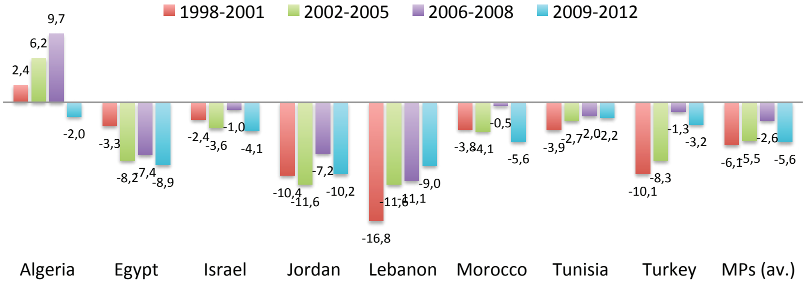
Regarding growth rates, Graph 2 shows that, irrespective of the decade, Mediterranean countries have always been outrun by other regions. Only Latin American countries have recorded average growth rates below those of Mediterranean coun-

Table 1.
Inflation rate (consumer price index.%)

Country Name	*1980s*	*1990s*	*2000-2008*	*2009-most recent*
Algeria	*9*	*18.6*	*2.9*	*5.8*
Egypt. Arab Rep.	*17.4*	*10.5*	*7.1*	*10.1*
Israel	*129.7*	*11.2*	*1.9*	*2.8*
Jordan	*7*	*5.1*	*4.4*	*3.4*
Lebanon	*n.a*	*n.a*	*n.a*	*2.6*
Morocco	*7.6*	*4.4*	*2*	*1*
Syrian Arab Republic	*22.6*	*8.2*	*5.1*	*12.2*
Tunisia	*7.6*	*4.9*	*3.2*	*4.3*
Turkey	*51.3*	*77.2*	*25.6*	*7.5*
West Bank and Gaza	*n.a*	*6.1*	*4*	*2.8*
MPs (av.)	***31.5***	***16.2***	***6.2***	***5.2***
Latin America (av.)*	***249.5***	***290.4***	***8.4***	***6.7***
ASEAN (av.)	***10.1***	***8***	***5.8***	***5***
Non-EU Eastern Europe (av.)		***766.9***	***26.4***	***20.9***
BRICS (av.)	***98.2***	***218.5***	***6.9***	***6.4***

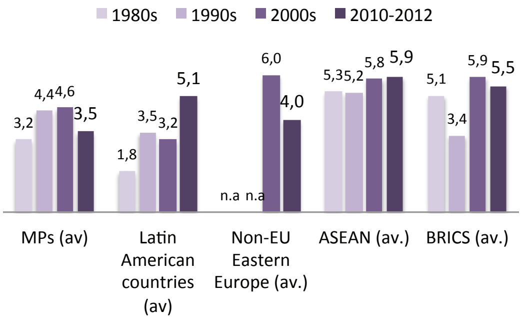
Source : WDI. World Bank

Figure 1.
Budget balance as a percentage of GDP



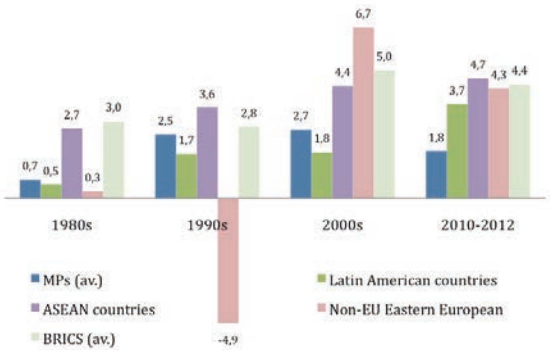
Source: EIU

Figure 2.
Average growth rates by region



Source: IMF-WEO

Figure 3.
Average growth rates
of GDP per capita by region



Source: WDI, World Bank

tries. It is not surprising therefore that the growth rates of GDP per capita have evolved so little. Graph 3 shows quite significant gaps between Mediterranean regions and the countries of regions which have progressed the most in terms of GDP per capita. This gap was at its lowest in the nineties (1.1 percentage points as compared to ASEAN). However, this gap reaches 4 percentage points during the 2000s as compared to non-EU member Eastern European countries and almost 3 percentage points as compared to ASEAN between 2010 and 2012.

The unemployment rates are amongst the highest in the world. On Graph 4, we can see that the rates are higher than in Asian countries, Latin American countries and than the average of BRICS. Moreover, the total level of participation, which is around 48% for all countries of the region, is very low (it reaches 58% for non-EU member eastern European countries, 62% for BRICS, 65% for Latin American countries and 72% for ASEAN countries). The level of participation of men (which is 70% on average for Mediterranean countries) is comparable to those of other regions (63% for non-EU member Eastern European countries, 74% for BRICS, 80% for Latin America and 82% for ASEAN). However, with the exception of Israel, the level of participation of women in Mediterranean countries is extremely low. Indeed, it amounts to 22%, as compared to 62% for ASEAN and around 50-52% for the other regions.

I.2. Undisputable progress regarding social indicators

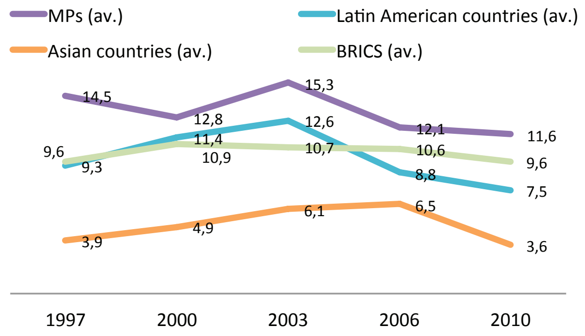
Living conditions in Mediterranean countries have improved considerably over the past 30 years. Life expectancy has progressed, for the entire region, from 62.6 years in 1980 to 74.4 years in 2011 (cf. Graph 6), which positions the region above BRICS (with 66.8 years), ASEAN (70 years) for non-EU member eastern European countries (70.7 years). Only Latin American countries are slightly above with an average of 75.2 years in 2011. Similarly, infant mortality rates have greatly decreased (cf. Graph 7). For the entire region, they dropped from 65.6 (for 1,000 births) in 1980 to 15.7 in 2011, i.e. a level well beneath that of

BRICS (23.6 for 1,000 births in 2011) and ASEAN (21.8). Even though further progress is expected to achieve yet lower figures (the rate for Latin America is 12.5 and that of for non-EU member eastern European countries is 6.3), we must acknowledge that true progress has been achieved in this field.

Concerning education, the rising school enrolment rates (shown in Table 2) in primary schools (on average, practically all children in the region are now enrolled in school), in secondary schools (where enrolment rates have progressed from 56.5% in between 1980-1985 to 87.5% on average for 2000-2012) and in higher education (which, for the same periods, progressed from 16% to 40.5%) and higher literacy rates, as shown in Table 3, from 56.3% in the mid eighties to 81%, on average, towards the end of 2000-2012, illustrate the efforts made in this direction and the obvious progress achieved. We note, however, that the literacy rates of all Mediterranean countries are lower by comparison to other regions.

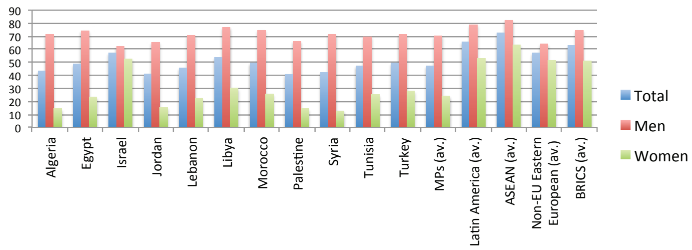
Another important point to add to the achievements of Mediterranean countries are the reduced levels of poverty. Graph 8 shows that, amongst developing and emerging countries, Mediterranean countries have, on average, along with the non-EU member eastern European countries, the lowest percentage of the population below the international poverty line. Indeed, only 1.8% of people live with less than 1.25US$ per day. Moreover, the intensity of this poverty [1], estimated at around 0.3%[2] shows that the daily incomes of people living beneath this threshold are very close to the 1.25US$ mark. Similarly, the Gini index (shown in Table 4), which measures

Figure 4.
Unemployment rate by region (percentage)



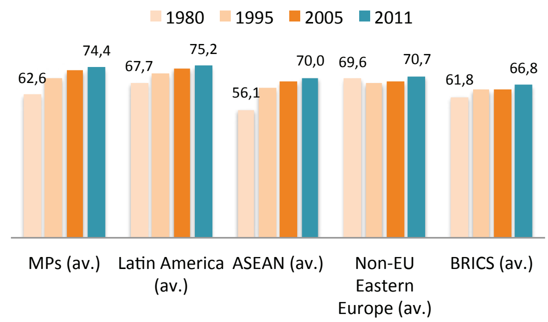
Source: WDI-World Bank

Figure 5.
Participation rates by country and by region, 2010 (%)



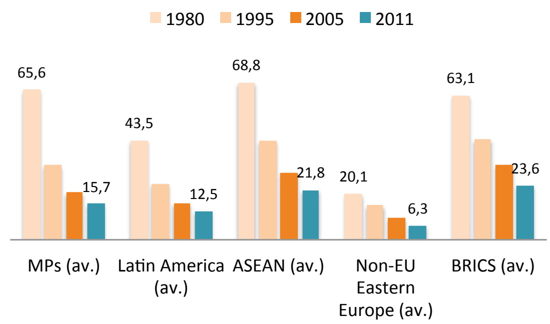
Source:KILM-ILO

Figure 6.
Life expectancy at birth by region (in years)



Source: WDI, World Bank.

Figure 7.
Infant mortality rates, by region (per 1000 births)



Source: WDI, World Bank.

Table 2.
Enrollment by region (gross. percent)

	Primary			Secondary			Tertiary		
	1980-1985	1990-1995	late 2000's-2012	1980-1985	1990s-1995	late 2000's-2012	1980-1985	1990-1995	late 2000's-2012
MPs	97.9	99	106.3	56.5	64.4	87.2	16	18.1	40.5
Latin America	112	112.9	111.5	59.4	63.1	88	19.4	23.6	57.8
ASEAN	134.8	102.4	109.4	43.7	48	69.1	11.4	12.3	27.7
Non-EU East. Europe	104.3	106.1	99	98.1	92	99.3	44.7	41	83.4
BRICS	104.2	114.5	112.4	59.1	63.7	86.6	17.3	15.8	32.2

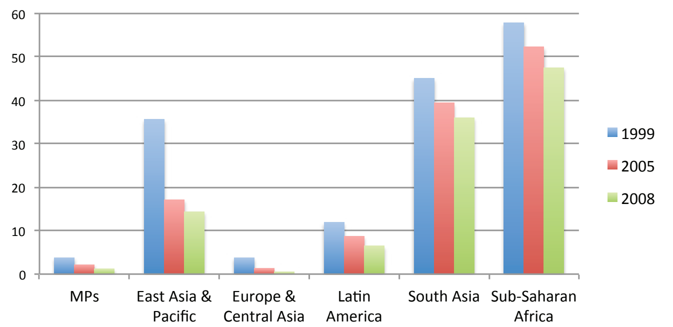
Source : WDI. World Bank

Table 3.
Literacy rates by region
(% of the population over 15 years)

	early to mid 1980s	mid 90's to early 2000's	late 2000's-2010
MPs	56.3	76.7	81
Latin America	86.4	93.6	95.7
ASEAN	76.4	87.9	89.7
Non-EU Eastern Europe	97.9	99.5	99.7
BRICS	71	84.5	87.1

Source : WDI. World Bank

Figure 8.
Evolution of the number of people living below the poverty line of U.S. $ 1.25 * per day (% of total population)



** International poverty threshold estimated by the World Bank since 2008.*
Source : POVCALnet, WDI, World Bank.

Table 4.
Indicators of poverty and inequality. by region. for the most recent years

	Gini index	National poverty line (%)	International poverty line - Population (%) below US$1.25 a day	International poverty line - Population (%) below US $2 a day
MPs	36.8	15.8	1.8	10.3
Latin America	48.6	25.2	3.1	6.5
ASEAN	39.8	18.5	16.3	38.6
Non-EU East. Europe	26.8		0.1	0.1
BRICS	46.3	24	15.7	31.5

Source : POVCALnet. WDI. World Bank.

the degree of inequality between incomes, shows that Mediterranean societies are relatively more equalitarian (along with non-EU member Eastern European countries) than those of other regions of the southern hemisphere.

However, although Table 4 confirms the idea that poverty in Mediterranean countries is less severe than in other regions, it also tends to show that a large proportion of the population finds themselves in a vulnerable situation. Indeed, when the 1.25US$ bar is moved to 2US$ per day, the proportion of poor people rises from 1.8% to 10.3%. In addition, the use of a poverty line that is specific to each country increases the average percentage of poor people in the Mediterranean to 15.8%.

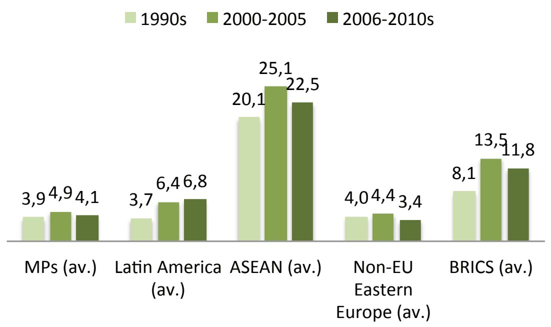
I.3. Weak integration within the global economy

In Mediterranean countries, tariff dismantling has not been sufficient to trigger the dynamic integration of the economies. The effects of this dismantling on growth and productivity have been relatively limited; in turn this has not helped to develop exports from these countries. Nor did this opening up give rise to a move in production towards the upmarket segment and the production of new comparative advantages (FEMISE, 2012).

Graph 9 confirms the idea that the share of high technology products has remained low and has progressed very little in Mediterranean countries. Indeed, this share amounted to 3.9% in the nineties, and then 4.9% in the 2000-2005 period, before dropping back to 4.1% between 2006-2010. By comparison, the share of ASEAN countries over the 2006-2010 period was 22.5%, that of BRICS was 11.8% and that of Latin American countries was 6.8%. Only non-EU member Eastern European countries have a slightly lower share than Mediterranean countries.

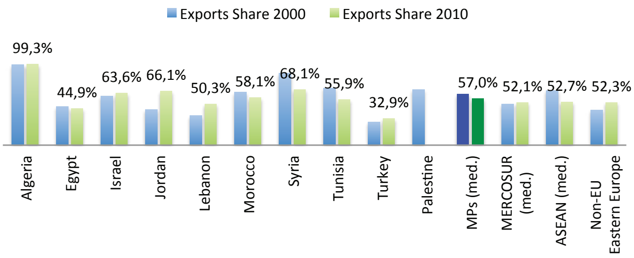
Moreover, even though Graph 10 shows that exports from Mediterranean countries have become more diversified, the diversification of exports has not reached the level of other developing regions. The share of the 10 products most exported by SME on average reached 57% of total exports in 2010, as compared to 63% at the start of the decade; this suggests a certain commercial diversification but which remains low as compared to other regions.

Figure 9.
Share of high-technology products (% of manufactured exports) by region



Source: WDI-World Bank

Figure 10.
Part of the most exported 10 products (% of total exports) by country and region



Source: FEMISE calculations on COMTRADE data using TradeSift

As a conclusion to this descriptive analysis of the situation in Mediterranean countries, we may say that, despite growth that remains insufficient to allow income per capita to converge with those of Northern countries (particularly the European ones), social indicators have progressed considerably over the past 30 years. This progress has indisputably reduced the level of poverty and has prevented a deepening of the inequality gap that often arises when economies open up. However, the type of growth that prevails in these economies goes hand-in-hand with (i) weak integration within the global economy and (ii) a very high unemployment rates that are largely underestimated considering the very low participation levels. Consequently, the growth of Mediterranean countries has been rather favourable to the poor (pro-poor growth). However, it would appear to be lacking in inclusivity, insofar as it leaves a large part of the population without any employment prospects, as it has not integrated women in the field of productive economic activities and, as we will see in the second sub-section, the imbalances between regions within the countries are tending to grow.

II. Managing economic fundamentals during political transition

The Mediterranean states are in a difficult economic and social situation. They simultaneously face, (i) political transition, with for some countries intense social instability (ii) an international crisis which reduces both development potential and migrant remittances and, (iii) a steep price increase for basic foodstuffs and oil (for importing countries). It is thus no surprise to see a deterioration of all macro-economic indicators (cf. a detailed description of the macro situation of each country in the country profiles, part 2 of this report). However, the previous analysis shows a degradation of structural indicators which could be a sign that the current difficulties are not just conjunctural but also linked to deeper rooted problems. In this document we will seek to identify the stalling points or contradictory aspects inherent in these economies.

Some obstacles to economic growth may be common to other emerging economies or developing economies in the world. Explanations of a general nature have been suggested recently with two approaches; one based on the notion of "middle-income trap ", and the other which places political institutions at the heart of the analysis.

II.1. The "middle- income trap" explanation

Over the last fifty years, many countries (most during the 60s and 70s) quickly entered the middle-income bracket. Of these, few have reached high-income status[3]. Amongst the 101 middle-income countries in 1960, only 13 had reached the high-income bracket by 2008[4]. Israel is the only Mediterranean country of the 13. The others are stuck in what Gill & Kharas (2007) were the first to call the "middle-income trap". The middle-income trap corresponds to a development level whereby countries have succeeded in increasing revenue via the development of low-wage industry while increasing productivity via the reallocation of resources from agriculture to industry due to the fixing of agricultural prices at a relatively low level and the introduction of imported technologies and an extensive growth system (that is to say, with a high accumulation of production factors).

This was then followed by wage increases which eroded competitivity. On the one hand, these countries can no longer compete with countries where wages are even lower and which have penetrated the international market, and on the other, they are unable to compete with richer countries in producing products of high added value. At the same time, these countries face new challenges in terms of social cohesion and growing inequality while a large proportion of their population lives in poverty.

The stalling points identified in recent literature (Flaaen and al., 2013, Aiyar and al., 2013, Eichengreen and al., 2013, Agenor & Canuto, 2012, Felipe, 2012, Nungsari & Zeufack, 2009) are the following: the insufficient structural transformation of these economies which did not develop high productivity activities in industry and services,as well as a lack of skilled labour and a lack of innovation. These stalling points receive unanimous mention by all authors, and Agenor & Canuto (2012) add three more: insufficiently developed communication and information infrastructure, a lack of protection of property rights (particularly in terms of patent protection) and a lack of flexibility on the job market specifically regarding redundancy conditions.

Although some of these obstacles could concern Mediterranean countries, they are, in our opinion, too general for two reasons, firstly in terms of content and secondly because they do not take into account the regional specificities of the zone. The literature on the middle-income trap is an interesting starting point for analysis but must be completed and developed. This will be done hereunder, in consideration of the specific stalling points of Mediterranean countries.

II.2 An explanation based on political institutions

Inequality in the world, and the fact that some countries are rich and some poor, would essentially be due to the nature of political institutions; the latter decide upon the content and operations of economic institutions which in turn create the incentive systems which influence human behaviour and thus will or won't develop vectors for growth (cf. Acemoglu & Robinson, 2012). The authors distinguish economic institutions which we may qualify as exclusive de facto (edfac) (Acemoglu & Robinson name these "extractive institutions"); these are organised in such a way that an elite can take hold of and seize for their own benefit part of the country's resources to the detriment of the majority of the population, while not protecting ownership rights in an intangible manner and without giving economic incentives to ensure long term growth.

Inclusive economic institutions however, on the contrary, guarantee the right to ownership, a fair legal system, ensure individual freedom, the development of the private sector as well as provide access to health and education for all. The edfac economic institutions are set up by political institutions that are also edfac (and are characterised by the fact that power remains in the hands of an elite) and, on the contrary, inclusive economic institutions are set up by inclusive political institutions (power is shared more widely). For these authors, economic growth is possible in a country run by non-inclusive political and economic institutions, this growth could moreover be facilitated if there is at the same time strong political centralisation able to allocate resources to high productivity sectors (one type particularly found in the Mediterranean is the "authoritarian bargain model" founded on a non-democratic form of implicit social contract).

This is the example of China, South Korea and the Soviet Union. However, according to the authors, this type of growth is not sustainable for two reasons. Firstly, with institutions of this type the nature of growth is different than that developed by inclusive institutions. With inclusive institutions, growth is sustainable because carried by innovation and technological change. With edfac institutions growth is based on existing technology. Only inclusive institutions are able to create the necessary incentives for the development of innovation activity. In the case of South Korea, the highest growth rates ever seen in the country were linked to the fact that despite a little inclusive political institution, the country set up economic institutions with an inclusive approach. The second reason is that under edfac institutions, the control of power is very lucrative and highly sought after which can lead to political instability.

We recognize that the theory of unequal wealth between states could be criticised principally because it leads one to believe that if the "right" political and economic institutions exist and are operational then economic growth will be automatic because boosted by the behaviour of agents reacting properly to the incentives of the economic system. Although these "inclusive" type political institutions are fundamental, they are not enough to create growth. In our opinion, public action is essential to start, support or accelerate the process of economic growth.

However, this theory throws light on one of the stalling points for Mediterranean countries which has been little developed until now. It shows that understanding the nature of the political system in place is very important in order to understand the way in which an economy works. Also that it is essential to undertake an in-depth analysis of the links between the economic and political systems in order to define the best adapted recommendations for economic policy and particularly to better understand and anticipate how they will work once adopted. The interactions between the economic and political systems are one of the aspects of the notion of governance. The use of this concept and subsequent recommendations remains however somewhat general, and the precise reality of the concept is never clearly explained.

It could be said that until the Arab Spring, economists ignored the effect of the political system in place on the organisation and running of society. They thus also ignored the importance of its' impact on the economy. Only the tip of the iceberg, corruption, was seen as being harmful for the economy. We may criticise these economists not so much for having misunderstood the heart of the problem as for having spieled out "standard" recommendations in an insufficiently analysed and understood context, without doubting their content.

II.3 The effects of political transition

II.3.1 The current primacy of politics over the economy and consequences

In political terms, the situation of Mediterranean states is far from uniform (according to the concept of Acemoglu & Robinson), some have reached different levels of development (Israel, Turkey, Morocco, Lebanon), others are at the beginning of the transition process (Egypt and Tunisia), while Syria is in the midst of an internal conflict which as a repercussion jeopardises the political situation in the Lebanon. It can thus be considered that the majority of Mediterranean countries are undergoing political transition and are at very different phases in the process.

In global terms, political transition means the breaking of close-knit ties between politics and the economy, the reducing of the power and influence of the elite, the breaking of the arbitrary power of the authorities and public and/or military services on people and businesses, the setting up of a fair and independent legal system, the respect of individual freedom, giving greater participation to the people, having more open and transparent governments legally accountable for their acts and the redefining of the traditional "social contract" under which the population (or at least part of it) traded political freedom in against jobs in the public sector and free access to all public services (health, education etc). The transition is a long process which will not play out in a linear manner and is generally accompanied by political instability and social unrest.

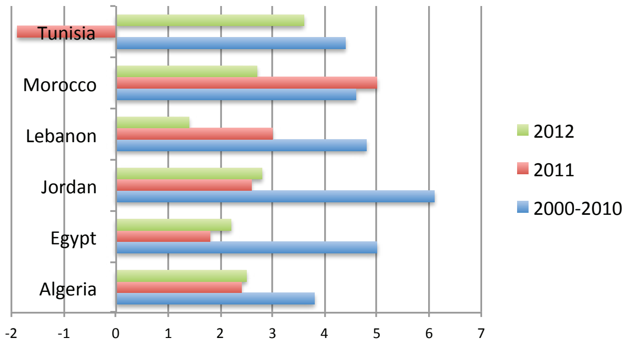
In economic terms, periods of political transition are generally accompanied by a deterioration of the macro situation and a loss of interest in economic policies. Regarding first the macro situation, the Mediterranean countries undergoing transition, are struck by an economic downturn and greater macro instability. In order to detect the macroeconomic trends linked to periods of political instability and to provide useful lessons for the Mediterranean countries in transition, the economists of the WMF (2012) have listed 11 episodes of political instability of similar intensity to those observed during the Arab Spring for low revenue and middle revenue countries (5).

They show that these episodes of political instability were accompanied by strong contraction of production and investment. The countries recorded a drop in GDP of over 4% during the year of political instability. In all the countries studied, growth rates dropped below trend during the year in question and the following two years. Unemployment rates grew on average by 1 to 1.5 percentage points during the two years following the beginning of the period of political instability, and it took 4 to 5 years for the situation to right itself. Consumption resisted while public and private investment dropped by around 20% on average during the year of instability and remained weak through the following years.

A study by Freund & Mottaghi (2011) on 50 cases of political transition shows that GDP dropped by 3 to 4 percentage points during the transition but quickly rose again after. This J-type curve trend of economic growth during political transition is further confirmed by the empirical analysis of Freud & Jaud (2013), which identifies 90 experiences of the shift from an autocratic regime to democracy. The authors note that the countries are confronted by temporary difficulties with drops in growth of around 7 to 10 percentage points during the year of transition, and that the drop could reach as much as 21 percentage points in countries where transition is gradual and the period of political instability longer. Egypt and Tunisia confirm these trends. Graph 11 shows that indeed, when taking the 10 year period pre-Arab Spring as a reference (2000-2010), economic growth in Tunisia lost an average of 6 percentage points in 2011 followed by a 5 point gain the following year. The drop in growth for Egypt was less marked (3 percentage points in 2011) with almost no gain in the following year. The recent revival of political and social unrest will once again impact growth rates negatively in 2013. In both countries the unemployment rate has grown by 4 percentage points as compared to the pre-Arab Spring period. Thus, we must expect in Mediterranean countries that economic perspectives in the short and mid-term will remain difficult as long as political transition is still unclear. An element specific to Arab countries undergoing transition is the operational difficulty of implementing new constitutions.

In a context of growing difficulty, the governments of countries in transition are paradoxically less active economically. If over the last 20 years the dominant philosophy could be resumed as "Economic reforms first, political reforms later", since the Arab Spring the aphorism has, in fact, been reversed. State authorities concentrated on political reform while the economy was given a back seat. Main measures taken [6] sought above all to respond to the emergency of political instability and social unrest. All countries increased subsidies for foodstuffs and oil at different levels and in a non-continuous manner since some countries reduced them later (as Jordan, for example). This policy of subsidies also created a certain level of economic distortion (we will come back to the question of subsidies later). Algeria, Egypt, Jordan and Morocco increased wages in the public sector thus further accentuating the difference in revenue between public employees and the rest of the population. Morocco moreover increased the minimum retirement benefit level from 600 to 1 000 Dirham per month for civil servants and their families. In Tunisia, tax declarations were postponed by several months and for even longer for large export companies. In Algeria, Egypt and Tunisia, governments created public sector jobs (2.5 million in Algeria, the granting of permanent posts to 450,000 public sector contract workers, in their jobs for at least 3 years in Egypt, the recruitment of 40,000 people and 4,303 qualified unemployed persons in Tunisia). These social measures are, with differing levels of success, an answer to public discontent and a way to lessen slightly the dramatic impact of the situation on the poorest members of society. On the other hand, they provoke or maintain distortion, only partially target those most in need (as we will see when looking

Figure 11.
Comparison of annual growth rates before and after the Arab Spring in the Mediterranean countries



Source: WDI-World Bank

at the question of subsidies), further accentuate certain inequalities (particularly between public and private sector jobs, formal and informal) and do not in any way tackle the fundamental difficulties of these economies (sluggish job-market and private sector etc). They are wholly unable to act as the key measures of an economic policy designed to accompany political transition and kick-start the economy.

II.3.2 The necessity to define a clear economic policy which goes beyond short-term priorities

A well-adapted economic policy is all the more necessary during periods of political instability which are often coupled with social unrest, and which have a heavy negative impact on the economy with as a consequence a drop in the population's standard of living:

√ Firstly, tourists are discouraged and turn to other destinations which in such countries as Tunisia and Egypt where tourism contributes greatly to the GDP and offers employment to a large part of the active population (both in the formal and informal sector), has a major effect on the standard of living of populations. In the formal sector alone, in 2010 tourism represented 13% and 16%of GDP, and 11% and 15% of total number of jobs in Egypt and Tunisia, respectively. This activity also represents a major source of foreign income, particularly in Egypt, where it was estimated in 2010 at over

11.6 billion dollars, almost two thirds of service exports and almost 30% of total exports. In February 2011, cancellation of holiday reservations brought down the number of tourists in Egypt by 80%, which provoked a drop in tourism revenue of around 53% , with very negative economic consequences.

√ Secondly, foreign investors are hesitant to set up in the countries concerned, which deprives the economy of the expected booster effect (we will come back to this point later) and which contributes to a drop in global investment. In the light of recent events in Egypt, most multinationals have either cut down or stopped business altogether, closing production sites (Sanofi, Electrolux, Shell, Suzuki, Toyota, etc.).

√ Thirdly, this impacts the anticipations of domestic operators. On the one hand the elite, or the part of the population which controls business, no longer enjoys a business-friendly environment. Moreover, in such a changing context, the owners of a large part of the countries' capital are unready to risk investment. On the other hand, the political and economic environment is neither yet sufficiently ready for the development of the rest of the private sector nor for the emergence of a new group of entrepreneurs. As a consequence, political and social instability and to a lesser extent, uncertainty in the face of a world crisis, means that investors are biding time until they have clearer visibility of the evolution of the country and more favourable conditions.

The total cost of transition in economic and social terms is considerable, particularly for Egypt, Tunisia and of course Syria, where political transition has not yet started and where nobody is able to say when the conflict will end. It should be said, however, that this has been the case for all transition processes since the end of the 80s. The German reunification process concerned 18 million people and cost 350 billion dollars. In Eastern Europe the cost in terms of GDP and unemployment at the beginning of the 90s was also very high. But once a clear orientation had been taken and a strategy chosen, the rebound was spectacular. The vision of joining the EU and the considerable financial support this could bring (70 billion Euros for Poland alone), a rich flow of foreign investment and swiftly adopted institutional reforms all went to profoundly modify the situation in 20 years.

Albeit clear that transition in the Mediterranean is not about a shift from a planned system to a market economy, and although less accentuated, the economic factors at play are of the same nature: transient political uncertainty creates unfavourable anticipation, the change of elites provokes major disorganisation and if the hopes of those leading the change wither then a general feeling of defiance will develop. All this leads, at different rates depending on the extent of the transition, to a degradation of economic equilibrium (employment, prices, budget external balance), which may last for some time and must be accepted by the population. This transitional phase may be shorter if the international community is sufficiently involved in facilitating short-term management and if the new powers have a vision which meets the aspirations of the people.

If tension is prolonged we note in all cases an amplification of the negative impacts of political transition. Added to this is the fact that some Mediterranean countries have to absorb very large numbers of refugees from neighbouring countries; this disturbs the economy, creates tension on the job market and calls into question the pursuit of certain social policies while bringing down even further the standard of living of the poorest populations (see box 1 on the issue of refugee influx).

It is necessary to keep in mind that the evolution of the standard of living of populations will play a key role in social stability and the pursuit of the transition process. Thus to maintain and improve standards of living, it is essential that public powers take charge of the economic sector via the adoption of adapted economic measures. The viewpoint of Femise is that authorities cannot simply limit their action to emergency decisions regarding short or very short-term concerns particularly since, as we have seen, some of these decisions create distortion and can have mid-term negative effects which then must be managed in consequence.

How should the economic policy of a country in political transition be managed? There is relative agreement on what must be done (have a vision, in particular for the youth, pursue political reform, improve funding access for business, set up a regulatory framework and system of governance ensuring businesses of a simple, transparent and fair approach, limit the possibility of allowance seeking, consolidate public accounts and reduce external debt, rebalance territories and deepen the integration processes underway), however there are but few indications as to how to apply the reforms and set up the economic policy measures. We often read, as the IMF stated (2012), that "the coming reform programme is complex and its' implementation will take a certain amount of time".

Box 1. The question of refugee influx

In 2011 Tunisia had to handle an important influx of Syrian refugees. Since the start of the violence in Syria, Lebanon, Jordan and Turkey are also seeing the arrival of large numbers of refugees. Turkey which has just announced the closure of its borders with Syria for geopolitical reasons, has received between 260,000 and 400,000 Syrians. In Lebanon the number is between 700,000 and one million persons. In Jordan in January 2013, the number had already reached one million refugees and 1.2 million are estimated in the near future which represents one fifth of the total population of Jordan. With the pursuit of violence, Syrians will continue to flee their country to seek asylum in a neighbouring country. If Turkey closes its borders the pressure on Lebanon and Jordan will be even greater.

The refugee question is important because if ill-managed by the international community, the risk is greater political, economic and social instability in the receiving countries. On the one hand, it is essential to provide decent living conditions to the refugees (which requires major effort in terms of infrastructure) as well as access to healthcare and particularly to education. In this area, due to great numbers of children amongst the refugees, the needs are quite considerable *.

On the other hand, all of this represents a very high budget for the governments in the receiving countries, which they are unable to fund alone. Also, the presence of refugees increases pressure on the job market. In order to prevent economic problems sparking off tension between refugees and the local community, it is essential that the international community assists these countries in bearing the burden of administering to the refugee population.

* The cost of welcoming and assisting Syrian refugees for the government of Jordan is estimated by the end of 2013 at 1.31% of GDP and 6% of Jordanian budgetary revenue (cf. D. Dali, 2013, AFD, Macroéconomie et Développement, Sept)

In the short term, some Mediterranean countries are in a very worrying situation. Following the resumption of political and social unrest, Egypt is completely strangled financially. At the end of June, the central bank had only 14.9 billion dollars of exchange reserve as compared to 35 billion at the beginning of 2011, just enough to ensure 3 months of importation. Fortunately the Arab funds allow the Egyptian transition government to organize future elections while maintaining standards of living and even lessening the weight of the budget deficit. Tunisia is also in a critical situation. The only way to loosen the financial stranglehold is to call on international aid which will require, in the coming weeks and months, strong mobilisation of all the funding authorities. The international aid, albeit crucial in giving a little breathing space to the country, will certainly not be able to solve the fundamental problems, structural in nature and much more difficult to solve.

II.4 Longer term problems linked to the job market

In order to analyse job market related issues, we will first consider the supply aspect and then that of demand.

II.4.1 Job supply: human resources ill-prepared for the economic and societal changes underway

As suggested by Agenor & Canuto (2012), can we also say that one of the main constraints on growth in these economies is an un-flexible job-market? For Femise, the answer to this question is clearly no, despite the fact that a certain amount of flexibility is vital to stimulate employment in the private sector and to allow companies (particularly micro, small and medium companies) to adapt quickly to fluctuation in demand. The more acute problems are to be found elsewhere. One of these problems is the lack of well-trained human resources.

Since independence, Mediterranean countries have invested massively in education which has meant much greater access of populations to education and a marked increase in the proportion of a particular age-group enrolled in higher education. This is a very positive point for these countries. As shown in tables 5 (in % of GDP) and 6 (in % of public expenditure), the percentage of spending on education is generally high, with the exception of Lebanon and Turkey, which have chosen an education system with partial private sector funding. The countries which invest the most as a percentage of GDP or public spending, are Israel (6% of GDP and 13.6% of public expenditure), Tunisia (6.2% of GDP and 21.5% of public expenditure), Morocco (5.4% of GDP and 25.7% of public expenditure), followed by Syria (5.1% of GDP and 18.9%of public expenditure). These figures are comparable to other emerging countries (Malaysia, 6% of GDP and 21.3% of public expenditure, Brazil, 5.8% of GDP and 18.1% of public expenditure, Thailand, 5.8% of GDP and 29.5% of public expenditure).

Although illiteracy still remains high in certain countries (Morocco for example) and not everyone enjoys equal access to education facilities (poor populations, rural populations and girls are the most affected), overall the quantitative result is relatively positive. However, the quality of education systems in the Mediterranean is being questioned more and more, due to (i) increased unemployment rates amongst graduates, (ii) weak results obtained by students in international assessments, and (iii) low-level employability of graduates.

(i) Excepting Israel, youth unemployment has risen everywhere, reaching between 25% and 45%, which are the highest levels in the world. Even more worrying, as shown in graph 11, is the fact that in Egypt, Algeria, Tunisia, Morocco and Jordan, it is the graduate population which is the hardest hit by unemployment. In these countries we can observe a growing link between the level of unemployment and the level of education. This is particularly alarming because in time it could stall growth. At an individual level, it could discourage families and de-motivate young people from investing in education (considering that the higher the level of education the greater the probability of unemployment). At the macro level, the abnormally high unemployment rates of graduates reduce the efficiency of public spending on education and prevent economies from benefitting from the positive external impact that this spending should bring (greater capacity to integrate technology transfer, greater capacity to develop innovation in businesses etc). Moreover, these young graduates remain jobless for long periods. In Morocco the average period of unemployment for graduates is 40 months, as compared to 24 months for the rest of the unemployed population (Aita, 2008). In Tunisia, the level is 28 months for graduates of higher education as compared to 19 months for non-graduates (Stampini & Verdier-Couchane, 2011). Such long periods of unemployment reduce the skills of these trained young people which in turn diminishes the quality of global human capital in the country.

The youth unemployment rates, already excessively high, are probably under-estimated considering the very low level of young people in the active population. This low level of participation is linked both to the marginalisation of women and to the fact that discouraged young people finish by pulling out of the formal job market and head for the informal sector, either by creating their own business (this represents 45% of new jobs created in Algeria between 2000 and 2007, and in Tunisia 81% of companies are independent workers in the informal sector), or by taking low-paid jobs, under the minimum wage and with no social protection. Informal employment represents between 43 and 50% of total non-agricultural employment in the North African countries (Dyer, 2005). Emigration is another possibility for these young people.

Table 5.
Education expenditure as% of GDP

MPs	Most recent year	2000	1990	1980	Others Countries	Most recent year	2000
Algeria	4.3	na	na	6.6	Brazil	**5.8**	4
Egypt	3.8	na	na	4.2	Chile	4.1	3.7
Israel	**6**	6.5	6.1	8.6	Korea. Rep.	5	na
Jordan	na	na	na	na	Malaysia	**6**	6
Lebanon	1.6	1.9	na	na	Romania	4.2	2.9
Morocco	**5.4**	5.8	5.3	5.9	Thailand	**5.8**	5.4
Syria	5.1	na	na	4.6	East Asia & Pacific	4.4	3.3
Tunisia	**6.2**	6.2	5.8	5.2	Latin America & C.	4.9	4.5
Turkey	2.9	2.6	2.1	na	Sub-Saharan Afri.	4.3	3.4
West Bank & Gaza	na	na	na	na	EU	5.2	5

Source : WDI. 2013. World Bank.

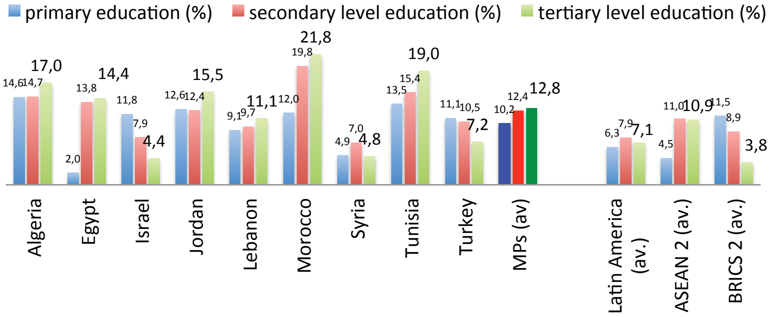
Table 6.
Expenditure on education as% of public expenditure

MPs	Most recent year	2000	Other Countries	Most recent year	2000
Algeria	**20.3**	na	Brazil	18.1	12
Egypt	11.9	na	Chile	17.8	17.9
Israel	13.6	13.8	Korea. Rep.	15.8	na
Jordan	na	na	Malaysia	**21.3**	**26.7**
Lebanon	7.1	9.2	Romania	na	7.5
Morocco	**25.7**	23.5	Thailand	**29.5**	**31**
Syria	18.9	na	East Asia & Pacific	na	14.7
Tunisia	**21.5**	17.4	Latin America & Carib.	na	15.5
Turkey	na	na	Sub-Saharan Africa	16.2	na
West Bank and Gaza	na	na	EU	11.4	11

Source : WDI. 2013. World Bank.

(ii) In international student assessments, the most well-known being the PISA (Program for International Student Assessment) carried out by the OECD in 2006 and 2009 and the TIMSS (Trends in International Maths and Science Study) carried out every 4 years since 1995 by the International Study Center (Boston College), Mediterranean countries obtain relatively low scores as compared to the average of all countries taking the tests. (cf. Tables 7 and 8, next page). Although the methods used in such studies may be discussed and the results of the assessments should be used with caution, all the scores obtained are coherent and reveal a certain number of weaknesses in the basic learning curriculum. This in turn undermines the quality of training in higher education.

Figure 11.
Unemployment rate by level of education (2010 *, 15 + years)



Source: KILM and Martin (2009)
** Most recent available year*
ASEAN2 (Indonesia, Philippines), BRICS2 (Russia, Brazil)

(iii) Operators, be they domestic or from foreign companies, continually express the fact in studies (cf. those run by the World Bank (ICA) or Femise for research projects), or interviews, that it is difficult to find skilled and qualified workers. The difficulty to find qualified labour is often given by multinationals as being one of the biggest obstacles to setting up a business in Mediterranean countries. The lack of employability [7] of trained people is linked to several different factors.

- The first is that in higher education, social and human science courses have been better developed to the detriment of science and technology courses.

- The second factor is that the education system in most Mediterranean countries was built in such a way as to prepare most graduates, and particularly highest-achieving students, for the Civil Service. Employment in the public sector is generally very high. In Syria, it represents around one third of all jobs, 22% in Tunisia and almost 35% in Jordan and Egypt (cf. BIT, 2012). Moreover, wages in the public sector are on average 30% higher than those in the private sector (whereas, throughout the rest of the world, they are generally, on average, 20% lower). In Morocco the difference is as high as 75% (Kocoglu & Flayols, 2012). Alongside the wage benefit, are the other benefits associated with public sector employment (job protection, access to social security, an advantageous retirement system). These advantages influence young people both in terms of course choices for higher education and in their strategy for seeking employment, sometimes seen as a quest for secure income via public sector jobs (see the references in Kococklu & Flayols, 2012, previously quoted). Indeed, young people are tempted early on to choose general training courses which open the door to jobs in the public sector. Once graduated, young people tend to remain unemployed until they find a job which corresponds to their expectations in terms of wages and working conditions, which generally the public sector is the most likely to provide. The risk is long-term unemployment and/or finishing up in the informal sector or emigration.

- Finally, the third factor is linked to the way in which the job market works. In some of these countries, and for many years, the political interface prevented the job market operating in a fair and transparent manner by building the recruitment system on the notion of merit and the recognition of individual skills. The dysfunctions inherent in the political systems of these countries have necessarily entered the rationality of individual behaviour.

As a consequence, it is essential (i) to rethink the education system as a whole, right from primary school, in order to align it with the profound changes modifying the way in which society operates, (ii) to better adapt the education system to providing the qualifications and skills necessary for economies, in order that human capital contribute to the dynamics of the private sector and allow for a new, more intensive type of growth, centred on knowledge and innovation (see below). Having said this, the problem of underemployment, particularly that of jobless young graduates, will not be solved by simply improving the education and training systems if the countries do not also sort out the problems responsible for blocking demand on the job market.

II.4.2 Demand for jobs: demand in decline and a production system unable to offer quality employment

The needs for employment in the Mediterranean countries are tremendous. Just to maintain the levels of activity and the unemployment rates at their 2010 level, Blanc (2011) considers that all of the Mediterranean countries would need to create a minimum of 34 million new jobs by 2030. As we might hope that women's participation will have progressed by then, this figure should be even higher. According to the estimations carried out in 2010 by the IMF, 18 million jobs would have to be created during the present decade if unemployment is to be curbed and work offered to the newcomers on the labour market in Egypt, Jordan, Lebanon, Morocco, Syria and in Tunisia alone. How can job opportunities be created for these millions of people whose expectations have become increasingly insistent since the Arab Spring? This is, without a doubt, the priority issue for the large majority of the region's decision makers.

The public jobs recently created by the governments of a certain number of countries (cf. the previous section) can only partially quench the discontent ex-

Table 7.
Results of TIMSS international math evaluation

	1999	2003	2007	2011
Algeria	na	na	387	na
Egypt	na	406	391	na
Israel	466	496	463	**516**
Jordan	428	424	427	406
Lebanon	na	433	449	449
Morocco	337	387	381	**371**
Palestine	na	390	367	404
Syria	na	358	395	380
Tunisia	448	410	420	425
Turkey	429		432	452
MPs average	**422**	**413**	**411**	**425**
World average	**487**	**468**	**458**	**472**

Source: http://data-visualizer.iea.nl/

Table 8.
Scores obtained by the Mediterranean countries in the PISA assessments, compared with other emerging countries

	On the overall reading scale	On the mathematics scale	On the science scale	Ranking on 71 countries
Korea	539	546	538	2
Estonia	501	512	528	13
Poland	500	495	508	15
Hungary	494	490	503	26
Latvia	484	482	494	30
Slovenia	483	501	512	37
Czech Republic	478	493	500	34
Slovak Republic	477	497	490	35
Israel	**474**	**447**	**455**	37
Turkey	**464**	**445**	**454**	40
Chile	449	421	447	44
Romania	424	427	428	49
Thailand	421	419	425	50
Brazil	412	386	405	53
Jordan	**405**	**387**	**415**	55
Tunisia	**404**	**371**	**401**	56

Source: OECD PISA 2009 database.

pressed by the populations. However, the capacity for job creation within the public sector has largely reached its limits and cannot, in any case, be a solution considering the extent of underemployment in the region. The only possible way to create jobs is through the development of a dynamic private sector.

In recent years, certain governments have adopted this course and have attempted to lead a significant number of reforms to encourage private sector development. As shown in the previous section, the structural adjustments undertaken in the 90s succeeded in stabilising the macro situation within the Mediterranean countries. Parallel to this, entire sections of the economy have been privatised and, as from the end of the 90s in some countries, or the beginning of the 2000s in others, many opened their economies to international competition by radically reducing customs duties on imported industrial products and by rationalising their non-tariff measures. Some countries also opened, often partially, their capital accounts and adopted an investment code that encourages FDI (foreign direct investment). In line with the recommendations issued by international institutions and/or within the framework of action plans signed with the EU, major economic reforms were undertaken and, according to the standard evaluation criteria employed in international rankings, most of the countries have indeed made headway, as demonstrated by the progress in the yearly Doing Business rankings since 2004. Different reports have indeed underlined the major efforts made by MED governments to improve business regulations for local entrepreneurs. Morocco, for example, was amongst the 50 economies in 2013 to achieve the best improvements in the business regulatory environment in recent years (cf. Doing Business Report, 2013). Added to these positive points are a rather favourable geographical location (considering the short distance between the European market paired with maritime access for most countries) and the opportunity afforded by a young active population whose level of education has progressed considerably. On paper, most of the conditions have been established for the Mediterranean countries to count on their private sector to achieve extremely high growth rates over long periods. However, this is not what is observed.

As also underlined in the previous part, Mediterranean countries have recorded relatively low growth rates as compared to other emerging or developing regions. The mean growth rates per inhabitant have also been amongst the lowest in the world since 2010. Moreover, for part of the countries of the region, the annual growth rates are highly variable according to climate variations, given the important role still played by the farming sector with regard to the rest of the economy. Consequently, even in countries that swiftly led a large number of economic reforms, the private sector has not developed with the expected energy. A number of reasons can explain this lack of dynamism.

- √ **The first** is the contraction of end-consumer demand caused by the current situation. Before the 2008 crisis, this was not an issue and all of the analysts put the focus on institutional matters, business climates and the quality of labour. The crisis has led us to rediscover that expected consumption is a decisive element for investment and recruitment. Even within a favourable business climate, no company would take the risk of recruiting if there were any likelihood of a significant decline in the use of their production capacity. This aspect is directly linked to the previously mentioned urgent need to successfully complete the political transition and to define a clear and common economic strategy, supported by the community of international donors.
- √ **The second,** often cited, is that of a business environment that is still not very favourable for local enterprise.

A number of surveys [8] have been conducted to identify, within each country, which were the greatest obstacles for companies in their business. Although the weight of each deterrent can differ between countries, the same type of obstacle is pinpointed for each region: the difficulty to obtain funding, administrative, fiscal and legislative red tape, the extent of the informal sector and corruption, insufficient infrastructures and, as already mentioned, the lack of qualified labour. The problem of access to information and advisory services for companies is also frequently underlined.

One of the principle problems for businesses is access to funding. This obstacle is linked not to the cost of financing, insofar as interest rates are not high, but to the difficulty to obtain a bank loan and/or cash flow facilities.

The banks lend money more readily to large, well-known, companies, occasionally with more or less distant connections to the political power. Personal relationships and, possibly, links with those in power play an important role in the loan attribution system. Moreover, loans are only granted if the entrepreneur is in a position to provide significant guarantees which systematically include personal assets, generating the risk of losing personal or family heritage in the event of bankruptcy. The difficulty to obtain a loan is therefore higher for SME and start-ups and yet these are the largest potential source of job creation. The banks are indeed lacking in both financial tools adapted to more risky investments and, as the external audit system is not very developed, they have trouble evaluating the financial situation of the SME. The banks don't necessarily have the required skills to assess the potential of new projects. In the case of Morocco, a Femise research project [9] (2010, published in 2012) revealed that bank loans were not awarded to the most productive companies. However, a positive link was established between the granting of loans and the firm's productivity when the latter called upon an external chartered accountant to audit their accounts. This result shows that the banks' lack of information skews the granting of loans to the detriment of the most productive companies.

The banks rarely justify the refusal to lend money to a company, but the refusal generally stems from insufficient guarantees or from the fact that the particular business sector is not doing well. In Morocco, for example, in the printing and publishing sector, 70% of the loan requests made by the surveyed companies were refused in 2012. In the clothing and textile industry, another sector suffering from the crisis, practically all of the loans requested by the surveyed companies were refused in 2012. In Egypt, in 2012 once again, regardless of the sector, less than 15% of the surveyed companies obtained a loan (cf. Ayadi et al., 2013, study supported by Femise).It should also be added that the banks' response time is very long, as they generally have a backlog of applications to examine, which can be extremely penalising for companies that necessarily miss opportunities for their development.

It is not therefore surprising that the Mediterranean countries, despite a relatively large banking system, have the highest loan concentration rates in the world, reflecting the strong focus of banks on large companies (Rocha et al, 2011). A large part of these countries' economies, small and medium companies in particular, have very limited access to bank loans. According to the Enterprise Surveys conducted by the World Bank between 2005 and 2010, amongst the total of loans granted to companies within the MENA region, the share given to SMEs would amount to only 8%. The lack of alternative solutions (such as leasing, factoring or investment funds dedicated to SME and start-ups) obliges entrepreneurs to use only internal resources to fund their cash flow and investment. Lastly, it should be noted that for the MEBA region, microfinance loans were given to only 1.8% of the population (i.e.

half of the percentage observed in Asia and South America).

Companies also complain about the amount of administrative, legal and fiscal red tape and/or the difficulty to comply with all of the procedures, through lack of information and advisory services, regardless of the field (land, fiscal, standards, facilities, export, regulatory modifications, etc.). It is very difficult for small and medium companies to retrieve this information and to gain access to advisory services, even more so when they are located in small towns or rural environments. Companies must also deal with a lack of coherence in the measures implemented to support growth, employment and sometimes even export, which has created a certain amount of distortion and dysfunction. In Egypt, for example, companies consider that the tax system does not offer much incentive as it is too fragmented (measures in favour of employment, measures in favour of export, etc.) and does not have a coherent framework. In addition, the companies' visibility is made hazy due to the frequent modifications in mechanisms and legislative and regulatory frameworks, causing company managers and project carriers to progress with caution, to adopt a wait-and-see attitude or even to lose their momentum all together. Due to administrative constraints and long payment deadlines, public markets are only accessible to fairly large companies.

In certain countries, the business aid mechanisms, particularly those set up in favour of exports, encourage entrepreneurs to use them to earn money through import and re-export operations which generate almost no added value or jobs. Yet these mechanisms come with a cost and the budgets spent on them by the state could be used to fund more effective measures. Moreover, these import-re-export operations mobilise capital that does not feed the economy, whereas it could be used differently. These dysfunctions are rarely spotlighted and as the mechanisms are not assessed, we have no information on their efficacy in creating added value and jobs. It would be useful to undertake some empirical analyses to measure the added value exported by Mediterranean countries. Their result would be an initial indicator to evaluate the efficacy of the export aid mechanisms.

Another important source of deterrence for companies is corruption and the weight of the informal sector within these countries. Entrepreneurs must often pay bribes in order to complete a certain number of administrative and legal procedures and to facilitate customs procedures. It is also difficult to win a public market without paying bribes.

Lastly we may add that in certain countries, the infrastructures are not sufficiently developed. This is the case in particular for Algeria and Egypt, where companies face problems of electricity supply and insufficient public transport networks. Generally speaking, infrastructures have a positive influence on private sector growth. Although the methods and variables used to measure infrastructures can be the object of debate, this causal relationship is confirmed both by a large proportion of the empirical literature and by the theoretical literature (cf. for example Straub, 2008). Not only does public expenditure stimulate demand and create jobs [10] (direct effects), but it also improves the productivity of companies by reducing their costs (better access to energy, reduction of transit time for goods, etc.) and by providing them with new opportunities (access to new markets, possibility for training via new technologies, etc.).

Spending on infrastructure also leads to a better distribution of activities throughout the country and can help to create new opportunities for populations in rural settings. However, to precisely assess and understand its effect, it is important to consider the conditions in which these infrastructures are used (management methods, maintenance, supply of services to companies and private individuals, etc.).

In the literature and the recent reports published by international organisations, these obstacles are most frequently pinpointed to explain the lack of dynamism within the private sector. As stated above, certain countries have adopted a large number of economic reforms with the aim of improving the business environment. These reforms have not borne the expected effects within the private sector. We better understand the reasons for this since the Arab Spring. Indeed, these measures could not solve the basic problems of these economies, meaning the nature of the system by which all of these societies are organised, based on a strong collusion between politics and the economy, the strong influence of elites, the arbitrary power of the authorities; public and/or military intervening amongst individuals and companies, a legal system lacking in fairness and individual freedom that is not always respected.

Even in countries where the political institutions have achieved a great deal of progress (in Morocco for example), the economic organisation remains subject to operating rules dominated by the system of favouritism and patronage, that benefit well-established companies and those with a good network. The rational and behaviour of operators are based on these operating rules. Overall, the economic process remains dominated by the protection of the interests of a small segment of the population.

The analysis is further complicated by the fact that these societies have become doubly dual. The long term duality between a small group of society that benefits from the system of favouritism and patronage on the one hand and, on the other, the bulk of the population that does not belong to the inner circle, has recently been joined by a new form of duality. The latter is experienced by most of the population, in particular a large number of entrepreneurs, which are faced with international competition on export markets and on local markets alike, and who are therefore obliged to adapt their behaviour to the rules of a competitive game, whereas meanwhile, they must operate within a different system that is not adapted to these competitive rules. The companies, in particular the SMEs, must therefore juggle with two opposite rationalities. On the one hand they must be increasingly competitive and productive, they must quickly adapt to changes in demand, to their new competitors, to new standards, they must innovate, upgrade their products, etc. and, on the other hand, they operate within a "business environment" (access to funding, access to land, relationships with the administrative systems, competition with the informal sector, etc.) It is not because a company is competitive, in the sense of good productivity, for example, that it will be granted funding.

Similarly, the legal system dealing with the resolution of disputes (resolution of insolvency, carrying out of procedures, etc.) can take a long time. Access to land can also be complicated in certain countries. It is important to stress that these micro-economic distortions become particularly cumbersome obstacles for company development, and therefore for the growth of the country, when these companies must deal with international competition, not just for exports, but also on the domestic market. The commercial reforms have increased the proportion of companies faced with this duality whilst the domestic reforms have not created a business climate within Mediterranean countries that converges towards an operating system based on economic efficiency.

It is clear that the approach for this region has been too technocratic; hence, the real issues have been overlooked. Beyond the long list of measures to be adopted to improve the business environment, their efficacy in the politico-social context of these economies has not been queried. Nor

Table 9.
The main obstacles expressed by companies in Mediterranean countries

	Percent of firms identifying one of these problems as a major constraint											
	Year	Corruption	The courts system	Finance	Practices of competi-tors in the informal sector	Electricity	Transportation	Tax rates	Tax administration	Business licensing and permits	Labor régulations	An inadequately educated work-force
Algeria	2007	**64.3**	29.3	**50.1**	**54.5**	**48.1**	24.7	46.7	30.4	25.9	13.8	36.8
Egypt	2008	45.2	6.5	31	**61.7**	14	14.9	46.3	28.8	13.6	27	**50.1**
Jordan	2006	40.7	16.6	25.2	27.8	23.7	11.7	**52.8**	36.4	**41.5**	13.7	32.6
Lebanon	2009	**66.5**	**40.2**		**52.7**	**75.6**	**42.2**	**59.3**	**50.4**	28.9	35.9	**55.5**
Morocco	2007	27.3	30.1	31.6	34.5	37	8.2	**55.7**	17	9.3	15.8	30.9
Syria	2009	**67.1**	**60.8**	34.1	47.9	**57.5**	18.3	42.7	**50.5**	**42.4**	**50.3**	**59.6**
Palestinia	2006	**66.5**	17.1	36.7	43.7	**63.6**	**52.3**	38.2	25	**39**	12.1	25
MENA		**65.3**	**26.5**	**40.7**	**30.7**	**54.9**	**26.8**	**41.2**	**35.6**	**32.2**	**17.8**	**29.3**
All Countries		36	18.1	32.6	30.4	40	22.2	34.2	22.2	15.1	11	26.3

Source: Enterprise Survey. World Bank

has the question been broached as to how far, or rather, which combination of measures might break through the fundamental constraints that are preventing these economies from progressing. Consequently, although certain economic measures have been useful, they have not acted upon the crux of the problem.

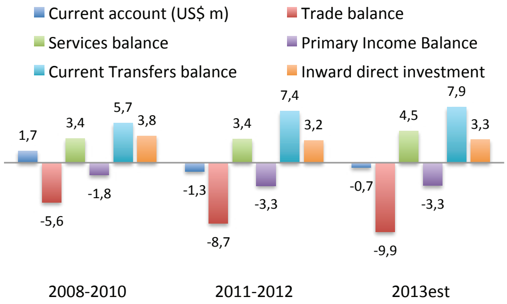
√ The **third reason** that can explain the lack of dynamism within the private sector is the effect of the tariff dismantling implemented in almost all of the Mediterranean countries. Within the context that has just been described, it is not surprising that the incentives and opportunities created by the opening up did not act as a lever within the private sector. In the 2012 Femise General Report, the chapter dedicated to this question of trade liberalisation showed that (i) the effort to open up for industrial products, although largely asymmetrical, was consequent as the average customs duties for all Mediterranean countries dropped 28% in 1992 to 7% in 2009, that is the lowest average, alongside the countries of Asia and the East, of all emerging and developing countries, with the exception of European countries, (ii) as shown in graph 13, since around 2002/2003, the trade balances of the Mediterranean countries related to the rest of the world have deteriorated tremendously (for trade excluding oil, the trade deficit rose from 40 billion dollars in 2001 to 180 billion in 2011) and, (iii) Mediterranean countries drew very few benefits from this tariff dismantling as the opening up seems to have neither increased exports, nor increased the aggregate productivity of the countries.

Did the tariff dismantling, however, contribute to increasing the companies' difficulties? According to a number of analyses (for example that by Taghdidi-Rad, ILO, 2012), the answer would appear to be affirmative. This is also what comes out of the interviews and surveys conducted amongst local entrepreneurs (such as those already quoted, for example, and conducted by Ayadi et al. 2013, for Femise). Considering graph 13, this result is not surprising. The fact that the trade balance with the rest of the world deteriorated far more than that with the EU, leads us to believe that there has not merely been an increase in imports from the EU but, above all, a high penetration of low cost imported products in the Mediterranean markets. Yet, as already underlined, the companies of the region are relatively poorly positioned; they have not moved their ranges upmarket, they have not adopted systems and production methods that are sufficiently competitive to compete with EU countries and their labour costs are too high to compete with products imported from countries, such as China, where wages remain very low.

Although, in the short run, this pressure from foreign competition puts local companies in a difficult situation, it simultaneously obliges them in the medium term to adjust and adapt their strategy by positioning themselves on new market segments. If these decisions and adjustments by the companies are to be made they will require, at the economic level, a set of reallocations via inputs and outputs and via a change in the size of firms that will create winners and losers and, parallel to this, will increase aggregate productivity.

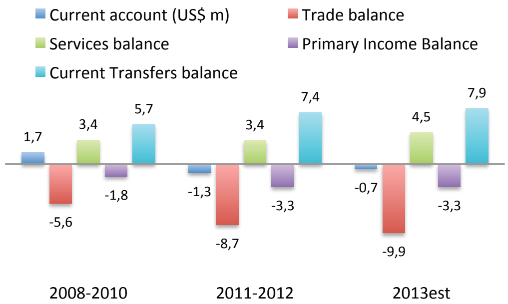
The problem is that the adjustment process demands an economic environment that the companies of the region do not have, for reasons explained above. This absence of resilience required for companies to react probably partly explains the continuous downwards spiral of the trade balance suffered by the Mediterranean countries with all of their partners and, above all, probably in addition, a higher proportion of losers (which are not necessarily pulling out of the market but which are struggling).

Figure 12a.
Current account and FDI inflows, average MPs (excl. Turkey), U.S. $ bn



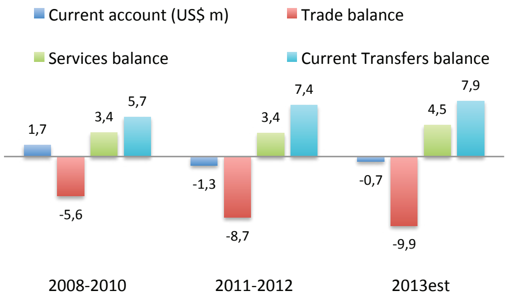
Source: EIU

Figure 12b.
Current account
average MPs (excl. Turkey), U.S. $ bn



Source: EIU

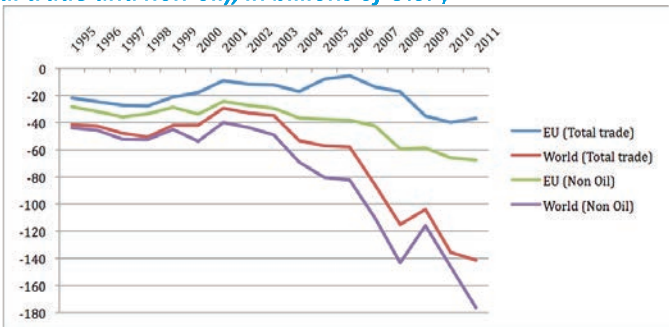
Figure 12c.
Transfer equation
average MPs (excl. Turkey), U.S. $ bn



Source: EIU

√ **The fourth reason** which can explain the lack of dynamism within the private sector is the absence of a large market, linked to the region's weak economic integration. Despite the many trade agreements in which these countries have engaged, the Mediterranean region remains a fragmented market with limited economic relations between the countries [11]. Similarly, foreign direct investments between the countries are not very developed. For example, within the Arab Maghreb Union (AMU), they represent less 1% of the FDI of this area. Also, although it has progressed regarding the trade in goods, regional integration remains weak compared to the other regional blocks. For example, at the time of their creation, intra-regional trade represented, as a total percentage of goods

Figure 13.
Evolution of the trade balance of MPs with the EU and all partners (total trade and non-oil), in billions of U.S. $



Source: COMTRADE

traded, 65% for the EU, 41% for NAFTA, 14% for Mercosur and 16% for ASEAN[12].

Through gravity models that allow the estimation of trade levels that should exist within the region, considering the size of the populations, the distance between countries, the presence of a common language and an entire set of characteristics specific to these economies, many studies show that this trade remains largely below its potential (Behar & Freund [13], 2011, Diop et al., 2010, Achy, 2006, Péridy, 2005 and several Femise on-line Femise studies [14]). This weak trade between Mediterranean countries can be explained by the combination of several factors.

Firstly, although customs duties on industrial products, between Mediterranean countries, have been mostly eliminated [15], some have recently introduced new measures (taxes or any other non-tariff measure), which are sometimes more restrictive than the tariffs themselves. Moreover, in the current trade agreements, there is the need for a series of harmonised institutional mechanisms which can play a role that is just as important as tariffs or non-tariff measures in the progression of trade. Sometimes, these mechanisms are provisioned for within the written agreements, but are not applied. Therefore, there are no dispute resolution mechanisms, no harmonised system of rule of origin with a diagonal or total cumulation, no harmonised system for standards, no harmonised systems of payment between the countries (see this point in box 2, on the creation of the Maghreb Bank for Investment and Foreign Trade, within the framework of the AMU) and no agreement on the harmonisation of competition rules or the protection of intellectual property rights. Nor is there any agreement on the free circulation of labour. Moreover, we should specify that the superimposition of agreements involving the countries of the region and that we have attempted to illustrate in the appendices (cf. Appendix 2), produces a sort of “spaghetti bowl“ that does not facilitate the homogenisation of a certain number of mechanisms or the adoption of procedures that would stimulate trade within the zone (such as total cumulation for example). We can also question the role played by the Association Agreements in the South-South integration process. The Mediterranean countries have indeed favoured bilateral relations (particularly with the EU), to the detriment of regional agreements.

An argument that is frequently forwarded to justify this priority is that the Association Agreements with the EU act as an incentive and a facilitator for regional integration. Femise is not entirely convinced by this argument. Indeed, we consider that although in certain areas the institutional and legal harmonisation adopted within the framework of European agreements (Association Agreements, Neighbourhood Policy and/or Advanced Status) can be used as a basis or model to facilitate the harmonisation of certain procedures within the region, in other fields, the priority granted to bilateral relations with the EU has probably slowed down the progress of regional integration.

Another aspect that limits the development of trade between the countries of the region is the lack of cross-border infrastructures. It is indeed essential that the region benefit from a better network of maritime, road, rail, telephone and broad band internet connections.

Finally, beyond these obstacles to the development of trade between Mediterranean countries, Malik & Awadallah (2013) consider that the main problem is due, as already mentioned, to the current political system in these countries. According to these authors, as in most countries the elites are seeking to preserve their privileges, it is not in their interest to change the current regulation systems and even less to hand over certain decisions and/or certain reforms to a supranational authority.

This market fragmentation is very costly for the entire private sector. It prevents companies from realising economies of scale, from developing, from consolidating their position on a wider market and from being more competitive on the international market where they are in competition with giant multinationals. It also prevents the development of regional production networks that have allowed certain countries, such as those in ASEAN, to gain a better position on the international value chain. This shows, moreover, that regional integration and integration within the international trade system are not contradictory and can, to the contrary, be complementary: stronger regional integration can help to gain a better position on international markets.

Extensive cooperation between Mediterranean countries would also mean a very positive evolution of the political and economic institutions of each country, thus creating another very important asset for the private sector. Another advantage linked to enhanced regional cooperation is that it allows an increase in foreign direct investments, insofar as, with a larger market, it increases the attractiveness of the zone and makes large scale investment viable.

Overall, cooperation between the countries would also make it possible to set up large scale collaborative projects in different areas (energy, innovation, training, etc.), whose external effects on the private sector would be very significant. It would also strengthen the countries' negotiating power on the international scene.

Box 2. The example of a recent initiative, adopted within the framework of the AMU*, favourable to regional integration: The establishment of a common bank called the "Maghreb Bank for Investment and Foreign Trade" (MBIFT)

This initiative was rekindled in January 2013 during the 5th Regional conference on Maghreb integration, within the framework of the AMU. The decision to create this bank dates back to 2000. The MBIFT will initially be endowed with 100 million dollars, with a contribution from each country amounting to 20 million dollars. Its headquarters will be in Tunis and it will have an agency in each of the 4 countries. It should be officially opened on the 16th December 2013. This bank will mainly be in charge of financing large infrastructure projects common to the 5 AMU countries, of promoting inter-Maghreb trade and encouraging the circulation of goods and capital between the countries of the region.

*The creation of the MBIFT should be seen as a positive element for South-South integration. It is however unfortunate that it was not established on a larger scale, including at least one other agreement, such as that of Agadir** for example, which would have allowed a large number of countries to be Included. It is also unfortunate that it has not been endowed with a more substantial capital (in 2006, when the idea of the common bank was revived, a capital of 500 million dollars was on the table).*

** As a reminder, the AMU includes 5 countries (Algeria, Libya, Mauritania, Morocco and Tunisia).*
*** The Agadir Agreement included Egypt, Jordan, Morocco and Tunisia.*

All of the empirical studies that have analysed the impact of a greater regional integration amongst Mediterranean countries draw the conclusion of a positive effect on the whole economy [16]. Brenton et al. (2006), for example, find that the GDP per capita in Algeria, Morocco and Tunisia could have practically doubled between 2005 and 2015 if there had been significant integration.

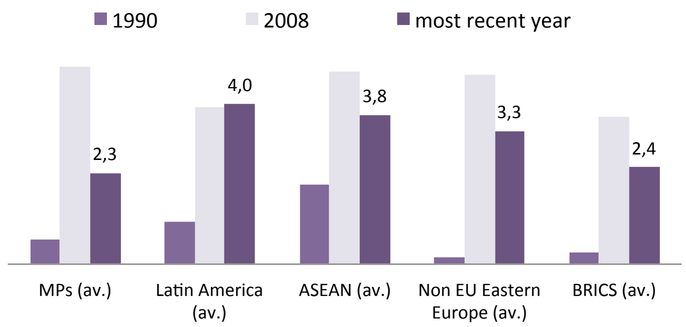
√ **A fifth reason** could explain the private sector's lack of dynamism. This is the limited impact of foreign direct investments (FDI). In the 2000s, FDI progressed significantly. For the entire region, they rose from 0.6% of the GDP in 1990 to 5% of the GDP in 2008, reaching, as shown in graph 14, the highest average rates as compared to all other regions. The countries that recorded the highest growth in FDI are Jordan (which progressed from 0.2% in 1995 to 10.8% in 2000, then to 15.8% en 2005), Egypt (progressing from 1.2% in 2000 to 6% in 2005), Israel (progressing from 1.4% in 1995 to 6.4% in 2000) and Tunisia (progressing from 1.5% in 1995 to 5.8% in 2008) (cf. Table 10).

Even though the net FDI flows to all of the Mediterranean countries remain much lower than for Latin American countries, the annual average over the 2000-2008 period was on a par with that of ASEAN countries and slightly higher than non-EU European countries (cf. Graph 15). In table 11, we can also see that the annual average amount, between 2000-2008, of the net FDI flows towards Mediterranean countries was multiplied by 6 as compared to the annual mean of the 90s, which is significant even if in the same period we may note that the sum of net FDI flows towards non-EU European countries was multiplied by 9. However, after 2008, FDI towards Mediterranean countries were those that increased the least as they rose from a yearly average of 2.87 billion dollars between 2000 and 2008 to 3.73 billion dollars after 2009, whereas in the other regions, FDI more or less doubled. These figures confirm, as already underlined, that the political and social instabilities added an additional affect to the crisis by diverting part of direct investments away from the region.

In 2012, all of the Mediterranean countries drew around 2.8% of total FDI amounts, against 24.1% for east and south-east Asia, 2.5% for south Asia, 3.5% for western Asia, 18.1% for Latin America and the Caribbean and 6.5% for European transition countries (cf. World Investment Report 2013, CNUCED [17]). Consequently, these figures show that despite a clear increase in FDI towards Mediterranean countries during the past 10 or 15 years, there is still plenty of room for progress to catch up with the FDI amounts directed towards the other regions. Moreover, when we look at the distribution of FDI we can see that 2 countries, Turkey and Israel, alone attract half of the region's FDI. Table 12 indeed shows that the distribution of FDI between Mediterranean countries has changed over the past 3 decades. Whereas in the 80s, Egypt attracted 59% of the region's FDI, in the 2 following decades, the FDI turned more towards Israel and Turkey. In very recent years, FDI flows have been distributed as follows: 31% for Turkey, 21% for Israel, 11% for Egypt and for Lebanon, 7% for Algeria, 5% for Jordan, Morocco and Syria, 3% for Tunisia and 1% for Palestine.

Owing to a lack of data on FDI flows [18] (amount per sector sufficiently disaggregated and by region over several years) and to insufficient information from the company data base on the Mediterranean productive system, it is difficult to assess the impacts of these direct investments (their potential positive effects are presented in box 3). If these impacts are assessed merely in terms of job creation, the impact of FDI remains very limited. The main reason is linked to the type of sector in which foreign capital has been invested. Almost two thirds of FDI received by MENA countries between 2003 and 2011 were indeed invested in the mining sector (including coal, oil, natural gas and ore) and the real estate sector. Whereas these sectors do not create many jobs and have limited spillover effects on the rest of the economy. Industry attracted only 20% of the MEBA region's FDI, followed by tourism with 13% (including transport services, communications, financial services, software, information technology, health and defence), that represented 5% of FDI. Graph 16 shows the sectorial distribution of FDO entries relative to their contribution to job creation directly linked to the investments. We can see that more than half of the jobs that FDI created were in industry. Foreign investment in the mining and real estate sectors only created respectively 7% and 5% of jobs related to FDI. We also see that with only 5% of foreign investment, service activities made a contribution of 19% to direct job creation. Insofar as the sectors that create the most jobs, i.e. industry and services, received only 25% of FDI, the impact on direct job creation was relatively low. Although there are no empirical analyses, it can be deduced, from this distribution of foreign investments and these direct impacts on employment, that the impacts of FDI in Mediterranean countries have probably been quite low. Generally speaking, the sum of FDI flows or their share in the GDP of the economies is not the most important element to be considered. Regarding the impact of FDI flows on the economy of the host country, the most decisive aspect is their quality, i.e. the sectors involved, the degree of integration within the country's economy, the

Figure 14.
Foreign Direct Investment,
net inflows, by region (% of GDP)



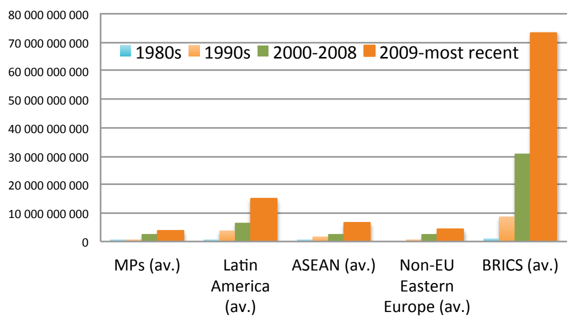
Source: WDI, World Bank

Table 10.
Foreign Direct Investment.
net inflows. by region / country (% of GDP)

	1990	1995	2000	2005	2008	2009	2010	most recent year
Algeria	*0*	*0.6*	*0.5*	*1.1*	*1.6*	*2.2*	*1.4*	*1.4*
Egypt	*1.7*	*1*	*1.2*	***6***	*5.8*	*3.6*	*2.9*	*-0.2*
Israel	*0.3*	*1.4*	*6.4*	*3.6*	*5.4*	*2.3*	*2.5*	*4.6*
Jordan	*0.9*	*0.2*	***10.8***	***15.8***	***12.9***	***10.1***	*6.2*	*5.1*
Morocco	*0.6*	*0.3*	*0.6*	*2.8*	*2.8*	*2.2*	*1.4*	*2.5*
Syria	*0.3*	*0.9*	*1.4*	*1.7*	*2.8*	*4.8*	*2.5*	*2.5*
Tunisia	*0.6*	*1.5*	*3.5*	*2.2*	***5.8***	*3.5*	*3*	*0.9*
Turkey	*0.5*	*0.5*	*0.4*	*2.1*	*2.7*	*1.4*	*1.2*	*1.6*
MPs	***0.6***	***0.8***	***3.1***	***4.4***	***5***	***3.8***	***2.7***	***2.3***
Latin America	***1.1***	***1.7***	***3.6***	***2.9***	***4***	***2.7***	***3.4***	***4***
ASEAN (av.)	***2***	***3.7***	***2.2***	***3.8***	***4.8***	***3.5***	***4***	***3.8***
Non EU Eastern Europe	***0.2***	***0.3***	***1.4***	***5***	***4.8***	***3.9***	***3.6***	***3.3***
BRICS	***0.3***	***1.5***	***2.2***	***2.4***	***3.7***	***2.4***	***2.3***	***2.4***

Source : WDI. World Bank

Figure 15.
Foreign Direct Investment,
net inflows (BoP, current U.S. $), decade average



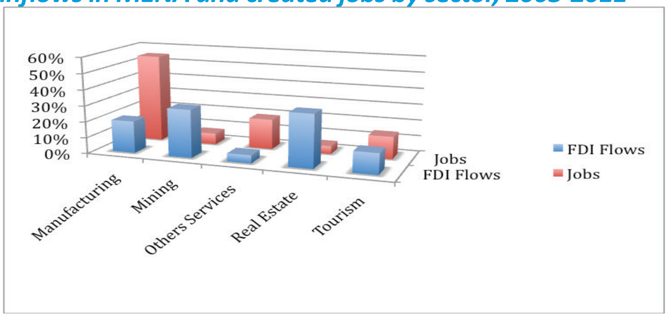
Source: WDI, World Bank

Table 11.
FDI. net inflows (BoP. current U.S. $ million). annual average

Country Name	1980s	1990s	2000-2008	2009-most recent
Algeria	34.41	210.02	1 274.96	2 701.51
Egypt	859.65	746.09	4 485.96	4 204.83
Israel	126.21	1 240.02	6 384.03	7 860.58
Jordan	45.6	89.35	1 542.92	1 844.32
Lebanon	na	na	2 728.83	4 186.51
Morocco	65.25	213.43	1 440.77	1 910.77
Syria	11.41	112.5	532.95	1 699.41
Tunisia	157.03	356.29	1 244.23	1 097.47
Turkey	168.3	771.7	9 102.89	11 575.25
Palestine	na	173.92	31.49	227.05
MPs (av.)	183.48	434.81	2 876.90	3 730.77
Latin America (av.)	495.53	3 821.96	6 861.55	15 129.89
ASEAN (av.)	267.56	1 597.84	2 861.31	6 536.36
Non-EU Eastern Europe (av.)		**272.63**	**2 498.90**	**4 160.43**
BRICS (av.)	**926.69**	**8 693.10**	**31 089.38**	**73 467.70**

Source : WDI. World Bank

Figure 16.
FDI inflows in MENA and created jobs by sector, 2003-2011



Source: World Bank, 2011 (fDi Markets data)

Table 12.
Share of FDI (net inflows) in MPs

Country Name	1980s	1990s	2000-2008	2009-most recent
Algeria	2%	5%	4%	7%
Egypt	59%	19%	16%	11%
Israel	9%	32%	22%	21%
Jordan	3%	2%	5%	5%
Lebanon	0%	0%	9%	11%
Morocco	4%	5%	5%	5%
Syria	1%	3%	2%	5%
Tunisia	11%	9%	4%	3%
Turkey	11%	20%	32%	31%
Palestine	0%	4%	0%	1%
MPs	**100%**	**100%**	**100%**	**100%**

Source : WDI, World Bank

partnerships and the conditions of provisioned knowledge and technology transfer, their location, their technological level, etc.

√ Lastly, the macroeconomic policy has not been directed with the purpose of supporting a dynamic private sector. We must indeed recall that the economic reforms undertaken in the eighties under the umbrella of the main donors (IMF and WB), marked a turn in the macro policy adopted by most of the region's countries. Whereas until then it mainly targeted growth and rising living standards (reduction of poverty, general access to health and educational services etc.), the objective pursued became macro stabilisation, the privatisation of the productive sector, market liberalisation and attractiveness to direct foreign investment. The macroeconomic policies of most Mediterranean countries have followed this direction until today. As seen in the previous part, moreover, prior to 2008, the macro indicators were mostly positive and, as also seen above, most of the Mediterranean economies have opened out to international competition.

The economic crisis, followed by the consequences of the Arab Spring (increased public expenditure, drop in tourist revenues, etc.) has deteriorated the public and external balances of most countries in the region. Some of them are in a very difficult macro-economic situation (see country details in sub-section 3 of the present report). This calls for three priorities:

- √ The first is to ensure a short term macro-economic viability with the help of external funding;
- √ The second is to progressively regain macro-economic viability to give some leeway for economic policy, which will in particular require that the question of subsidies be dealt with (cf. following point).
- √ The third is to redirect the macro-policy towards a growth objective by easing the monetary policy and by using exchange rates to contribute to improving competitiveness on export markets.

II.5 Problems linked to the subsidy system

The subsidising of farming produce and energy has become a real burden for Mediterranean countries. In 2009, they subsidies amounted to between 2.5% (for Israel) and more than 26% (for Egypt) of public expenditure (cf. Graph 17). Following the steep rise in food and energy prices in 2007/2008, the share of subsidies in the countries' GDP, in 2008, reached almost 10% in Egypt, 9% in Syria, 4.8% in Morocco, 3.5% in Tunisia and 2.5% in Jordan.

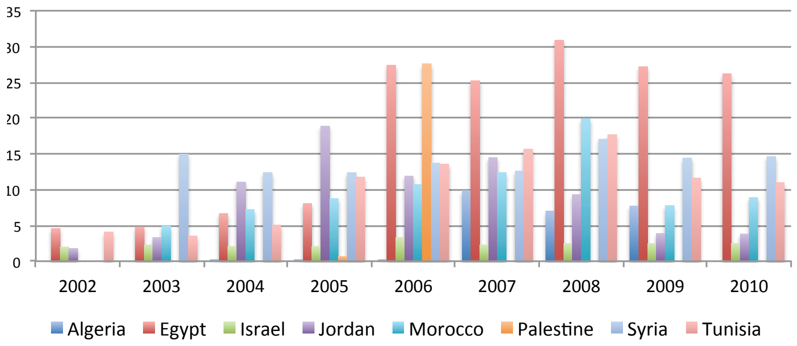
Box 3. FDI spillover effects [19]

The inflows of foreign direct investment are potential sources of technology transfer and means by which to acquire knowhow in many fields (commercial, managerial, organisational, knowledge of export markets, etc.) that can improve the efficacy of the companies in which foreign capital is Invested (or which they create) and ensure their development. Companies that own foreign capital are generally larger, more productive and better integrated in international markets. Therefore, they are likely to create more jobs and to give higher wages. To these so-called «direct» effects we may add the «indirect» effects, also called spillovers, which go beyond the capital contribution and job creation directly linked to foreign investment. The indirect effects of FDI correspond to all externalities that benefit other domestic firms, whether they belong to the relevant FDI business sector or not. Although geographical proximity or a supplier/customer relationship can facilitate the creation of these externalities, these positive impacts can trickle through the whole economy. Two types of effect are more particularly singled out:

- *√ Horizontal spillovers, which are the externalities that occur within a given industry ("intra-industry level"). In this case, domestic companies seek to achieve the level of efficacy and the competitiveness of the foreign company, through imitation and the adoption of the same technologies and/or by recruiting labour trained by the foreign firms (Javorcik, 2004).*
- *√ Vertical spillovers, which occur between industries via a customer/supplier relationship. Foreign companies setting up in a country have certain demands in terms of the quality of products manufactured by their suppliers. Thus, they are willing to purchase their inputs locally if this quality is guaranteed, which generally triggers an improvement in the efficacy of these domestic supplier (or customer) companies , often with the collaboration of the foreign companies that can, through partnership agreements, help in this upgrading process.*

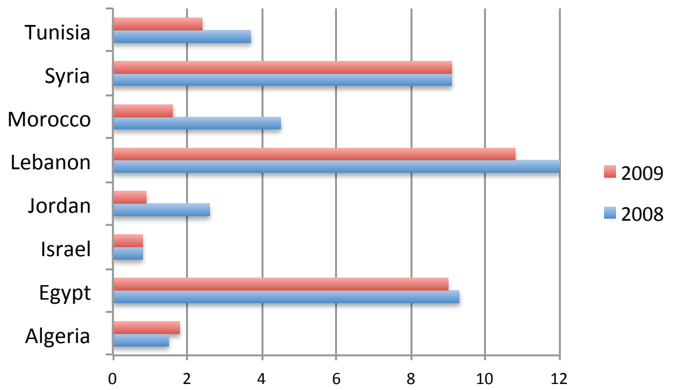
In all, the technological transfers generated by FDI can take place via a number of channels, the main ones being: (i) incentive through competition which stimulates domestic companies to imitate the production processes and the managerial organisation of the foreign company, (ii) the upgrading of suppliers (or customers) and, (iii) the turnover f labour which, after working for foreign companies can be recruited by domestic companies which thus draw the benefits of enriched human capital. However, if these mechanisms are to operate, the gap in technological level and human capital between the foreign and domestic firms must not be too great. This is what the literature terms "the gap problem" (see Gorodnichenko et al., 2007, for example). The spillover effects can thus only take place if the host country has sufficiently trained human capital, a sufficiently advanced technological level and a favourable environment (access to financing, not too much red tape, etc.) that allow domestic companies, regardless of their size, to respond positively to these incentives.

Figure 17.
Evolution of the share of subsidies for food and energy as a percentage of government expenditure, 2002-2010



The data for 2010 correspond to projections.
Source : Albers & Peeters (2011)

Figure 18.
Evolution of the share of subsidies for food and energy as a percentage of GDP



Source : Albers & Peeters (2011)

This high increase in subsidies can largely be explained by the strong dependence of these economies on basic staple foodstuff imports. All of the Mediterranean countries record the greatest food deficit of all regions of the world in terms of grain imports and in percentage of domestic consumption. Moreover, the region's dependence on food imports is likely to grow further over the coming two decades, with the probable exception of Morocco (BAD, 2013). Table 13 shows, for 7 Mediterranean countries [20], the share of each cereal in the total consumption (column 1) and in the total imports (column 2) of cereal products. The last column corresponds to the level of dependence on imports [21]. We may note that wheat shows the greatest consumption in Mediterranean countries and that the level of dependence for this product is also very high, with the exception of Morocco and Syria, which have a level of dependence of only 35%. The most striking fact, however, is the very high level of dependence of Mediterranean countries with regard to cereal product imports. Except for Egypt, all have levels of dependence of between 90% and 100% for at least one cereal product. This is the case, for example, for all cereal products consumed by the population in Jordan. This situation of food insecurity makes Mediterranean countries extremely vulnerable to foodstuff price increases on the international markets. To this dependence on farming produce we must also add, for some, a dependence on energy imports (oil and above all gas).

Also, the soaring prices of foodstuffs and energy in 2007-2008, followed by those in 2011, contributed to deteriorating external balances and led to rising inflation [22]. For all Mediterranean countries (except for Turkey), the rate of inflation was 3.4% in July 2007. In July 2008, it rose to 10%, i.e. a 7 percent increase. During the same 12 months, the inflation rate of foodstuffs increased by 9 percent, rising from 5.8% to 14.8% [23]. The steepest escalation of prices was recorded in Egypt, with an inflation rate exceeding 20% in the first months of 2011. For the entire region, 60% to 80% of the increase in the consumer price index would be due to the soaring prices of foodstuffs. These strong price increases caused the cost of living to increase, giving rise to severe social impacts, with an increase in the poverty and under-nourishment of part of the population. The repercussion on the number of families suffering from severe hardship was very high as a large share of the population was already in a fragile situation [24]. The middle classes were also strongly affected by these price increases insofar as the food budget in Mediterranean countries represents, on average, a large proportion of household expenditure (between 35% and 55% depending on the country, only 17% for Israel).

To mitigate the negative effects of this strong increase in global prices and to respond to the growing dissatisfaction voiced by the populations, the governments of Mediterranean countries eliminated taxes on grain and above all generously increased the amount of subsidies used to limit the rise in foodstuff and energy product prices. In 2008 and in 2011, budgetary balances deteriorated by more than 2% on average (cf. Albers & Peeters, 2013 & 2011). Before the prices of foodstuffs and energy rose, the subsidies intended to control foodstuff and energy prices already amounted to a significant share of public expenditure. Today, their weight has become extremely high. Insofar as, according to forecasts (such as those, for example, made by the World Bank), foodstuff and energy prices will most likely continue to increase, or at least remain at very high levels for at least the coming 10 to 15 years [25], this extremely costly subsidy system cannot be sustained in the medium term, especially as it is not limitless.

Indeed, by using the General Compensation Fund, the objective of which is to control the prices of staple products, the Mediterranean countries have established a "universal" type subsidy system in the sense that it applies to all individuals who purchase subsidised products. Whereas this system has double-sided limits:

√ **It creates a distortion regarding the allocation of resources.** Indeed, these subsidies

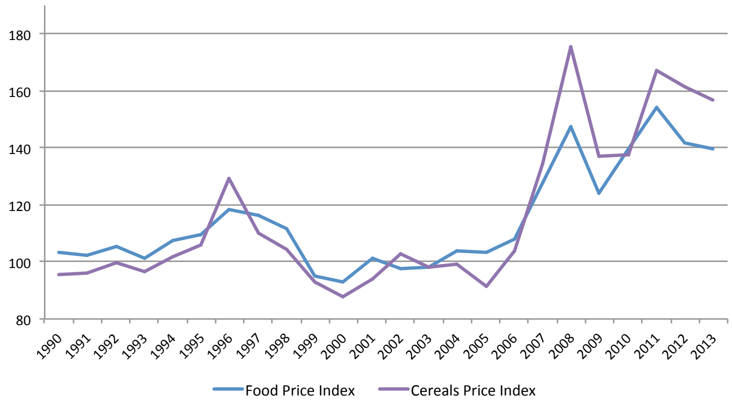
Table 13.

Rate of dependence on grain imports from Mediterranean countries

	Share in the total consumption of grain products	*Share in total imports of grain products*	*Rate of import dependency*
Algeria			
barley	*7.7*	*0.1*	*-0.9*
corn	*19.4*	*29.8*	*98.5*
rice	*1.9*	*3*	*99.2*
wheat	*71*	*67.1*	*60.2*
Egypt			
barley	*0.3*	*0.2*	*15.8*
corn	*31.8*	*34.9*	*44.6*
rice	*18.3*	*0.2*	*-10*
sorghum	*1.8*	*0*	*0.8*
wheat	*47.8*	*64.8*	*55.3*
Jordan			
barley	*16.5*	*16.4*	*95.6*
corn	*18*	*18.5*	*100*
rice	*15.2*	*16.2*	*103.4*
wheat	*50.2*	*48.9*	*93.8*
Lebanon			
barley	*5.7*	*4.4*	*67.2*
corn	*29.6*	*33.9*	*100*
rice	*8.8*	*10.1*	*100*
wheat	*56*	*51.7*	*80.6*
Morocco			
barley	*16.4*	*3.1*	*7.2*
corn	*15.4*	*34.4*	*89.7*
oat	*0*	*0*	*14.3*
rice	*1*	*1*	*40.7*
sorghum	*0.6*	*1.3*	*85.1*
wheat	*66.76*	*0.2*	*34.9*
Syria			
barley	*10.5*	*4.1*	*21.2*
corn	*23.9*	*42.9*	*97.6*
rice	*7.2*	*15.3*	*114.8*
wheat	*58.4*	*37.7*	*35.1*
Tunisia			
barley	*13.7*	*6.6*	*29.5*
corn	*16.9*	*27.6*	*100*
wheat	*69.4*	*65.8*	*56.6*

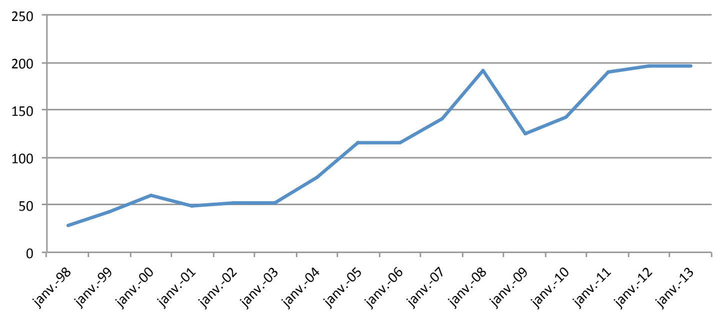
Source : World Bank. 2011.

Figure 19.
Evolution of the price index of food



Source: United Nations Food and Agriculture Organization (FAO). Index 100 in 2002 for the overall index and 2004 for the index of grain prices.

Figure 20.
*Evolution of the price index of energy **



** Includes, oil, natural gas and coal.*
Source: IMF, Index 100 in 2005.

benefit companies which use subsidised products as inputs and above all create a "false" incentive to develop activities that use subsidized products. Regarding energy, they do not encourage individuals or companies to change their consumption behaviour and/or decisions relative to this (vehicle use and design, insulation, etc.); they also make the use of other energy sources less attractive, as they are less profitable. Regarding foodstuffs, these subsidies do not encourage research and development around new farming practices that could generate better yields.

√ **It indifferently benefits wealthy and poor populations**. People that have financial capacity have easier access to these subsidised goods and therefore consume more than populations in great difficulty. Although the subsidy system does cushion the negative impact of rising prices on poor populations, its universal nature makes it a less efficient means by which to fight against poverty (cf. BAD & INS, 2013)[26].

Consequently, Mediterranean countries will have to gradually move towards another system of household aid that will allow the dilution of public funds to be reduced whilst better targeting the struggling populations. Several countries (in particular Jordan and Morocco) have, moreover, begun to reduce the size of these subsidies or have begun implementing initiatives that can gradually replace these subsidies (Tunisia, for example, with the recent development of targeting schemes within the framework of the National Programme for Assistance to Needy Families and Free Medical Aid).

The question of subsidies should also lead Mediterranean countries to reconsider their strategy regarding food security. When, not so long ago, agronomists specialised in the region pulled the alarm bell as to the growing dependence of Mediterranean countries regarding the imports of highly consumed staple foods, most economists found the question somewhat obsolete and absurd insofar as, for them, the countries were increasingly economically integrated and because market laws, with the exception of a few cases of failure, are the most effective means by which to allocate resources and structure the countries' production systems. We now realise the extent of the economic and social consequences of having allowed these countries to become so vulnerable to the volatility of global prices without having taken care to implement, at the regional or international scales, systems to protect the poor populations against these price increases.

II.6 Conclusions on macro-economic aspects and the functioning of the institution

1. Within a context of political transition, it is essential that the governments do not give economic questions a back seat, by limiting their actions to emergency measures that mainly respond to short term concerns. The governments of Mediterranean countries must adopt a clear and sufficiently ambitious economic policy to counter the negative effects of political transition and to positively influence private sector expectations.

2. Considering the very concerning economic situation of certain countries, it is essential that the international community rally round, as it did upon the German reunification and the political transition of the eastern European countries. International aid represents a vital input in order to loosen the financial stranglehold on these countries and to avoid weakening the undergoing political changes.

3. It is essential that these Mediterranean countries turn progressively towards a new growth model pulled by increasing productivity, based on the enhancement of the human capital employed by companies and on constant efforts to innovate in all fields (product innovation, marketing innovation, process innovation, etc.).

4. It is therefore crucial that the governments of Mediterranean countries adopt a series of measures which deal at once with the basic problems (administrative red tape and obstacles, land issues, corruption, problem of access to funding, lack of information and advisory services, weight of the informal sector, etc.), which prevent companies from concentrating on developing their business and from correctly responding to the incentives of the economic system (openness, competition, etc.);

   b. and encourage companies to change their production and marketing methods in order to grow their competitiveness and efficacy.

5. A vital condition for this change is the establishment, in all Mediterranean countries, of political and economic institutions led by governments that are sufficiently brave and enlightened to:

   a. reduce the power and influence of the elites that are close to the political power and who still have their hand on a large share of the countries' economies,
   b. break with the system of collusion, between the political and economic worlds,
   c. modify the operating rules of most of these economies that remain too reliant upon the system of favouritism and patronage,
   d. guarantee individual freedom (in particular by limiting the arbitrary power of the authorities, public services, the police and/or the army over individual and firms), also guarantee a fair legal system and the sharing of power,
   e. allow inclusive development which opens, as broadly as possible, access to opportunities- for the entire population and, in particular, for those that are the most excluded (poor population in rural settings, women, etc.),
   f. listen and respond to young people's aspirations.

6. It is in the interest of all Mediterranean countries to progress towards greater regional integration to provide their companies with the opportunity of a larger market, of developing regional production networks and implementing common large-scale projects, regardless of the sector (infrastructure, energy, innovation, training, etc.).

7. The energy and foodstuffs subsidy system (i) weighs too heavily in the budget of Mediterranean States, (ii) creates large distortions that

benefit certain categories of the populations or certain companies that are not in line with general interest and (iii) does not sufficiently target the neediest populations. However, it must be scaled down gradually and must be replaced by new, probably direct, aid systems for the most underprivileged families, and by funds dedicated to regulating the evolution of the global prices of staple foods. Indeed, we cannot continue to tolerate that the increasing global prices of foodstuffs, accentuated by financial speculation [27] which gains considerable added value from the consequences of natural disasters or the unexpected rise of global demand for these products, have such a dramatic effect on the life of populations that cannot understand and even less accept this sudden deterioration if their living conditions. Femise's point of view is that after analysing and evaluating the efficacy of the measures already implemented, international organisations (and/or the governments of the northern countries) should pursue their efforts to limit, even more efficiently, the volatility of global prices and/or its impact on poor populations.

Meanwhile, Mediterranean countries must undertake a certain number of actions in the farming sector in order to reduce the vulnerability of their economy and, generally speaking, redefine their strategy regarding food security. The donors and the EU should strongly encourage and support this type of action.

III. Propose a vision and establish the basis for a new impetus

The previous remarks show the scale of the task to be accomplished within a context that remains politically unstable. Yet the pressing urgency requires that means be found to preserve economic balances and the populations' standards of living in the short term and these means can only be achieved within a more stable political environment. The proposal of a vision to which all may adhere and which opens up promising prospects will allow this stabilisation to be achieved all the more rapidly. To accomplish this, we believe that it is necessary to propose a medium term vision targeting youth and that joins and reconciles political and economic demands.

III.1 The vision: work towards an inclusive knowledge economy by favouring widespread creativity and innovation

A number of works have chosen this direction. Amongst the most recent, we may quote the CMI/World Bank report, "Transforming Arab Economies: Traveling the Knowledge Road; "The Arab Knowledge report 2010/2011" by the Mohamed Bin Rachid Foundation and the UNDP Regional Bureau for Arab States; the Femise report for the EIB/CMI "Mobilising capital around innovation in the Mediterranean" (2013). These works on the region echo a global movement through which big data is made available, in particular by the major global forums, on different benchmarks regarding the quality of education (PISA, TIMMS), by the creation of new international scientific journals within emerging countries (cf. e.g. "Science, Technology and innovation Policy Review" Republic of Korea, and the agreement of the Egyptian Ministry of Higher Education with Elsevier for the international diffusion of local scientific journals).

The important point is that these works, although through different approaches, broaden the technical framework of the knowledge and innovation economy traditionally centred on science, national innovation systems, specific sectors, operations concentrated within dedicated centres or specific zones, specialised educational and research institutions, to create a global development strategy. It is this broader framework that Femise has chosen to focus on here, considering that this is imposed by the historic times currently experienced by the MEDs. The hypothesis drawn here is that innovation can lead to a new growth model that can only be developed within the framework of a transformed social contract which, if successfully achieved, will involve society as a whole and particularly young people. We therefore consider that, in order to succeed, the development of innovation requires a broader outlook and must be promoted at the very highest level of the state (as is the case in Singapore, Korea and also in India where it is now considered by the presidency as being one of the principle means by which to achieve social inclusion).

The economic impact of innovation

Schumpeter's broad definition of innovation is retained here: "an idea that is turned into economic activity", as this definition justifies the extensive position adopted here, as in the previously mentioned works. Indeed, the generation of ideas requires a generally creative society and in order for innovation to take place, these ideas must be transformed into economic activity.

This is clearly where economy meets with politics, insofar as if this strategy achieves broad consensus and also targets the most fragile elements of society, the youth, the poor, women, neglected territories, it will allow the political compromises which are currently struggling to transpire. A number of recent works looked at this question from two different angles. Although all underline the need to move towards a strong and inclusive growth model that is more focused on productivity and less on capital accumulation and on the establishment of a new, more participative social contract that particularly targets the young, major questions remain as to its conception and implementation.

Innovation must lead to a new growth model based on Total Factor Productivity

All academic and professional economists currently agree upon this point. If a significant share of growth is achieved by Total Factor Productivity (TFP), i.e. by a residual (and organisational) element that does not directly correspond to the quantitative accumulation of human and physical capacity, the positive impact on competitiveness and employment is enhanced. This is due, in particular, to the fact that total productivity does not necessarily substitute labour for capital and allows an increase in wages indexed on productivity and not on prices, thus maintaining the competitiveness of prices as the actual exchange rate is not calculated in proportion to the increase in revenues. This residual, also called the Solow residual (for which it is difficult to paint a precise picture) means that the accumulation of physical and human capital has a more than proportional effect on growth. All countries are affected by this issue. For those that have plenty of money to invest, thanks to neutral resources (case of Algeria amongst the MEDs), the investment must become more productive (with yearly investment growths exceeding 10% and 4% of the GDP, Algeria like many other oil-rich countries obviously displays a growth level that is too low as compared to its accumulation capacity). Conversely, for countries that have few natural resources, in order to improve the population's well-being it is essential, through organisational and creativity effects, to achieve growth that exceeds that of capital growth. How can this residual, a marker for dynamism, be achieved and where does the role of innovation come into the process?

If the policies followed in the Mediterranean over the past twenty years with the help of major international operators, including the EU, are considered from an operational perspective, they are mostly and implicitly focused on the quest for allocative efficiency. The idea is to improve the efficiency of the allocation of production factors within a same technological frontier (generally characterised by the relationship between the output and the factors used) by opening up to international competition. In this case, it takes us closer to the momentum of the curve which translates this relationship by reallocating the least efficient production factors, in terms of employment, to the most efficient. This can take place between

Box 4. The academic position

For the past twenty years or so, it has been observed (and theorised) that product growth is due not only to capital accumulation based on savings, of both domestic and external origin, but more essentially on innovation led by companies within the context of a favourable institutional environment. The economic theory has shown that when growth was based mainly on capital accumulation this led, through a drop in capital yield and an increase in the cost of its depreciation, to a stationary status. This terrible eventuality was highlighted by the neoclassical theory that met with the analysis made by Marx on the need to devalue constant capital to maintain profit levels, unless it was possible to move technological frontiers.*

The first breakthrough was achieved by considering that capital productivity could increase thanks to the accumulation of knowledge within a competitive environment (the so-called AK model, Frenkel 1962, Romer 1986, Lucas 1988). According to this approach, knowledge is considered as a particular type of capital which, as it builds up, «contributes to the collective creation of new technological and organisational knowledge, through a process of 'learning by doing' and imitation» (Aghion 2002 op. cit). Here, knowledge creation is endogenous and directly favoured by accumulation on condition that it is disseminated throughout society.

The second breakthrough, which is the basis for modern growth theories, refers to the ideas developed by Schumpeter. These theories are based on the following key idea: moving technological frontiers or growing the level of technological innovations, in the form of new products and new processes, can be an important factor of growth that is relatively independent from capital accumulation. Here, it relies upon on improving intermediate goods. Moreover, this is the essential reason that justifies a more endogenous growth strategy by pursuing controlled international opening up. Without the freedom to import intermediate goods, there is little likelihood that technological transfer will take place.

A very simple formulation used by Philippe Aghion and Peter Howitt (*) allows us to define an initial position on this question. Based on a Cobb-Douglas type technology, we may formulate that:

$y = A.\ x\gamma$

where:
y = the final product
x = the quantity of intermediate goods used in the production of the final product
A = a parameter of productivity that describes the quality of the intermediate goods.

The production of intermediate goods uses more or less qualified work part of which can be used in research to generate innovation. Each innovation will improve A and therefore Increase growth. If this is constant, we achieve an enhanced endogenous growth process. If y represents the coefficient of the improvement of intermediate consumption thanks to innovation, the growth of productivity in each sector will be yA. Set down in this way, the question presents a number of advantages: :(i) it focuses attention on productivity and not on capital accumulation, (ii) it leads to the question of which factors will allow A to increase (R&D expenditure, education, institutional framework, ICT, etc...) and will lead to a constant growth process, (iii) it sets down a permanent framework that allows us to judge the relative position of a country and to provide elements according to which actions can be ranked within the framework of a national or regional strategy, (iv) it replaces all of the different initiatives undertaken in favour of innovation (technological centres, competitiveness centres, transfer agencies, incubators, etc...) within the only framework that counts - efficacy In terms of growth and employment.

- *Philippe Aghion and Peter Howitt : Growth with quality improving innovations an integrate framework ü in Handbook of Economic Growth Volume 1 Elsevier 2005* sectors, between companies of a same sector, or between production plans of a same company. All policies that target international openness and the liberalisation of product markets led in the Mediterranean by the elimination of customs barriers and in the former Eastern European countries, have mainly sought this type of efficiency through market competition. The international opening reallocated the production factors towards competitive sectors, to the detriment of others; the subsequent effect being to cause both a modification on the specialisation of the countries involved and significant reallocations between the firms and sectors within each country.

Here, the TFP improves but there is a simultaneous dilution of the social space shared between people positioned in the sectors, qualifications, territories, in demand on international markets and those who are not part of this specialisation process. In this case, there is indeed a net gain in GDP, but inequalities also increase and there are contrasted effects on employment. In this way, for example, a study by the ILO carried out in Jordan, which is one of the countries that became very involved in the international competition game, showed that fewer jobs were created than those that were destroyed by imports competing with local production. Finally, we may note that our economic theories that support these policies have the major defect of reasoning within a framework of the hypothesis of full employment, and cannot, therefore, foresee these effects.

Innovation's field of action: moving beyond allocative efficiency by shifting the technological frontier

The second component of the increase in TFP's contribution to growth is the shifting of the technological frontier through leaps in product, process and organisational innovation and through the implementation of the learning process that will lead to endogenous growth and the creation of new companies. In each case, each input or factor unit produces more on location. This mechanism requires a certain maturity of the economic and social system and is naturally the target of voluntary policies. When we speak of shifting technological frontiers, we are talking about establishing a knowledge-based economy, something that most Mediterranean countries are now explicitly attempting to achieve. In particular Tunisia, Jordan, Egypt, Morocco and Turkey.

If international competition sets in there will be losers, but they can draw compensation from adapted social redistribution policies, which remain insufficient in the Mediterranean where compensation policies are frequently inefficient. The works of economists have shown that these two approaches are not antinomic. Of course, to achieve endogenous growth requires good infrastructures that might be under-used for some time, investment in research, education and training which will only yield mid to long term results. As for money spent on research for innovation, this will also take time to be turned into market values and relies on innovations that will give rise to consumable products and that the demand for these products be sufficient. Nevertheless, Femise considers that the choice of international openness remains a valid one, on condition that it is supported by the appropriate structural policies (industrial or development policies or and social policies). Indeed, the opening up to imported intermediate products increases productivity through technology transfer. Foreign direct investment, if this is chosen, also favours the appropriation of better technologies and a large integrated regional or global market encourages economies of scale for national champions.

But nothing can replace a true national innovation strategy supported by general mobilisation and based on strategies that target major vectors for change. To single out these vectors and identify the possible directions, hereafter we shall rank the Mediterranean countries as compared to 38 countries and according to 93 criteria including the main industrialised countries and emerging countries.

The relative situation of Mediterranean countries

The two types of innovation involved: scientific and technological innovations, creative innovations.

Here we will report on the work carried out by Femise for the EIC/CMI (2013 op.cit) using the GII 2012 data base that firstly, considers results in terms of innovation by combining scientific and technological output with creative output, and secondly, using a set of almost 60 variables gathered into five blocks (human capital, market sophistication, business sophistication, Institutions, Infrastructures), evaluates which elements are decisive.

In so doing, it is possible to position the MEDs and to explain, for the more recent years, several types of innovation: on the one hand, those that stem from highly educated labour, involving significant spending on research, and which develop "knowledge and technological ouputs" – a type of development that is often to be found within the country in a context of openness to exchange, movement of capital, product and services trade liberalisation and a favourable business climate; on the other hand, those that are of a more incremental nature using new technological combinations without spending too much on research and cultural products, that are less territorially localised. These are "creative outputs". Graph 21, which compares the situation of Mediterranean countries to a sample of emerging countries and to the main developed countries, reveals the lag of MEDs (with the exception of Israel), for the two selected pillars that describe the country's position regarding innovative outputs.

If these innovative outputs are used to rank a set of 38 countries that includes the main developed countries, emerging countries and the MEDs, we can note that: (i) Mediterranean countries are lagging behind (with the exception of Israel), in particular for technological outputs. Lebanon, Tunisia, Turkey and Jordan, however, are in a position that is comparable to that of Chilli, South Africa and Vietnam, (ii) that the shifting of the technological frontier considered from the angle of "knowledge and technology outputs" does not take place proportionally to the development of creative outputs, (iii) that the MEDs are generally in a better position regarding creative outputs (with the exception of Algeria which is the last of the thirty-eight countries selected to study this indicator and, to a lesser degree, Lebanon which nevertheless achieves the average for emerging countries regarding outputs and creative innovations).

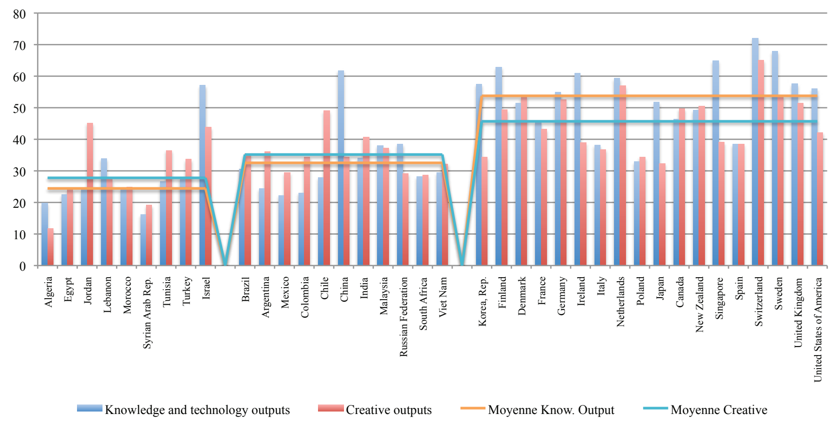
Table 14.
The content of the concept of innovative outputs in the Global Innovation Index

Knowledge and technology outputs pillar	*Creative outputs pillar*
Knowledge creation	***Creative intangibles***
Domestic resident patent	*Domestic res trademark reg/bn PP$ GDP*
PCT resident patent	*Madrid res trademark reg/bn PP$ GDP*
Domestic resident utility model	*ICT & & business model creation*
Scientific and technical articles	*ICT & organizational model creation*
Knowledge impact	***Creative goods & services***
Growth rate of PPPs GDP/Worker	*Recreative & culture consumption %*
New businesses / th pop 15-64	*National feature films /mn pop 15-69*
Computer software spending % GDP	*Paid-for dailies circulation /th. Pop.15-69*
ISO 9001 quality certificates/ bn PPPS GDP	*Creative goods exports %*
	Creative services exports
Knowledge diffusion	***Creative of on line content***
Royalties & license fees receipts / th GDP	*Generic top-level domains(TLDs)/th/pop*
High tech exports less re-exports %	*Country Code TLDs/th. Pop 15-69*
Computer & commercial services exports %	*Wikipedia montly edts/mn pop 15-69*
FDI net outflows % GDP	*Video uploads on YouTube/pop 15-69*

Source INSEAD GII 2012

This is an extremely important result for the countries studied insofar as these creative outputs will contribute significantly to societal transformation over the coming twenty years and to the appearance of new services, new communication means and new forms of integration within the global economy without necessarily requiring massive investment. These comments therefore call us to examine the overall creativity of the MED societies and the context within which this creativity can be developed.

Figure 21.
Scores in terms of innovation outputs in averages



Source : INSEAD GII 2012

The confirmation of the relative position of the Mediterranean countries based on a series of criteria

Out of the thirty-eight countries considered here, the ranking according to the content of the GII global indicator (93 criteria grouped into the five inputs and the two outputs, “knowledge and technology output” “creative output”) which provides a general picture, confirms the presence of four classes of countries:

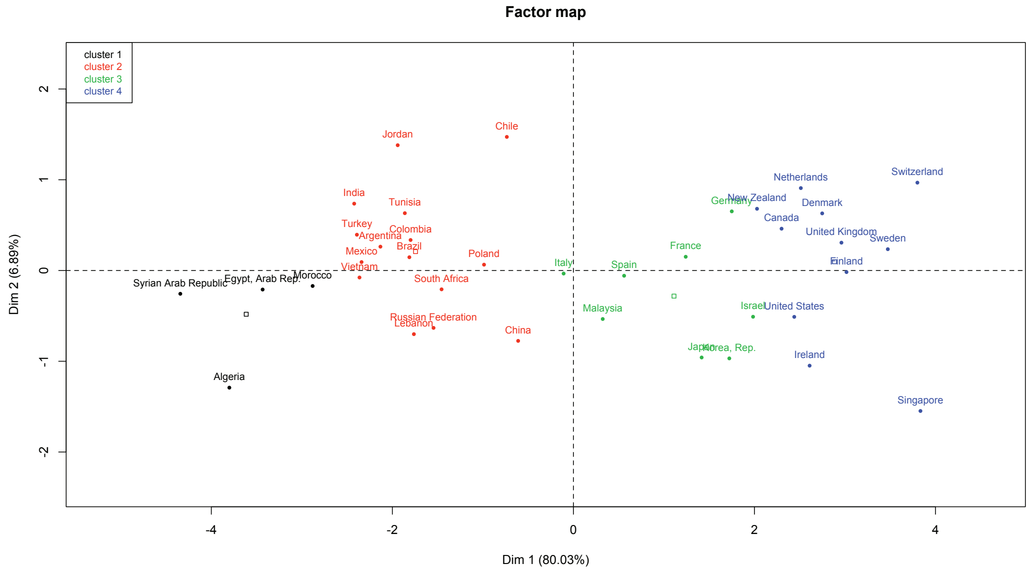
Class 1, groups together the sample’s lowest performing countries amongst which are four Mediterranean countries (Syria, Algeria, Egypt, Morocco) which exhibit lower scores in practically all the dimensions of the first axis that alone explains 80% of the variance (between -32% for human capital where the lag is the smallest, as compared to -49% for “creative outputs”, -50% for “ knowledge et technological outputs” and -36% for institutions, market sophistication and the business market).

Class 2, groups together the intermediate countries and includes four Mediterranean countries, Turkey, Jordan, Tunisia, Lebanon, which are beneath the average of the selected sample of 38 countries. The lag for these countries for all pillars and regarding inputs is slightly above -20% on average. As compared to all 141 countries, the lag is around -6%. We may note that this group of countries is above all lagging in “human capital and research” and institutions (-25% and -20% respectively for the sample countries, -8% and -6% for all 141 countries). Here, the “creative outputs” are not discriminating, meaning that the countries belonging to this group are within the average for this type of innovative product.

Two classes, 3 and 4, group together the sample’s innovative countries. These are characterised by a clear superiority regarding infrastructures, “human capital and research” (especially in group 3), institutions, market sophistication and business. The results regarding “knowledge and technological outputs” are the highest for group 4, by +42 % as compared to the sample’s average and +95% as compared to the 141 selected countries. We may note that this class groups together in particular Singapore and Switzerland that are singled out from the PCA carried out here, and from the GII, as being the most innovative countries.

We may also note that Jordan, Tunisia and Turkey are relatively well-positioned for creative innovation (axis 2) as compared to other Mediterranean countries. From this, we may draw the conclusion

Figure 22.
Grouping of 38 countries
into 4 groups around two main axes



Source : FEMISE-BEI (2013)

that on the one hand, the innovation market develops within an independent system that must aggregate several types of changes in different sectors and, on the other hand, that creative industries generate specific forms of innovation that do not abide by the same determinants as technological innovations.

Graph 22 summarises these results for the 38 countries selected for the sample. A more detailed study (cf. Femise/BEI 2013 op. cit), clarifies the following points:

√ A country's capacity to innovate depends firstly on information and communication structures (and the use of ICT), on the qualitative aspects regarding the training of human capital (quality of research organisations, research budgets, quality and duration of training). Here, Mediterranean countries have made considerable progress in the availability and use of ICT, but are significantly lacking in the quality of human capital and in the development of a strong research capacity.

√ Secondly, innovation capacity depends upon a model that is open to international exchange, particularly industrial exchange linked to technology transfer and enabled by the imports of technological products, FDI inflows, the capacity to register patents, the development of professional training within companies, the number of students pursuing higher scientific and technical studies, mobility, the business climate and, especially the possibility to obtain financing. This is clearly the direction in which Mediterranean countries have evolved over the past ten years with the contrasting results mentioned earlier. Here, innovation is not at the heart of the process but is rather perceived to be a by-product of the process of opening up and transformation of the more general business climate.

√ The third set of determining factors concerns institutions. The criteria usually selected have less impact on the selected thirty-eight countries than one might have expected. From the test carried out and confirmed via a long term chronological approach it appears that, from the institutional view point, there is a clear emergence of criteria related to fundamental freedoms, the strength of the law, the quality of regulation, freedom of the press, women's participation, in particular in the development of creative innovations. Here we clearly stand in the very substance of the Arab Spring.

The content of a vision: innovation as the foundation of a new social contract with youth based on creativity and the freedom to participate.

The limits of the two dominant approaches to the knowledge society

Two approaches have now been developed to establish a knowledge society. **The first,** stemming directly from international expertise as it is conveyed by the major international organisations, considers that the establishment of a knowledge society and the road towards innovation require the adoption of a blend of evolutions that concern institutions, the business environment, infrastructures, just as much as education and the research system. This vision leads to benchmarks similar to the one used here and that lead to choosing policies according to the relative position of the country at hand with regard to the global success stories that are used as a reference. Although they have the undeniable interest of quantifying the state of a relative situation, these benchmarks present three difficulties, (i) the first is that reasoning in terms of lag privileges a reference development model that can be quite distant from society's deep-rooted aspirations, (ii) the second, is that on the operational front these benchmarks de facto open up outlooks for all sectors which, within the context of rare resources, becomes inefficient considering the number of reforms to be achieved in each ministerial department, (iii) the third is that it results in both a lack of prioritisation of actions and the multiplication of sectorial or territorial operations or limited projects whose results are often disappointing when assessed.

The second approach is that illustrated by the Arab Knowledge Report (2009-2010) which underlines "the necessity to develop the foundations of a knowledge society, its principles, its methods and mechanisms to prepare future generations to actively participate in the construction of a knowledge society and the access to its broad fields" . To achieve this "efforts are centred on the principles that will allow this momentum, amongst which are freedom, integration with the needs for development, opening and intercommunication in all fields, particularly in the fields of science, technology and humanities". It adds a point that is doubtless the most specific aspect of this approach, that these foundations must be based on (i) an enlightened religious discourse that prepares the new generation to work on, persevere in and consolidate moral characters, (ii) to promote the Arabic language as the main tool with which to achieve social integration and communication amongst youth, (iii) the development of citizenship and identity with particular attention paid to human rights, freedom, justice and a sense of belonging. Here, the advantage is definitely that the question of knowledge is repositioned within the historical progress of society and the consolidation of identities, which encourages an evolutionist outlook (Radosevic 2012). However, if we look back at European history (cf. Colin Roman) and the current debates between Shiites and Sunnis or the difficulty to adopt the Tunisian constitution, it is possible that the primacy granted to religion, which undeniably conveys humanistic values, might in certain cases and for certain key questions lead to focussing debates on the revelation or religious currents rather than on science. As for Arabisation, although it is perfectly desirable, it must at least be accompanied, as is now the case in all other countries of the world, with an efficient level of bilingualism allowing scientific publications and the global circulation of ideas and researchers.

The conclusion drawn from these two approaches to a knowledge society is, firstly, that it is necessary to adopt an organic and evolutionistic approach that finds its roots in the historical evolution of the given societies whilst defining a reasonable path for progress and, secondly, that the route towards a knowledge society must take into account the way in which Mediterranean societies, whose identity must be considered, can transform their societal characteristics into the universal laws of science and technology illustrated by the first option. It is this intelligent transformation that will provide an answer to the different aspirations of young people.

The content of a discourse targeting youth

When the Arab world was at its peak and responsible for most of the scientific discoveries, the House of Wisdom in Bagdad welcomed scholars from all backgrounds and translated Greek and Latin books. The important scientific discoveries made in astrology, mathematics (trigonometry) and physics were added to with technological innovations in many fields. “Open” innovation thus became the key to success in the modern world.

What has changed, in most cases, is that societies which innovate are creative societies in which individual freedom is promoted and in which science and technology, on the one hand, and culture and arts on the other, develop side-by-side. This aspect will no doubt be consolidated in the future due to the fact that the development of the digital economy, social networks and internet will allow each individual to create content, including marketable content.

This renewed need for creativity, which has been constant and central to the history of sciences, is good news. Of course, nowadays, the role of the isolated genius within scientific production has been demolished via an organisational effect. Now, science develops thanks to anonymous specialised researchers integrated, via their research laboratories, within a larger network composed of other specialised anonymous researchers. Scientific and technological production will remain marked by this reality for some time. This explains how a number of countries manage to hold a position in the world of technological and scientific innovation that is largely superior to their position regarding the institutional function and the production of creative outputs.

The reason for this is that scientific and technological innovation can be produced by good engineers working within a framework of voluntary national policies. The most striking example is the position achieved by certain countries regarding scientific and technological innovation through significant military expenditure (China, South Korea and Israel in particular). Regarding incremental innovation that can give rise to new products or brands, all you need are ideas and the knowhow to turn them into business. This is why the development of creative innovation is the key to the future.

A society able to produce a large range of innovations is therefore a generally creative society regarding research and cultural activities. The point of view defended in the present report is that the main challenge for Mediterranean countries consists in opening up this route to young people who are currently under-occupied, and of whom almost 40% are mostly self-employed within the informal sector. In the absence of a project or global vision, they might find themselves caught up in the two intellectual imprisonments: firstly, the debate on lifestyles based on different interpretations of the place of religions and its values within society and, secondly, international openness or closure and the resurgence of the former self-centred model.

We will take the risk of stating here that the time has come for those in power to cultivate major ambitions for knowledge, culture and innovation. This is doubtless the best means by which to mark the breakthrough linked to the Arab revolutions.

Following the Arab Spring, the youth are expecting to be offered, wherever they might be and regardless of their social condition, a future in which they can flourish through discovery, science, and the creation of companies or activities. They also demand to be allowed to participate in political decisions related to these fields. Femise voiced this in its 2013 report for the EIB (FEMISE/BEI 2013 op.cit), to which we will refer herein. This vision would be expressed as follows: “ Following the

Arab Spring, we wish to build a society of open knowledge, develop our creativity in scientific and cultural fields in order to contribute to the construction of human knowledge as in ancient times and to produce innovations that carry new market values. We will listen to the expectations of our youth and will involve them in our strategic choices, so that they might have access, as in ancient times, to all scientific discoveries, that they might discuss all philosophies and embark upon all industrial and commercial adventures".

Such is the social contract that implies the choice of innovation proposed to the youth herein.

III.2 The axes of an innovation oriented policy

Four points in the orientation of public policies are decisive if this ambition is to be achieved: (i) the first concerns the need to pursue and consolidate the tremendous effort for school enrolment and training that has been ongoing for the past fifty years within Mediterranean countries, (ii) the second, is to develop teaching methods and certification mechanisms in order to encourage creativity and the acquisition of skills and behaviours that will foster innovation, (iii) the third, is to set up a system of research and cultural promotion that will encourage innovation, iv) the fourth, is to allow the generalisation of innovation through the creation of new economic activities based on the evolution of existing companies and company creations.

The pre-requisites: continue to forge an identity and national coherence

The MEDs, similarly to many countries that have won their independence, have established a massive system to allow access to education. If we simplify to the extreme, we can distinguish three main steps that correspond to the vision adopted for the development of the societies at hand.

The first step consisted in setting up and generalising access to education, in particular of the highest level. The goal was to give access to knowledge to the greatest possible number of young people and to socialise to build awareness of their national identity.

Public education was responsible for achieving this on a meritocratic basis, primary and secondary education was generalised, general education diplomas were favoured (in particular in human and social sciences) which, in a number of cases, gave almost automatic access, or totally automatic access to the civil service (case of Egypt) in a context of the prevalence of public enterprises. This is the reason for the substantial share of current educational expenditure within the MEDs budgets.

The second step, which began towards the beginning of the 80s, consisted in developing school enrolment, encouraging higher education and the development of technical and professional education, mostly public. The aim was to develop the qualification of pupils whilst continuing the quantitative development of school enrolment. Faced with the considerable costs, a dual educational soon developed with a traditional system operating on public resources and majoritarily concentrating on general education and a private, more professionalised system that required the financial participation of the pupils, subsidies and occasionally, managed to attract corporate contributions.

The third step, which took place in the mid 90s, was that of an international opening up, stimulated by the demand of foreign investors and the competition in many formerly protected sectors. The challenge was to boost employability through the production of qualifications tailored to the demand from companies (in particular foreign companies for which the quality of labour is an important aspect in the decision for installation), and through the development of sectorial mobility, whilst keeping the cost within acceptable limits. Despite the efforts made, a number of questions remain and must be addressed to consolidate the existing educational: (i) the public education system is obviously not suited as it stands if we consider education yield in terms of employment and wages which, in the region, are particularly low. These yields are dwindling not merely due a loss of efficacy in the educational system but also to the low progression of job openings in the civil service, (ii) the quality achieved in basic skills as evaluated by international tests is insufficient, (iii) professional training must develop higher levels and improve the quality of both basic skills and professional skills.

These inadequacies are responsible for the exceptional rate of unemployment amongst graduates which, in Mediterranean countries (except for Israel and Turkey), increases alongside the level of education. To this we may add the persistence of large pockets of illiteracy. Moreover, conditions for lifelong training must be established. To summarise the axes of the essential policies through which to pursue and consolidate the basics we may underline:

√ **Continue the fight against illiteracy** that makes personal achievements and socialisation difficult (Morocco with a level of literacy of 56% is particularly concerned, as are Egypt and Algeria with rates slightly above 70% also), the levels of illiteracy of the entire population of these countries are between 28% and 44%. Despite significant progress, the levels of illiteracy amongst the 600,000 young people between the ages of 15 and 24 remain high (i.e. an illiteracy rate of 9 % amongst the youth today). In Egypt, 2 million young people find themselves in this situation (illiteracy rate of 13%), in Morocco 1.3 million (illiteracy rate 20%, whilst Jordan, Lebanon and Tunisia are in a situation close to a 100% literacy. To this, we must add that it is abnormal that young girls on average are more successful than boys in secondary and higher education, whilst they present a higher percentage of illiteracy amongst the 15-24 year olds (except for Jordan and Lebanon).

√ **Regarding employability,** actions must focus on two main targets: the dropouts (on average, considered to amount to 20% of all school enrolments) who leave school without any diplomas or recognised skills (raising a considerable ethical problem in societies within which school attendance is mandatory), long term unemployed graduates with no perspective of a paid job or self-employment (which also raises a problem of justice in societies that have established diplomas as a marker of social integration). Dealing with this type of population requires the creation of new institutions that can later disseminate throughout the entire educational and professional training system. They could be used as an experiment to bring about a deeper change within the entire educational and training system regarding the issues of concern: definition/accreditation for all pupils of a baseline at the end of mandatory schooling, a skills-based approach (including for self-employment), apprenticeship type courses, involvement of companies in schools, teaching methods based on success rather than sanction.

√ The need to **continue developing school enrolment in the pre-schooling.** Although all MEDs now have levels of primary and secondary school enrolment close to those of the reference countries (a gross rate of close to 100% and a net rate of 96% for primary education), school enrolment in the preschool period is well below that of the reference countries. Reducing this gap is important and all of the specialists underline the importance of preschool attendance in the person's development and self-confidence.

√ The obligation **to strengthen the efficiency of education** in terms of results and learning and in terms of cost. Results (PISA 2009, TIMSS 2011) reveal a considerable lag in learning: for PISA, compared to the mean of the sample at 493 points, Tunisia and Jordan are ranked around 60th with an approximate 10% gap as compare dot the mean. For TIMSS, which measures learning in mathematics and different scientific subjects, the selected Mediterranean countries are also behind, a lag that is greater for level 4 (end of primary school) than for level 8 (middle of the second cycle of secondary school – the ranking includes 12 grades). However, we may underline that the countries that are the least well ranked in these two levels are Morocco (- 47% as compared to the mean for level 4, - 25% for level 8) and Tunisia (-31% for level 4), whereas Turkey, Jordan and Palestine are close to the average.

Table 15.
Unemployment rate by level of education

	basic	*intermediate*	*advanced*
Algeria(2010)	*7.6*	*8.9*	*20.3*
Egypt. (2006)	*2*	*13.8*	*14.4*
Israël (2008)	*10.1*	*5.9*	*3.7*
Jordan (2010)	*11.5*	*8.3*	*15.1*
Lebanon (2008)	*8.8*	*9.7*	*11.1*
Morocco (2009)	*11.1*	*8.3*	*15.1*
Syria (2009)	*6*	*17.1*	*11.9*
Tunisia (2010)	*9.2*	*13.7*	*22.9*
Turkey (2010)	*10.4*	*13.1*	*9.8*

Source: ILO Department of statistics 2011. Eurostat (Turkey). Martin. 2009 (Egypt)

As for the **budgetary question,** contrary to an opinion that is widespread within circles of international expertise, the quantitative public financial commitment is not, generally, overblown (with the exception of Tunisia). It lies between 4.4 % of the GDP (Egypt 4.4%, with a global ranking of 58, Algeria 4.5%, 54th) and 6.7 % of the GDP (Tunisia, with a global ranking of 13) for countries that have not developed a great amount of private education. For those that have widely developed the latter, Lebanon and Turkey, public commitment is significantly lower (respectively 1.6 % and 2.6% of the GDP). These results are confirmed by the share of educational expenditure per pupil in the GDP per capita. We may however underline that the evolution over the past fifteen years reveals a strong increase in the total expenditure per student, whereas the expenditure per student as a % of GDP per inhabitant has decreased. This stems from the gap between the GDP growth rate and the rate of access to higher education. Thus, in fifteen years, the countries of the MENA region show expenditure per student that amounts to 58% of the GDP per capita, whereas the same ratio for the average of the OECD countries is 36. When these figures are compared to the average cost of a student in all cycles, we can see that there is a specific issue with the cost of higher education.

These comments show the necessary directions by which to strengthen the pre-requisites to ensure progress in innovation: fight against illiteracy that is a major source of exclusion, professionalise secondary education, develop vocational training for dropouts and long term unemployed graduates, develop short higher education cycles and change their focus, improve teacher training in particular through a system of continuous training, in certain countries we noted that almost 40% of secondary school teachers in scientific subjects did not themselves achieve the grade that marks success in the end of secondary school examinations. This is the very illustration of the efforts that have had to be made to march the Mediterranean countries towards general access to education.

The foundations upon which to implement the new growth model: developing creativity at all levels of education

To move towards creativity and innovation, it is essential to raise the question of educational content that can no longer be composed of passive, routine learning, procedures or other theories within a an extremely large set of subjects. The key aim is to train creative individuals who have a good level of technical knowledge. This means that beyond the standard functions of education regarding personal development, socialisation through the learning of historical references and values, employability, a new function must be introduced which is that of training creative individuals.

Training for creativity

A number of points must be underlined here:

√ All individuals must be considered as potentially creative. Indeed, any individual with a right hemisphere in which subjectivity and imagination are developed, in which emotions are registered, has the ability to form analogies, to create metaphors of reality, and with a left hemisphere which is that of objectivity, analysis, precision and choice. The difference between individuals resides in the type of interaction between the two hemispheres. An authoritarian and rigid education based on standardisation (as is the trend in societies in the process of constructing their identity) will considerably limit the possibilities to use the imagination. The keys which are generally identified are as follows:

√ A creative individual must have faith in himself and take intellectual risks.

√ A creative individual must be able to produce totally new ideas. This requires a diverging mind that can deviate from the norm. It is therefore necessary to create a non-authoritarian framework so that the diverging ideas of a creative mind can be encouraged and treated with respect.

√ A creative individual must be able to solve problems rather than to learn passively.

√ A creative individual must be able to transfer solutions and methods from one area to another. This means that specialisation according to fields should not take place too early on.

√ A creative individual must be encouraged to take risks, be evaluated in a non-repressive manner, but whilst acknowledging their progress within a framework that leaves them free, at least partially, to take an interest in the area of their choice.

√ A creative individual must not be isolated. Communication with others (in particular at the international level) will bring them a broader basis of knowledge in particular within a multi-disciplinarian framework. To develop this system of exchange, group work must be privileged, as must the harnessing of ICT, which bring a gigantic knowledge base.

To move in this direction, it is necessary to undertake a global reflection on teaching methods. Here we note a few key points:

√ The first is to question the monopoly of the diploma as a marker for qualification. The former, based on an overall average of an increasing number of subjects must be completed by the development and accreditation of more specific skills.

√ Amongst the skills to be taught, the spotlight must be put on the ability to solve problems.

√ The possibility of knowledge transfer from one field to another must be encouraged, which means that multi-disciplinarity must be established at the under-graduate level, which will have the operational consequence of increasing the sizes of the universities.

√ Good knowledge of the conditions required to protect ideas is also required. With regard to this, the development of in-depth knowledge of intellectual property law is essential.

√ Finally, to all of this we must add the need to allow advanced students to improve their skills abroad, in particular with the help of post-doctoral grants.

The tool: a national system of effective innovation

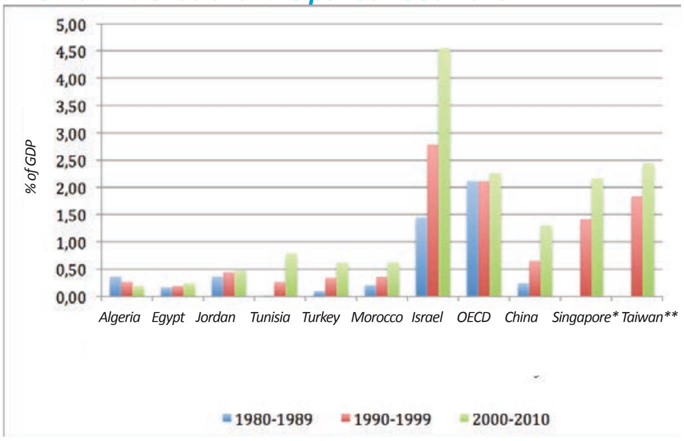
Within the organic approach adopted, here we shall highlight the five points that are decisive for the innovation process to operated efficiently: (i) governmental commitment to the establishment of an effective innovation system, (ii) the assertion that research is a national priority (iii) the functioning of the basic element, the research laboratory (iv) working conditions and the status of researchers and (v) the availability of ICT.

- **A national innovation policy is necessary** under the responsibility of the Prime Minister or at least through the coordination of several ministries. The reason is, firstly, that an overall strategy must be proposed, a favourable institutional environment created and horizontal synergies developed; secondly, it is essential that a national policy of the highest level, coordinate the actions and make the necessary arbitrations. In many cases, when a national policy targeting innovation is launched, all of the ministerial departments will attempt to position old strategies within the framework in order to benefit from budgetary resources or to develop a whole range of new tools, centres, clusters, incubators with different names (often set up by a bureaucracy with limited skills) whose results are uncertain in terms of employment, spill over effects on the rest of the productive apparatus and cost-benefits. A well-piloted and above all well-evaluated global vision is therefore necessary.

  There are different solutions. Three forms can be distinguished: (i) a central form around the Ministry of Research and Higher Education associated with other ministries and major research organisations scientific academies that guide public policies and allocate the means through dedicated agencies or funds (in the Mediterranean this is the case for Algeria, Tunisia and Egypt) (ii) a central form but with a sectorial orientation, as in Morocco, based on specific plans: the Green Morocco Plan, Emergence plan, Rawaj plan, impact plan, tourism plan etc. (iii) a more clustered form as in Jordan and Lebanon that groups together the main industrial, research, finance and marketing components within specific sites, but still under the authority of an inter-ministerial committee in which the Ministry of Higher Education and Research plays a key role.

  But international experience shows that the centralised level, even when well-coordinated, is not sufficient and that an effective national innovation system requires intermediate research organisations linked to specific laboratories and universities. This is due to the disappearance of the large industrial research laboratories of the last century, the urgency linked to international competition and the acceleration of technological development cycles. This results in a large variety of organisational models for partnership relations between universities and the private sector which depend on the strength of local and regional universities, industrial clusters, national priorities regarding R&D and the operating of funding agencies. These forms of decentralised organisation require considerable progress in decentralisation.
- **Declare research a national priority** which means that it should figure amongst the budgetary priorities. In the graph above we can see the gap between the research efforts made by MEDs (except for Israel) and those of OECD countries and Asian leaders. In the coming five years, it will be necessary to grow the expenditure on R&D as a proportion of GDP from the current 0.4% to 1% of the GDP if this new direction is to be credible. For Egypt, for example, this would represent an additional expenditure of around 500 million dollars, a sum that is relatively accessible thanks to international aid.
- **Turn research laboratories into the centre of attention** and change the so-called “confinement” model where the isolated genius comes up with a discovery that will cause a shift in paradigm. Laboratories must be granted greater autonomy (directly or via the universities) and must be better organised, research laboratories must be opened out by including them in international networks, by developing their relationship with companies and by allowing them to create foundations. Inclusion within international networks is currently formal or limited in time, as it is difficult for multilateral institutions to sustainably support the networks which they themselves initiated. Beyond this effort of consolidation, a decisive measure that could

Figure 23.
R & D on GDP trends over the period 1980-2010



*Source : UNESCO and OECD, *1994-1999, **1995-1999*

strengthen North-South cooperation between laboratories and the creation of new teams, would be the development of a large scale programme of post-doctoral grants.

√ **Consolidate a specific status for researchers** guaranteeing total independence of thought and allowing lecturer-researchers to include their research activities within their hours of duty. Facilitate the to-and-fro between public research and private research without a loss of status for public researchers. This reflection on status is decisive considering the indications available today: thus, when Morocco launches a plan for voluntary redundancy to alleviate the weight of the civil service, a large proportion of researchers apply. Similarly, the survey conducted in the present study reveals a large number of dysfunctions: erratic finances, a profession whose value is not recognised as compared to administrative jobs, unplanned recruitments, formal rules for evaluation, etc…

√ **Continue to develop ICT equipment**, in particular by encouraging the installation of secure servers and by generalising the broad band networks required to operate the mobile-internet merger.

Generalisation through enterprise and the creation of economic activity

Companies can no longer be considered as those that hunt down new ideas and staff trained elsewhere. They are increasingly those that produce ideas and are fully fledged innovators. An innovative company is one that has certain particular characteristics that are not yet widely spread throughout the Mediterranean. They carry out "open innovation" in the sense that they follow the flow of global ideas and discoveries of which they also offer their share, an aspect that is essential when they relocate. Their internal organisation adopts a matrix form through projects in which project managers cohabit with classical department managers. The main challenge identified by this report is that of developing the creation of innovative companies and innovation within SMEs.

This requires:

√ **The strengthening of links between companies and the training system** in particular at university level. Companies must be able to participate in the training of innovators, either within dedicated academic centres (cf. for example the spin offs and incubators of Cambridge University, the role of Stanford in the development of Google), or internally, by opening up to researchers and developing learning at high levels or by directly participating in the strategy of universities regarding innovation within a dedicated board.

√ **The development of private research and incentives** to encourage MEDs in this direction. For existing countries, the most operational lever is that of fiscal incentives, the impacts of direct tools (subsidies, R&D contracts, loans) have proven less convincing

. √ **The development of an ecosystem that encourages innovation**. Within this ecosystem, the question of financial resources for the development of new companies is decisive. On the one hand, because 40% of graduates are currently self-employed, more often than not within

Box 5. The question of public action in the development of innovation within the Mediterranean, the AFD's (French Development Agency) point of view

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Innovations are not solely technological but are multiform (including financial products – micro-finance, environmental credit lines, processes, organisation, consumer behaviours and, as seen, purely creative and cultural activities). To complicate matters, they are also multi-territory and operate in a network.

They are not, therefore, isolated inventions. Their common point is that they develop a general climate that will produce a competitive edge. Innovation is «having a head start». In this respect, innovation obviously serves company competitiveness.

The point of view defended here is that public action must move innovation out of laboratories and into the heart of company growth strategies.

As we have seen, innovation is fed by the entire surrounding environment, by an ecosystem that combines operators, infrastructures and knowledge. Innovation therefore carries a complex genetic heritage born from a matrix and an ecosystem. Nevertheless, there are four basic hesitations on behalf of public policies today, related to the choice of the system, the method, the place and the operators. What are the questions raised by these public policies?

The first question concerns the level of action. Is this ecosystem the result of the organisation of a society that works according to a decentralised model, i.e. based on the interaction of different operators acting within a non-constraining environment (freedom of action, expression, favourable legal framework, etc.)? Or is it the result of a more centralised system in which the State sets up, for example, the conditions for the production of innovation for certain previously selected sectors (spatial, army) ?

The second question concerns the method. Should financing favour an elite within a general education system that will select the best and shut them into a «Star City», or should it simply encourage the proliferation of ideas, with the hope of singling out from the mass a multitude of «weak signals» and wide-ranging calls for projects?

The third question concerns the place. Should public action link an ecosystem to a territory (the centre) or, to the contrary, escape this territory (e.g. through the development of sectors in which certain segments can be relocated, therefore by wagering on the mobility of factors and operators - should industrial territorially-anchored zones be created or clusters)? How far should clusters organised for international cooperation be supported?

The fourth question concerns the operators. Should the creation of companies by young graduates by supported or should this support go to innovation in companies that are already competitive? Should the proliferation of ideas be financed or should the stakes be placed on the capacity for diffusion and agglutination around a national champion?

What role should be played by cooperation in the creation of an Innovative environment in the countries of the south of the Mediterranean?

The AFD, similarly to other cooperation and development agencies, intervenes in landscapes where unequal capacities and skills are the most powerful explanatory factors of the spiral that prevents certain regions of the south of the Mediterranean from making progress on the path to convergence. Within this environment, the question is: should we concentrate on the global challenges of innovation or, to the contrary, the challenges of «activity clusters» ? Should the all economic sectors be upgraded or, to the contrary, should investments focus on specialisation?

In the first case, priority is given to strengthening the education system at all levels and improving skills in all sectors of business.

In the second case, specific sectors should be targeted and research should concentrate it means on a limited number of high level teams in scientific disciplines that will boost the competitiveness of strategic activity clusters.

The above shows that we no doubt need to do both if we wish to achieve innovation, a social project and include creative industries in the process. But in actual fact, the answer often stems from the limited financial means, the lack of cooperation between donors and the trouble they have in supporting regional projects. In the current situation, it is difficult to lead both a large scale educational policy to fight against Illiteracy and ensure that there is an effective higher education and research system whilst financing the country's infrastructures for high tech connections.

The hierarchy adopted begins with an initial development initiated by sufficient human and financial resources. This is then to be relayed by dynamic entrepreneurship that carries successive waves of company creation which will, finally, enrich the initial critical mass with the help of by an ecosystem, an environment that is favourable to the spatial diffusion of externalities. This is how, for example, the AFD intervenes, depending on the country, in one of these three steps. For example, it finances:

- √ *Public policies for vocational training and education (but never research so far),*
- √ *High added value sectors with a strong potential for external diffusion (solar energy Morocco),*
- √ *Infrastructures (ICT),*
- √ *Entrepreneurship through risk capital funds, guarantee products (which are a tool for sharing risks), micro and meso financing....Within this financial perspective, we may note that the idea is not to reduce the risk through by-products which are mostly speculative...but to share the risk, insofar as it is used to finance the real economy within a close relationship with the entrepreneur. Innovation also means taking risks, therefore. The risk of investing in new activities such as agro-ecology or the sustainable management of tropical forests or CSR In companies.*

the informal sector and are not in a position to create their own company and, on the other hand, because they are faced with a banking system that only gives loans if the collateral security and guarantees are substantial. Banks must therefore be re-qualified to extract them from their current high-return culture.

- √ **A change in scale to encourage the creation of new innovative companies**, by progressively installing a more decentralised and integrated approach similar to that of the German Mittelstand. Six components contributed to the successfull development of the Mittelstand:
  (i) Strong decentralisation at a regional level, especially regarding economic intervention,
  (ii) A network of SME-SMI,
  (iii) A decentralised banking system allowing substantial loans to be granted without referring to the head office, but with a public guarantee and whose main mission is to finance entrepreneurial activity.
  (iv) Links with universities and research centres,
  (v) Training focussing on apprenticeship that provides access to the highest responsibilities.

Achieving a change in scale through the essential coordination of international cooperation.

In order to go further, it is necessary to call upon and better coordinate international action on the basis of an explicit and joint request issued by the MEDs. If the community of international donors wishes to act efficiently, this work shows that they must select actions that will impact the organic function of research systems, education-training and companies through projects that are likely to bring about true social change.

This means, first of all, that the governments must adhere to the ideas developed herein and that they be eager to proceed. In order to give significant weight to this intervention, three conditions should ideally be met: the first is that the government must agree with the general vision and submit it to their citizens as one of the major future directions; the second is that on the organisational level, they accept to complete their current actions with a more horizontal reflection on the question of innovation, therefore more integrated and targeting a larger population; the third is that the decentralized (or even de-concentrated) levels be given greater responsibilities and means of action.

Regarding the community of donors, an additional difficulty arises: how can transversal projects spanning several countries benefit from significant support whereas guarantees generally target the national level. This is an important question in the case of open innovation which can only be developed through cooperation between several countries. Lastly, this clearly involves the funding of intangibles which, beyond technical assistance, is not common practise. Recent changes, however, should allow this direction to be adopted and could act as an example. Thus, the EIB lent 1.5 billion € to Greek banks to finance a large number of SME thanks to the use of Structural Funds that gave a 500 million € guarantee in place of the State. By boosting the Greek SME they managed to call upon subsidies from Structural Funds themselves whilst managing to self-finance the national counter-part. But without access to structural funds, the countries of the South can not envisage this solution.

Moreover, thanks to European budgetary allocations (in particular the European Investment Funds), the French Public Investment Bank has managed to fund guaranty systems, stakes in the regional funds and seed funding. An extension of the EIF to Mediterranean countries could help to develop this type of intervention.

For the region, it is possible to call upon the regional funds for SME guarantees set up within the framework of the Deauville partnership. However, this fund offers limited resources (400 million $). Similarly, the EIB has managed to fund long term investments related to education in Jordan… The crisis has therefore enabled partial progress but an overall plan remains lacking. It is unfortunate that the crisis leads to the implementation of a considerable amount of budgetary support they might maintain the economic equation within a minimal equilibrium whilst failing to significantly modify the conditions for future growth. Femise's point of view is that a reorientation, even if only slight, supported by a global and rallying vision would add weight to the efforts of the international community.

The authors of the present report consider that in order to head in the proposed direction, the below priorities must be adopted. For the Commission and bilateral agencies, by using and developing the tools available in Europe:

- √ **Technical assistance for the design and creation of an integrated and decentralised system** similar to the German Mittelstand,
- √ **Technical assistance to rework teaching methods** targeting creativity, innovation, problem solving and group work, in all levels of education.
- √ **A regional programme** benefiting from significant funds for cooperation and innovation-research (co-supervision of theses, post-docs, mobility of doctoral students) and training for teachers in scientific subjects,
- √ **Targeted educational and training projects** that could be run by associations in partnership with the private sector : "second chance" schools, innovation Masters degrees, university spin offs, training of banking executives in the financing of innovative SMEs.
- √ For the IFIs the most important project is the **financial aspect** that should allow the funding of decentralised projects.

To this end, the creation of a guarantee fund, intended to fund targeted incubator projects and others, selected and steered at the regional level by the decentralised or concentrated authorities granted autonomy in their economic decisions. But, to obtain significant results, the scale of multilateral involvement must be altered.

Box 6. Existing programmes in favour of regional cooperation within the framework of the Euro-Mediterranean Partnership, in the field of innovation and human capital

There are a large number of regional programmes, financed and co-financed by the EU, in very different areas (energy, environment, transport, support for private sector activities, youth, education, etc..). Three of them specifically concern innovation and human capital:

- The MIRA project (The Mediterranean Innovation and Research coordination Action), launched in January 2008, is intended to encourage scientific collaboration between EU member countries and Mediterranean partner countries. Its objectives are (i) to create a platform for discussion and exchange through the organisation of meetings between the operators involved, (ii) propose training activities, and (iii) prepare the Implementation of a Euro-Mediterranean Innovation Space (EMIS). The creation of this Euro-Mediterranean Innovation Space, will allow all of the previously developed programmes to be continued and consolidated (the most important for innovation being the Medibtikar programme that was operated between 2006 and 2010). This project is financed within the framework of the 7th FPRD. MIRA is thus a portal gathering information on all of the opportunities for the funding of EU-Mediterranean Partner Countries in the field of sciences, technologies and innovations, that can be either bilateral sources (mostly within the framework of Association Agreements), or multilateral sources, such as the framework programme in Science and Technologies, or other European programmes such as ENPI, FEMIP-EIB, etc. This portal also collects information on other international multilateral programmes from international organisations such as UNESCO, the OECD, the World Bank, etc.

- The Erasmus Mundus II project, which strives to promote cooperation between different higher education establishments through partnerships, mobility and exchange programmes for students, researchers and teachers. The allotted budget was 254 million € between 2007 and 2012 and 70 million € for 2013 covering a large number of countries (Armenia, Azerbaijan, Belorussia, Georgia, Moldavia, Russia, Ukraine, Algeria, Egypt, Israel, Jordan, Libya, Morocco, Palestinian occupied territories, Syria, Tunisia and any other partner in the world).

- The Tempus project, the purpose of which is to contribute to the modernisation of higher education establishments and to create opportunities for cooperation between operators. This targets Armenia, Azerbaijan, la Belorussia, Georgia, Moldavia, Russia, Ukraine, Algeria, Egypt, Israel, Jordan, Libya, Morocco, Palestinian occupied territories, Syria and Tunisia. The annual budgets were 38 million € in 2007, 34.4 million € in 2008, 39.4 million € in 2009, 30.4 million € in 2010, 57 million € in 2011 and 59.5 million € in 2012.

It should be noted, moreover, that although they do not directly target innovation and human capital, a number of programmes (in particular those focusing on energy, the environment and the information society) include a training and technology transfer section that can help to strengthen the Mediterranean countries' human capital in certain specific sectors. We may mention, for example, the EAMGM (EuroArab Mashreq Gas Market Project), the development of an integrated electricity market, MED-EMIP (Cooperation in the field of energy), MEDREG (Energy regulators), SEMIDE (Cooperation In the water sector), MEDA Eau, SMAP II (Sustainable Environmental Development), EUMEDIS (Information and Communication Technologies, etc.).

*Lastly, the EU has established a certain number of political instruments within the framework of the Barcelona Process. As an example, we may refer to the Monitoring Committee for EuroMediterranean Cooperation in RTD (MoCo), the introduction of sciences and technologies within the Association Agreements, the activities carried out at the level of the International Cooperation and Assistance Division (INCO), a certain number of projects consisting **in establishing an overview of scientific, technological and innovation systems within the region (ASBIMED and ESTIME), certain systems implemented for international scientific cooperation (INCONET, BILAT, ERAWIDE, SICA, etc.) and, lastly, the creation of national contact points for scientific collaboration between the EU and the Mediterranean Partners. .***

This is a sensitive subject to which we must draw attention. In the Mediterranean, it has been overly customary to dedicate the bulk of the money (most of which currently comes from the Gulf countries) to budgetary support that is undifferentiated or related only to general conditions. There has also been too little energy deployed in encouraging banks to take risks in favour of SMEs and too much window dressing on specific subjects lacking true impact on growth and employment considering the amounts at hand.

Endnotes

1. The poverty gap corresponds to the ratio (poverty threshold – median income of the poor population)/poverty threshold.
2. Cf. Femise Note on Inclusivity (2012).
3. The classification of countries according to revenue, proposed by the World Bank, uses the gross domestic revenue. The groups are as follows: Low income (≤ 975$), Lower middle income (between 976 and 3855$), Higher middle Income (between 3856 and 11905$) and High income (≥ 11905$). Amongst the Mediterranean countries, 4 are classed in the lower middle income category (Egypt, Morocco, Syria and the Palestinian Territories), 5 are countries with a higher middle income (Algeria, Jordan, Lebanon, Tunisia and Turkey) and 1, Israel, is classed as a higher income country.
4. These countries are Equatorial Guinea, Greece, Hong Kong, Ireland, Israel, Japan, Maurice, Portugal, Porto Rico, South Korea, Singapore, Spain and Taiwan.
5. South Africa, Albania, Korea, Ivory Coast, Honduras, Madagascar, Myanmar, Paraguay, Philippines and Togo.
6. For further details on the social measures adopted in 2011, see the AfBD Report (2013).
7. For a more in-depth analysis of this question of skills and employability, see chapter 4 of the report done by Femise for the EIB titled "Mobilising human capital towards innovation in the Mediterranean" EIB November, 2013.
8. For example, the World Bank's "Enterprise Surveys" that gathers together a significant amount of information on the business environment as perceived by companies and the main obstacles to their development. The data is available, sometimes for a number of years, for Algeria, Egypt, Jordan, Lebanon, Morocco, Syria and Palestine. The data is accessible on the World Bank site https://www.enterprisesurveys.org). A recent survey, financed by Femise, was also conducted by Ayadi, De Groen, Kamar, Kassal and Mouley (2013) amongst micro, small and medium countries in Algeria, Egypt, Morocco and Tunisia. The results of this survey are on the Femise website, Research Femise n° FEM35-10. (http://www.femise.org/). Data not yet available.
9. "Deep Integration, Firms and Economic Convergence", directed by Patricia Augier, Research Femise n° FEM33-23.
10. According to a study be Ahmed & Guillaume (2012), 1% of the GDP spent on infrastructures could, in the short run, generate 87,000 new jobs in Egypt and 18,000 in Tunisia.
11. It should however be specified that part of the exchanges between countries of the zone might not be compatible with the official figures. To our knowledge, there is not, however, any quantified estimation of these exchanges.
12. cf. Economic Integration in the Maghreb, World Bank, 2010.
13. To give an idea of the size of the gaps obtained by the literature, this recent work shows, for example, that he exchanges between MENA countries represents only 50% of their potential level. Certain studies obtain the same figure of 75%.
14. http://www.femise.org/etudes-femise-integration-regionale/
15. These customs duties in the industry, between Mediterranean countries, which were 33% in 1993, dropped to 8% in 2008, then 1% in 2009 (cf. Rapport Général 2012).
16. A recent study carried out by the economists of the AFD (E. Comolet, N. Madariaga and M. Mezoughi), in collaboration with the CEPII, titles, "Growth and trade integration in the Eu-

ro-Med: Can we speak of the cost of a non-Mediterranean?" (June 2013), shows that, with the exception of Turkey, no Mediterranean countries would draw any advantages from a MED-MED commercial liberalisation. In this study, regional integration is simulated by the total liberalisation of industrial goods, accompanied by the partial or total liberalisation of agricultural goods. The fact that trade intensification within the region does not incur any positive effects is not surprising for several reasons. Firstly, customs duties between Mediterranean countries are already close to zero. Consequently, the only change simulated is the dismantling of tariffs for farming produce. Secondly, customs duties are not the main cause of the low level of trade. As underlined above, the main obstacles reside elsewhere. In particular, they reside in the existence of non-tariff measures that can be constraining, in the absence of harmonised procedures (related to financing, customs, transport, intellectual property rights, conflict resolution, etc.), in the non-application of a total cumulation system to define the rules of origin or the weakness of cross-border infrastructures that complicate the transport of goods and travel for people. Yet, none of these aspects are taken into account in this empirical analysis. Lastly, we must remember that this type of simulation cannot integrate the dynamic effects that can be generated by an enhanced integration throughout the entire economy.

17. United Nations Conference on Trade and Development (UNCTAD), 2013. "Global Value Chains: Investment and Trade for Development", World Investment Report.

18. Even before broaching the question of their de-aggregation by sector and/or region, the use of data on FDI flows raises a problem. This data can be obtained from three main sources: - The CNUCED that provides the aggregated flows of FDI per country obtained by the aggregation of information provided by the central banks on the financial inflows and outflows, which lead to also including physical investments ("Greenfield", new production units or "Brownfield", the enlargement of existing units), financial investments linked to mergers-acquisitions, which are only changes in corporate ownership with no new input of capital. However this calculation method does not take into account the dividends that the foreign firms have reinvested. - ANIMA that records FDI projects in a detailed manner (location, sector, etc.), without knowing if these projects correspond to actual investments; - fDi Markets, that you must pay to access and which provides FDI data per sector and the number of job creations directly linked to these FDI. However, the source of this information is not specified.

19. There is a significant amount of literature on this question. Amongst the most recent articles, we may mention, for example that by Hanousek et al. (2011).

20. Information is lacking for Israel, Turkey and Palestine.

21. The level of dependence on imports of goods "I" corresponds to the ratio of the net imports of product "I" over (cf. World Bank, May 2011).

22. It has been shown that a 10% rise in global food prices almost immediately incurs a 1% increase in the consumer price index (CPI) of Mediterranean countries. However, a 10% drop in global food prices has practically no impact on CPI (cf. Albers & Peeters, 2013 & 2011).

23. These effects on domestic prices have been more marked in Algeria, Egypt, Israel, Jordan, Lebanon and Palestine, as compared to Tunisia and Morocco whose farming sector is more developed.

24. In Mediterranean countries, a large part of the population is indeed just below the poverty threshold. Whereas more than 3% of the population lives with less than 1.25 dollars per day in Egypt, in Morocco and in Tunisia, more than 12% of people live below the 2 dollar/day threshold. This percentage rises to 18.5% in Egypt (BAD, 2013).The slightest increase in the cost of living therefore has a very strong social impact.

25. Even more pessimistic, Oxfam foresees the doubling of food prices over the coming 20 years (Oxfam, 2011).

26. A recent study led by the African Development Bank and the Tunisian National Statistics Institute, in collaboration with Centre for Research and Social Studies (CRES), assessed the impact of food subsidies on poor and vulnerable populations. This study shows that subsidies have helped to reduce the growing income inequalities and helped prevent the nutritional status of households from deteriorating. However, the work also shows that until 2010, Tunisian households received 888 million Dinars in food subsidies of which only 107 million benefited poor households. In addition, only 9.2% of the subsidies went to the poorest households, 60.5% to middle class households, 7.5% to the rich population and 22.8% were transferred away from households (restaurants, cafés, tourism and illicit cross-border trade). It is, however, important to specify that this study shows that a "possible elimination of basic foodstuff subsidies would, in the short term, increase the level of poverty by 3.6 percentage points, taking it from 1.5% to 19.1%. As for populations in extreme conditions of poverty, this elimination would cause a rise in extreme poverty of almost 1.7 percentage points."

27. In 2008, 150 billion dollars were invested in stock indexes or agricultural fund assets as compared to only 15 billion dollars in 2004 (cf. BAD, 2013).

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Sub-section 2.

Strengthen social cohesion
By reducing territorial gaps

For Med countries, there is no other alternative than to offer a new social contract which substantially and visibly breaks with a past that has been largely rejected by the populations. As seen in the previous section, this social contract must be implemented within a context of market openness and exacerbated international competition, under great economic duress, in particular regarding public deficits. Meanwhile, the young populations have expressed strong social demands and now aspire to a real and rapid convergence towards the living standards of Europe, the neighbouring territory that is so geographically close and yet so far in terms of daily living conditions.

Whatever the economic constraints weighing on the countries, one of the main issues is to ensure that the populations benefit from the greatest possible equality in their opportunities for personal achievements, despite the disparities encountered, in particular those linked to individual geographical location. The goal is to offer the same opportunities to all individuals throughout the country, regardless of their social or geographical origins in particular. Many observers have already noted that it is not by chance if the Arab Spring uprisings began in a medium sized town in the centre if Tunisia, in a place where living conditions and development possibilities are far from those of European standards, but also from those of the better positioned locations within the country: a place that we could qualify as an "underdevelopment trap". Here the prevalent domestic development model was clearly brought into question. The latter, despite relatively high average domestic growth rates over more than a decade, has indisputably failed in terms of inclusivity: the possibilities afforded by growth have been disseminated neither amongst certain segments of the population, nor within certain regions of these countries.

The recent turmoil within Arab countries leads us to make 4 comments on these questions of inclusion, inequalities and disparities:

- √ The protagonists' perception, as subjective as this may be, is just as important as actual facts. It is, after all, part of the social contract insofar as the latter is subjectively judged by the population. This perception is itself based on daily experience and therefore belongs to a local, spatial framework, located at a specific place within the hierarchy of territorial disparities.
- √ An approach based solely on income (i.e. the inequalities measured through household expenditure or income) cannot account for all of the actual disparities, or for the protagonists' perception of them. The protagonists base their estimation of the actual situation on more refined, personal issues that are closely related to their everyday concerns. With regard to this, the recommendations made to move towards greater democracy (in particular by the EU), first require a certain level of general culture in order to raise the political debate and achieve sustainable change within a participative framework. We note with interest that in Morocco a survey amongst the youth of the Marrakech-Tensift Al Houz region, led by the OCEMO [1] and covering the 16-34 year age range, revealed that only 20% of the young people questioned wished for greater freedom, and therefore a greater participation in decisions, whereas 70% put public security at the top of their wish list.

√ The question of the convergence of domestic measurements, such as GDP per capita, towards references such as the European Union, is no more reflective of the population's perception. Beyond perception itself, as rightly shown by Stiglitz regarding the US, convergence at the domestic level does not guarantee that inequalities will be alleviated, even if only regarding income. According to his figures, the American GDP has quadrupled in the past 40 years and doubled in the past 20 years but for the average American, when taking into account inflation, their personal situation has deteriorated within the space of 45 years. For individuals benefiting from an average level of education, this loss would even represent 40% over 40 years. The main postulate here is that "Inequality is a product of political and not merely of macroeconomic forces" which quite rightly led the author to call his article : "Inequality is choice" (J. Stiglitz, 2013) [2].

This chapter will therefore examine the question of territorial imbalances in Mediterranean countries from the angle of inclusive development, i.e. a development that goes beyond reducing inequalities in terms of revenue or social well-being, to also encompass the level of participation and opportunities.

It is organised into three parts. The first part seeks to highlight the level of territorial imbalance organised into 3 levels: natural disparities, inequality of revenues and inequality of opportunities. The second part looks at how disparities and inequalities have evolved in each country and how populations perceive the different forms of disparity and inequality, particularly those related to opportunities. The third part successively approaches the advantages and the different forms of decentralisation, the spatio-administrative organisation in the countries of the region, and the extent to which they contribute to the observed level of opportunity disparities. We shall conclude with the possible routes towards a decentralisation that would allow the spatial disparity of opportunities to be reduced.

I. The level of disparities and inequalities between territories within the MEDs

I.1.Revenue inequalities within MEDs as compared to other regions

Poverty and revenue inequalities are indisputably amongst the most frequently studied points in Mediterranean countries. The observations made are sometimes said to be paradoxical. Income poverty is fairly low in Mediterranean countries, at least at the lowest threshold and relative to all other developing regions. However, as soon as the threshold below which a person is qualified as poor is increased slightly, the percentages of the population involved quickly increase: poverty is not as severe, but a large part of the population could succumb as a result of the slightest external pressure, for example when food or fuel prices increase; this means that the general social situation is weak.

If we then take an interest in the question of inequalities within Mediterranean countries and their dynamics, the overview is ambiguous. The table below shows two indicators of inequality: (i) the GINI coefficient, which measures the unequal nature of distribution (the higher it is, the more unequal the distribution) and (ii) the share of the various income deciles in consumption.

On the basis of this data, it is quite clear that the MEDs have not succeeded in substantially reducing inequalities over the past decade. Although the inequality indexes do underline that the MEDs are not in a significantly worse position than most of the other emerging regions. If we take a median value, the MEDs position even seems slightly better than that of other regions. However, 2 very clear cut phases can be distinguished during this period: (i) a downwards trend of inequality during the second half of the 90s, (ii) a rise from the middle of

Table 1.
Level and evolution of inequality in the Mediterranean and some emerging countries in the years 1990-2010

	Period 1-2-3	Gini 1	Gini 2	Gini 3	Share of 2 lowest decile in Income or Consumtion 1	2	3	Share of the 2 highest decile 1	2	3	Share middle inc. (3-6) 1	2	3
Algeria	1988-1995-...	40.2	35.3	...	6.5	7	...	47.2	42.6	...	27.8	25.6	...
Egypt	1995-2004-2008	30.1	32.1	30.8	9.5	9	9.2	39.9	41.5	40.3	29.4	28.7	29.4
Jordan	1997-2006-2010	36.4	37.7	35.4	7.6	7.3	7.7	44.4	45.5	43.6	26.9	26.3	27.2
Morocco	1990-2000-2007	39.2	40.6	40.9	6.6	6.5	6.5	46.3	47.7	47.9	25.4	24.8	25
Syria	...-2004-...	...	35.8	...	...	7.7	...	...	43.9	...	...	27	...
Tunisia	1995-2000-2005	41.7	40.8	41.4	5.7	6	5.9	47.9	47.3	47.9	24.6	25.1	24.9
Turkey	1994-2002-2008	41.5	42.7	39	5.8	5.6	5.7	47.7	48.9	45.1	25	24.4	26.8
Palest.	...-2007-2009	...	38.7	35.5	...	6.5	7.4	...	45.6	43.4	...	26.1	27.7
Median	**Ex.Turkey. Pales.**	**39.2**	**36.8**	**38.2**	**6.6**	**7.1**	**7.1**	**46.3**	**44.7**	**45.7**	**26.9**	**25.9**	**26.1**
Argentina	1995-2003-2010	48.9	54.7	44.5	3.9	2.7	4.4	53.7	57.5	49.4	21.6	18.6	24.1
Brazil	1995-2003-2009	60.2	58.8	54.7	2.2	2.3	2.9	64.3	63.4	58.7	15.7	16.7	19.5
Paraguay	1995-2003-2010	58.2	56.9	52.4	2.4	2.8	3.3	61.7	60.9	56.4	17.1	17.7	20.5
Uruguay	1989-2006-2010	42.4	47.2	45.3	5.3	4.6	4.9	48.1	52.5	50.9	24.9	21.8	22.7
Venezuela	1995-2003-2006	47.2	48.1	44.8	4.1	3.3	4.3	51.9	51.9	49.4	22.6	22.7	24.1
MERCOSUR	Mediane	**48.9**	**54.7**	**45.3**	**3.9**	**2.8**	**4.3**	**53.7**	**57.5**	**50.9**	**21.6**	**18.6**	**22.7**
Indonesia	1993-1999-2005	29.3	29	34	9.5	9.6	8.3	39.1	38.9	42.8	29.9	30.2	27.9
Thailand	1994-2002-2009	43.5	42	40	6.1	6.3	6.7	50.4	49	47.2	23.1	23.9	24.8
Viet Nam	1992-2002-2008	35.7	37.6	35.6	7.8	7.5	7.4	44	45.6	43.4	26.8	25.8	27.3
Cambodia	1994-2004-2008	38.3	41.9	37.9	8	6.9	7.5	46.8	49.4	45.9	25.4	23.9	25.9
Philippines	1994-2003-2009	42.9	44.5	43	6	5.4	6	49.5	50.7	49.7	23.5	22.7	23.3
ASEAN	Mediane	**38.3**	**41.9**	**37.9**	**7.8**	**6.9**	**7.4**	**46.8**	**49**	**45.9**	**25.4**	**23.9**	**25.9**
Ukraine	1995-2004-2009	39.3	28.1	26.4	6.2	9	9.7	45.7	37.3	36.3	26.2	31.1	31.6
Belarus	1995-2001-2008	28.8	30.7	27.2	8.5	8.2	9.2	37.2	39.1	36.4	26.9	25.9	27.5
Non EU East C.	Mediane	**34**	**29.4**	**26.8**	**7.3**	**8.6**	**9.4**	**41.5**	**38.2**	**36.3**	**26.5**	**28.5**	**29.6**
China	1996-1999-2005	35.7	39.2	42.5	7.2	6.4	5	43.3	46.1	47.9	27.1	25.3	24.8
India	1987-1993-2004	31.9	30.8	33.4	8.8	9.1	8.6	41.1	40.1	42.4	28.8	29.3	28
Sel. Emer.	Mediane	**42.4**	**42**	**42.5**	**6.1**	**6.3**	**6**	**48.1**	**49.4**	**47.9**	**24.9**	**23.9**	**24.8**

Source: FEMISE FEM3d-05 ; Own calculation using PovcalNet developed by the Development Research Group of the World Bank. http://iresearch.worldbank.org/PovcalNet. Access in July 2012

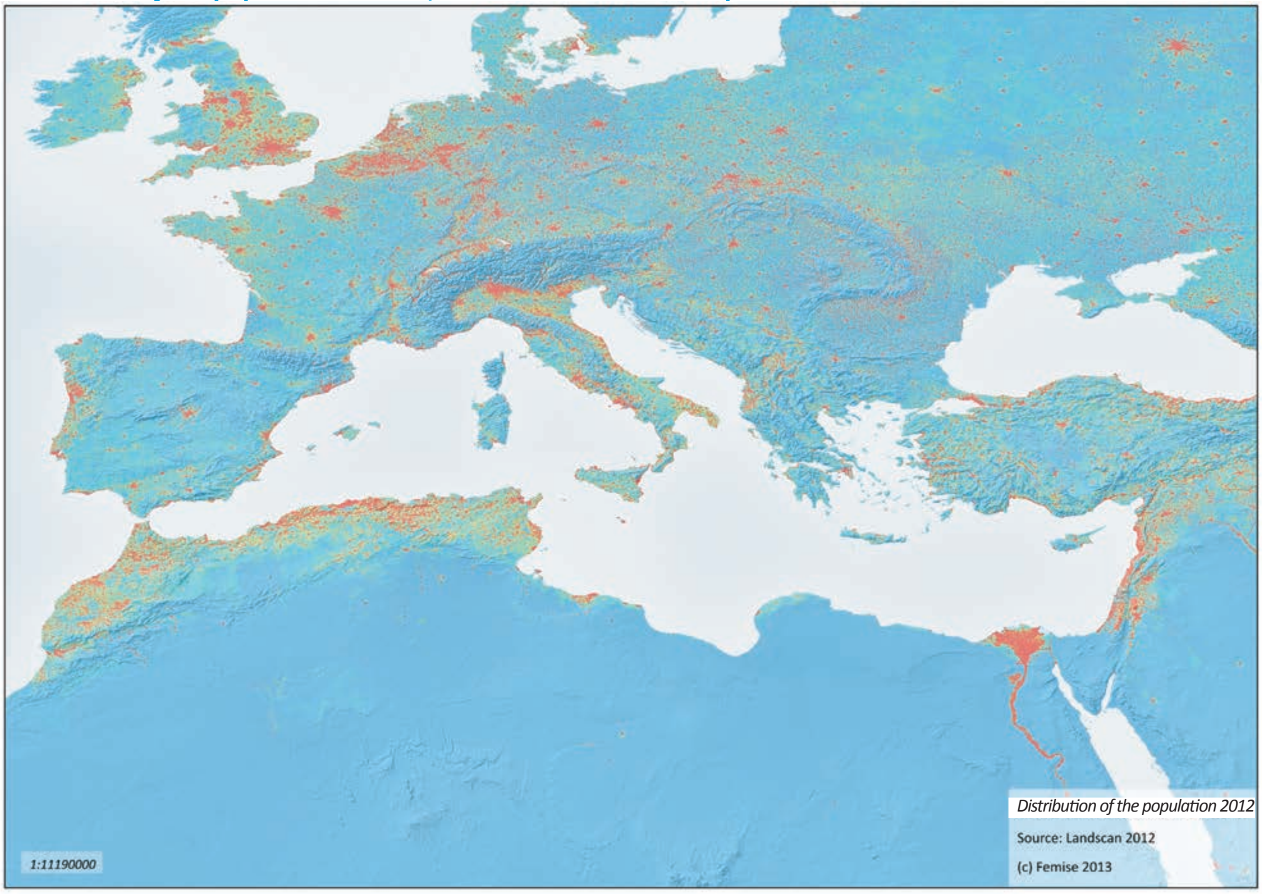
the 2000s until today (exactly the opposite of that observed in the other regions of reference). Even in Egypt where the movement is reversed, the slight drop between 2004 and 2008 merely takes us back to the level of inequality observed in 1995: 15 years of globalisation and partnership have not therefore changed the inequality of revenues in Egypt. We may note, in addition, that the regional trend shows that the middle-income class has not benefited from the two decades of growth, as most of the gains have been cancelled out over the last period.

I.2 Disparities related to geographical location in the Mediterranean

Distribution of the population

The first striking characteristic when looking at the region as a whole is that the populations of the sou-

Map 1:
Distribution of the population in 2012, Mediterranean and Europe



Source: Authors, based on LandScan2012 data; the more the point is red, the higher the number of people living in the area

thern countries are highly concentrated along the coasts and rivers. This concentration is significantly higher than in Europe. Although the map is not the territory [3][4], it has the merit of illustrating the geophysical constraints that mark the southern territories with, in particular, the deserts, the factors of activity concentration and, already, certain territorial disparities. **Here we illustrate the challenges related to the territorial development of these countries.**

The first constraint is geophysical and is due to the presence of the African and Eastern deserts. As shown in map n°2, land use is first and foremost linked to habitability based on its “non-desert” nature.

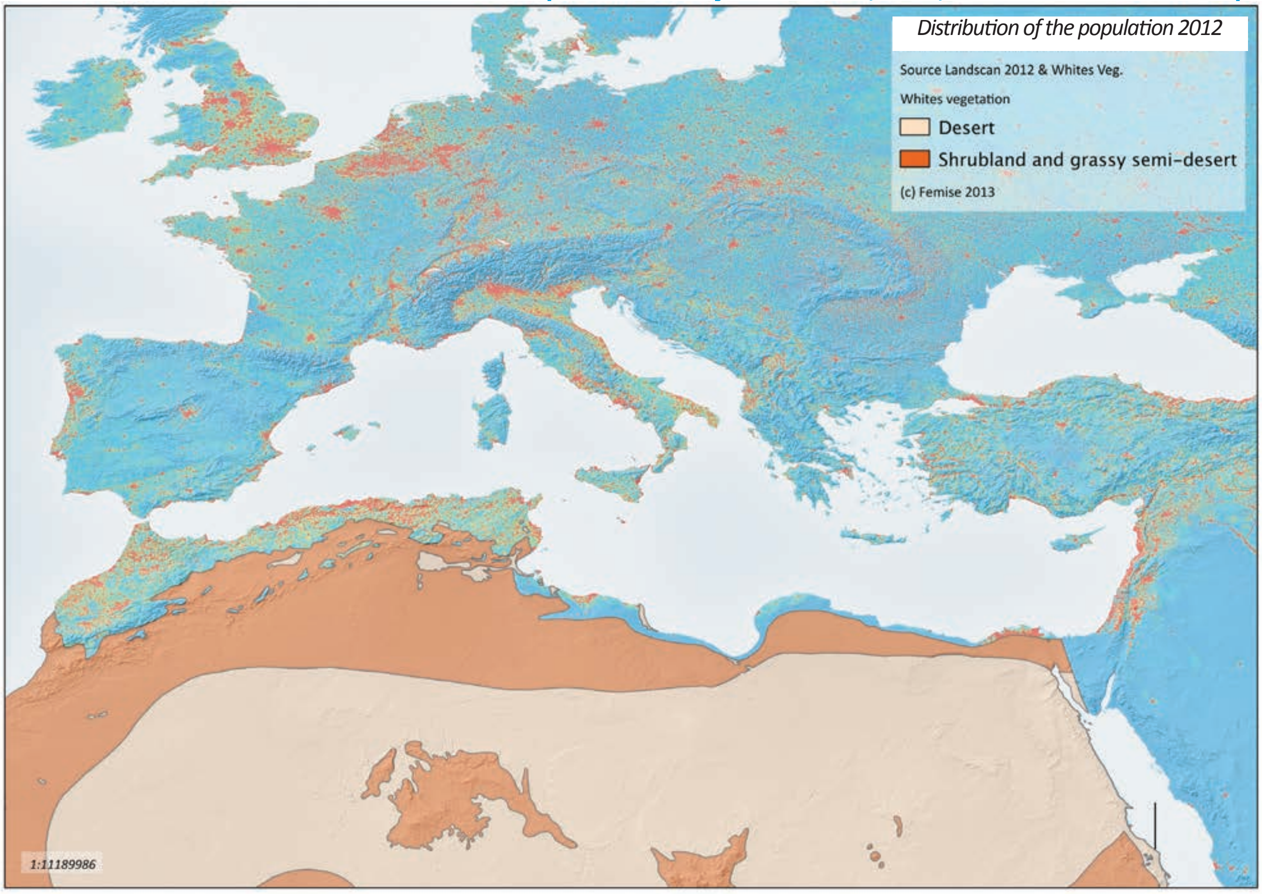
A number of major implications stem directly from this geophysical constraint:

- √ **The Urban-Rural dichotomies and the question of accessibility** in certain areas are of major importance in these countries.
- √ To the contrary, the population concentration necessarily means that a larger share of the population than in other emerging regions can have ready access to basic infrastructures such as those for health or education.
- √ Coastal density creates **strong competition for land use between very important economic activities** such as tourism, agriculture or fishing. They also make these countries more vulnerable to the possible impacts of climate change.

Thus, more than 75 million people live less than 30 km from the coast and 111 million less than 50 km away, i.e. respectively 26% and 38% of the entire population.

- √ Urbanisation within the region is higher than in most regions displaying a similar level of development. Table 3, brings together a number of indicators on the dispersion of the

Map 2:
Population and African deserts, 2012, Mediterranean and Europe



Source: Authors, based on LandScan2012 and Unesco AETFAT-UNSO data: White Franck 1993. The AETFAT chorological classification of Africa: history, methods, and applications. Bull. Jard. Bot. Natl. Belg. 62: 225-281.

Table 2.
Littoralisation population. 2012; Mediterranean and some European countries

Littoralisation	Proportion of the population located within x km of the coast (2005)			
	- than 30 Km	- than 50 Km	- than 75 km	Maximum distance from the coast (km)
Algeria	14.1	47	64.8	1 575
Egypt	21.8	22.2	23.6	986
Israel	86.6	86.6	86.6	117
Jordan	0.3	0.3	2.1	371
Lebanon	85.4	100	100	49
Morocco	19.1	41.5	58.9	464
Palestine	1.3	66.9	100	58
Syria	7.2	7.2	33.4	462
Tunisia	48.8	64.8	72.7	321
Turkey	33.7	44.3	52.9	531
Libya	34.9	81.9	86	1 245
France	18.6	26.4	33.1	413
Germany	7.6	11.5	11.6	451
Spain	43.7	52.6	56	321
United Kingdom	47.7	56.5	88.4	101

Source: Authors' calculations based on data from econ G-4. W. Nordhaus / Yale University. calculated on the basis of the distance within an area of 1 ° longitude and latittude

Table 3.

Disparity location of the population indicators. 2012; Mediterranean and some European countries

	Population 2012 (Mios)	Gini population by area */**	% Of occupied territory *	% of territory occupied by X% of the population 50%	80%	90%	Density (inhab.km2) Average	populated area	for 50% of the pop.
Algeria	37.261	0.951	26.7	0.7	2.8	4.7	16	60	1 191
Egypt	83.56	0.943	13.4	0.8	2.2	3	84	631	5 060
Israel	7.659	0.647	93	3.9	14.6	22	340	365	4 370
Jordan	7.004	0.885	84.2	0.7	3.7	6.3	78	93	5 395
Lebanon	4.619	0.572	99.9	4.8	30.4	49.7	441	442	4 436
Morocco	32.221	0.874	97.1	1.9	16.6	28.2	77	80	2 072
Palestine	4.362	0.543	99.7	9.1	26.4	44.7	697	699	3 655
Syria	20.687	0.767	97	1.3	11.4	22.6	110	114	4 187
Tunisia	10.646	0.779	72.4	2.7	14.7	25.4	68	94	1 244
Turkey	79.498	0.735	99.6	2.2	22.9	42.7	102	102	2 272
Libya	5.576	0.967	14.5	0.1	0.3	0.7	3	24	2 233
France	63.193	0.564	99.7	5.5	29.9	49	115	115	1 050
Germany	81.222	0.473	99.9	9	35.5	55.6	228	228	1 269
Spain	44.624	0.656	99.9	2.2	11.8	24.2	89	89	2 047
Un. Kingdom	62.83	0.648	97.8	5.3	18	31.5	257	263	2 425

Source: Authors' calculations based on: Population -> Landscan 2012; administrative maps -> 2.0 GADM
** Land area where an area contains at least one inhabitant (resolution 10 km x 10 km)*
*** The Gini coefficient is a measure of the dispersion of a distribution. The Gini coefficient is a number ranging from 0 to 1. where 0 means perfect equality and 1 means total inequality when we look at the dispersion in a certain population.*

population throughout the Mediterranean region (plus 4 European countries as a comparison), and allows us to identify three types of country.

√ A first group of countries whose population uses only a small part of the land with a high concentration of the population: 90% of people living on less than 10% of the land. These are the large countries of North Africa (Algeria, Libya, Egypt). Here we find the coexistence of vast empty areas, very sparse rural zones and strong urbanisation. Egypt, however, is shown to be in a rather specific situation. Indeed, the mean density in inhabited areas exceeds 631 inhabitants/km2, most of the population faces urban issues, but the heterogeneity of urban equipments is strong. To the contrary, rurality is more present in Algeria and Libya.

√ A second group contains countries with occupation levels exceeding 70%, but for which 90% of the population is grouped together on less than half of the land: Morocco, Tunisia, Jordan, Turkey and Syria. The mean density of the inhabited surface area is around 100 inhabitants. per km2, which once again gives an important weight to the rural population. In these countries, the issues are fairly close to those observed for the 4 European references regarding population distribution.

√ The small Mashreq countries form a third set, with a mean density of inhabited surface area exceeding 300 inhabitants/km2. Here, within practically all of the administrative territory, the issues are more "urban". Lastly, we may note that although 90% of the MEDs population lives on around 10% of the administrative territory, the disparities in density are very high and problematic in the organisation of these very different living environments, with densities in inhabited zones that vary from 23 to 699 inhabitants/km2, i.e. a factor of 30.

Urbanisation, rural environments and accessibility

As shown in Table 4, the urbanisation of the region is relatively higher in the Mediterranean than in other developing regions.

In Mashreq, more than 80% of the population in Israel, Jordan and Lebanon is urban. This is also true for Libya. In Algeria and Turkey, urbanisation levels exceed 70%, figures that are therefore comparable to those of Europe. According to official figures, there is significantly less urbanisation in Morocco, Syria and Tunisia, but also…in Egypt where less than half of the population is considered to be urban. This apparent contradiction with the average densities calculated above and this estimated degree of urbanisation actually highlight the strong disparity between the existing types of habitat: inhabitant density does not necessarily mean a town, which in fact underlines the heterogeneity between habitat zones themselves, between towns, in particular in terms of equipment.

A number of other points are to be underlined regarding urbanisation:

To begin with, the region displays extensive "macrocephaly", i.e. a (too) heavy weight of the main city within the entire urban fabric. Indeed, geographers consider that beyond the 20% bar we can talk of hypertrophy. In principle, the "large cities" are open to the world, are the first recipients of the positive impacts of openness and are places that provide and distribute rare services. Large cities hold the potential of acting as a d**riving force for investments** and for public facilities and play a role in **disseminating services**, practices or technologies. It is therefore obvious that the more the "large cities" correctly span the country, the greater the strength of these positive externalities. To the contrary, when this weight is high, it is generally the **symptom of strong centralisation**, or even of the presence of a power that **captures income** and redistributes it in a very local manner. This can give rise to **a drain phenomenon** and not to distribution. But this phenomenon seems to be declining in the Mediterranean, only 2 countries show a level significantly below 20% and close to the average observed in middle income countries: Algeria and Tunisia. If we consider this at the scale of the century, this polarisation around a handful of cities within each country is fairly new in the Mediterranean and can mainly be explained by centralising and capturing policies which have also led to strong rural exodus (Côte et Joannon, 1999). This can be interpreted as **a translation of the «Authoritarian Bargain Model» throughout the territory.**

To support this view, we can do a comparative regional study of the rural exodus towards urban zones that has been observed in almost all regions since the middle of the last century. Generally speaking, as noted by the World Bank (Banque Mondiale, 2011), the migration of populations towards urban zones is accompanied by the shift of labour forces from agriculture to industry and services. From this point of view, the region is out of step. Although the share of agriculture has dropped significantly in terms of added value, its importance in terms of employment remains high (see map n°3), which shows that urban migration does not occur due to a transition towards an industrial model, but most probably due to the desire to come closer to the capture zone.

This can have 2 important consequences, one in rural zones and the other in urban zones:

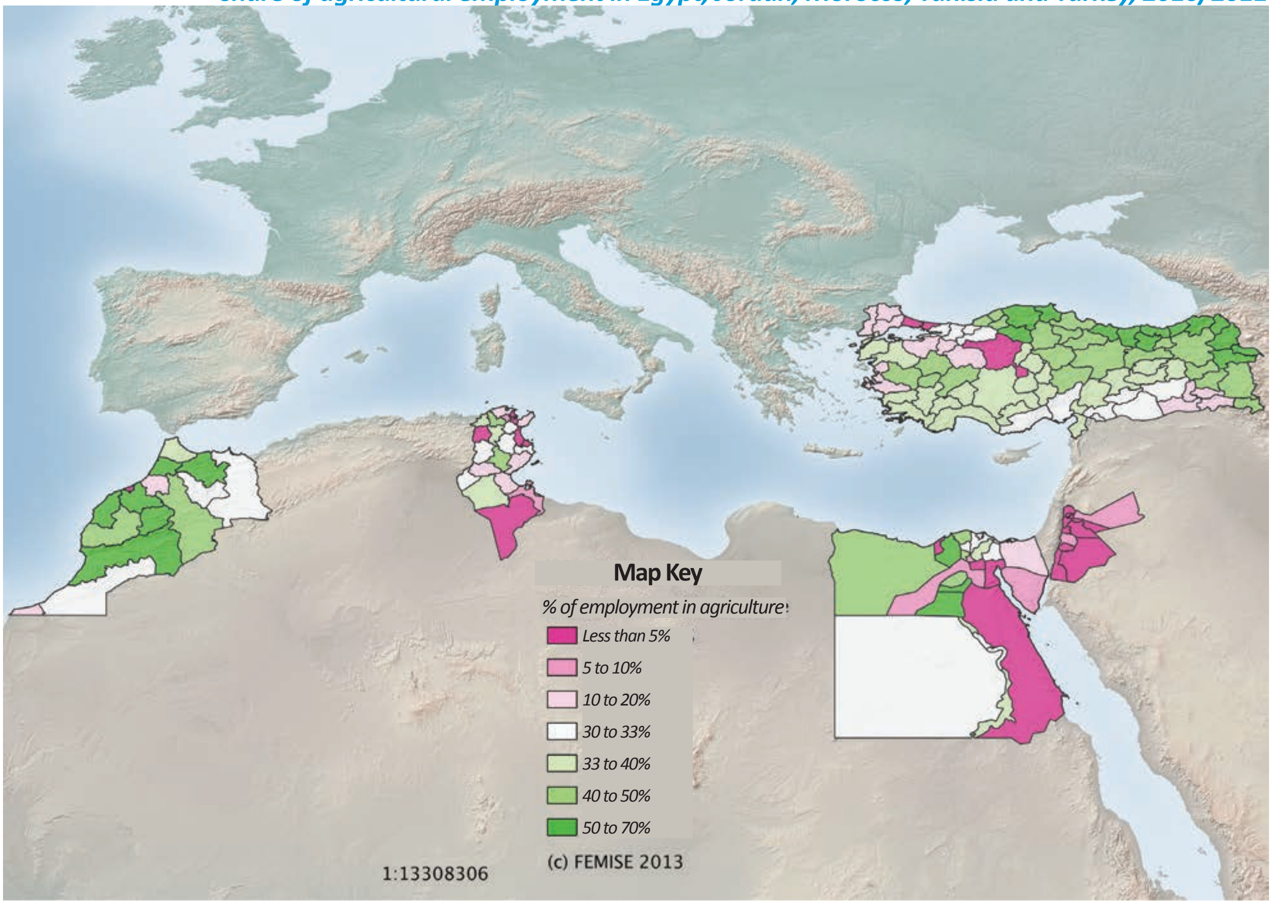
(i) This migration, failing the development of substitution activities to replace farming jobs, means that farming generates relatively less added value but by and for a rural population whose numbers remain high and who depend on agriculture for employment. **This therefore**

Chart 4.
Indicators of urbanization. 1995 and 2012; Mediterranean and selected countries

	Population of the largest city in% of the total urban population		Population living in agglomerations of more than 1 million inhab. in% of the total population		Urban population as% of total population	
	1995	2012	1995	2012	1995	2012
Algeria	12.3	10.3	6.9	7.8	56	73.7
Egypt	37.1	31.8	21.2	19.8	42.8	43.7
Israel	48.5	46.4	58.2	57.1	90.9	91.9
Jordan	29.6	21.8	23.2	19.2	78.4	83
Lebanon	49.3	51.3	41.8	46.4	84.8	87.4
Morocco	21.3	18.1	19	18.8	51.7	57.4
Palestine	nd	nd	nd	nd	70.4	74.6
Syria	25.9	25.9	30.7	33	50.1	56.5
Tunisia	12.4	10.9	0	0	61.5	66.5
Turkey	21.1	20.2	27	33	62.1	72.3
Libye	27.3	23.7	20.7	18.6	76	77.9
France	21.3	18.7	22.1	22.6	74.9	86.3
Germany	5.8	5.7	9	9.4	73.3	74.1
Spain	15.7	16.8	23.1	26.8	75.9	77.6
U.K.	17.4	17.2	26.1	25.9	78.4	79.8
Argentina	36.1	34.7	38.9	40.3	88.7	92.6
Brazil	12.7	12.3	36.4	40.4	77.6	84.9
Paraguay	51.4	51	26.8	33	52.1	62.4
Uruguay	54.3	52.1	49.1	49.7	90.5	92.6
Venezuela	14.6	11.3	32.6	33.3	87.3	93.7
MERCOSUR	22.3	21.1	32.2	35.1	72.6	79
Indonesia	12.1	7.4	9.4	8.9	35.6	51.4
Thailand	34.2	31	10.7	14.9	30.3	34.5
Viet Nam	23.8	23.3	7	10.9	22.2	31.7
Cambodia	44.8	55.1	7.8	10.7	17.3	20.2
Philippines	28	25.3	14.9	14.2	48.3	49.1
ASEAN	8.7	6.6	10	11.9	32.2	49.6
Ukraine	7.5	9	12.2	13.8	67	69.1
Belarus	23.8	26.3	16.2	19.8	67.9	75.4
Non EU East C.	20.2	20.1	16.7	19.6	57.2	60.2
China	2.7	2.4	11.7	21.8	31	51.8
India	4.9	5.9	10.4	12.7	26.6	31.7
Middle Income	14.3	12.4	14.9	19.5	39	49.5
High income: OECD	17.6	16.6	32.3	35	75.4	80.8

Source: World Bank

Map 3:
share of agricultural employment in Egypt, Jordan, Morocco, Tunisia and Turkey, 2010/2011



Source: authors, CAPMAS data for Egypt, National Survey of Employment, Haut Commissariat au Plan (Department of Statistics) for Morocco, Turkish and Jordanian national offices, regional offices Tunisian development

creates the risk of creating pockets of poverty or insecurity in rural areas. In map n°3, moreover, we note that the disparities within countries are extreme: the agricultural employment rates exceed 50% in certain Moroccan and Egyptian regions relative to respective national averages of 39.8% and 28.2%.

(ii) Migration towards cities therefore takes place without any pre-determined job prospects and jobs will only be found according to the economic opportunities and characteristics of rural migrants, in particular in terms of education and health. The risk of a gap between migrant skills and the needs of the urban service society, open to the world and to competition will grow alongside rural-urban disparities. This gap between skills and the formal job market demands is, moreover, a major characteristic of Mediterranean countries. Due to a lack of concordance and therefore employment, **an urbanisation of poverty and marginalisation is taking hold,** with ever more blatant disparities within a restricted area, within the city itself. It is within the urban space itself that ”local poverty traps” are also created, making these disparities even more visible. Because the gap is so great in a place where 2 worlds live side-by-side, the risk of social explosion is obviously exacerbated.

Thus, if we add demographic pressure and (geographical) land and water scarcity (due to the arid nature of the region), there is a high risk of seeing on the one hand the emergence of severely lagging regions and, on the other hand, urbanisation accompanied by poverty, on the fringes of the traditional urban fabric (slums, etc…).

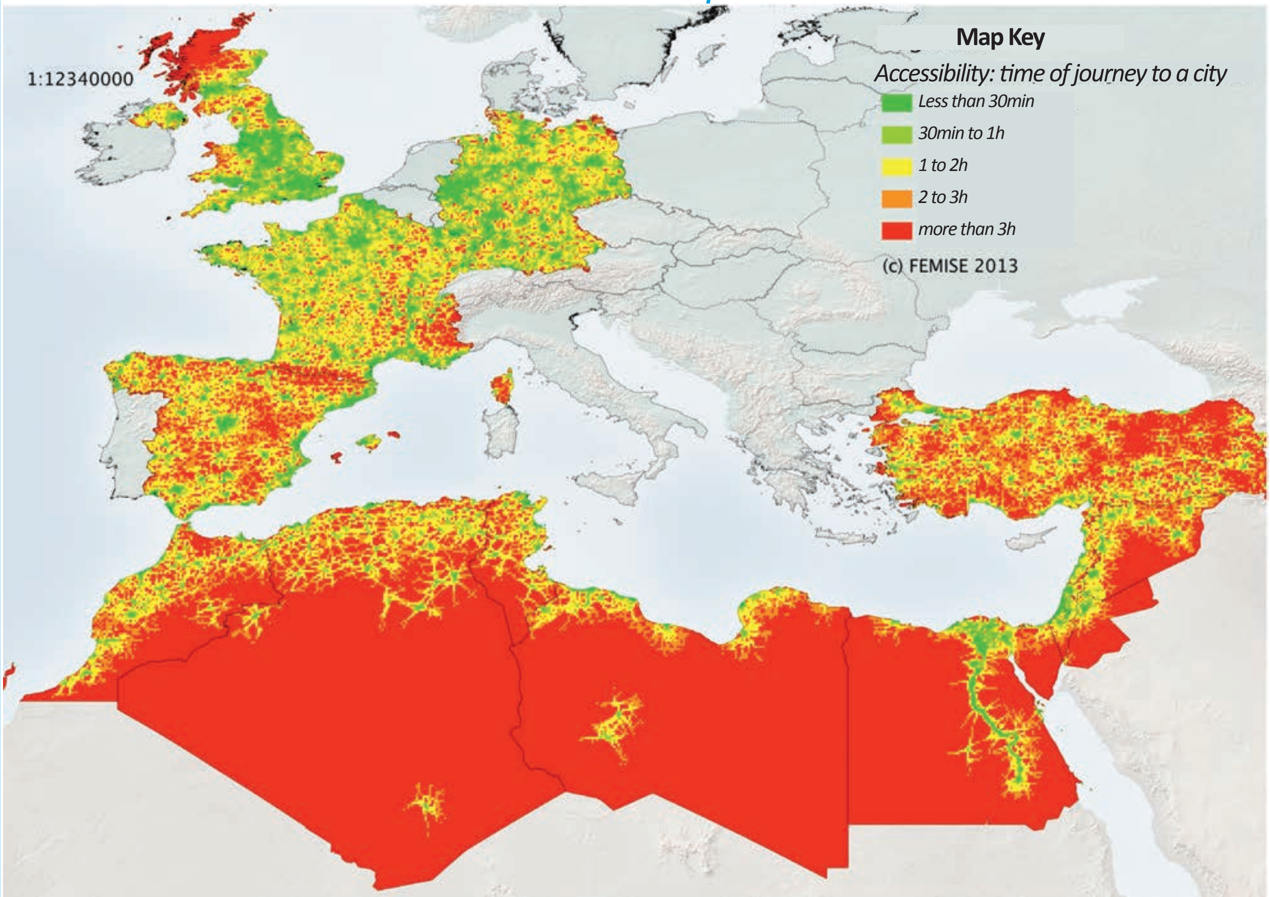
The concentration of populations within a small part of the territory does, however, have a positive

Table 5.
Importance of agricultural employment in 1995 and 2012 and selected Mediterranean countries

	Share of employment in agriculture				Share of agriculture VA in GDP			
	Around 1995		Around 2010		Around 1995		Around 2010	
Algeria	21.1	2001	11.7	2010	10.5	1995	6.9	2010
Egypt	34	1995	28.2	2010	16.9	1995	13.9	2011
Israel	2.9	1995	1.7	2009	nd	1995	nd	2010
Jordan	4.9	2000	1.7	2011	4.3	1995	3.4	2012
Lebanon	nd		nd		7.6	1995	6.3	2012
Morocco	44.4	2002	39.8	2011	15.1	1995	15.1	2011
Palestine	14.3	1996	11.8	2010	nd		nd	
Syria	28.4	1995	14.3	2011	31.6		22.9	2009
Tunisia	18.7	2005	17.7	2010	13	1995	8.7	2012
Turkey	43.4	1995	24.2	2011	16.3	1995	9.1	2010
Libya	nd		nd		5.2	2002	1.9	2008
France	4.9	1995	2.9	2011	3.3	1995	1.8	2009
Germany	3.2	1995	1.6	2011	1.3	1995	0.9	2010
Spain	9	1995	4.2	2011	4.5	1995	2.7	2010
U.K.	2	1995	1.2	2011	1.8	1995	0.7	2010
Argentina	0.6	1995	1.2	2011	6.1	1995	10.1	2012
Brazil	26.1	1995	17	2009	5.8	1995	5.2	2012
Paraguay	40.1	1995	26.4	2011	20.1	1995	17.4	2010
Uruguay	ns	1995	10.7	2011	8.6	1995	9.4	2011
Venezuela	13.5	1995	8	2011	5.5	1995	5.8	2010
MERCOSUR	19.4	1995	15	2011	7.1	1995	5.3	2012
Indonesia	44	1995	35.9	2011	17.1	1995	14.7	2011
Thailand	52	1995	38.7	2011	9.5	1995	12.4	2011
Viet Nam	70	1996	48.4	2011	27.2	1995	21.3	2012
Cambodia	77.5	1998	55.8	2011	49.6	1995	36.7	2011
Philippines	44.1	1995	33	2011	21.6	1995	12.8	2010
ASEAN	50.8	1995	36.7	2011	19.3	1995	11.1	2011
Ukraine	22.5	1995	15.8	2008	15.4	1995	9.6	2011
Belarus	21.2	1994	nd	2011	17.5	1995	9.9	2011
Non EU East C.	33.4	1995	16.4	2009	16.9	1995	9.2	2011
China	52.2	1995	36.7	2010	20	1995	10	2011
India	59.9	2000	51.1	2010	26.3	1995	17.4	2012
Middle Income	51.4	1994	37.4	2010	15.7	1995	10	2011
High income: OECD	5.7	1995	3.4	2010	2.3	1995	1.4	2010

Source: World Bank

Map 4:
Accessibility: average time to reach a city of more than 50,000 inhabitants;
European and Mediterranean countries selected 2000



Source: Authors, from Nelson, A. (2008) Travel time to major cities: A global map of Accessibility. Global Environment Monitoring Unit - Joint Research Centre of the European Commission, Ispra, Italy. Available at http://www-tem.jrc.it/accessibility

consequence, insofar as a larger proportion of the population resides "close to" essential infrastructures, notwithstanding the issue of macrocephaly mentioned above. Although the map shows that in most of the Mediterranean region it takes more than 3 hours to reach a medium-size town, the region has a low population density. We should note that the times measured are done so as from available transport infrastructures to which average speeds are applied (possible heavy traffic is not therefore taken into account).

Concentration allows Mediterranean countries to display statistics on the percentage of populations that are less than 30 nominal minutes from an urban centre comparable to those of the reference European countries (see table hereafter). Naturally, this "good accessibility" is based on the hypothesis that cities of more than 50,000 inhabitants offer rare and sought after facilities in a rather homogenous manner. The greater the split in urban hierarchy, the more these access times should be considered with circumspection.

Apart from this, the relatively good accessibility de jure incurs certain consequences relative to mobility development plans, particularly within the context of strong urbanisation that can become marginalised. As shown in the maps of series n°4, the priority is not to be given to long distance transport infrastructures, for which the network would appear to be satisfactory outside of the arid zones, at least quantitatively speaking. However, it is very important to facilitate short journeys in urban/per-urban and rural areas. With the aim of combating unequal opportunities, the focus should first be put on improving medium distance connections and connections within isolated areas. Concer-

Table 6. Proportion of the population and ease of access to urban areas in the Mediterranean, 2000

	% Of population with access to a city of 50,000 inhabitants:		
	less than 30 minutes	less than 1h	more than 1h
Algeria	30%	48%	52%
Egypt	70%	91%	9%
Israel	75%	92%	8%
Jordan	61%	70%	30%
Lebanon	53%	75%	25%
Morocco	37%	56%	44%
Palestine	65%	91%	9%
Syria	54%	65%	35%
Tunisia	36%	52%	48%
Turkey	38%	56%	44%
Libya	67%	76%	24%
France	55%	77%	23%
Germany	59%	81%	19%
Spain	64%	79%	21%
UK	76%	92%	8%

Source: Authors' calculations based on: Population -> Landscan 2012 A. Nelson, 2008, op. cit.
Percentages are calculated on the basis of a resolution of 10 x 10 km and correspond to the population in 2012.

ning this aspect, it would appear that regional rail transport should be studied, in particular in rural areas.

Moreover, regarding accessibility, the question arises as to the availability of services. The fact that infrastructures exist does not mean that they are used in an optimal manner. Considering this data, we would tend to believe that the priority should be given to the quality and availability of existing networks and collective services. The objective regarding the need for inclusivity would therefore be to facilitate access to facilities which will themselves combat unequal opportunities, in particular schools and healthcare centres.

Nevertheless, except for the east coast, the share of the population that resides less than one hour away from an urban centre in countries of the south is significantly lower than in the reference European countries. In Algeria, Morocco, Tunisia and Turkey, more than 40% of the population resides more than one hour away (practically the double of the European reference). To a lesser extent, this is also the case in Syria. On the basis of the 2012 population, this represents more than 90 million people.

I.3 Economic concentration: area productivity

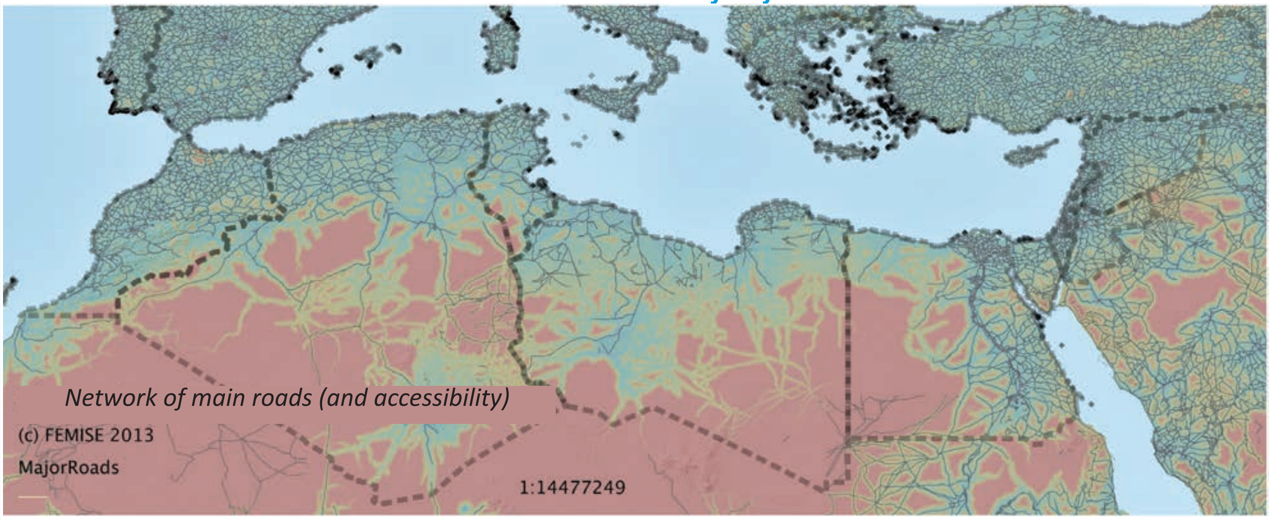
The next step is to take a look at the distribution of wealth throughout the territory. To this end, we shall examine productivity in the different geographical zones within each MEDA country. The following map shows the GDP per square km for the entire Mediterranean region. It has been created using the G-Econ data, developed by W. Nordhaus and Yale University, which provides an evaluation of the GDP per surface area of 100 km by 100 km. These GDP are estimated in PPP $ and are therefore comparable.

The interest of using GDP per km2 is to attempt to approach the notion of opportunity, defined here as the probability that an individual residing in a prosperous zone might benefit from positive externalities. We shall presume, in particular, that the possibility of finding a job on the formal job market is all the greater when a person lives in a high formal productivity zone.

As we might expect, the wealth creation zones follow the same trend in terms of population concentration: the Moroccan Atlantic coastline, the Algerian coast, the areas around Tunis, Tripoli and Bengazi, the Nile delta, the Mashreq coastal zones, the centre of the southern coast of Turkey around Mersin, the region of Izmir… To the contrary, the “South” of North African countries and the “East” of Mashreq or Turkey are generally low production sites.

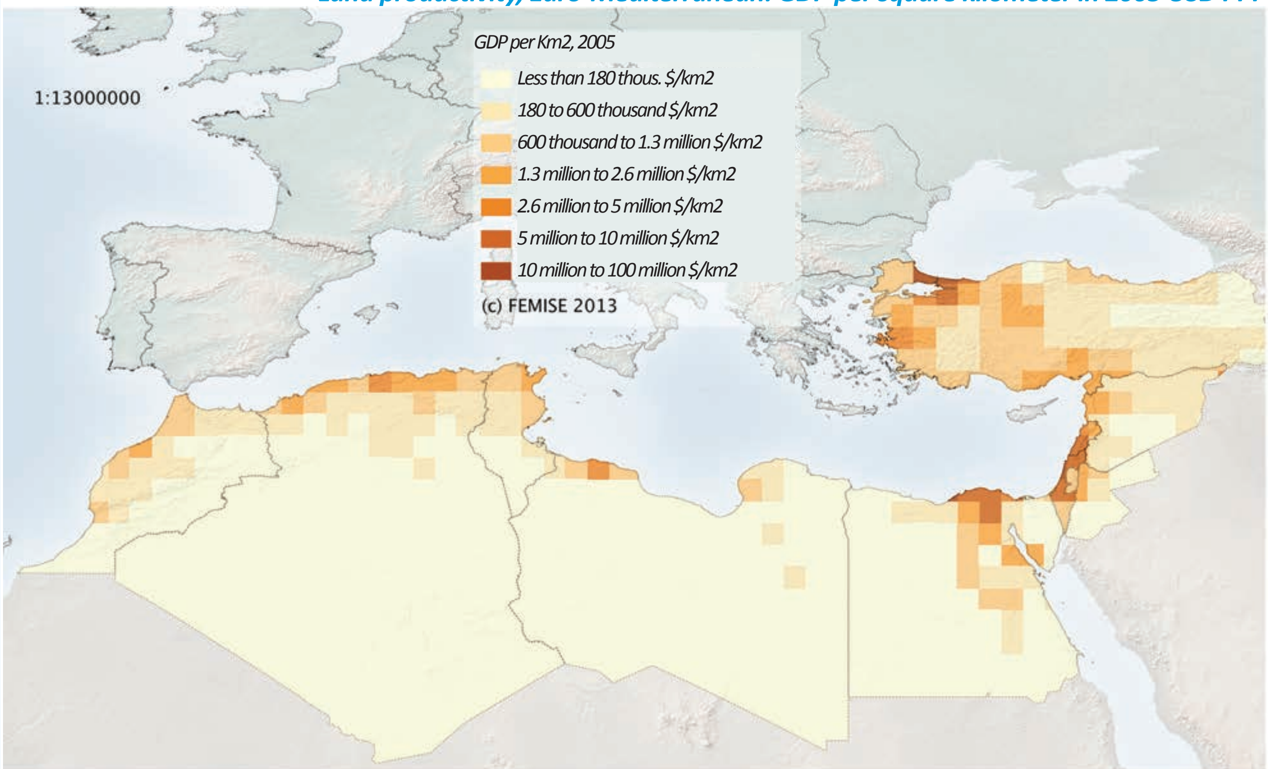
In fact, if we calculate the Gini coefficient for the geographical distribution of this wealth density, we see a strong imbalance in distribution (see table 7).

Map 5:
Network of major roads in the 2000's in the Mediterranean



Source: authors, based on the Center for International Earth Science Information Network (CIESIN) / Columbia University, and Information Technology Outreach Services (ITOS) / University of Georgia. 2013. Global Roads Open Access Data Set, Version 1 (gROADSv1). Palisades, NY: Socioeconomic Data and Applications NASA Center (SEDAC) http://sedac.ciesin.columbia.edu/data/set/groads-global-roads-open-access-v1.. In the background the accessibility map, data A. Nelson, 2008, op. cit.

Map 6:
Land productivity, Euro-Mediterranean: GDP per square kilometer in 2005 USD PPP



Source: Authors, with G-econ4 data (2011), Yale University and William Nordhaus. 'Cells' and the calculations of the Yale team with resolution of 1 ° of longitude and latitude, about 100 km at the equator.

Table 7.
Spatial disparities of wealth and changes 1995-2005 in the Mediterranean and other countries

	Gini Population 2005 GPW*	Gini GDP.km2 2005	Gini GDP.km2 1995	Evolution of Gini between 1995-2005
Algeria	0.886	0.872	0.875	-0.37%
Egypt	0.907	0.912	0.92	-0.91%
Israel	0.574	0.631	0.646	-2.21%
Jordan	0.737	0.764	0.764	0.01%
Lebanon	0.505	0.322	0.322	-0.10%
Morocco	0.653	0.621	0.613	1.25%
Syria	0.552	0.533	0.548	-2.74%
Tunisia	0.686	0.557	0.549	1.41%
Turkey	0.46	0.656	0.628	4.52%
Palestine	0.274	0.386**	0.384	0.52%
Libya	0.858	0.864	0.863**	0.12%
France	0.547	0.562	0.557	0.93%
Germany	0.511	0.397	0.402	-1.25%
Spain	0.636	0.732	0.722	1.31%
UK	0.744	0.661	0.645	2.53%
Argentina	0.813	0.881	0.887	-0.71%
Brazil	0.8	0.916	0.92	-0.45%
Paraguay	0.827	0.813	0.796	2.13%
Uruguay	0.687	0.559	0.554	0.78%
Venezuela	0.807	0.836	0.838	-0.24%
Indonesia	0.829	0.745	0.753	-0.98%
Thailand	0.56	0.735	0.716	2.77%
Vietnam	0.681	0.586	0.586	-0.01%
Cambodia	0.738	0.605	0.604	0.23%
Philippines	0.692	0.562	0.554	1.41%
Ukraine	0.534	0.441	0.435	1.45%
Belarus	0.507	0.394	0.379	3.78%
China	0.746	0.838	0.818	2.42%
India	0.515	0.564	0.552	2.23%

Source: Authors' calculations from the G-econ4 data (2011). Yale University & W. Nordhaus
** These Ginis are calculated on the population of each "cell" of 100 km by 100 km. using a different source from that of Table 2. which used cells 10 km x 10 km. For Med countries. the values are not directly comparable.*
*2000 ** Palestine. Libya 1990*

For all countries, we can see the similarities between the disparities in population distribution and in wealth zones within the territory. Regarding Mediterranean countries, considering the vast uninhabited areas, this naturally tends to introduce a bias and increase the Ginis. In the following table, therefore, the 2005 and 1995 Ginis are calculated according to the distribution of "inhabited" territories, defined as those with a density of 1 inhabitant per square kilometre.

These 2 tables call for a few comments:

√ The values vary tremendously between the different regions, which tends to indicate that the distribution of activities within each country has mainly been determined by history, but also by national cultural and by political choices.

√ In the same way, it is difficult to unearth a clear trend in the disparity dynamics within the sample of countries. They can be stable, diminishing or growing over this decade, but without there being any apparent trend in a particular place. For the 3 BRICS present, disparities have increased in China and in India, but have slightly waned in Brazil.

√ Regarding MEDs, we can note, once the empty zones have been taken into account : (i) a level of disparity that remains generally high, in particular in Egypt, Libya, Algeria and Turkey; (ii) Turkey seems to be in a system of inequality which grew between 1995 and 2005: not only is the distribution of wealth more disperse than that of the population, but its imbalance increased notably within the 10 years; (iii) these inequalities show a fast upward trend in Turkey, Tunisia and Morocco. (+1,9 to +4,5%). They are also increasing, but at a far slower pace, in Palestine and in Libya and remain stable in Jordan (where they are intrinsically high) ; (iv) They are indeed declining in Egypt, but remain at record levels within this country (the highest index of the region). This is also the case for Algeria and for Israel which are also amongst the countries where these inequalities are the highest.

I.4 Disparities in health and education: opportunities for personal development at stake

The question of inequalities obviously goes far beyond those related to location or income. In order to properly understand the real living conditions and opportunities that are truly offered to inhabitants, it is important to look at the possibilities that they are offered to develop their own capacities. This involves health and education conditions.

We will begin by looking at health conditions amongst children. Rather than using an approach based on facilities, where questions arise concerning the possibilities of use, access, staff training and the gap between principles and use, we will approach the subject through the results relating to infant mortality and malnutrition (based on underweight children). On these levels, the Mediterranean countries have rather good performances as compared to other developing regions. But the question at hand is that of inequalities linked to location.

The 2 indicators selected (infant mortality and the % of children underweight) do not reflect exactly the same situations. In both cases, the result obtained depends upon both the facilities available, their accessibility and coverage and household incomes. We might think that the first is more sensitive to facilities and access to health care, and that infantile underweight is more influenced by household revenue than infantile mortality. The mapping of these two indicators shows slight differences insofar as the same zones do not stand out in all cases. Some zones might indeed be more behind in facilities than in household income and vice-versa. But we observe that there are also zones that show a gap in the 2 indicators selected and therefore accumulate larger structural deficits.

Graph 1 and maps n°7 and 8 call for a number of comments:

- √ To begin with, we may note that the internal disparities within each country are well above the disparities between countries of the region.
- √ The inter-country disparities in terms of infant mortality are fairly limited, amounting to 10 ‰, i.e. 30% of the regional average. The disparities within each country are stronger and, except for Turkey, vary from 40 to 133% of the respective national averages (from 10 to 28 ‰).
- √ Regarding the prevalence of underweight children in the region, the inter-country dis-

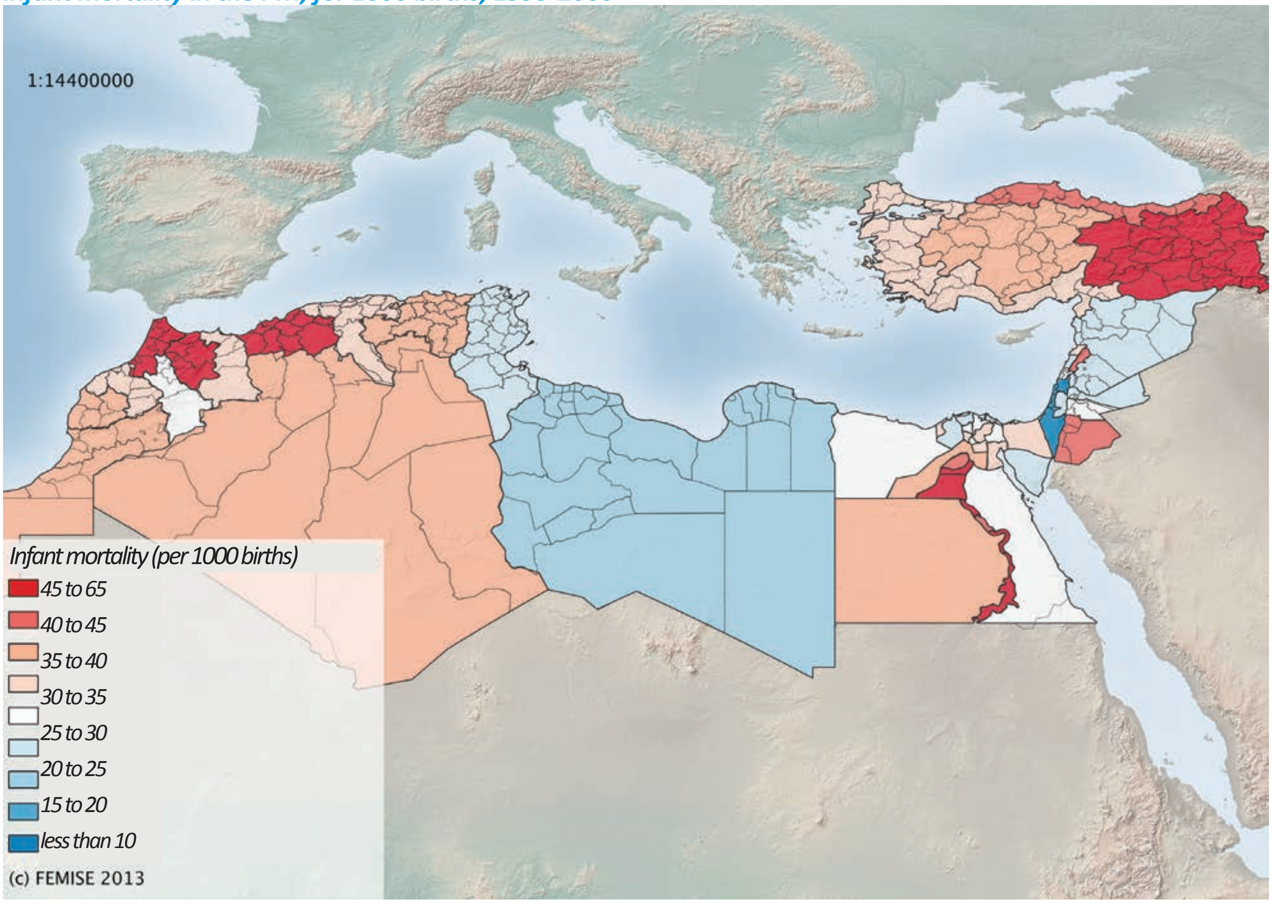
Table 7b.
Spatial disparities of wealth and changes 1995-2005 in the Mediterranean and other countries

	Gini GDP 2005 km2 Density> 1 h. km2	Gini GDP 1995 km2 Density> 1 h. km2	Evolution 1995-2005
Algeria	0.67	0.673	-0.35%
Egypt	0.793	0.806	-1.70%
Israel	0.631	0.646	-2.21%
Jordan	0.602	0.602	0.00%
Lebanon	0.322	0.322	-0.10%
Morocco	0.571	0.56	1.85%
Syria	0.49	0.506	-3.20%
Tunisia	0.457	0.447	2.24%
Turkey	0.656	0.628	4.52%
Palestine	0.386	0.384	0.52%
Libya	0.745	0.743	0.31%
France	0.557	0.552	0.94%
Germany	0.404	0.399	1.22%
Spain	0.732	0.722	1.31%
UK	0.657	0.64	2.58%

Source: Authors' calculations from the G-econ4 data (2011). Yale University & W. Nordhaus

** These Ginis are calculated on the population of each "cell" of 100 km by 100 km. using a different source from that of Table 2. which used cells 10 km x 10 km. For Med countries. the values are not directly comparable.*
*2000 ** Palestine. Libya 1990*

Map 7:
Infant mortality in the PM, for 1000 births, 1995-2000



Source: authors, based on the Center for International Earth Science Information Network (CIESIN) / Columbia University. 2005. Poverty Mapping Project: Global Subnational Infant Mortality Rates. Palisades, NY: Socioeconomic Data and Applications NASA Center (SEDAC). http://sedac.ciesin.columbia.edu/data/set/povmap-global-subnational-infant-mortality-rates.

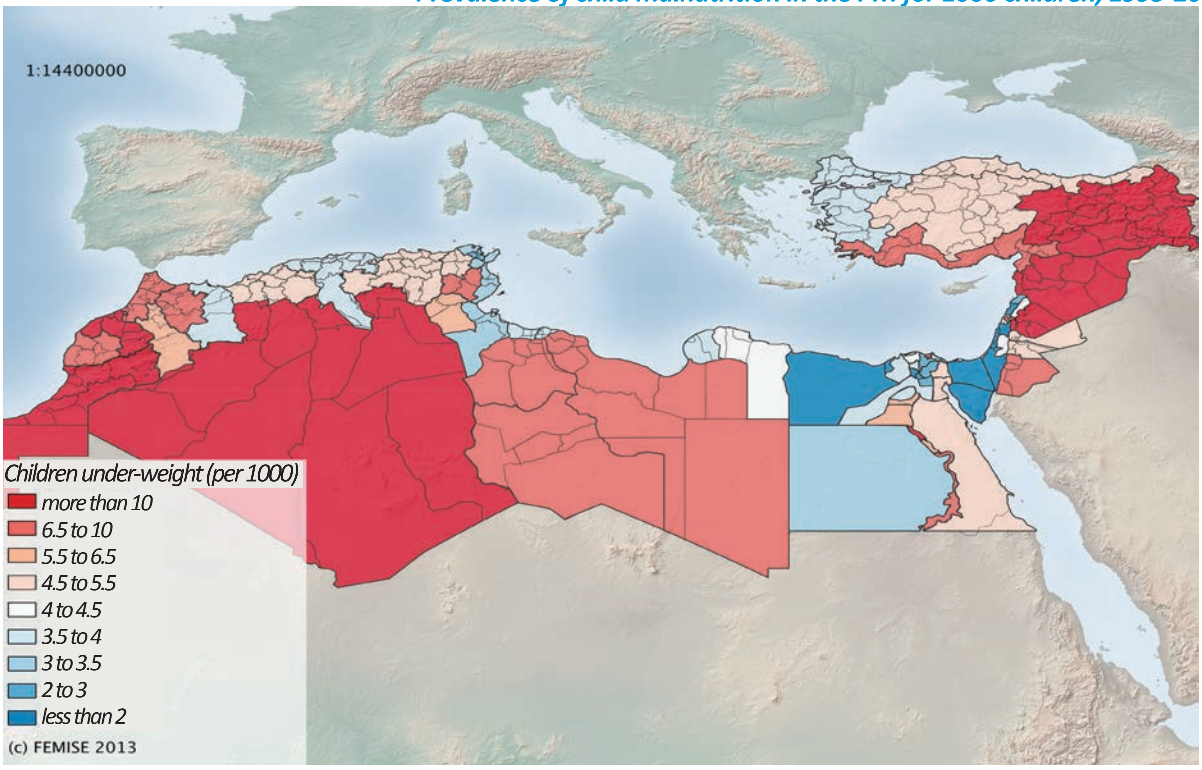
parities reach around 4 % between Lebanon and Turkey, i.e. 76% of the inter-country average. Within each country, accept Jordan and Tunisia, the figures are closer to 6 and 9 %, or between 210% and 600% of the national average. We may also note the very similar situation in Morocco and Turkey regarding underweight prevalence amongst children and that of Egypt and Lebanon.

√ Secondly, intra-national variability is greater in the case if infant underweight than in that of infant mortality (a factor 2 to 2.5 as compared to a factor 1.3 to 1.8). From this we may deduce that: (i) national efforts focus first on urgent issues, in which tremendous progress has been made as frequently underlined by FEMISE, but sometimes to the detriment of daily matters; (ii) the gaps in household revenue hold more importance in the question of spatial disparity.

√ In terms of infant mortality, Egypt and Morocco display the greatest disparities (from 25 to 28 ‰ or 88 to 133% of the average national rate). Algeria and Turkey show lesser disparities for equivalent averages (32 to 40% of the national average).

√ In the field of underweight prevalence amongst children, it is no surprise that large countries such as Algeria, Egypt, Turkey and, to a lesser degree, Morocco, display the strongest disparities (from 6 to 9% or 215 to 475% of the national average). This can illustrate the difficulty for Mediterranean countries with restricted public budgets to set up and maintain effective facilities over vast areas, or even to guarantee their accessibility to all of the scattered population. In Tunisia, the provincial 2.4 % gap nevertheless represents 104% of the national average. As for Jordan,

Map 8:
Prevalence of child malnutrition in the PM for 1000 children, 1995-2000

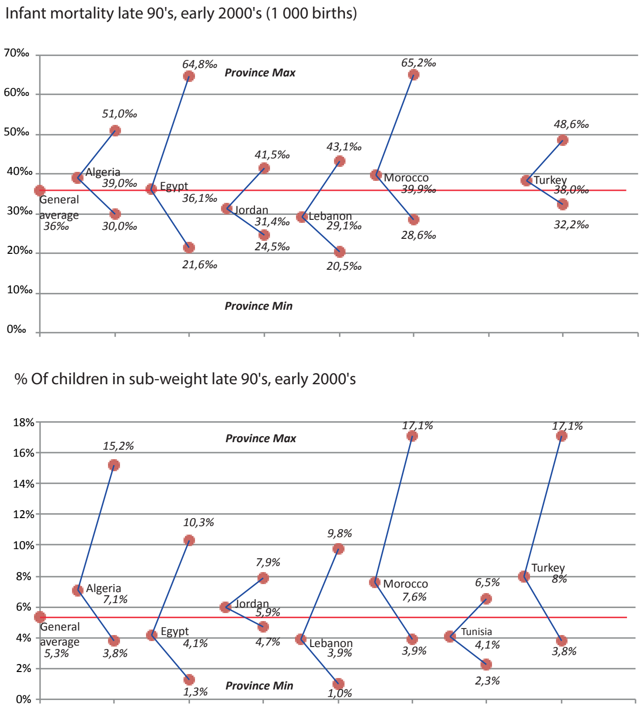


Source: authors, based on the Center for International Earth Science Information Network (CIESIN) / Columbia University. 2005. Poverty Mapping Project: Global Subnational Prevalence of Child Malnutrition. Palisades, NY: Socioeconomic Data and Applications NASA Center (SEDAC). http://sedac.ciesin.columbia.edu/data/set/povmap-global-subnational-prevalence-child-malnutrition.

in this division into 3 main regions (North, Centre, South), the situation is far more homogeneous than in other countries, with the gap between provinces amounting to a "mere" 42% of the average, i.e. in this case below the inter-country heterogeneity.

√ We may also note that the minimum points are closer to the national averages than the maximum points. This shows that for a majority of regions in each country, the situation is closer to the average than to the maximum, but that there are, in each country therefore, areas where the situation is considerably worse than others. Regarding infant mortality, the regions where the situations are the least favourable are: the western Algeria, Asouan in Egypt, southern Jordan and the Bekaa plain in Lebanon, the north central Morocco and eastern Turkey.

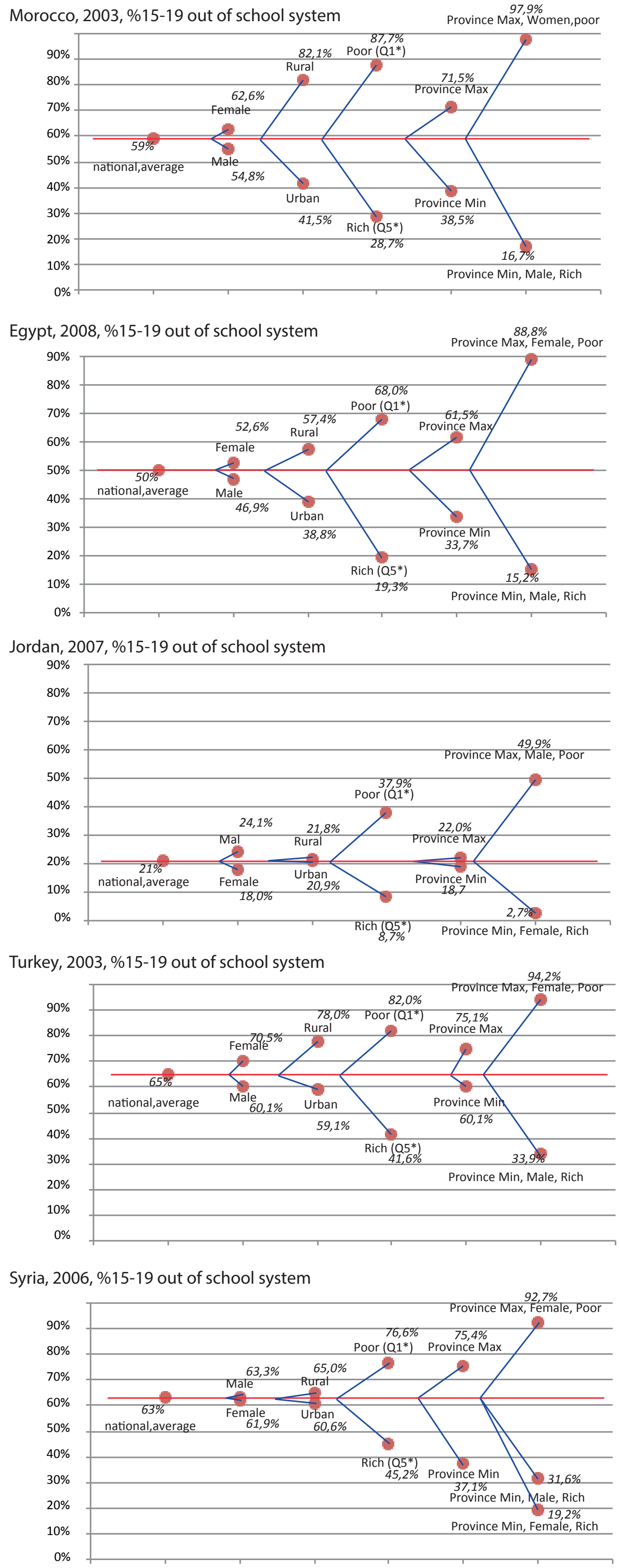
Figure 1.
Prevalence of child malnutrition in the PM for 1000 children, 1995-2000



Source: authors, based on the Center for International Earth Science Information Network (CIESIN) / Columbia University. 2005. Poverty Mapping Project: Global Subnational Prevalence of Child Malnutrition. Palisades, NY: Socioeconomic Data and Applications NASA Center (SEDAC). http://sedac.ciesin.columbia.edu/data/set/povmap-global-subnational-prevalence-child-malnutrition.

Figure 2.

Disparities in education (1) *[5]*



Source: Authors' calculations from the database: «World Inequality Database on Education (WIDE)» Unesco accessed in October 2013
** Q1: first income quintile, Q5: lowest income quintile*

For underweight, we can mention: southern Algeria, Assuit in Egypt, southern Jordan and Morocco, the Bekaa plain, west central Tunisia and eastern Turkey.

Inequalities in education

The 2 following indicators were chosen to analyse disparities in education: young people from 15 to 19 years that drop out of school and the average number of years of education in those above the age of 23. The first is more an indicator of inclusivity whereas the second is an indicator of the overall performance of the systems.

These 2 indicators are assessed according to gender, income and location (urban/rural and provinces or regions), in order to better evaluate inequalities with regard to education according to these criteria. When we consider the opportunities and their disparities, it becomes obvious that education is one of the main indicators insofar as a large part of an individual's progression and opportunities will depend upon the knowledge acquired in education. We approach this question by determining the inequalities in education faced by the populations and according to the aforementioned criteria. These will be assessed according to the gaps between specific groups as compared to the national average.

Regarding the first indicator which is the percentage of young people that drop out of school, the main comments stemming from the graphs opposite are as follows:

√ The differences between the 5 countries are both clear and strong: the national percentage of 15-19 year-olds that have dropped out of school varies from 21% in Jordan to 65% in Turkey, i.e. a difference of 44 percentage points.

√ the different forms of inequality are not of the same intensity. Some create a significantly greater divide than others.

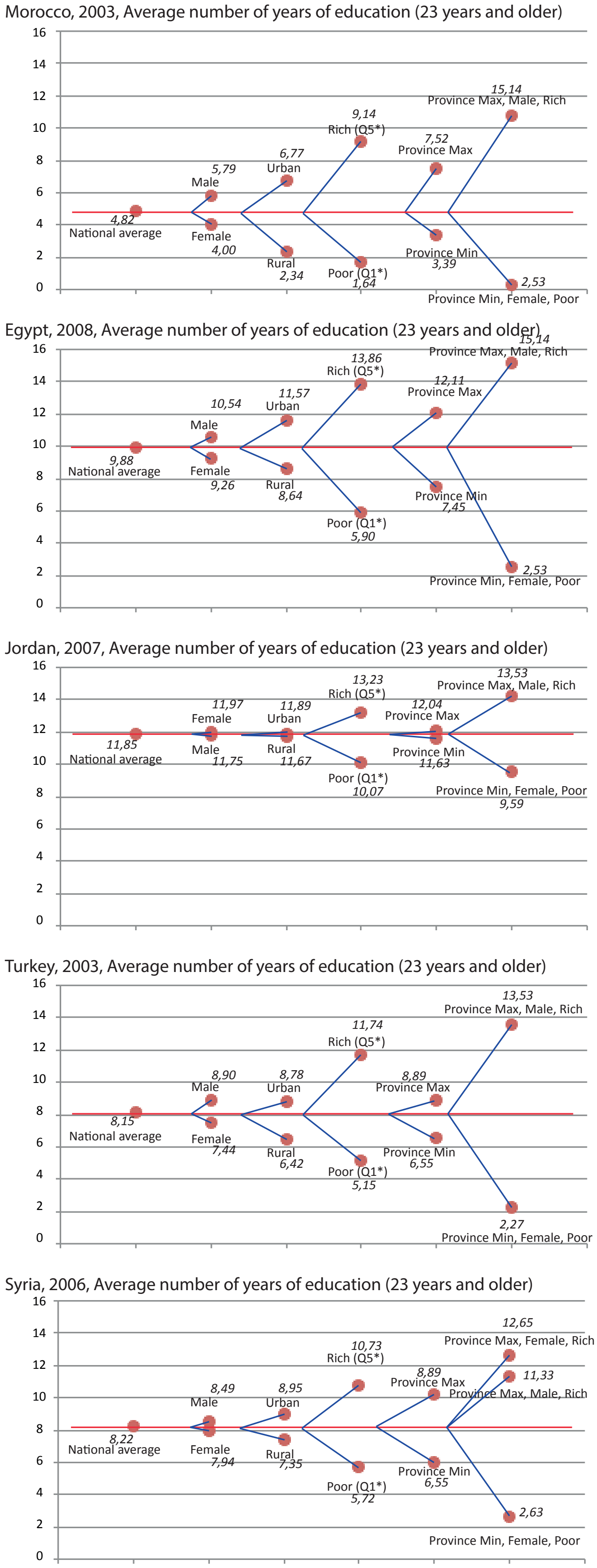
- √ Thus, in practically all of the countries studied (Egypt, Jordan, Morocco, Syria and Turkey), gender has become the least dividing criterion in education. Only Turkey shows more than 10 percentage points regarding the gender gap for young people who have dropped out of school.

The efforts within the Mediterranean to reduce gender inequalities throughout the entire education system seems to have proven successful, although the situation of women still remains lacking in most cases. This will not prevent us from believing that the Mediterranean, as we will see later on the question of disparities on the job market, cannot stake a claim to true gender inclusive development.

- √ The principle source of inequality in access to education in the countries studied, with the exception of Syria that will be developed later, is that of income. The gap, according to the income quintile ratios examined, varies from 29 to 59 % points (Egypt : 49 pts ; Jordan: 29 pts ; Turkey 40 pts ; Morocco : 59 pts ; Syria : 40 pts). In fact, except for Jordan, the differences within each country are at least as great as the national disparities in the Mediterranean region.
- √ The spatial disparities, be these between urban and rural environments or between provinces, are substantial and can even rise to the scale of the differences between countries. The rural and urban gap varies from 1 to 41 pts (Egypt: 19 pts ; Jordan: 3 pts ; Turkey: 19 pts ; Morocco: 41 pts ; Syria: 4 pts). The gap between provinces is of a similar scale between 4 to 33 pts (Egypt: 28 pts; Jordan: 1 pt; Turkey 15 pts; Morocco : 33 pts; Syria: 4 pts).
- √ But when gender, income and location gaps are combined, the unequal opportunities linked to education become striking and in all cases rise significantly above the disparities between countries: Egypt: 74 pts; Jordan: 47 pts; Turkey: 60 pts; Morocco: 81 pts; Syria: 74 pts. This practically amounts to the difference between the risk that a young boy will drop out of school in certain provinces as compared to a young girl in another province. And in Morocco, where this difference is the greatest, we therefore realise that a young girl from a poor family living in the region of Marrakech has a 97.9% chance of leaving school between the age of 15 and 19, whereas the same risk for a young boy from a rich family living in the region of Casablanca amounts to only 16.7% (resp. 88.8% vs. 15.2% in Egypt, and 94.2% vs. 33.9% in Turkey). In Syria, where the gender gap is low (and favourable to young girls), if spatial and income disparities are added up, a young girl from a rich family in Lattakia would have only 19.2% chances of dropping out of school whereas another girl from a poorer background in the region of Aleppo would have a 92.7% chance.

  This obviously has an impact on the number of years of study according to the place of residence and consequently on the level of human capital in the different regions. As all of the work on growth and development have shown just how far human capital is decisive in the process of growth and development, these disparities affect the future outlook of the territories. From this point of view, the main comments called for when looking at the average number of years of study in the over 23s are as follows :
- √ The inter-country disparities between the MEDs studied are low. Although Morocco displays a significant gap as compared to the average of the 5 countries: 4.8 years of study for an average of 8.6 years, i.e. 3.8 years fewer. It remains that between Egypt (9.9 years), Jordan (11.9), Turkey (8.2) and Syria (8.2), the gaps are small and remain below 4 years.
- √ As we might have expected, the hierarchy between forms of disparity is close to that observed previously. For this indicator also, the gender gap remains particularly low for Mediterranean countries: 1.3 years in Egypt, 0.2 years in Jordan, 1.8 years in Morocco, 2.4 years in Turkey and 0.6 years in Syria.

Figure 2b.
Disparities in education (2) *[6]*



Source: Authors' calculations from the database: «World Inequality Database on Education (WIDE)» Unesco accessed in October 2013
** Q1: first income quintile, Q5: lowest income quintile*

√ The disparities linked to income generally create a greater divide: 8 years in Egypt, 3.1 years in Jordan, 7.5 years in Morocco, 6.6 years in Turkey and 5 years in Syria. They dominate rural/urban disparities (from 0.2 to 4.4 years) and those between provinces which are greater (0.4 to 4.7 years). The latter exceed 4 years in Egypt, Morocco and Syria and actually represent 50% of the regional average.

√ When we add up all forms of disparity, inequalities are once again exacerbated. The gaps exceed 10 years in all countries except for Jordan, varying between 10.02 and 12.61 years). In other words, a young, poor woman from the region of Marrakech has generally only had 0.3 years of education , as compared to 10.8 years for a young man from a wealthy family in Rabat (2.5 years and 15.1 years in Egypt; 9.6 and 14.3 years in Jordan; 2.3 and 13.6 years in Turkey; 2.6 and 11.3 in Syria).

I.5 Employment inequalities

Participation in the formal job market remains a priority issue in the region. In this section, it is considered as being an indicator of opportunity, in the sense that participation in the job market remains the first source of stable income, which will allow individuals to invest in particular in their education and health. On the territorial side, this mean level of activity can be considered as an objective measurement of regional economic potential and of the level of opportunities offered.

For all of the MEDs, as shown in the tables below, the national activity levels are low, even relative to other developing regions. In 2011, they were generally lower by 50% throughout, if Israel is excluded. Moreover, the activity rates have been on a downward trend over the past decade (with the exception of Egypt and Israel).

Table 8.
Level and trends in participation rates in the Mediterranean countries and a selection of emerging countries 1999-2011

	1999			2005			2008			2011		
	Male	Female	TTL	Male	Female	TTL	Male	Female	TTL	Male	Female	TTL
Algeria	76	11.9	44	73.2	13	43.2	71.7	14.1	43	71.9	15	43.6
Egypt	73.8	19.7	46.7	75.8	20.6	48.2	73.9	23.1	48.4	74.3	23.7	48.9
Israel	60.7	47.3	53.8	60.8	50	55.2	62.4	51.4	56.7	62.4	52.5	57.3
Jordanie	68.4	12.3	41.8	66.9	12.1	40.6	65.8	14.6	41.1	65.9	15.6	41.5
Morocco	79.6	30.2	54.3	77.4	27.9	51.9	76.5	26.6	50.7	74.3	25.5	49.2
Syria	80.6	21.1	50.8	76.1	16	46.4	73.6	14.5	44.3	71.6	13.1	42.5
Tunisia	72.2	23.6	47.9	68.3	24.3	46.2	69.1	24.9	46.9	70	25.5	47.6
Turkey	75.8	30.1	52.8	71.2	23.8	47.3	70.8	24.9	47.6	71.4	28.1	49.5
Median	**74.8**	**22.4**	**49.4**	**72.2**	**22.2**	**46.8**	**71.3**	**24**	**47.3**	**71.5**	**24.6**	**48.3**
Med. ex. Isr. Turk	**74.9**	**20.4**	**47.3**	**74.5**	**18.3**	**46.3**	**72.7**	**18.8**	**45.6**	**71.8**	**19.7**	**45.6**
Argentina	74.6	42.2	57.9	76.6	48.8	62.2	75.2	48.8	61.5	74.9	47.3	60.7
Brazil	82.7	55	68.5	82	58.9	70.1	81.4	58.5	69.6	80.9	59.6	69.9
Paraguay	87.3	49.6	68.6	85.7	54.7	70.3	85.9	55.6	70.8	86.3	57.9	72.1
Uruguay	76	51.7	63.3	74.1	52.8	62.9	76.6	54.7	65.1	76.5	55.6	65.6
Venezuela	83.2	48.3	65.8	81.5	51.5	66.4	80.1	50.6	65.3	80.2	52.1	66.1
Median	**82.7**	**49.6**	**65.8**	**81.5**	**52.8**	**66.4**	**80.1**	**54.7**	**65.3**	**80.2**	**55.6**	**66.1**
Indonesia	84.7	50.9	67.6	85.3	50	67.5	84	51	67.3	84.2	51.2	67.5
Thailand	80.2	64.2	72	81	65.7	73.2	80.9	65.2	72.9	80	63.8	71.7
Viet Nam	83	74.5	78.6	81.7	73.5	77.5	81	73.1	77	81.2	73.2	77.1
Cambodia	84.1	76.2	79.9	86.7	76.4	81.3	86.6	79.4	82.8	86.7	79.2	82.8
Median	**83.6**	**69.3**	**75.3**	**83.5**	**69.6**	**75.3**	**82.5**	**69.1**	**74.9**	**82.7**	**68.5**	**74.4**
Ukraine	65.5	52.2	58.2	65	51.7	57.7	65.7	52.5	58.4	66.6	53.3	59.3
Belarus	65.6	52.9	58.7	62.9	51	56.4	61.9	50	55.4	62.6	50.2	55.9
Median	**65.5**	**52.6**	**58.5**	**63.9**	**51.4**	**57.1**	**63.8**	**51.2**	**56.9**	**64.6**	**51.8**	**57.6**
China	82.9	71.4	77.3	81.2	69.1	75.3	80.5	68.3	74.5	80.1	67.7	74.1
India	83.1	34.5	59.7	83.3	37	60.8	81.7	32	57.6	80.7	29	55.6

Source: Authors' calculations from ILO. Laborsta EAPEP database

Of course, we might argue that these low activity rates are partially compensated for by the existence of an informal sector, which actually ensures a minimum level of income. But when the situation is approached from the angle of disparities, this informal form of compensation is no more than an additional form of inequality, which in particular impacts access to social services and safety nets that are also dividing points.

Regarding employment, two forms of social disparity are strong within MEDs, as compared to those observed in other emerging countries: gender disparities and those linked to age (also see table 9). Gender disparities are extremely extensive, almost 50 %. Although the levels have increased over the past decade which, due to the slight decrease in the general level, leads to a decrease in the gender gap, the latter nevertheless remains far greater than that observed in Latin America (25 %) in south-east Asia (15 %) or in eastern European countries (10 %).

Regarding the gap related to age, this differs according to a number of points. When measured relative to the average level, it is firstly not as

Table 9.
Level and trends in participation rates among young people in the Mediterranean countries and selected emerging countries 1999-2011

	1999	2005	2008	2011
	20-24	20-24	20-24	20-24
Algeria	47.9	38.9	34	31.8
Egypt	49.1	56.2	47.9	48.2
Israel	53.4	51.1	51	50.9
Jordan	45.9	44.7	45	44.3
Morocco	51.9	45.9	42.6	39.6
Syria	50.8	47.6	43.8	41.2
Tunisia	48.6	45.2	44.8	44.5
Turkey	57	52.4	52.7	54.1
Median ex. Isr. Turk	**48.8**	**45.6**	**44.3**	**42.7**
Argentina	64.5	65.8	64.6	61.9
Brazil	76.2	79.1	78.5	78.4
Paraguay	64.5	70.2	73.8	77.1
Uruguay	80	75.1	75.7	74.6
Venezuela	56.2	63.7	49.9	52.4
Median	**64.5**	**70.2**	**73.8**	**74.6**
Indonesia	72.3	70.4	69	68.2
Thailand	72.9	71.5	71.2	69.3
Viet Nam	83.1	81	79.9	79.2
Cambodia	76.8	82.5	78.3	77.7
Philippines	67.1	52.8	50.4	52.2
Median	**72.9**	**71.5**	**71.2**	**69.3**
Ukraine	69.3	63.6	53.3	47.1
Belarus	73.8	65.3	60.7	60
Non EU East	**70.1**	**63.9**	**54.6**	**49.4**
Median	**71.5**	**64.5**	**57**	**53.5**

Source: Authors' calculations from ILO. Laborsta EAPEP database

great, remaining between 0.7 and 12 pts, and diverges considerably between the different countries: it is greater in Maghreb (in particular Algeria and Morocco) than in Mashreq. Despite this, the performances of MEDs as compared to other regions remain, regarding this aspect, considerably lagging behind other emerging countries: the median level of activity is almost 30 pts behind the level in Latin America, 25 pts below that of south-east Asia and 7 pts beneath that of the selection of Eastern countries. Even more alarming is the fact that, contrary of the gender gap, the dynamics of the last decade have been clearly negative: the level of activity amongst youth have dropped in all countries, more strongly in Maghreb and in Syria and more strongly than the general levels of activity; the disparities related to age and the job market have therefore deepened.

In order to take this analysis further, we re-examined these disparities at the sub-national level, in 5 Mediterranean countries for the year 2012 (except Morocco: 2011), in order to better take into account the post-Arab Spring situation. We above all observe that activity remains a minority characteristic. Only Turkey reaches a 50% level of participation in 2012, Egypt, Lebanon and Morocco are between 47 and 48%. In Jordan, the level is of 40%. Activity levels for men vary between 70 and 75% (except for Jordan with 61%), which remains well below the levels observed in other developing regions (80-82% in Latin America, south-east Asia China or India).

√ The graph opposite clearly shows that the disparities linked to the participation of the active population between countries are very small relative to Intra-country disparities. Heterogeneity is greater between the provinces within each country.

√ In all 5 countries, inequalities in terms of participation in the job market are quite identical regarding gender and age. The main source of inequality in almost all places is gender, with gender gaps approaching 50%.

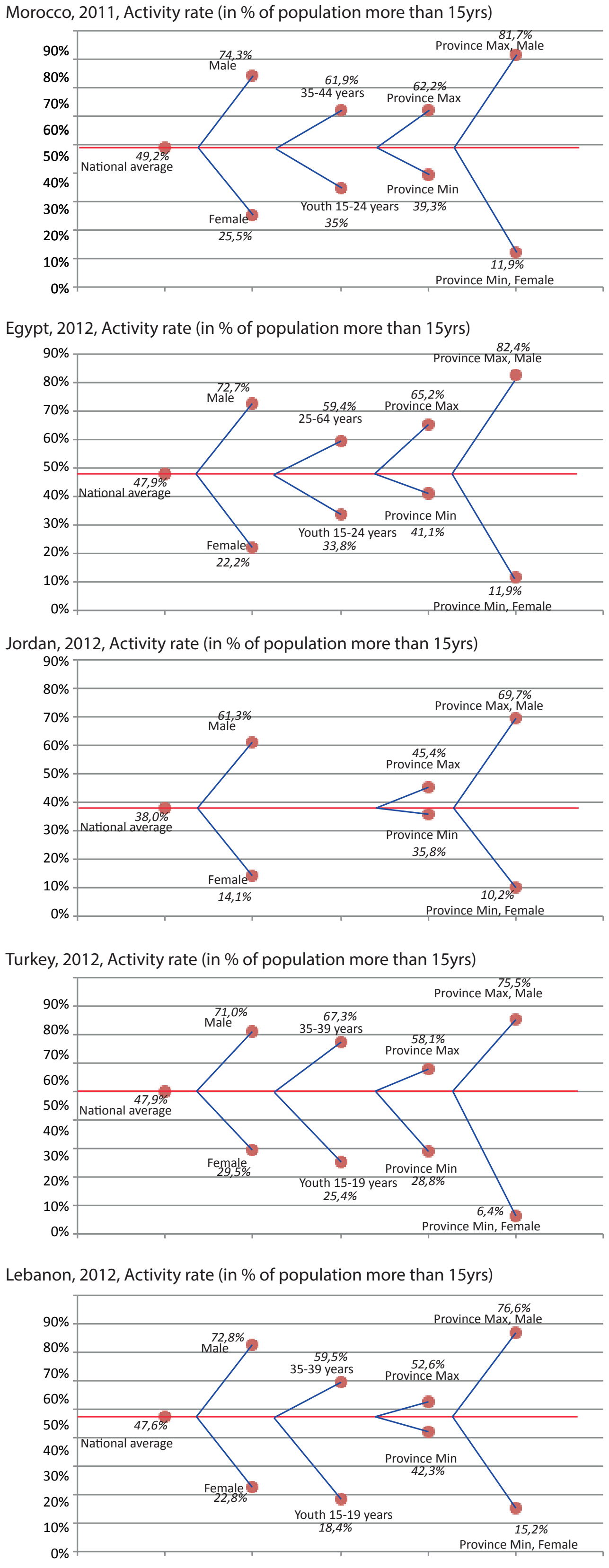
√ Age is generally speaking a major source of disparity and, as shown in the table below, a disparity that has shown a significant upwards trend over the past decade.

√ In large countries (Egypt, Morocco, Turkey), spatial inequalities remain high, with a 25 % gap, making them more or less similar to those linked to age. The disparities in level of activity are remarkably similar between Egypt and Morocco. In Turkey, although the gender gap is smaller, the stronger provincial inequalities cause an accumulation of disparities of the same scale.

- √ Jordan once again stands out with a lower level of provincial disparities, but those linked to gender are of the same scale as elsewhere. In Lebanon, the inequalities between provinces also appear low, but in both cases they do still reach around 10%. In fact, in both of these cases it is rather the size of the other disparities, in particular gender, that tends to give an image of low spatial disparity. Moreover, all of these inequalities add up to induce localised and extensive general inequalities.
- √ When gender and location inequalities are put together, the gaps can reach 70%. A Moroccan (or Egyptian) woman in certain locations barely has more than a 12% chance of being active, whereas men elsewhere have more than 80% chances of being active. The situation is even worse for women in the east of Turkey. But in Jordan and Lebanon, despite the reduced size of the countries, the cumulated gap amounts to around 60 %.

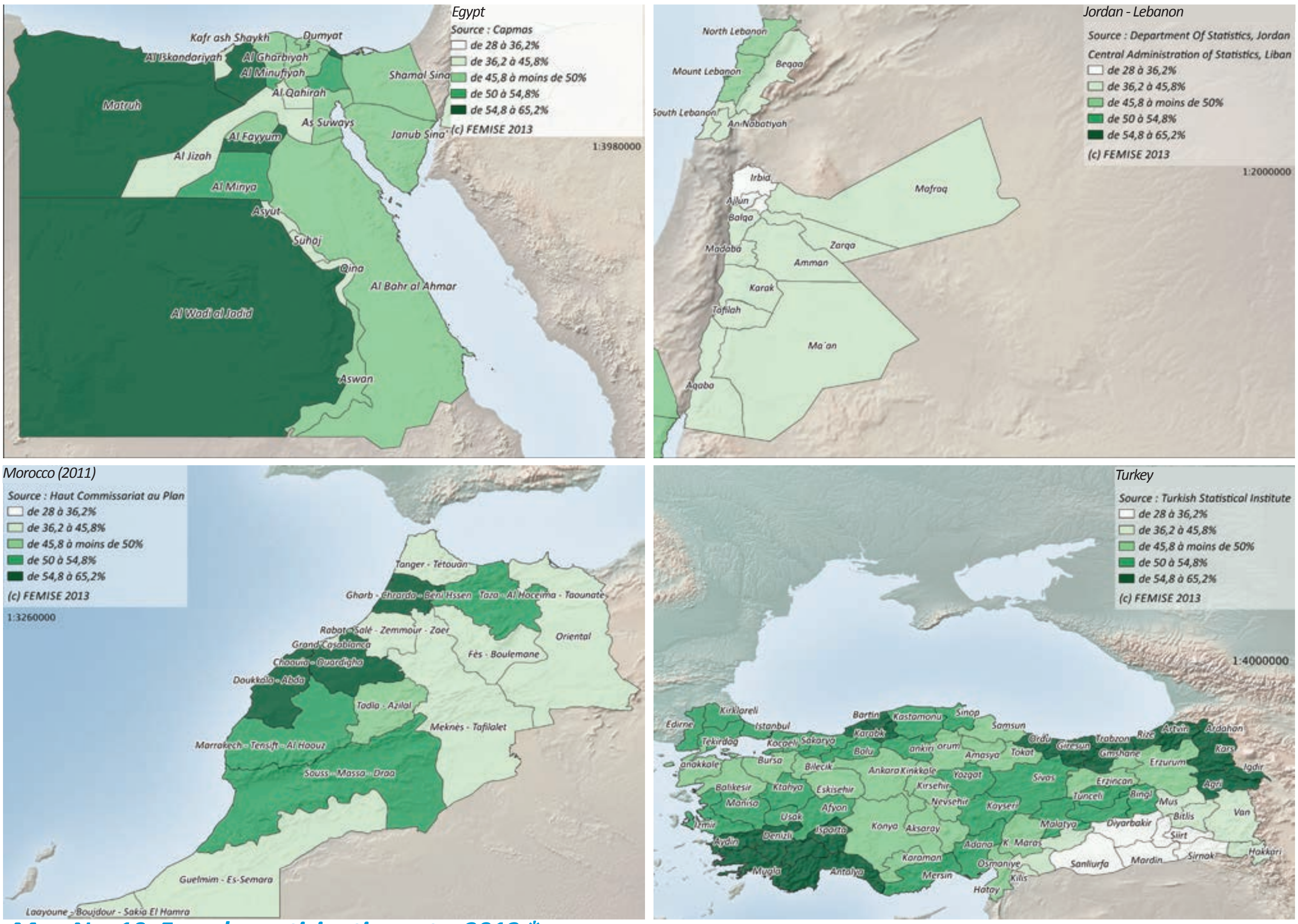
It is through this accumulation of disparities that certain regions can become true under-development and poverty traps. It is obvious that the low level of activity amongst women weighs upon household income, due to the absence of a wage, whereas the low level of activity amongst young people cannot compensate. As seen previously, as disparities in income play a major role in the opportunities for young people to acquire an education, in particular for girls, the inequalities in terms of opportunity can but crystallise. Insofar as we have also demonstrated that the evolution of indicators is not heading in the right direction, these phenomena will tend to be replicated in the following generation, and within the same territories.

Figure 3.
Disparities in employment *[7]*

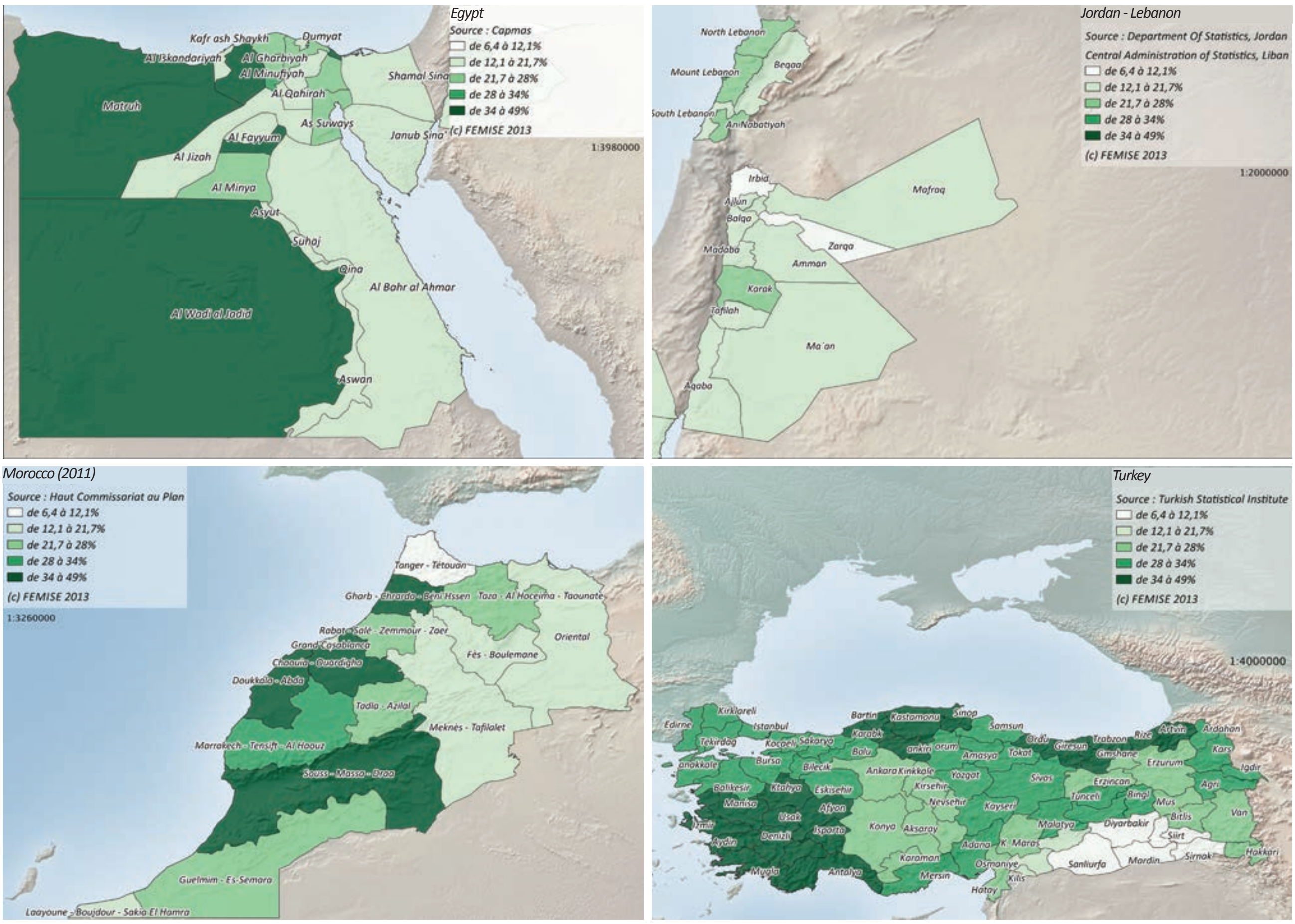


Source: Authors' calculations from: Morocco, Haut Commissariat au Plan, Egypt, CAPMAS, Jordan, Department of Statistics, Turkey, Turkish Statistical Institute, Lebanon: Central Administration of Statistics.

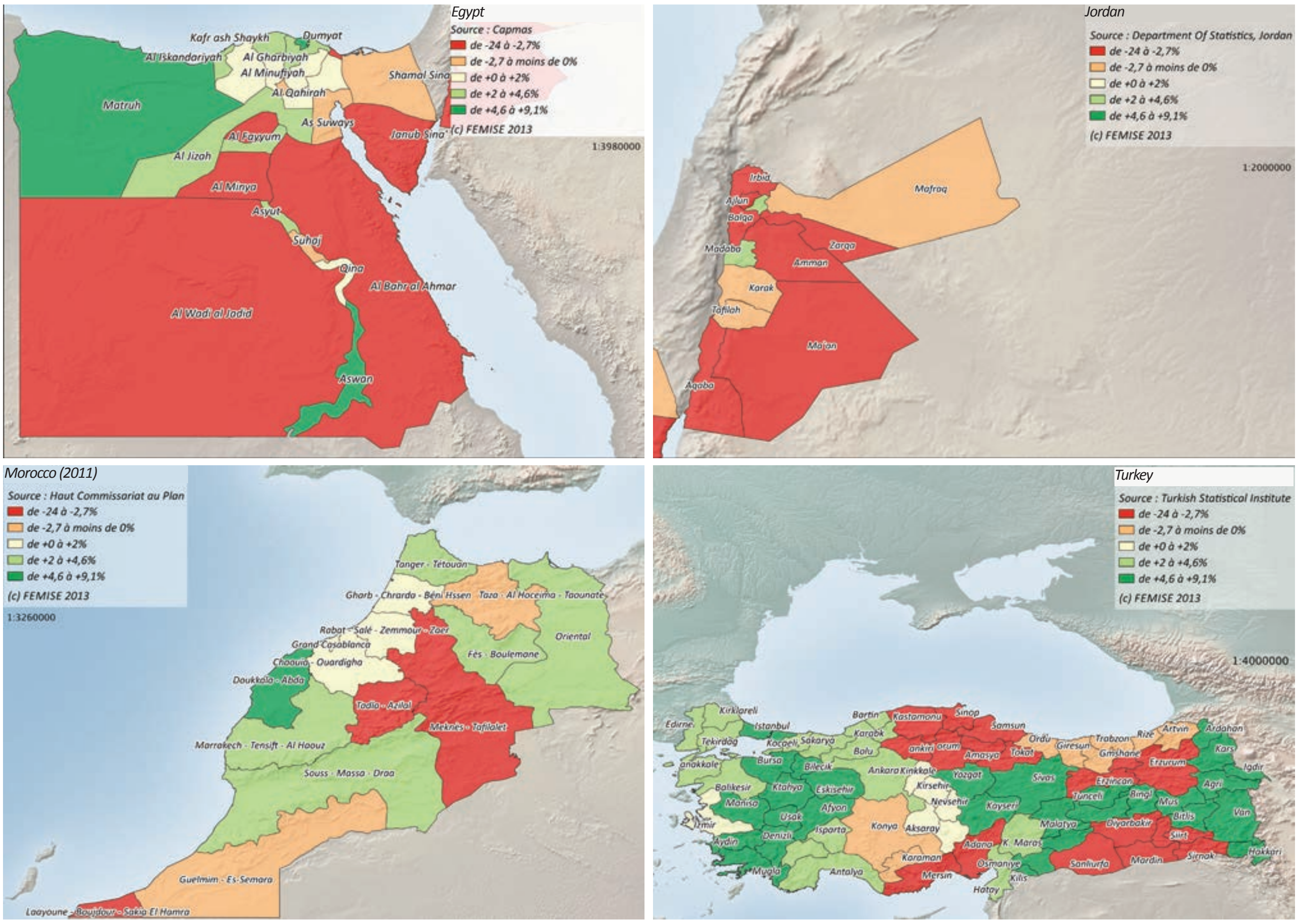
Map No. 9. Activity rates, Mediterranean 2012 *



Map No. 10. Female participation rate, 2012 *



*Map No. 11: Recent Trends in employment, 2011/12 **



Source for cards 9-11: authors, using national survey data on employment, Haut Commissariat au Plan (Department of Statistics), CAPMAS, Jordanian Department of Statistics, Lebanon Central Administration of Statistics, Turkish Statistical Institute.
** Except Morocco: 2011 for rates and 2010/2011 for the development of employment*

As a conclusion to this section, we would like to briefly summarise and underline the following points:

√ A strong imbalance in the distribution of the population, in particular in the large countries surrounded by deserts, with a concentration of inhabitants in small areas, in particular along the coasts. This leads to the fact that a majority of the population has satisfactory potential access to basic facilities and infrastructures in urban zones, whereas another part is subject to highly divergent living conditions. One of the consequences of this heterogeneity is that it complicates the territorial development policies that would allow the entire population to live in more favourable environments . In particular, it increases the risks of forming two types of local poverty traps: one in urban environments, within the largest towns due to the appearance of slums consecutive to rural exodus, the other in rural or peri-urban environments. And these 2 types of local poverty cannot be dealt with in the same way.

√ Although the countries are significantly more "urbanised» relative to emerging countries in general, there is also a greater imbalance in their urban hierarchy, with a heavy weight of the main cities (macrocephaly). The heterogeneity of urban facilities that accompanies this phenomenon therefore places in greater perspective the frequently mentioned relationship between being in an urban area and having satisfactory facilities to cater for daily needs. The risk is that the cities do not disseminate value but, to the contrary, capture it. One of the main consequences of this is the co-existence of 2 different forms of poverty, one linked to rurality and to the lack of basic facilities and the other to urban poverty, more directly linked to a lack of job opportunities.

√ When we look beyond income/wealth disparities at aspects which will more directly determine an individual's capacities and opportunities, in particular health, education and employment, we observe:

(i) That for all of these indicators, the disparities within each country are far stronger than between the countries themselves. If we are to consider that, from the out start, the region lacks in homogeneity, then we must also understand that even more diverse situations co-exist within each society, in particular between territories. There is an even greater gap between certain areas and the majority of the other national areas.

(ii) That the different forms of inequality do not act with the same intensity, according to the indicators or the countries observed. Although disparities in income are generally the strongest, gender, place of residence and age also play highly significant roles. However spatial disparities can vary greatly according to the country. From this point of view, the smaller Mashreq countries logically display smaller spatial disparities.

(iii) That the importance of gender varies significantly depending on the indicators and we may note that gender inequalities are now low regarding education, but very high regarding access to employment. The countries' cultural specificities are of particular importance in certain forms of inequality.

√ Far from being contradictory or substitutable, the different types of disparity add up, creating extreme differences in opportunities between individuals within different regions. This is in particular the case for higher education or employment, with individual probabilities that are diametrically opposed according to where they live, gender, age and their family's income.

II. Evolution, perception and political consequences of disparities

II.1. How have these disparities changed over the past decades?

The elements examined so far provide us with some preliminary indications on the evolution of disparities within Mediterranean countries in recent years. In the previous section, we thus noted that:

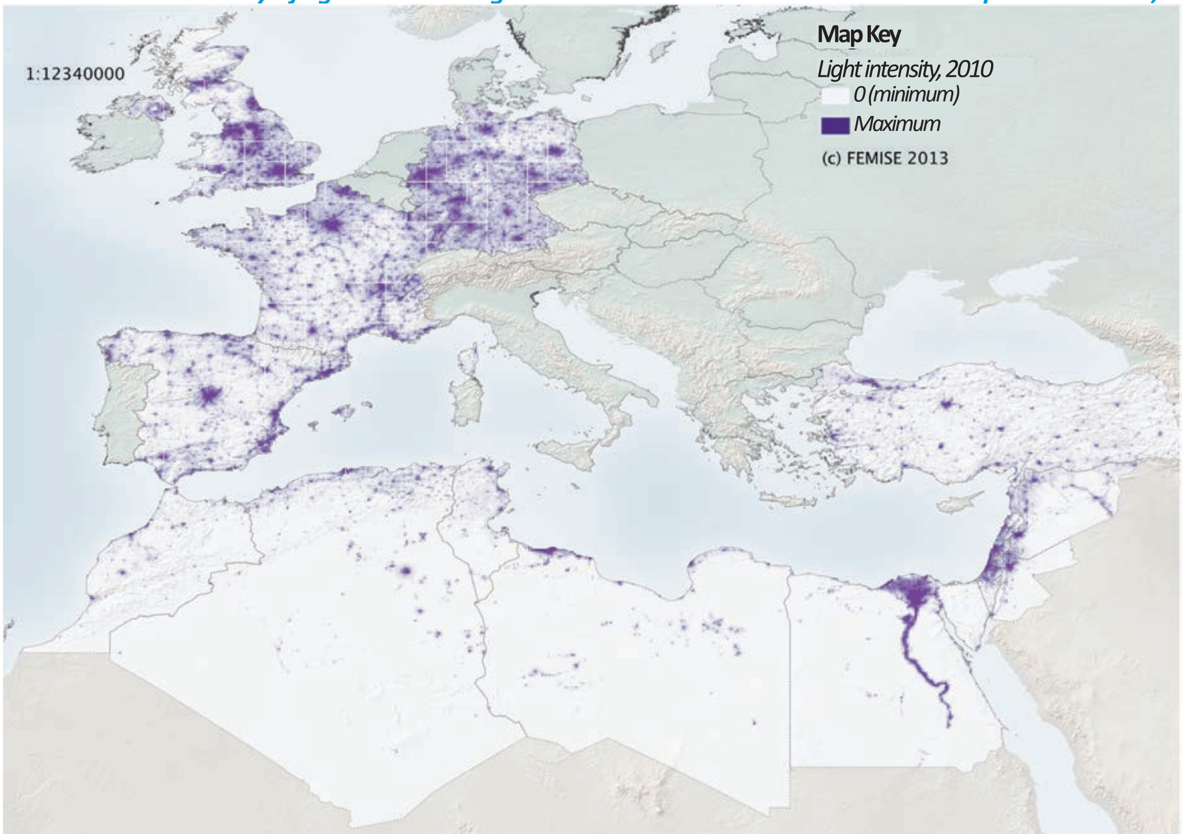
√ At the national level, the indicators for income inequalities have not really changed over the past two decades. This near-stagnation is the result of contradictory movements with a slight drop during the second half of the 90s before a new increase from the mid-2000s.

√ Regarding spatial income disparities, the wealth gap within territories shows, as expected, a strong polarisation linked to that of the population, although to a slighter degree. Even if this first imbalance is taken into account, the spatial distribution of wealth displays great differences. Moreover, when examining the evolution of these disparities, no general downwards trend can be identified. To the contrary, for half of the Mediterranean countries, in particular Morocco, Tunisia and Turkey, there was even an increase between 1995 and 2005.

To complete this initial overview, we have used a very specific indicator: nighttime lights measured by defence satellites [8], in different years. As a brief presentation, these are measurements of the intensity of the land's light emission at night. It thus measures the density of the population, activity, facilities and living standards all at once.

The use of nighttime lights and their spatial distribution allows us to approach opportunities and "well-being" in a more precise manner than through income indicators alone. Nighttime lights were first used on a number of occasions to determine different spatial indicators (e.g. Elvidge et al., 2009; Sutton PC, Costanza, 2002, Sutton PC et al., 2007; Nordhaus W. & Chen X., 2010, 2012): indeed, it is quite intuitive that the level of facilities be correlated with the level of wealth and that the more appliances that a household owns the more they will tend to use electricity which will be reflected in nighttime light. The question of electricity, particularly in developing countries,

Map No. 12:
Intensity of light emission night in the Mediterranean and in some European countries, 2010



Source: Authors, using data from Earth Observation Group (EOG) of National Geophysical Data Center (NGDC), from National Oceanic & Atmospheric Administration (NOAA). http://ngdc.noaa.gov/eog/dmsp.htlm

is also correlated with well-being. Beyond light itself, it means cooking and heating (or air conditioning) methods that are not harmful to human health and a higher level of educational facilities for children. We therefore consider here that this indicator is a measure of the living standards and human development offered by the territory.

This data and the tables below give rise to the following comments:

- √ In all of the countries, there was a strong progression in nighttime light between 2000 and 2010. If we put aside the small, densely urbanised Mashreq countries (Israel, Lebanon and Palestine), average growth rates are around 80% (median rate of 84%). This is better than three of our four European references and close to that of Germany.
- √ The average gap with figures observed in Europe still remains very high how however. As the growth differential is low, the ratio of night-time light remains at a ratio of 1 to 4 (the ratio of medians at 4.3 in 2000 and 3.9 in 2010). Although we can speak of a convergence between the 2 shores, its rate is far too low given the geographic proximity and that of media coverage.
- √ But, once again, the greatest gaps are observed internally. In all of the Maghreb countries and in the larger Mashreq countries, the Gini coefficients calculated according to nighttime light per territorial zone are significantly higher in the countries of the south. For most of the southern countries, therefore, not only is the endowment on average far smaller than for their northern neighbours but, in addition, its distribution is significantly more imbalanced, even when taking into account solely the occupied parts of the territory.

Algeria, Jordan, Libya, Morocco and Syria show similar situations, both regarding facilities (night-

Table 10.
Luminous intensity per area occupied 2000&2010 (in unit/km2 *) and its territorial disparities in the Mediterranean and selected European countries **

Pays	Intensity per km2 in 2000	Intensity per km2 in 2010	Evolution 2010/2000	Gini 2000	Gini 2010	Evolution of Gini 2010/2000
Algeria	2	4.26	114%	0.856	0.816	-5%
Egypt	14.97	27.09	81%	0.635	0.584	-8%
Israel	24.26	34.05	40%	0.595	0.54	-9%
Jordan	2.95	6.89	134%	0.872	0.837	-4%
Lebanon	23.08	29.25	27%	0.531	0.493	-7%
Libya	2.87	6.07	111%	0.847	0.817	-4%
Morocco	1.13	2.72	140%	0.891	0.841	-6%
Palestine	24.46	40.45	65%	0.478	0.438	-8%
Syria	4.84	8.29	71%	0.743	0.709	-5%
Tunisia	4.18	7.69	84%	0.714	0.643	-10%
Turkey	3.21	6.16	92%	0.713	0.685	-4%
median PM	**4.18**	**7.69**	**84%**	**0.714**	**0.685**	**-4%**
France	14.67	24.08	64%	0.513	0.468	-9%
Germany	21.24	39.5	86%	0.448	0.361	-19%
Spain	9.37	15.44	65%	0.64	0.587	-8%
great Britain	25.69	35.72	39%	0.623	0.555	-11%
Median Eur.	**17.95**	**29.9**	**67%**	**0.713**	**0.643**	**-10%**

Source: Authors' calculations from data Earth Observation Group (EOG) of National Geophysical Data Center (NGDC). from National Oceanic & Atmospheric Administration (NOAA). http://ngdc.noaa.gov/eog/dmsp.htlm

** The images give an intensity ranging from 0 to 63 to the approximate scale of kilometers. The resolution here is 10km and is the sum of the intensities recorded by satellite areas 10km x 10km (0.1 °)*

*Gini ** Intensity and distributions are based on the areas occupied. ie where there are people.*

time light) and disparities, even though Morocco displays significantly less nighttime light (in 2010 reaching the 2000 median of quoted countries). These countries lie at a scale of around 1 to 5 relative to European references (nighttime light per km2 amounting to 5 times less). To this first gap we may add greater disparities, even when considering only inhabited territories, with a Gini median in 2010 that is almost one third higher than the median of the four sample European countries.

Regarding the evolution, Syria lies outside this group with a nighttime light that has progressed significantly less, barely at the rate of the four European countries. For Algeria, Jordan, Libya and Morocco, however, the rate has been 1.5 to 2 times higher. Meanwhile, the Gini have diminished only slightly. In other words, the gap in level of disparities with European countries has deepened.

Tunisia and Turkey form a second set whose endowment is close (although slightly higher) to the countries of the first type, but with significantly fewer disparities. Growth within these 2 countries has been lower than to that of the first type, whilst remaining stronger than in Europe. The evolution of disparities is also more favourable, whilst remaining lower than in the European case (particularly in Turkey).

Egypt is a special case with an average nighttime light that is significantly higher and close to that of the "small" Mashreq countries, practically on a par with European countries. The population's organisation along the Nile corridor actually brings it closer to that model. The evolution remains less favourable however in terms of disparities. For example, although disparities are being reduced they are still higher than those in other small Mashreq countries (20% more than in Lebanon for example) and higher than the European mean (+15%). Regarding evolution, the growth of intensity remains within the average of other MEDs.

Thus, although the Gini coefficients have dropped on both shores, this reduction has been stronger

Table 11.
Luminous intensity per area occupied 2000 and 2010 (in unité/km2 *). depending on the population density in territories **

	less than 50 hab./km2		50 to 200 hab./km2		more than 200 hab./km2	
Country	Intensity 2000	Intensity 2010	Intensity 2000	Intensity 2010	Intensity 2000	Intensity 2010
Algeria	0.893	1.435	3.693	10.342	12.63	28.174
Egypt	3.783	8.098	14.384	29.399	35.477	61.145
Israel	6.955	12.243	21.75	39.12	58.451	71.621
Jordan	0.621	2.047	10.333	25.896	24.022	47.832
Lebanon	5.107	5.611	14.442	21.234	37.202	45.101
Libya	1.837	4.136	15.622	37.776	41.535	64.73
Morocco	0.157	0.464	1.577	5.023	12.633	23.45
Palestine	8.305	16.717	16.988	30.605	32.632	52.175
Syria	2.103	2.581	7.502	15.347	22.086	39.721
Tunisia	1.381	2.979	5.556	11.325	24.189	36.959
Turkey	1.206	2.338	4.326	8.926	20.32	36.118
median PM	**1.84**	**2.98**	**10.33**	**21.23**	**24.19**	**45.1**
France	6.009	10.895	16.933	30.999	55.441	73.536
Germany	7.059	16.576	15.728	33.64	44.073	70.334
Spain	4.056	7.885	17.614	30.758	49.888	65.912
great Britain	5.198	10.619	23.595	37.231	68.227	82.285
Median Eur.	**5.604**	**10.757**	**17.274**	**32.32**	**52.664**	**71.935**

Source: Authors' calculations from data Earth Observation Group (EOG) of National Geophysical Data Center (NGDC). from National Oceanic & Atmospheric Administration (NOAA). http://ngdc.noaa.gov/eog/dmsp.htlm

** The images give an intensity ranging from 0 to 63 to the approximate scale of kilometers. The resolution here is 10km and is the sum of the intensities recorded by satellite areas 10km x 10km (0.1 °)*

*Gini ** Intensity and distributions are based on the areas occupied. ie where there are people.*

in northern countries. We can therefore conclude that electricity consumption has not developed in the same way on both shores: in the north, the greater reduction in disparities would tend to show that the most extensive growth has taken place mainly in the areas that were the least endowed at the beginning of the period, whereas in the countries of the south, progress has concerned firstly the better endowed areas. The examination of nighttime light in territories according to population density, shown in the table below, supports this idea.

We can indeed see that the scale of disparities is far greater in the MEDs than amongst the European references. The ratio between the mean value for less dense/rural areas (i.e. less than 50 inhabitants per km2) and that of the more dense areas (i.e. more than 200 inhabitants per km2) practically amounts to 15 (15 times more nighttime light in dense areas) for southern countries as compared to 7 in the European references in 2010. Moreover, this ratio has increased in the south over 10 years (progressing from 12 to 15) whereas it has dropped for the EU references (10 to 7).

As shown by the calculation of growth rates according to density, the zones that were the least dense and that already had a relatively lower endowment at the beginning of the period, did not show the highest growth rates in most countries. Their lag relative to other national zones therefore increased.

This type of growth distribution increases disparities, in particular to the detriment of rural areas.

Table 12.
2000-2010 growth of the luminous intensity per area occupied by the population density of territories

Pays	less than 50 hab./ km2	50 to 200 hab./km2	more than 200 hab./km2
Algeria	60.8%	180.0%	123.1%
Egypt	114.0%	104.4%	72.3%
Israel	76.0%	79.9%	22.5%
Jordan	229.9%	150.6%	99.1%
Lebanon	9.9%	47.0%	21.2%
Libya	125.1%	141.8%	55.8%
Morocco	195.7%	218.6%	85.6%
Palestine	101.3%	80.1%	59.9%
Syria	22.7%	104.6%	79.8%
Tunisia	115.8%	103.8%	52.8%
Turkey	93.9%	106.3%	77.7%
median PM	**101.3%**	**104.6%**	**72.3%**
France	81.3%	83.1%	32.6%
Germany	134.8%	113.9%	59.6%
Spain	94.4%	74.6%	32.1%
Great Britain	104.3%	57.8%	20.6%
Median Eur.	**99.3%**	**78.8%**	**32.4%**

Source: Authors' calculations from data Earth Observation Group (EOG) of National Geophysical Data Center (NGDC). from National Oceanic & Atmospheric Administration (NOAA). http://ngdc.noaa.gov/eog/dmsp.htlm.

Additionally, if we compare the mean evolution of MEDs as compared to that of European countries, it is clearly apparent that growth has been stronger in the more densely populated zones of the MEDs, to the detriment of the others: the ratio between the different rates in the table below differs termendously. Even in Egypt, where the 3 different rates show a form that is compatible with the reduction of disparities, growth remains relatively stronger in the dense zones than in the less dense zones.

In short, it would appear that in a general context of the rising use of electricity, which can be assimilated with an improvement in basic conditions (i) the improvements have not spectacularly reduced the gap with the northern shore, contrary to the populations' expectations; (ii) within the countries themselves, a slight reduction in disparities can be claimed (slightly lower Ginis), but these remain significantly stronger than in northern countries, even if only inhabited zones are taken into account; (iii) not all territories have benefited from rising use of electricity in the same way and in most countries this is true for less densely populated areas. The gap with the best endowed national territories is thus widened and the divide between rural-medium isolated towns and urban centres is deepening.

II.2. The perception of disparities in the MEDs

Since the work published by Amartya Sen, economists are fond, as stated earlier, of differentiating between 2 forms of disparity: disparities related to "results" and related to opportunities. The first, most frequently referring to income or expenditure, are easier to observe and the most debated on a political level. These are also the most acceptable for economists, but not only. They also seem to be more commonly accepted by the populations, judging from the global survey on values (World Values Survey network, 2013). Only 18% of the population of surveyed countries [9] wish for "greater equality" in income. To the contrary, 23% believe that income could be even more differentiated, as long as it reflects individual effort. Moreover, 77% think that a more efficient employee should be better paid. And as shown in the chart below, the same considerations also apply to Mediterranean countries. In Egypt, only 10% would like income to be more balanced and 97% think that income should be linked to efficiency at work. If we look at 4 countries (Egypt, Jordan, Morocco and Turkey), the trend is similar.

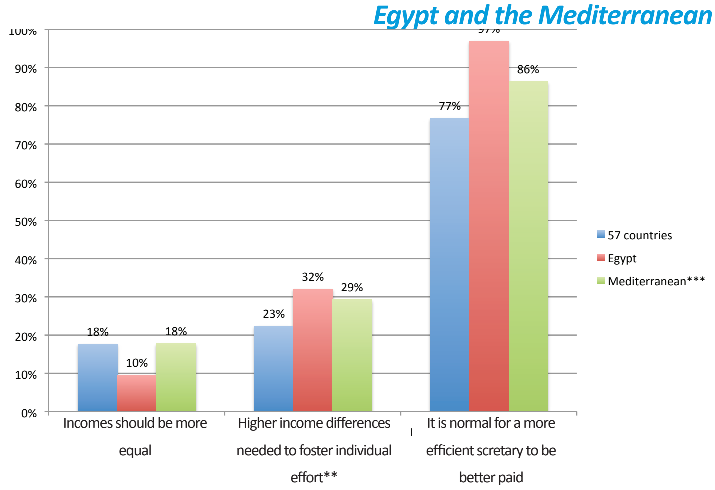
Does this mean that the Mediterranean is in a "paradoxical" situation, particularly in countries where the revolution took place in 2011 with a demand for greater fairness?

Our position is that there is no paradox if we consider (i) that unequal opportunities count the most, in particular from the viewpoint of the populations and (ii) that the protagonists' perception of these disparities and their evolutions is at least as important as the objective measurements of their dynamics and their extent.

Unequal opportunities are less well developed in the analyses (most measurements focus on distribution of revenues) and yet there is a general consensus that these must be reduced as much as possible.

Figure 4.

Perception of income inequality and fairness in the world, Egypt and the Mediterranean



Source: Authors' calculations from Values Surveys Databank, World Values Survey network (WVS) http://www.worldvaluessurvey.org/

** / **: Answers are given on a scale of 1 to 10, 1 being the most consistent with equality of income, 10 with the need for strong differences in income, for income equality, the percentages are the sum of responses 1 and 2 for the differences, the sum of the responses 9 and 10.*

****: Egypt, Jordan, Morocco, Turkey; enquêt year of 2007 except for Egypt: 2008*

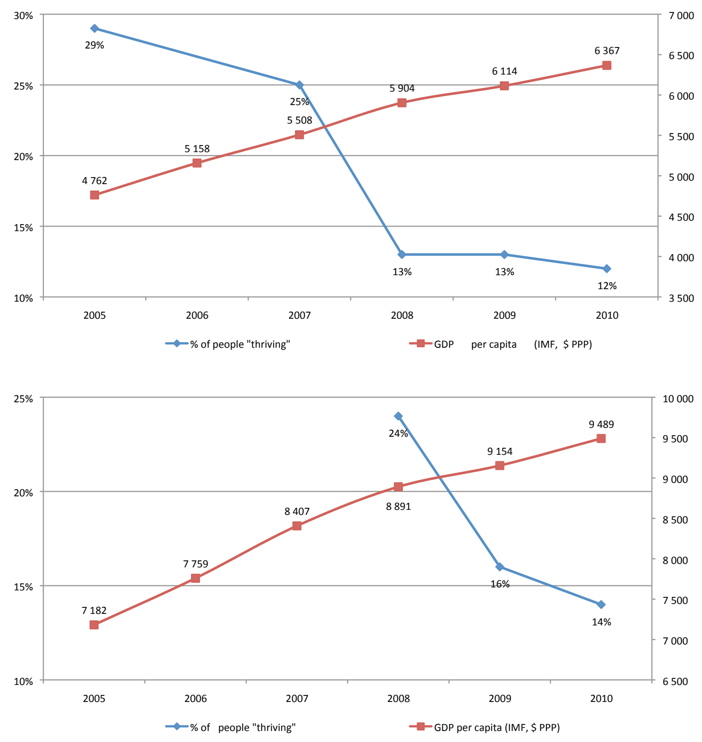
From the figures above, it is clear that concerning disparities related to "results", depending on each individual's position with regard to social equality, a more or less extensive share comes under the responsibility of the individual and depends upon their choices, efforts and personal investment. And this difference is commonly accepted.

Unequal opportunities depend upon circumstances that lie beyond the individual's control; amongst these are the family's standard of living, race, gender, ethnic origin, place of birth and residence...The general consensus here is that these disparities are unfair and that social policies (and politicians) must intervene to wipe them out.

The authors of the present report consider that events within the MEDs since 2010 are mainly due to the perception that these unequal opportunities have become increasingly unbearable whilst the growth during this period has been generally high. Moreover, in the case of Mediterranean countries, we must add a geographical and human proximity with the northern shores which further adds to the perception of the extent of these disparities. Whereas enrolment in secondary school is the general rule in Europe, regardless of the individual's gender and place of residence, the preceding pages show just how far opportunities to benefit from a secondary education can vary extremely within the same country: a young girl from a poor background in certain regions of Morocco has only a 2.1% chance of attending school between the ages of 15 and 19, whereas for a young man from a wealthy background living in a large urban area, the chances reach 83.3%.

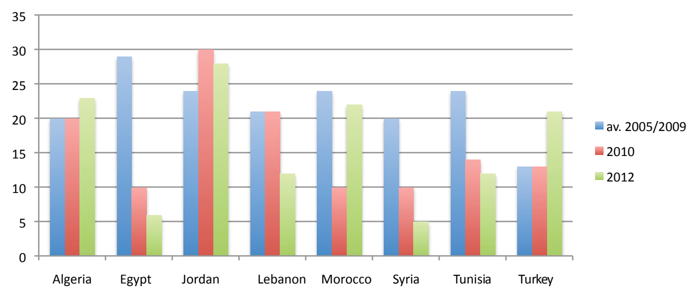
The graphs above give a meaningful illustration of these mechanisms. The Gallup institute carries out international opinion surveys (generally twice a year), in particular on the question of the populations' perception: the people surveyed are asked if they feel that the environment allows them to "achieve their full potential" in their country, at a given time. From this point of view, if we draw a parallel between the objective evolution of economic growth and the populations' perception of their environment in Egypt and Tunisia, we can see the extent to which the demand for fairness

Figure 5.
Percentage reported as thriving in Egypt and Tunisia before the uprising



Source :GALLUP

Figure 6.
Percentage reported thriving in the countries of the southern Mediterranean: 2007-2012



Source : auteurs à partir des données Gallup

expressed in Mediterranean countries concerns, far more than revenues, the question of opportunities.

It is clear that the progression of GDP per capita, which to a certain extent is the culmination of economic success, does not prevent the people from perceiving a deterioration in their situation obviously mainly due to the growing disparities analysed in the previous sections. This calls for two comments:

√ When unequal opportunities tend to be concentrated in certain zones, the effects tend to become stronger and lasting. In other words, spatial disparities tend to crystallise over time and be reiterated.

√ As seen previously, traditional social disparities and spatial disparities tend to add up and create greater gaps. The idea put forwards here is that, in certain areas, extreme and long-lasting opportunity gaps, in the context of young societies in which aspirations and hope are the driving forces of behaviour, can only lead to further disenchantment and violent reactions.

II.3. Have these inequalities had an impact on electoral choices?

For many observers, the votes that have taken place since the uprisings have been influenced by inequalities. A quick look at the mapping of votes in Egypt, Tunisia and in Morocco, interestingly shows that these votes were quite different depending on the regions. Within each national context, which remains important of course, the voting disparities are also a reflection of the unequal opportunities observed in local areas.

The votes for Islamist parties or candidates are due to different phenomena in each country: an urban phenomenon in Morocco; an identitarian phenomenon in Tunisia with a dispersal of votes amongst numerous lists and a political reaction in Egypt.

In Morocco, for example, the urban nature of the votes clearly shows the creation of divides within the urban areas themselves and which therefore go beyond the better known rural-urban divides.

The Tunisian case is quite interesting here, as reported by S. Ben Romdhane from Tunis University in a recent Femise study (Achy et alii, 2013). According to the author, regional inequality was a major contributing factor to the revolution. The mid-west (Kairouan, Sidi Bouzid and Kasserine governorates) has and continues to be the country's poorest region with an extreme level of poverty amounting to 14.3% in 2010, i.e. three time higher than the official average national rate estimated to be 4.6%. Whereas the situation has improved in other regions, progress was very limited in the mid-west region during the 2000-2010 period. No signs of convergence have appeared. To the contrary, the extreme rate of poverty is now 13 times higher than that of greater Tunis in 2010, whereas it was "only" 6 times higher in 2005. If we look at the investments made, meaning the funds that are supposed to have been fed into reducing the gaps, the imbalance is obvious. The Kairouan and Sidi Bouzid governorates thus received a cumulated yearly sum of 2,497 dinars per inhabitant and of 2,296 dinars par inhabitant respectively during the 1992-2010 period. This is about the same size of cumulated investments per capita as for the governorates of Ariana (2,392 dinars / inhabitant) and Manouba (2,107 dinars / inhabitant). However, considering the gap in initial conditions, the question is whether this effort was sufficient, as barely amounting to the level of the better developed governorates. Yet these initial local conditions in turn play a role in the attraction of private investment and here the gaps are more than significant. The Gouvernorates of Sidi Bouzid (2,758 D/inhab.), Jendouba (2,635 D/inhab.), Gafsa (2,613 D/inhab.) and Siliana (2,601 D/hab) did not manage to attract as much investment as Tunis and the coastline (9,508 dinars per inhabitant in Zaghouan, 8,672 dinars per inhabitant in Monastir and 8,189 dinars par inhabitant in Bizerte).

This is clearly a sort if underdevelopment trap which, regardless of the national dynamic, leaves these territories on the wayside. Additionally, the public investment figures tend to show that the decentralised public action did not target a reduction in disparities.

To summarise the previous sections, it would therefore appear that:

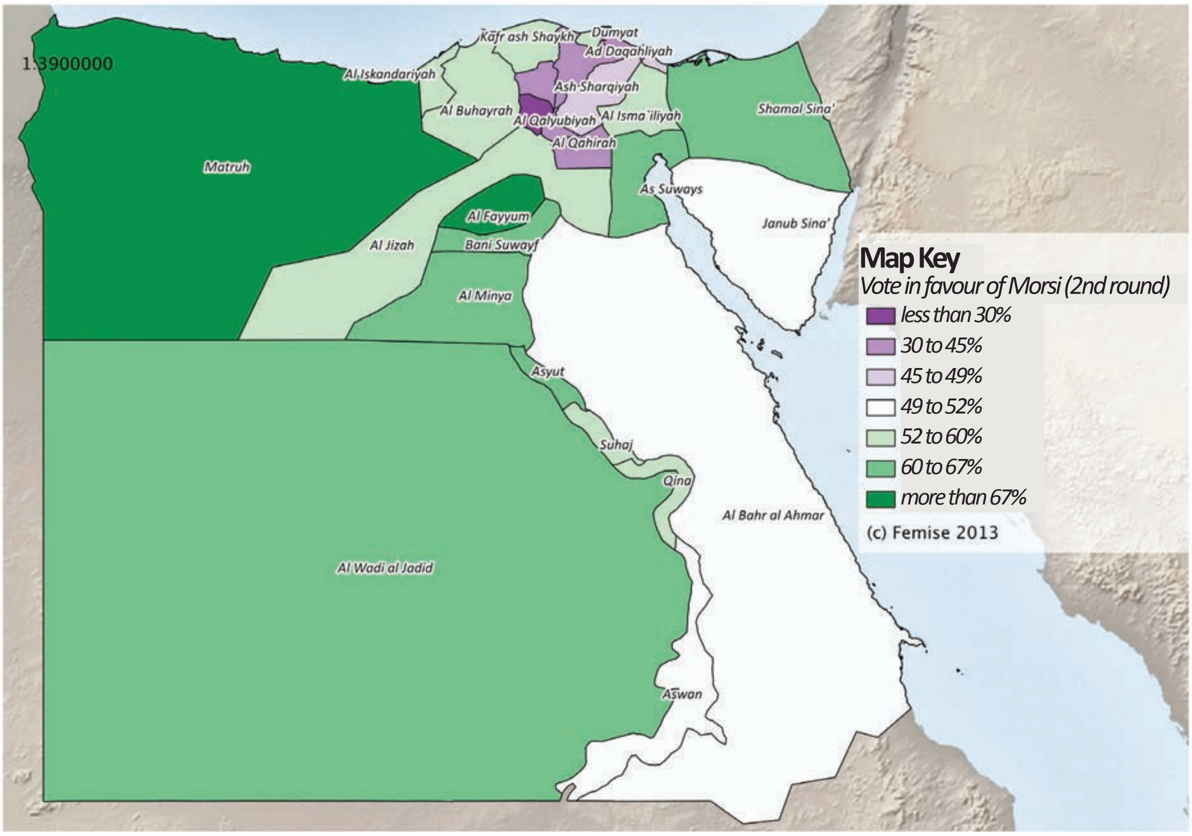
- √ The different types of inequalities are combined in the MEDs in such a way as to exacerbate them. As the dynamics of these inequalities have become disconnected from the indisputable economic progress, the populations' perception of these internal inequalities and of the persistent gaps with the European shores has progressively deteriorated;
- √ Political action has also been the cause of the disparity dynamics observed. Whether due to the persistent urban macrocephaly leading to a territorial incarnation of the capture policy or to the relatively lesser interest in developing less densely populated areas, public action has not succeeded in better disseminating economic progress.

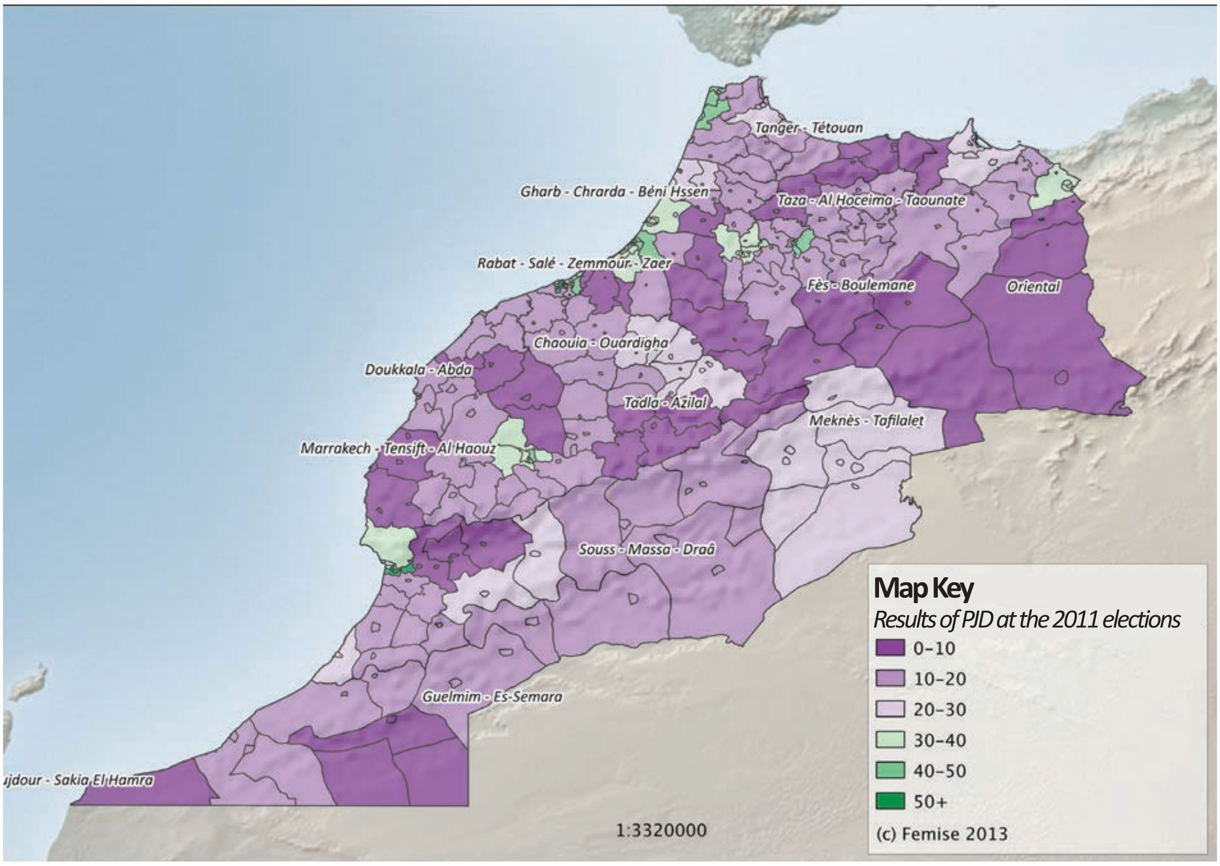
We may therefore consider that it is necessary to study how public action has been led within the territories so far and which changes would help to perceptibly reduce the unequal nature of opportunities.

III. Sub-national governance in question: moderation or production of the disparities?

The subject of decentralisation is above all a "political" debate which touches the very substance of power and individual principles. These debates can be violent: the "Girondins", sensitive to differences in customs and preferring to let the departments organise internal administration whilst the central state restricted its role to observation, literally lost their heads against the "Jacobins" who were in favour of an ideal republic, single and indivisible. Only a few decades later, Tocqueville, was in admiration before the state of democracy in America, in particular regarding the decentralised system that formed the basis of the

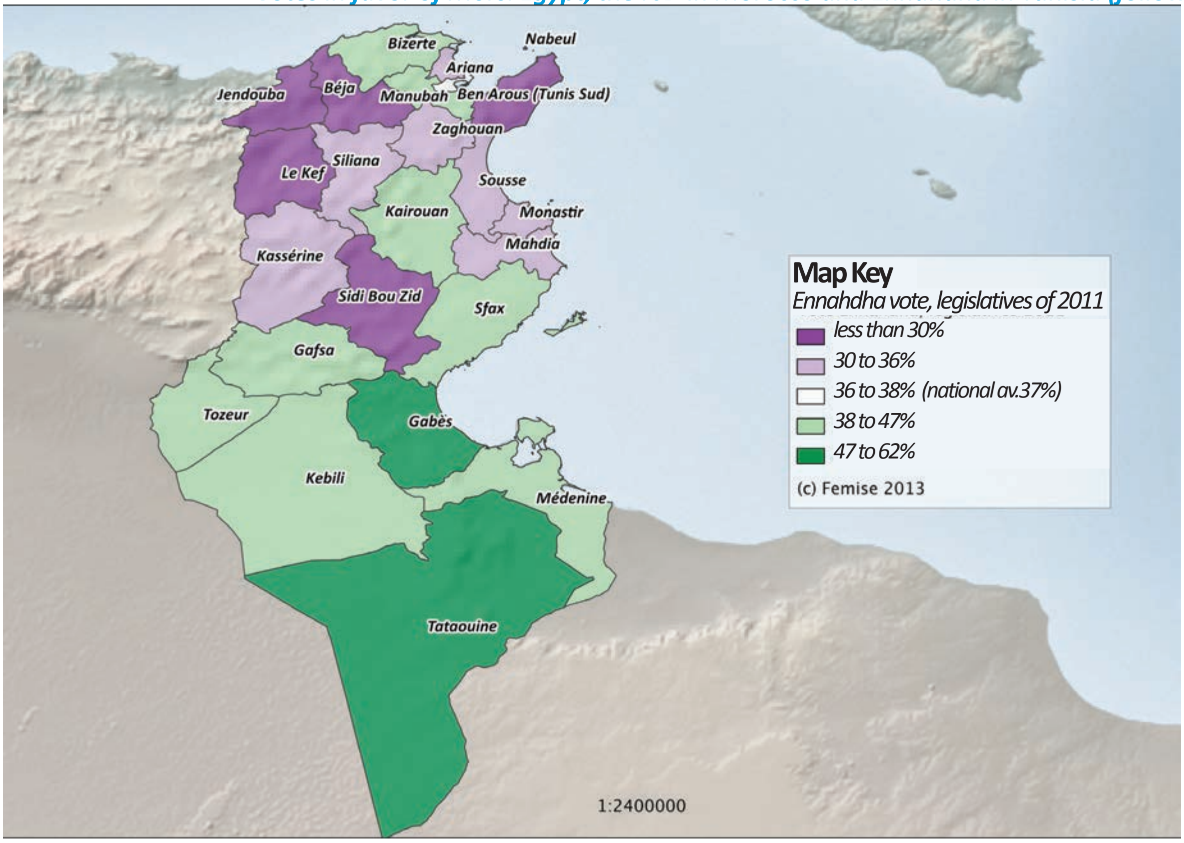
Map 13.
Votes in favor of Morsi Egypt, the PJD in Morocco and Ennahdha in Tunisia





Source: authors based on official or available data

Map 13.
Votes in favor of Morsi Egypt, the PJD in Morocco and Ennahdha in Tunisia (followed)



"equal conditions" so dear to the Marne General Councillor [10]: "Community institutions are to freedom as primary schools are to science; they make it accessible to the people; they give the people a taste for its peaceful enjoyment and accustom them to using it […]. Without community institutions a nation can give itself a free government, but it will not own the spirit of freedom» (Toqueville, De la Démocratie en Amérique, Tome 1, p.96).

This is an eminently political discussion and consequently it is in perfect tune to the MEDs needs today.

The first section briefly presents the key messages from economists on the relationships between decentralisation and development. The second section, based on a recent Femise study (Achy et Alii, 2013 [11]), presents the main current characteristics of the local administrative organisation in several Mediterranean countries. The third section compares these characteristics with the MEDs needs. The fourth and final section proposes some approaches to improve decentralisation and its impact on regional inequalities.

III.1. More decentralisation for enhanced national development

Several forms of decentralisation

As a political process firmly rooted in history and cultures, decentralisation is not a simple object for which we may define a set of universal rules. But we can, in the footsteps of Ebel et Yilmaz, 2002, differentiate between 3 forms on the administrative level

√ **Deconcentration,** the lowest degree, and by which central governmental agencies located in the capital hand over their responsibilities to agencies located in the provinces. In fact, this means that the deconcentrated, subordinate levels in the provinces are agents that answer to and are appointed by the central authority.

√ **Delegation** refers to the transfer of administrative authority and the executive (Public Policy Making), and/or responsibilities for certain precise tasks, to institutions that can be independent from the central authority or indirectly controlled by the latter. This generally involves the delegation of services by a central ministry to an body that must report back, that can be a public company, or a regional agency for planning and economic development.

√ **Devolution**, the most extreme form of decentralisation, establishes local governments that have the responsibility of providing a set of public services and the authority to raise taxes to finance these services; They in particular have the power to raise funds and revenues and to make decisions on investments. It is the devolution of administrative power that underpins the decentralisation of political power. It is also synonymous to financial decentralisation where the geographical entities have clear spending attributions, substantial budgets and clear, legal geographical borders for their action.

The economic arguments for decentralisation

From the economic point of view, the starting point resides in the works by Oates (1972, 1993): decentralisation allows gains in efficiency by establishing a direct link between the supply of local services and local “tastes”. The main theoretical argument is that “each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalise benefits and costs of such provision». We may also refer to economies of variety and follow Tiébout, 1956: more administrative units allow for a greater choice so that people can find a community that offers the desired level of services. The gains in efficiency are allocational or managerial (Ebel et Yilmaz, 2002). 2 main ones are note worthy:

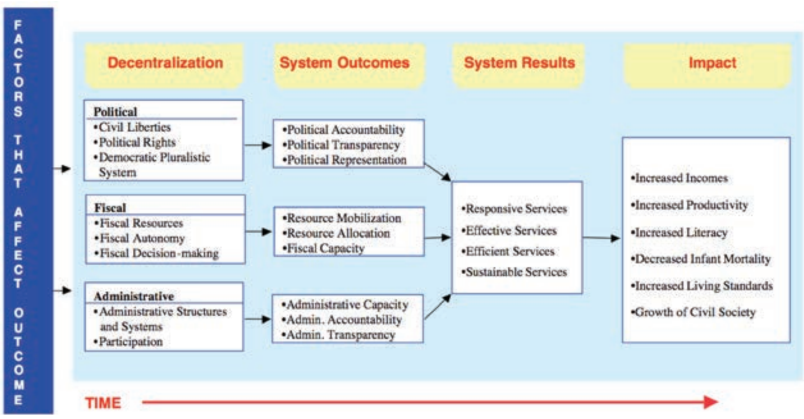
√ The best allocational efficiency comes from the fact that the local governments have better information on their residents and the public expenditure targeting the citizens better reflects the individuals’ choices.

√ Competition between the localities may arise, and if public property is paid for by local taxes, individuals will move to the communities that best suit their preferences: “they vote with their feet”. Fiscal decentralisation thus obliges local governments to maximise revenues due to budget constraints and therefore to optimise their policies.

Other analysis, quoted by Ebel et Yilmaz, also shows that a “decentralised fiscal system offers a greater potential for improved macroeconomic governance than a centralised fiscal system”[12]. This point of view is far from obtaining consensus, however, and some fear to the contrary that macroeconomic instability would be increased by decentralisation (e.g. Prud’homme, 1995, in the case of Argentina or Brazil, where the actions led by local governments reduced the capacities of the central states regarding macroeconomic policies). The fears concern:

(i) The implementation of independent demand mana-

Figure 7.
A schematic of the decentralization



Source : Ebel et Yilmaz, 2002

gement policies which are inefficient in small open and local economies;

(ii) Non-coordinated local monetary policies that create an important risk of inflation ;

(iii) Local authority debt that has national repercussions with an integrated capital market ;

(iv) Economic shocks that tend to be correlated between localities.

Decentralisation can also raise the question of economic equality. It adds a "within locality" dimension to the central dimension. According to Ebel et Yilmaz, regarding the horizontal dimension ("between-localities"), two factors in particular contribute to this: the inequality of tax bases between regions and regional characteristics affecting the cost of services. The redistribution policies that cover this horizontal inequality generally in the form of an allocation given to the poorest regions. But the problem is more complex for the within-locality dimension, particularly due to household mobility. The local governments are indeed obliged to lead "aggressive" redistribution policies, but they might have trouble doing so as this would eat away at their tax bases. On this level, coordination between central and local levels is essential.

What impacts on disparities in principle?

A number of studies have attempted, via empirical approaches, to determine the extent to which the level of decentralisation might act on disparities. But no consensus has been formed, underlining once again the importance of cultural and local history. Leßmann (2006) studied the impact of fiscal decentralisation on regional disparities using the data from a panel of 17 OECD countries from 1980 to 2001 and showed that a high degree of decentralisation is correlated with low regional disparities. Country specific studies such as that by Kanbur et Zhang (2005) for China, Kim et al. (2003) for Korea, Bonet (2006) for Columbia, and Akai et Sakata (2005) for the United States provide conclusive results. In the case of China, decentralisation increased regional inequalities, and a similar result was found for Columbian departments. In Korea, the effect was ambiguous, but in the United States decentralization decreased regional inequalities. Thus, country specific demonstrations are mixed, meaning that decentralisation is not necessarily a recipe for reduced regional disparities.

III.2. The state of decentralisation in the Mediterranean: or rather deconcentration

History has left a strong imprint on the organisation of the local authorities in the MEDs, with the heritage of the Ottoman empire and the colonising countries, France in particular, followed by the need to build new States and, more often than not, a "national" identity, on the basis of autocratic regimes. The MEDs have strongly centralised states even relative to other emerging and developing countries. We are therefore looking at "unitary" states with several sub-national administrative layers, of which the main characteristics can be summed up as follows:

- √ **Sub-national systems** marked by duality: the infra-national systems are composed by a mix between election and appointment. In the local authorities, the "President" is generally one of the appointed members and the appointed bodies have greater power and means.
- √ **The current organisation** is therefore more of a deconcentration than a decentralisation. There is a delegation of responsibility for implementation, whilst the decisions remain central: the organisation's centrality remains the rule and local decisions must be approved by the central authorities.

The deconcentrated jurisdictions vary between countries. Urban jurisdictions are very extensive in Morocco but practically inexistent in the pre-revolution Egypt, the administrative units were more like regional funds that paid for central actions, without any real power (Amin et Ebel, 2006, Achy et alii, 2013, op. cit.).

The organisation of local systems in the Mediterranean: 3 examples, Egypt, Morocco and Tunisia [13]

Egypt has five types of local authorities: governorates (Muhafazah), centres (Markaz), cities (Madina), districts (Hayy) and villages (Qariya). In Egypt, all local government officials are appointed: the governor by the President, the director of the Markaz by the Prime Minister, the heads of the cities and districts by the Minister of Local Development, and the heads of the villages by the governor. The plurality of appointments is often a source of conflict between the sub-national administrations that come under the authority of the different central governmental officers. There are currently 26 governorates. The domestic budget is divided into two parts, one for the central authorities and the other for the local authorities. The latter sets the budget for the different levels of local government. The bottom-up system functions as follows: the lowest administrative level (the village for example) places its requests with the level above (for example the Markaz) which calls upon the governorate level that compiles all requests and dispatches them to the different departments of the governorate. The system does not have a response mechanism: once decisions have been made at the central level, they cannot be contested or modified by the local authorities. The higher level central government does not control the aggregated budgetary allocations for the lower level units, which means considerable discretionary powers for the heads of the higher levels of management, in the absence of any accountability procedures to allow monitoring (Martinez- Vazquez et Tmofeev 2008). By law, public investments in the different governorates are undertaken by the relevant ministries; the Ministry of Local Development only manages investments for the maintenance and/or extension of the local governments' administrative functions. Actually, the local authorities do not play a decisive role in deciding upon where investments are made. The law allows local authorities to borrow under certain conditions and the loans must never exceed 40% of the governorates total annual revenues. In practice, the procedures through which these loans are obtained are difficult and if the loan is planned for a purpose that is not part of the development plan or of it will generate future expenditure, it will require the approval of the Parliament.

Morocco has three levels: economic regions, provinces and prefectures – which are comparable to the governorates in Egypt – and lastly urban or rural towns (Jamaat). The heads of the regions (Wali), provinces and prefectures (governors) are appointed by the King whereas the presidents of the urban and rural towns are elected. The powers and responsibilities given to the local authorities determine the scale of their financial needs. The share of current revenues managed by the local authorities in Morocco at the end of 2011 amounted to 11.5%, a share that has remained fairly stable over the past five years. The share of the local authorities' current expenditure amounted to 8.2% as compared to 10.6% in 2006. Regarding capital expenditure, the local authorities represent one quarter of the total investments made by the central State. This figure reveals the important role in Morocco of the local authorities in providing basic infrastructures for the local populations. The revenues received by and for the local authorities come from a large number of taxes. On average, this represents 24% of local revenue, for all local authorities together, but nevertheless varies considerably according to the authority: 7% for provinces and prefectures and 35% for the region. However, most of the taxes given to them have a very low yield. The local authorities' capital expenditure , i.e. 12.3 billion DH, almost doubled between 2006 and 2011. Investments in projects for large new infrastructures or those involving their repair represent 42% of the capital expenditure for local communities. The shares of contribution for integrated projects and national programmes represent respectively 17% and 15%. Moreover, 10% is dedicated to paying back their debts. Urban towns are the most active in terms of investment expenditure with a 43% share of investments One fifth of all investments is made by rural towns. An interesting fact is that the provinces and prefectures, that have limited revenues, have made a considerable contribution representing 28% of the local authorities' investments. Lastly, the regions contribute little, with only 8% of the investments.

In Tunisia, the country is divided into governorates (24), municipalities (262) and Imada (2066). The Governor is the head of the regional executive and is appointed by the President of the Republic. He is not a representative of the region, but a person appointed by the central government to act as its representative at the regional level. The Mayor, acting as the president of a municipal council, is an elected representative. However, the municipal councils remain under the authority of the central government by which they may be dissolved. The structure of the administrative system in Tunisia is two-fold: i) deconcentration within the context of the central ministries and ii) decentralisation within the context of the territorial administration through the creation of regional councils, municipal councils and rural councils. In the first case, the head of the regional department of each ministry is officially managed by the regional governor. Each governorate has a regional council which is a coordinating authority chaired by the governor and composed of presidents of the regional committees and the secretary to the governor. The regional councils are composed of regional deputies to the National Assembly, the presidents (mayors) of the municipalities of the region and the presidents of the rural councils. The governorates and the regional councils operate under the authority of the home office. The regional committees were created in 1994 to discuss matters related to local development. They represent the legislative body (vote by absolute majority with an open ballot), chaired by the governor and led by the secretary general. They include seven standing commissions composed of deputies elected amongst the governorate constituencies, the mayors of the rural municipalities, the presidents of the councils and other appointed members: one third of the members are elected, the two remaining thirds are appointed by the governor. The municipalities are governed by a municipal council which elects its mayor within its ranks. The municipal councillors are elected for a 5 year mandate by direct universal suffrage by the electors of the municipal area. Generally, the municipalities cannot finance the total amount of their expenditure through their own revenues and are supported by additional funding from the central government. However, this transfer is illegal and significant differences between financial allocations received by the municipalities are to be noted. The municipalities of Tunis (Grand Tunis) received the largest share of government transfers (16 %), followed by Sfax (9%), Ben Arous (8%) and Nabeul (8%), Sousse and Monastir (7%) on the coast. The inland regions received the smallest share with only 1% for the towns of Sidi Bouzid, Tataouine, Tozeur and Zaghouan.

How can decentralisation be described in the MEDs.

On the basis of the Femise study, the following points can be underlined:

√ **In Egypt,** the local administrative organisation is characterised by the following disadvantages: 1) the limited role of local administrative units in the establishment of local plans (as these are decided on a central level and according to a sectorial approach) ; 2) the limited role of the LPC in the monitoring of the LEC; 3) an inefficient hierarchical decentralisation system; 4) common supervision of the local units by the local authorities and the central government; 5) the limited power and role of the governor in most public bodies; 6) a lack of balance between rights and means; 7) a lack of fiscal autonomy for local units. A certain number of afflictions identified above are undeniable including the resistance to change shown by the central and local governments, the lack of human and institutional capacities amongst local units and the low financial resources.

√ **Morocco** has made significant progress as compared to most of the other Arab countries. We may note: 1) the need to establish rules and mechanisms aiming to increase the transparency of local councils that are accountable to their electors; 2) the budgetary resources must be transferred to the local councils and must have their own legal configuration for the collection of local tax; 3) the financial management should be based on the effects obtained and should concentrate on results rather than on resources; 4) the local councils must also more broadly adopt multiannual approach to planning and budgeting ; 5) the local elected councils need highly qualified and motivated staff so that services can be provided in an efficient manner. The poorly equipped and poorly paid staff undermine the reputation of local councils and project a negative image of what decentralisation can bring to people; 6) there are differences between legal provisions and current practices.

√ **In Tunisia**, administrative decentralisation has been hampered by the poor management of human resources and the weak capacity of bureaucratic staff posted in the regions. Moreover, most of the staff belonging to the public bureaucracy were and still are strictly linked to central administrative structures. We may note that even the civil servants (executives) employed and paid by the municipalities remain part of the home office. A number of factors have been unfavourable to the development of the country's inland regions. These can be summarised as: (i) the lack of an efficient regional planning and information system, (ii) lack of infrastructures for the development of farming activities and to attract local and foreign investments, (iii) the lack of adequate training programmes to upgrade the skills of farmers and diversify their production (iv) lack of industrial activity and services able to attract a large proportion of job seekers, particularly higher education graduates (v) limited access to funding and under-representation of the banking sector, loan units and administrations to support private investment, (vi) the non-settling of problems linked to farm land ownership, (vii) the lack of industrial zones benefitting from special advantages and (viii) insufficient incentives to draw foreign investors.

More generally, the Mediterranean experience underlines that:

√ Regional action also depends on decentralised financial means. Similarly to actual powers, these tend to be low in the MEDs (4.0 to 4.6% of the GDP, around 12% of total public expenditure in the 3 countries). This is largely below transition countries (26%) and developed countries (32%). Moreover, these essentially concern current expenditure, mainly wages (80% in Egypt, 57% in Morocco). In Egypt, moreover, local governments have no control over the payroll and merely make payments in the name of the central government.

√ The deconcentrated systems thus suffer from the weakness of their own revenues and their capacity to wield tax instruments. Own revenues represent only 10% of the budget in Egypt, 24% in Morocco. Transfers from the central state therefore represent the majority of local budgets. In decentralized systems, these transfers are used for equalisation. They are the tool that is intended to ensure equality between administrative territories, despite their possible differences in terms of fiscal potential.

√ The distribution of state transfers to local bodies is questionable and has not fulfilled its objectives. The regional disparities, although largely explained by different initial conditions amongst the regions and by unequal natural endowments, are exacerbated by public policies. In many cases, such as Tunisia for example, the decentralisation policy and public transfers have not succeeded in managing inequalities and, in certain cases, have even "contributed to increasing disparities and territorial exclusion".

√ A number of conditions must be present regarding fiscal decentralisation, such as fiscal autonomy both for revenues and expenditure, which is not observed in most cases. But, according to local researchers themselves [14], the granting of political or fiscal powers to the local authorities without a prior reform of local authorities and communities and without ensuring a better participation of the populations at the local level would make decentralisation inefficient. Such a reform must come back to the basics of decentralisation, that can be summarised by the following quote: "the aim of the decentralisation process is not just to weaken the central authority, nor to prefer local elites to the central power, but essentially to enable local governance to be more reactive to the needs expressed by the large majority of the population" (OECD, 2004).

√ Human resources, composed of elected and appointed members of staff, are a key factor of success in any decentralisation policy. But the mix adopted here, with a strong presence of the central state, means that the systems are simply deconcentrated. If the objective is to target real decentralisation, the systems by which the local authorities are composed will have to be adapted.

III.3 Moving towards a less centralised system that is more apt to reduce unequal opportunities throughout the national territories

It is clear that the MEDs remain profoundly marked by a unitary form of government dating back to the Ottoman and French historical heritage. For most of these countries, the past five decades have been dedicated to the construction of a state (or even of a national identity), which can largely explain the strong centralisation and even the persistence of autocratic regimes, dominated by single political parties. In territories with extensive geophysical constraints, this has led to strong, persistent socio-economic disparities between the different spaces and these inequalities between dynamic zones and the remote areas are pursuing their upward trend. For the social project itself, including a social contract that carries the ideal of a unitary nation, these strong disparities must be progressively but rapidly eliminated. The very existence of these inequalities calls for more decentralised action thus raising the question of the local authorities' administrative organisation within these countries. Despite the national specificities, a clear trend is currently appearing: it cannot be described as true decentralisation but, at the very best, as more or less advanced forms of deconcentration, even though Morocco seems to have made more progress. In some respects, the state has even participated in the negative dynamic of these inequalities, whereas the organisation was actually intended to obtain the opposite result. What can be done, with due respect to national choices, to reverse the movement and move towards a more efficient decentralisation that fulfils its role, at a time when several constitutions are being revised ?

It should be clear, however, that the questions of decentralisation must be approached with a certain subtlety, in particular regarding the issues of sectors and forms: the aim is to avoid creating other sources of inequality. In some cases, the action will be more efficient if carried by blind institutions simply combined with a deconcentration of implementation. This is certainly the case for the basic educational system, as it owns the mission of equal opportunities, and also for health systems which must guarantee the absence of discrimination. Greater decentralisation is possible regarding the economy and also regarding infrastructures linked to improving accessibility. It nevertheless remains clear that the choices made by the countries must be seen through to their logical conclusion, in particular regarding the staff that will be in charge of these missions.

Considering the elements above, the following general principles can be put forwards, organised into 3 main axes: the political dimension, the human resource dimension and the financial dimension.

The political dimension

This lies at the heart of societal choices: to guarantee the ideal of equal opportunities for all citizens of a country, whilst taking into account local and territorial specificities. It is important here to: (i) clarify the actual hierarchy between the local levels, on the one hand, and the local and central levels, on the other. It is difficult (or even impossible) to find one model in the literature that is clearly preferable to all the others. However, it is easy to understand what makes certain forms inefficient. It is not certain, therefore, that a hierarchy amongst authorities is necessary, and its form would remain largely debatable (contingent to the social and historical context).

But the chosen system must be clearly established and (ii) bodies that are independent (from the local authorities and the central state) must be set up in order to constitutionally ensure that the laws and prerogatives are duly respected. It must also be clear that decentralisation means that no chain of command should be established between the central power and the local authorities in particular, for example, ministries responsible for decentralised functions. The obligations of the local authorities are determined by the law and not by an element of the central executive power.

Moreover, the population's adhesion can only be consolidated through democratic expression and the choice of direct election for the principle local assemblies seems to be the best option, as implemented or plaaned by the majority of MEDs. But everything must reflect this choice, (iii) the local executive must represent the elected legislature and not be appointed by the central state. For the MEDs, the choice must be made to follow the decentralised pathway and, in this case, to do so in a decisive and coherent manner. Regarding the powers granted to each level, international and historical experience does not allow us to propose one model or another. Nevertheless, a focus on economic action and an incentives to decentralise banking activities with the aim of creating companies would be desirable in line with the recommendations issued in the present report regarding innovation.

The human resource dimension

This is a frequently noted point: the local authorities do not have sufficient skilled and qualified staff. Added to this is a certain lack of clarity for the staff as to which body they actually belong to. This means that the priority must be given to two types of action: the creation of a specific and coherent status for local "civil servants", and the training of staff whose skills will allow them to carry out the missions for which they are responsible. Regarding the first action, according to the experience of recent decades, it would be necessary to:

(i) Clarify upon which local authority the person depends; the link should be clearly local, but they must preserve a public law status that is identical to that of the central level to avoid weakening their position. This could be the case, for example, in primary schools where teachers are civil servants but the school is run by the town hall.
(ii) To implement salaries, career opportunities and sufficient autonomy to stimulate real motivation, to ensure that staff are not obliged to leave the authorities in order to further their career;
(iii) To allow evolution within the local levels or between authorities, in order to increase the skills and experience of all.

Regarding skills, training plans must be set up firstly for the current staff, but also to train the future local "elites", for example via:

(i) The creation of "national" schools for local government officers;
(ii) Continuing education modules (with the recognition and validation of acquired skills) allowing people to refresh their skills, particularly in the fields of finance and budgets, according to legal evolutions and international practices;
(iii) Institutional exchange missions and "organised" internships (particularly within the framework of the neighbouring policy), with European local authorities, to enhance the sharing of experience and skills amongst staff. Regarding these skills aspects, particular importance must be granted (at least to begin with) to those related to management and financial management, in keeping with the following point.

The financial dimension

Although international experience is heterogeneous, and we must once again underline the fact that the question of decentralisation is an area of sovereign and societal choice, the literature highlights the fact that the financial means possessed by the local authorities – financial decentralisation – are of high potential impact. The MEDs can no longer consider the local levels as mere annexes to the Central Treasury. Financial autonomy, combined with an autonomous power of decision, within the strict framework of national laws and strategies, must form the basis for financial decentralisation. Amongst the possible routes, we may underline the importance of:

(i) Creating independent supervisory bodies ("local" courts of auditors) in charge of verifying that local budgetary implementations are legal and beneficial for the general public;
(ii) Ensure a level of financial resources for local authorities according to their jurisdiction by law, through a mix of local taxes, autonomous financial revenues and state grants, the latter playing a role of equalisation and acting as a tool for convergence;
(iii) Encouraging local authorities to invest according to their contextualised interpretation within the framework of national plans; it must be made clear that too great a share of current expenditure within local budgets is not compatible with the main objective of reducing inequalities;
(iv) Authorise, within a strict framework, funding with loans, in particular with the help of international donors and the EU via the EIB. We might imagine the creation of a mutual bank for local authorities, run by competent staff, in charge of appraising applications from local authorities working closely with international bodies.

Notes:

1. cf. OCEMO, Initial results from the youth survey, Nov. 2013
2. Joseph E. Stiglitz, "Inequality is a Choice", editorial of the New York Times, 13 October 2013
3. Alfred Korzybski, fonder of general semantics
4. Within this notion we may immediately note that certain territories under discussion are not taken into account. To avoid any controversy, we will stick to the representation as proposed by the UN.
5. Source: calculations made by authors using the data base: «World Inequality Database on Education (WIDE)», Unesco ; consulted in October 2013
6. Source: calculations made by authors using the data base: «World Inequality Database on Education (WIDE)», Unesco ; consulted in October 2013
7. Source: calculations made by authors using : Morocco, Haut Commissariat au Plan ; Egypt, Capmas ; Jordan, Department of Statistics ; Turkey, Turkish Statistical Institute; Lebanon : Central Administration of Statistics.
8. The DMSP is a Department of Defense (DoD) program run by the Air Force Space and Missile Systems Center (SMC). Each DMSP satellite has a 101 minute, sun-synchronous near-polar orbit at an altitude of 830km above the surface of the earth. The visible and infrared sensors (OLS) collect images across a 3000km swath, providing global coverage twice per day. The combination of day/night and dawn/dusk satellites allows monitoring of global information such as clouds every 6 hours.

The data from the DMSP satellites are received and used at operational centres continuously. The data are sent to the National Geophysical Data Center's Solar Terrestrial Physics Division Earth Observation Group (NGDC/STP/EOG).

Data are cloud-free composites made using all the available archived DMSP-OLS smooth resolution data for calendar years. In cases where two satellites were collecting data - two composites were produced. The resolution reach 30 arc second grids, ie about 1km, spanning -180 to 180 degrees longitude and -65 to 75 degrees latitude.

9. 57 pays

10. According to Toqueville, the distinguishing feature of democracy does not reside in the inequalities at a given point. these are just a present in other systems (his reference in that period was the aristocracy, 1835-1840). But by turning « equal conditions » into «the standard » for society, economic inequality seen at a given point is considered by Toqueville to be« free and temporary » and social hierarchy no longer refers to a pre-established social order. Positions are not equal, but they can change. Social conditions may be unequal, but this is not due to the characteristics of the individuals. According to him, equality is a principle and a process.

11. Achy L, Ben Romdhane S., Ghoneim A, Sekkat K, «Decentralization and Economic Performance in Selected South Mediterranean Countries», Femise Research Report FEM35-19, to be published, 2014.

12. Huther and Shah (1998)

13. Principally based on the Femise study FEM35-19 for these 3 countries, Achy et alii, 2014, op. cit.

14. Achy et alii, 2013 op. cit.

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Part 2. Detailed situation in MPs : Country Profiles

ALGERIA

The need for a «structure-changing» long-term economic approach

Introduction

In the mid 1980s international oil-prices crumpled below ten dollars per barrel, heavily impacting Algeria's oil-dependent economy, leading to a long-term underperformance in the balance of payments and to economic growth stagnating at a 1% rate for a decade. A series of structural reforms was initiated, focusing on both the legal, institutional and decision-making framework, followed by an IMF driven second wave of liberalisation in the early 1990s and a third wave in the mid 1990s to impose macroeconomic stability through tighter fiscal and monetary policy. In the recent decade, the successful management of its debt, supported by the upturn in the price of oil, had helped restore the image of Algeria internationally and given a great opportunity for its development.

Yet, the transition to a market-based economy never fully occurred. It is well known that for long the country followed a growth strategy of extensive accumulation, without investing enough in the development of the private sector. But, the fiscal abundance spawned by oil-resources allowed for colossal public investment programs to develop infrastructure and generate jobs. Meanwhile, in last years report we noted how authorities seemed to save a great share of rents to promote economic diversification through macroeconomic incentives for the development of production. Even so the fact remains, despite the diversity of economic reforms and a strong fiscal stance, Algeria has kept the traits of an oil-dependent economy. Granted, authorities have shown determination in applying their investment agenda to expand the economy and develop infrastructure and skills. But such incentives have been inhibited by the lack of access to credit and "institutional disincentives". In the end, despite being shielded until know from the regional turmoil, the Algerian economy has been underperforming.

Perhaps most importantly, the country has not been capable to create a sufficient amount of high skilled jobs; Algeria suffers from a labor market demand and supply mismatch and the weight of Informality largely related to employment issues. Once again, the dynamic needs to be changed, authorities need to create jobs in the private sector, achieve higher and inclusive growth, initiate public confidence vis-à-vis taxation so that the private sector shows more interest in investing in the long-run. The country needs to Improve total factor productivity and implement a skills-based model of growth. But it also needs to improve the conditions of the civil society, make progress in the decision-making procedures, accelerate reform of the State, allow for decentralization.

> ***Perhaps most importantly, the country has not been capable to create a sufficient amount of high skilled jobs***

Lastly, while the country apparently sidestepped the regional turmoil without considerably shifting its economic and political model, there is need for greater change. There is "a deep social malaise" especially within "those struggling with difficult living conditions, bureaucracy, and corruption" and among the youth that feels "disconnected from formal politics" and disillusioned.

But, answering to all of that will not be an easy task, the last term of Abdelaziz Bouteflika will ex-

pire next year, transition will need to be smooth with the risk of incidents from Islamist militants always looming. The challenge is thus threefold:

i) Algeria must keep intensifying its reform efforts towards a productivity and skills-based and diversified economy,

ii) it must make more efforts towards inclusiveness, whether it be regarding unemployment, financial inclusiveness, the limited participation of women and the youth which deteriorates the social structure,

iii) It must ensure smooth political transition in a context that might not be the easiest one.

All in all, the Algerian case is a special one, somewhat distinct from other MPs with more conventional economies, with needs for a deep and structure-changing economic approach that would bear its fruits in the long term.

The short-term economic situation is the following :

- √ ***Real GDP growth*** *in Algeria is expected to remain close to the 3.3% range, up from 2.5% in 2012 and close to its 2005-2008 pre international crisis average. Growth was initialy expected to be higher but the In Amenas attack is expected to translate into a negative effect on foreign and domestic investment.*
- √ *The* ***budget balance*** *could reach -1.1% in 2013, due to cutbacks in spending and hydrocarbons revenue increases because of a higher output. Even so, the vast surpluses recorded in recent years are a distant memory, the recent spending surge damaged the fiscal stance and contributed to higher inflation.*
- √ *The* ***current-account balance*** *will remain in surplus, though an expected weak euro zone performance in 2013 could partly reduce demand for Algerian hydrocarbons.*
- √ ***Unemployment*** *is expected to fall to 9.3% in 2013 from 9.7% in 2012. But, Algeria always runs the risk of social unrest especially taking into account the high levels of youth unemployment.*

Among the long-term challenges we should note :

- √ ***A change in the structure of the domestic economy should happen in the longer-run.*** *Algeria needs to reduce the gap between oil and non-oil activities, the latter could improve the structure of exports and lead to the formation of several productive activities, develop SMEs, foster employment opportunities and increase growth. Also, monetary policy can play a key role in avoiding the Dutch-disease fall-back effect. All in all, Algeria has to come to terms with the fact that it will have to build a new growth strategy and focus on sectors that have the biggest likelihood to carry future jobs and growth, fiscal conditions being tighter.*
- √ ***The domestic policy shall be friendlier towards foreign investment.*** *The authorities will need to progressively remove their inflexible approach. Limiting the frequent introduction of amendments to the complementary finance law could be perceived positively by foreign investors who will not have to wait for additional legislation every year.*
- √ ***Trade integration must be strengthened,*** *the Algerian authorities recently decided to postpone full implementation of the framework with*

Key indicators	2005-2008	2009-2011	2012	2013	2014
Real GDP growth (%)	3.3	2.6	2.5	3.3	3.4
Consumer price inflation (av; %)	3.1	4.7	8.9	5	4.5
Budget balance (% of GDP)	13.6	9.7	-1.7	-1.1	0
Current-account balance (% of GDP)	22	5.9	5.9	6.1	4.5
Unemployment rate (%)	13.2	10	9.7	9.3	9

Source: WEO – IMF. April 2013 (latest) and EIU. estimates for 2013 and 2014 *the EU which is a step back. The links between Algeria and the EU are of capital importance, the latter is by far Algeria's biggest trading partner and Algeria represents a key supplier of natural gas to the European market. The country should benefit from its very large capacity to export agricultural goods to the EU but it still remains to be seen if the EU has the determination to offer "real improved access" to the European market for Algerian exporters in case bilateral relations go forward.*

- √ ***Authorities need to remedy a high level of financial exclusion*** *which is very high compared to other low & middle-income economies, the share of Algerians using ATMs appears considerably below the MPs average level suggesting limited banking integration and considerable financial exclusion. Meanwhile, there appears to be a phenomenon of rural exclusion as shown by the limited share of people in rural areas having an account.*
- √ ***Social institutions that encourage social trust and a good distribution process also foster the wealth of nations.*** *Efforts for additional transparency in governance and institutions will be a pre-requisite for growth in Algeria. Among others, authorities should establish a better balance in decision-making at both the central level and the local level including a reflection on the emergence of possible new regional structures.*

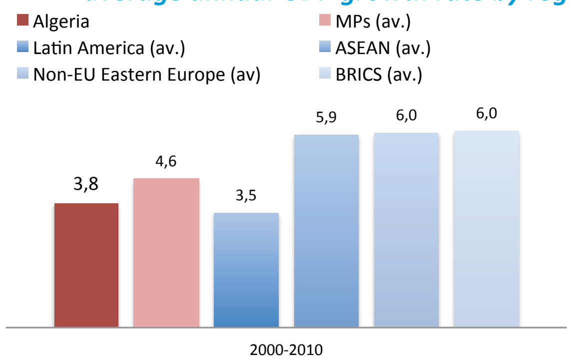
I. A 2012/2013 snapshot: macroeconomic situation and challenges

I.1. Economic growth that continues its upward trend

During the 2000-2010 period GDP growth in the MPs accelerated and reached an annualized rate of 4.6%. In the case of Algeria the average annual GDP growth rate of the recent decade was below the regional average and close to the 3.8% mark. This is also vastly below the levels observed in Non-Eastern Europe, ASEAN and BRICS economies but slightly above the growth rate of Latin American countries. In Algeria, GDP growth stood at 2.5% in 2012, close to the 2.6% average observed in the 2009-2011 period but still below the pre-crisis average rate. Provisional figures suggest that the rate of growth will bounce back to 3.3% in 2013 with oil and gas production staying as the backbone of the domestic economy.

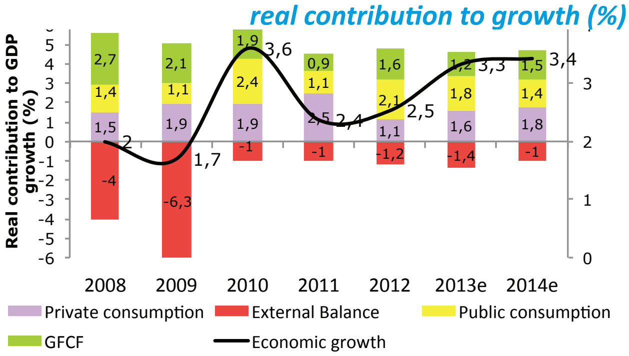
On the demand side, GDP growth is essentially driven by consumption and investment, public and private consumption are expected to contribute the most in 2013 to GDP Growth (respectively by 1.8 and 1.6 percentage points) while the contribution of investment could be slightly less pronounced than in 2012. Meanwhile, the external balance shall keep downward pressures on overall growth.

Figure 1a.
Gross domestic product, average annual GDP growth rate by region



Source : IMF, World Economic Outlook database and EIU

Figure 1b.
Gross domestic product, real contribution to growth (%)



Source : IMF, World Economic Outlook database and EIU

I.2. Oil and gas production to keep increasing though security concerns need to be resolved

The major developments and prospects for the oil & gas sector would be the following (BusinessMonitor, 2013):

- √ Recently, the In Amenas plant and Ain Chikh pipeline attack brought a sentiment of fear and insecurity. As a result, foreign investors might put their incentives on hold and the domestic hydrocarbons regulator ALNAFT will delay the offshore licensing round.
- √ On the flipside, the adoption in January of the 2013 Hydrocarbon law would provide a lift to "the production tax system, state ownership and exploration incentives". In short, undesirable policies that were established in 2005 have been reformed, a welcome first step that allows for durable exploration incentives, though the tax system remains "unclear and burdensome, and could deter some companies from entering the market". Furthermore, increased state ownership is all but a positive sign for foreign investors.
- √ Gas production at Eni-operated Menzel Ledjmet Est also started in 2013.

All in all, oil production is all but diminishing in the mid-run, it is expected to rise from an estimated 1.845mn barrels per day (b/d) in 2012 to 1.901mn b/d in 2016. Moreover, consumption of crude is estimated to steadily rise in the 2012-2022 period, by roughly 36% in the ten-year period to reach 569700b/d by 2022. The situation for gas would be similar; it is expected to increase by 41% in a ten-year span to reach 107bcm by 2022 as aspiring new projects materialize. Meanwhile, gas demand is expected to follow the supply surge and rise steadily from about 30.3bcm in 2012 to a predicted 52.3bcm in 2022.

The imminent challenge will be to ease security concerns, followed in the mid-term by a deepening of the tax reform. Additionally, maintaining such dependence on oil will probably keep translating in high volatility in export revenues. Linked to this issue is the fact that the domination of the hydrocarbon sector has played a role in diminishing domestic incentives to develop other tradable goods sectors, something that needs to be remedied as discussed in the last section.

I.3. Reduced unemployment but increased expectations

Unemployment in Algeria kept decreasing in recent years, falling from an average of 13.2% (2005-2008) to 10% (2009-2011) and reaching 9.7% in 2012. The surge in the number of unemployed in 2011 could be explained by a combination of both an insufficient rate of employment creation and the context of regional instability that had an impact on the regional production structure and hence contributed to a number of layoffs. But, since then employment creation has been enough to cover for the new entrants to the labour market. The rate of unemployment is expected to decline to 9.3% in 2013. This evolution is certainly a positive one, but it should also be noted that the recent decline in unemployment in Algeria is largely due to the strong growth of employment in the public service sector.

a. Labour market indicators that suggest a lack of quality and inclusiveness

Yet, when looking at indicators of the Algerian labor market one may conclude that they give an image of poor quality and discriminatory participation.

As noted by Achy (2013), the decline in unemployment during the 2000s went "hand in hand with a growing preponderance of underemployment, temporary jobs, and informal-sector activities…fifty percent of jobs created during the period 2005–2010 were temporary, compared to 30 percent of the jobs created during the 1990s and 20 percent before the 1990s". The youth unemployment rate in Algeria is slightly below the regional average, yet remains considerably higher than the rate found in Latin American and ASEAN countries. Thus, one finds a double discrimination, the first vis-a-vis the youth the second (and greatest) vis-a-vis women. More precisely, in the case of Algeria (ONS, 2010 data) one notes :

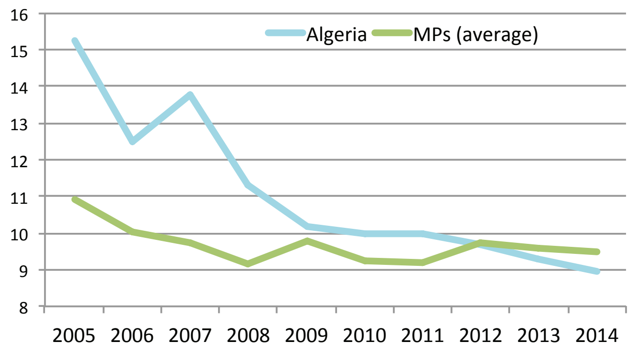
√ an employment rate that is rather low, close to 37.6% of the population aged 15 + ,
√ a low rate of participation for women in the domestic labor market (close to 14.2% for wome aged 15 +),
√ a rate of youth unemployment about three times higher than that of adults,
√ an unemployment rate for women more than twice the corresponding rate for men.
√ a high rate of unemployment among graduates (20.3%), even higher in the case of women graduates (33.3%).
√ Last but not least, one out of four young people are neither in the labor force nor in school, a rate that reaches 40% in the case of young girls.

Meanwhile, the total population is expected to exceed 40 million by 2020, with those less than thirty-four years of age representing more than two-thirds of the population. The latter “has also grown more educated, with an average of seven years of schooling now up from less than two years in 1980 and become more urbanized, with 72 percent of Algerians living in cities compared to 44 percent in the early 1980s” (Achy, 2013). Hence, this leads to “increase expectations for jobs and decent housing and could trigger widespread dissatisfaction that may contribute to social unrest”. Thus, while employment creation somewhat provided an answer to short-term needs, authorities need to have a long-term vision that provides an answer to the structural problems that the Algerian population has to face.

b. Social networks, a parameter to consider in finding a job

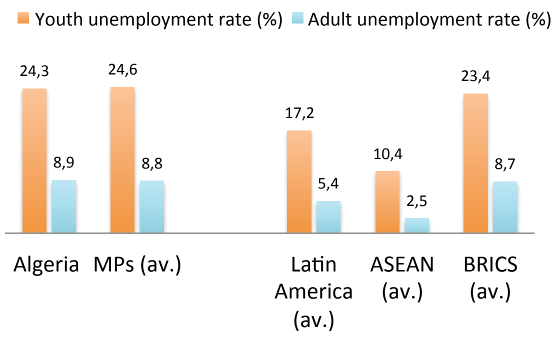
In a recent paper, Lassassi and Muller (2013) study the importance of social relationship networks in obtaining a job in Algeria.

Figure 2a.
Unemployment rate, as a % of labour force



Source : IMF, World Economic Outlook database and EIU

Figure 2b.
Unemployment rate,
by region and age group (%),most recent year



Source : IMF, World Economic Outlook database and EIU

They highlight how, human capital is an important factor in determining the use of such networks. It appears that those with a low level of education rely more on their friends and families to find employment, for less educated men the probability of getting a job through relationships is about 1.75 times greater than for those with higher levels of education (for women the probability is 2.72 greater). The authors also find that the use of such networks has increased over time and that the probability of finding a job through personal or family relationships for both men and women is more important in the case of private sector employees (the chance of finding a job through relationships is 3.12 times higher for men and 3.24 for women compared to employees in the public sector).

All in all, in studying the determinants of the use of relationship networks in the process of job-searching, findings suggest that the determinants of the use of such networks are completely different between men and women. There seems to be discrimination against women in the use of family networks. Indeed, it is men who benefit from family relations and the head of household to find a job. When women do benefit from such networks it is usually for unskilled and less protected labor, a fact that domestic authorities should keep in mind if they wish to reverse the situation and go towards a more inclusive approach.

Meanwhile, it appears that the unemployed are progressively moving away from the intermediation of government agencies in seeking a job. Indeed, the higher the unemployment rate in a region and the higher the use of networks of relationships in the same region to the detriment of public agencies intermediation. This result should challenge domestic authorities in revitalizing the role of public agencies intermediation in the labor market.

I.4. Inflation surge in 2012 to be moderated in 2013

Inflation stood at a record 8.9% in 2012, almost double the 2009-2011 average rate and triple the 2005-2008 average, a considerable surge compared to post international crisis levels as high food prices and domestic powerlessness increased. In recent years, in fear of unrest following political and socioeconomic instability throughout most of the Mediterranean, authorities had taken some measures, such as increasing subsidies for foodstuffs, that facilitated price-stabilization. Yet, in 2012 the inflation rate escalated, mainly because of higher food prices, which increased by 12.2% (Reuters, 2013). Furthermore, the inflation rise was derived by the surplus liquidity due to the recent increase in public spending.

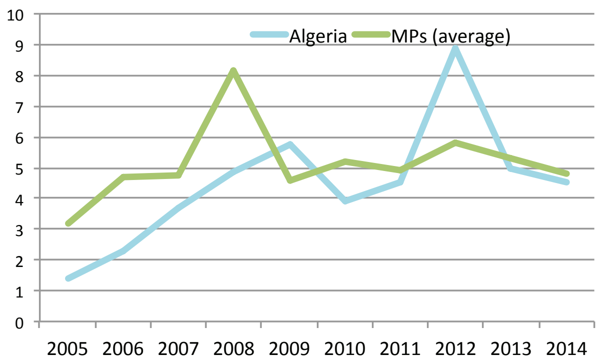
But, a slow-down is expected, food prices (a large component of the Algerian basket) in the first 11 months of 2013 increased by 3.4% compared to the same period in 2012. Meanwhile, the prices of manufactured goods recorded a moderate year-on-year increase, close to 2.3% % in the same period. Furthermore, services showcased a higher increase of close to 6.3%. Such tendencies lead to believe that inflation will fall and be closer to an average of 3.5% in 2013.

I.5. The external position: current account in surplus but tourism and FDI are very limited

The Algerian current account in 2012 remained at a surplus of 5.9% of GDP, which is equal to the post international crisis average during 2009-2011 but more than thrice less than the 2005-2008 average. Meanwhile, compared to 2011 a fall of close to 38% was noted bringing the current account to 12.3bn US$ after a noticeable rise in the import bill.

In 2013, an increase in export revenues (3.3%) driven partly by the rise in the oil production might still not be able to exceed import growth (5.4%), yet the trade balance is expected to remain in surplus close to 23.3bn US$ (EIU, 2013). When looking at the recent survey on the situation and perspectives of trade activity in Algeria, during the fourth quarter of 2012 commercial activity has if we are to believe retail merchants and wholesalers. This increase is more pronounced in raw material and semi-finished products, in textiles, clothing and leather, as well as «machinery and equipment”. However, a fall in trade of fuels and lubricants and in food products is confirmed. Most retail

Figure 3.
Inflation, average consumer prices (% change)



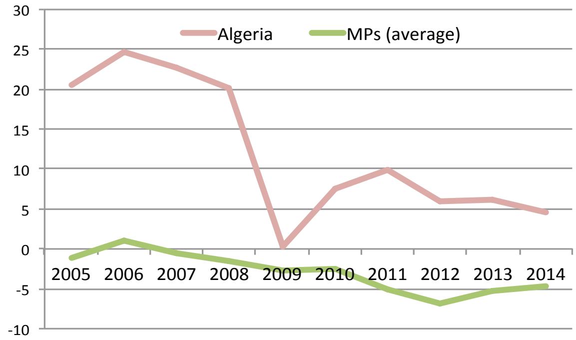
Source : IMF, World Economic Outlook database April 2013 (latest) traders and some wholesalers complain about delays in supplies that are quite long but also about the lack of availability of some goods. Nearly 60% of wholesalers and 68% of retailers are out of stock for specific products such as fuel-lubricants, machinery and equipment, hardware, Electrical Appliances and Perfumery (Office National des Statistiques, 2013).

As for the services balance it shall remain in deficit close to -7.2bn US$, slightly worse than 2012 levels. The inability to effectively launch tourism activity is in great part responsible and the situation seems to keep up worsening. Granted, last year saw two and a half million visitors visiting Algeria, most of which Franco-Algerians (1.5 million) followed by half a million Tunisians and 230000 visitors from other European countries and especially from France. Meanwhile, the Tourism minister reassured recently that « Algeria is not suffering from security problems any more than elsewhere » (ANSAMed, 2013).

Yet, in some regions « business is about half what it was before » (TheNational.ae, 2013) with media coverage of the regional turmoil convincing people that the region should be avoided. In Beni Isguen, an oasis village in central Algeria, hundreds of tourists « would arrive in buses to see the dramatic scenery and weird, mud architecture », they are now far less in the aftershock of the situation in Mali, Algeria's neighbour (TheNational.ae, 2013).

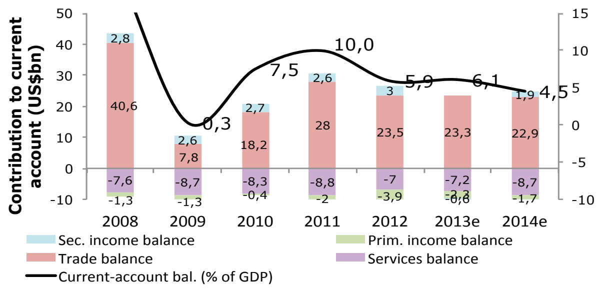
The numbers of tourists visiting the deep south were already divided by 3, from 1807 in 2011 to 643 in 2012 according to Tamanrasset authorities in the Sahara. Meanwhile, 70 of the 76 tourist companies in the city shut-down and most Europeans cancelled their reservations after the recent attack in Algeria (Associated Press, 2013). The government had announced that it would incite Algerians to travel to the south however tourist operators "complain that the visits are short, rare and don't involve the weeks of driving or trekking

Figure 4a.
Current account balance, as percentage of GDP



Source : IMF, World Economic Outlook database and EIU

Figure 4b.
Current account balance, decomposition (billions US$)



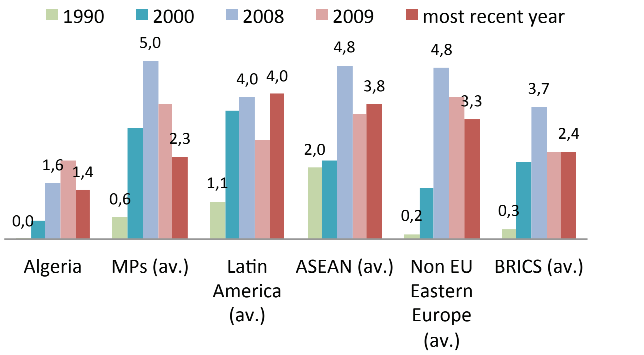
Source : IMF, World Economic Outlook database and EIU

through the mountains desired by foreigners, who paid $1,500 a week to local guides" (Associated Press, 2013). It appears that Algeria never truly tried to support its tourism industry and it has been admitted that the sector has been lagging behind and that efforts to develop the tourism infrastructure are needed (ANSAMed, 2013).

All in all, the current estimates for 2013 allow for optimism, the current account is expected to slightly increase and reach 6.1% of GDP in 2013. Meanwhile, official reserves had reached 188.3 billion US$ at end-September 2012 (IMF, 2013).

Lastly, one should mention that capital inflows remain traditionally limited with FDI inflows in end-June 2012 reaching only 1 billion US$ (IMF, 2013) and total inflows for 2012 fell by 15% 1.7 billion US$ (Reuters, 2013). Not only has investment globally been affected throughout the world, but Algeria has assisted at worsening the domestic po-

Figure 5.
FDI by region, % of GDP



Source : WDI, World Bank

tential for FDI; in 2010 it introduced new rules for FDI such as limiting the stake that a foreign investor can hold in a local firm to 49% while investment in other sectors than oil and gas has been limited at best (Reuters, 2013).

The state is not expected to give up the rule of 51/49% governing foreign investment even though the President of the "Forum des chefs d'entreprise" (Forum of Business leaders), the most influential employers' organization in the country, demanded the cancellation of this rule for non-strategic sectors, including SMEs, explaining that it had participated in the investment decline (Elmoudjahid, 2012). Currently, FDI stands at about 1.4% of GDP, below the regional average (2.3%) and also well below the FDI ratios found in other emerging regions.

I.6. Outfall on fiscal balance: is there need for a policy shift?

The main characteristic of the Algerian budget is its severe dependence vis-a-vis the price of oil on the world market. Taxes levied on hydrocarbons represent the main source of budget and are closely linked to oil prices, when the latter rise this automatically increases the budgetary income, a decline in these prices automatically reduces the same revenue. Furthermore, in addition to this price effect, one must take into account that the level of oil exports will determine the domestic import-capacity and thus the amount of all taxation revenue (custom duties, VAT, etc...) on imports.

Recent years have shown that even Algeria can be in a situation of a fiscal deficit, despite its oil reserves the country recorded a -1.7% deficit in 2012 which is only expected to slightly decrease in 2013, far from the 13.6% pre international crisis average level.

a. A system of redistribution that is not sustainable indefinitely

The domestic budget on one hand and the Algerian regime more generally face impending challenges one of which is the (non) sustainability of the redistribution system. If we look at what the authorities have distributed on average over the past three years some interesting observations emerge (Achy, 2013):

- √ About 12% of GDP goes to public-sector wages, in other terms this is the equivalent of more than a third of government spending (more precisely 37%). This colossal expenditure, that grew by a quarter between 2009 and 2012, is due to the fact that more than 2.7 million Algerians (almost 30% of the labour force) are civil service workers, versus an average of 18% in the MENA region. Oil income has even allowed the government to afford pay raises, something that might seem unthinkable in other countries of a similar development level. Public-sector employment has been among the most important means for the regime to exert political and social control.
- √ Meanwhile, a large share of oil income goes to subsidies, when excluding oil and gas the cost amounts to 3.8 billion US$ annually, representing about 6% of the government budget or 2% of GDP. Additionally, subsidizing energy costs as much as 6.6% of GDP and 20% of government spending. In this case, an "implicit subsidy" is being given that does not appear in the budget.
- √ Housing is also costly, authorities annually build about 175000 low-cost houses for the poorest. Such initiative would seem positive at first glance

however the supply is inefficient, the cost represents 3.2% of GDP and the measure has been tarnished by lack of transparency regarding who actually receives public housing and among who obtains the construction contracts.

√ Redistribution does not mean efficient inclusiveness in the Algerian case. The country is urgently in need of a "comprehensive institutionalized social protection system". Meanwhile, in order to promote youth participation and entrepreneurship, authorities offer microcredit to young entrepreneurs for self-employment. But, resulting projects are small, found in low-value-added sectors and do not contribute to economic diversification and new jobs. While a few have succeeded, they are usually those that received "privileged access to financing and contracts and enjoyed monopolistic or quasi-monopolistic positions in their markets, all in return for loyalty and kickbacks paid up the chain". In the end "these business elites resist any reforms that would open up the economy for entrepreneurship" (Achy, 2013).

a large share of oil income goes to subsidies, when excluding oil and gas the cost amounts to 3.8 billion US$ annually,

All in all there is a great share of income from the oil economy that could have been used in a myriad more effective ways to promote inclusiveness, foster productive employment or even simply alleviate the fiscal deficit, expected at -1.1% in 2013.

b. Can the upcoming elections have implications for fiscal policy ?

A growing literature suggests that elections can create distortions to economic policy, politicians being motivated to "direct" economic variables to some degree in order to get elected. Thus, could the looming elections in Algeria affect the short-term economic policy?

Sarantides (2011) argues that electoral incentives can have an impact on both the level and the composition of an economy's fiscal policy.

√ Policymakers that wish to be re-elected could re-orient public expenditure "towards more 'visible' current expenditure and away from less 'visible' capital expenditure in order to improve the voters' perception of their ability, thereby increasing the probability of being re-elected". This 'fiscal revenue' phenomenon occurs in developed and long established democracies (the focus group of the study).

√ The author highlights that in developing countries and in 'new' democracies one may more often observe a "budget cycle" instead of a fiscal revenue cycle. A general feature of political

Table 1.
Public Finance Indicators

	2011		2012			
	end Sep.	end Dec.	end Mar.	end June	end Sep.	end Nov.
Budget revenue	4442	5790.1	1468.8	3355.3	4922.6	5824.1
of which hydrocarbon	3070.2	3979.7	980.4	2304.5	3296.1	3850
Budget spending	4096.3	5853.6	2016.1	3857.1	5292.7	6346.2
Overall Balance	227.5	9833.3	-550.3	-517.7	-374.9	-514.6
Funding						
Banking	-611.9	-558.8	-120.6	-224.9	-331.6	-203.5
Non-banking	383.8	728.1	671	744	708.5	720.5
External (net)	0.6	-0.8	-0.2	-1.3	-2	-2.4

Source: Bank of Algeria

budget cycles (PBC) models is the existence of some uncertainty concerning the policymakers' competence. Thus, the latter has an incentive to manipulate fiscal instruments, if voters' expectation regarding competence depends on the value of this instrument. Such models predict a negative impact on taxation but aggregate public spending may rise "as the incumbent will have an incentive to increase expenditures in the election period financed by a deficit observed by voters in the postelection period". However, public spending may also fall "as a rise in the incumbent's level of effort will limit 'wasteful' public spending'".

In the case of where Algeria falls regarding these prior comments the situation is not initially clear, whether the country is a "new" or "old" democracy can be debated and the issue of re-election is not relevant. However, there is an issue of transition at stake and the electoral impact will be great. It is not far-fetched to assume that the current authorities will wish to have a smooth transition to a figure that endorses past policies and allows for continuity.

Was there a shift in fiscal policy, at least to some degree? The fact is that there has been surge in current spending that already occurred during the past three years (civil service wage increases and back payments) and already weighed-on the fiscal position. Hence, if we were to believe the theory on electoral incentives, Algerian policymakers that wish for a smooth-transition chose to re-orient public expenditure "towards more 'visible' current expenditure adopting a 'fiscal revenue cycle' that is more in line with practices of old democracies.

However, the rise in current spending does not mean that it has been politically motivated, at least not in its entirety. As noted by Schuknecht (2000), in developing countries public works projects can be easily started and stopped when close to an election period whereas current expenditures are a longer-term guarantee. The fiscal space of the Algerian authorities is also limited and thus an irresponsible and opportunistic fiscal policy would not seem as a realistic choice.

Hence, one could say that signs point towards a very careful stance on the authorities behalf that try to ensure smooth political transition.

I.7. Monetary policy

One of the main objectives of the Bank of Algeria is controlling inflation, hence, it carefully monitors inflationary processes and controls the money supply. It is expected that it will continue purchasing excess deposits in the banking system « but will probably be ineffective given the poor policy transmission mechanisms in Algeria's banking system » (EIU, 2013). Indeed, the Bank of Algeria pursues its efforts of managing excess liquidity. The reserve requirement ratio for banks increased to 12% in May. Despite the contraction observed in 2009 under the influence of lower oil revenues, excess liquidity persisted and seemed to be structural (Chafaï, 2013).

But, while liquidity absorption was increased in May along with the reserve requirement rate, interest rates were not. It appears that additional monetary policy tightening is required to combat inflation; while last year's decisions reduced free liquidity and the rate of inflation they were apparently insufficient to reduce to the level that was initially aimed.

As noted by the IMF (2013) "mopping up excess bank li-

Table 2.
Evolution of the Exchange rate

	Q2 2012		*Q3 2012*		*Q4 2012*	
	Quarter average	*End of period*	*Quarter average*	*End of period*	*Quarter average*	*End of period*
US$	*75.605*	*78.858*	*80.476*	*79.329*	*78.952*	*78.103*
€	*101.202*	*101.198*	*101.908*	*102.564*	*102.401*	*102.947*

Source: Bank of Algeria

quidity should be pursued and supplemented by raising the discount and repurchase facility rates to nudge up savings returns" and "measures to encourage savings, notably in the housing sector… and to deepen financial markets would contribute to reducing consumption and, hence, to easing inflationary pressures". The central bank has a comfortable stock of foreign exchange reserves, which shall help maintain exchange-rate stability.

II. Structural challenges: Promote innovation and inclusiveness

II.1. Limited competition that coexists with limited innovation

In his discussion on grounding endogenous growth in a resource-advantage (R-A) theory, Shelby D. Hunt (2012) argues that one of the prerequisites for a theory that could potentially ground endogenous growth models is that innovation should be a result of competition. In that respect, two different types of innovative behaviours are identified: those that are proactive and those that are reactive. An example of proactive behaviour is when a firm's market research finds a previously "unserved market segment" and "tailors a market offering for it". The author argues that when a proactive approach yields innovations that contribute to efficiency, firms will be rewarded by marketplace positions of competitive advantage and achieve greater financial performance. On the other hand, reactive innovative activities follow when poorer financial performance "signals firms" that their comparative disadvantage in resources has resulted in their inhabiting competitive disadvantage positions. Imitation of the "advantage-producing resource" ensues; firms in comparative disadvantage in resources seek to innovate by necessity.

The issue with Algeria is that any real efforts for innovation have been prevented by the chronic lack of competitiveness within the domestic market. Currently, Algeria stands at the 156 place among 185 economies on the ease of starting a business which limits competition. It is certainly not easy for an entrepreneur in Algeria to start a business, 14 business procedures are needed which is as many as a decade ago and almost the double of what is asked in the region on average. Starting a business is also very time-consuming, about 25 days are needed in Algeria versus 12 for MPs as a whole. Recently, the prime minister promised to improve the business climate and the environment for industrial firms, announcing a series of measures in favor of state-owned industrial firms. Public companies that already benefit from a "mise-à-niveau" program will also profit from improved funding conditions (Elmoudjahid, 2012).

This latter point is of crucial importance, we noted in last years' report how the share of firms using banks to finance investment decreased considerably in the latter decade, while at the beginning of the 2000s the share of Algerian firms using banks was above the regional average and close to the ASEAN economies average, in later years their share fell considerably (below 10%).

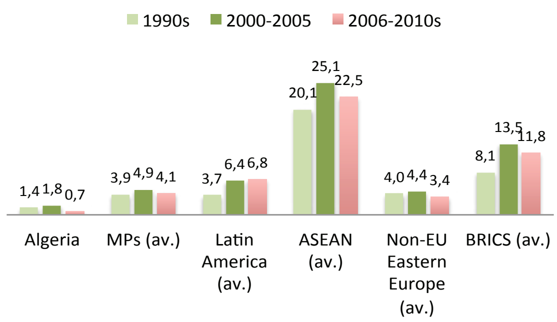
Thus, it is not surprising to find that the number of patents, trademarks and industrial designs has been consistently below the regional average during the last 15 years, suggesting a very limited innovation output (see annex). The level of high technology exports as a share of manufactured exports, while above the MPs average in the late nineties and early 2000s is now practically inexistent.

Some other indicators that could be linked to the "culture of innovation" are slightly more promising. For instance ICT services exports as a share of total exports more than doubled between 2005 and 2011, they represented 29.2% in 2005 versus 61.7% in 2011. Additionally, subscribers to mobile telephone lines (per 100 people) went from 0.28 in 2000, to 41.5 in 2005 and about 99 in the year 2011. Likewise, while not as marked, the share of Internet users per 100 people developed positively, from 0.49% in 2000 to 14% in 2011 (FEMISE-EIB, 2013, forthcoming).

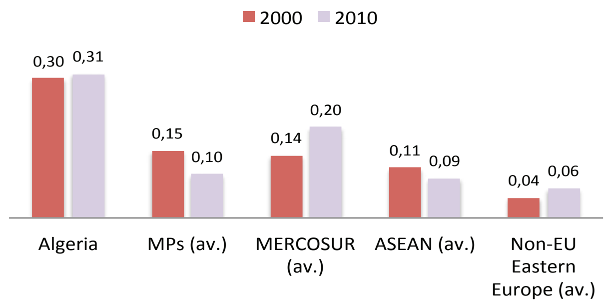
ALGERIA VERSUS THE WORLD: A GLIMPSE AT SELECTED STRUCTURAL INDICATORS

Figure 6.
Integration dynamic that is lacking (selected indicators)

a. High-tech. exports (% of manuf. exports)



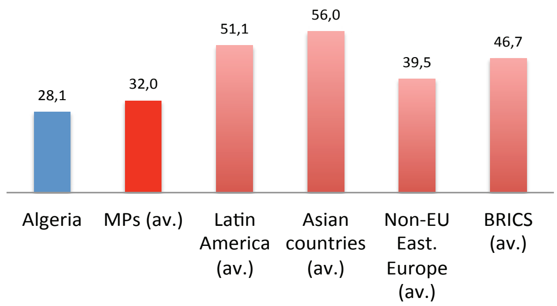
b. Trade Concentration Index



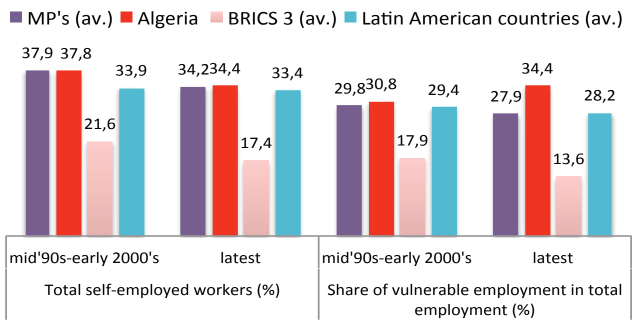
Source: WDI, FEMISE calculations using Tradesift and Comtrade data, based on SITC rev3 3-digit data.

Figure 7.
Domestic labour market dynamic, issues still unresolved (selected indicators)

a. Labour force participation rates, 15-24 (%)

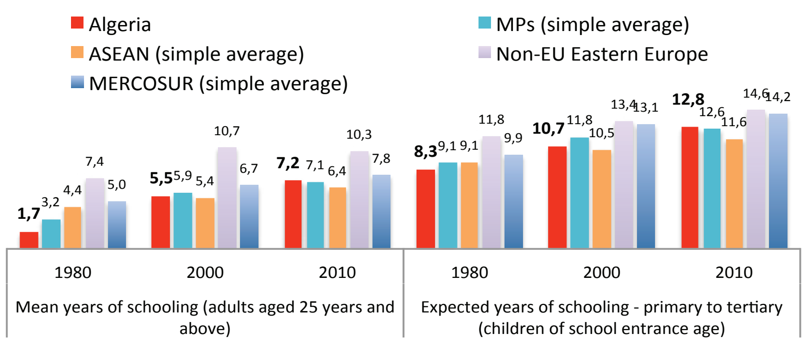


b. Informality and quality of employment



Source : IMF, World Economic Outlook database April 2013 (latest) and EIU

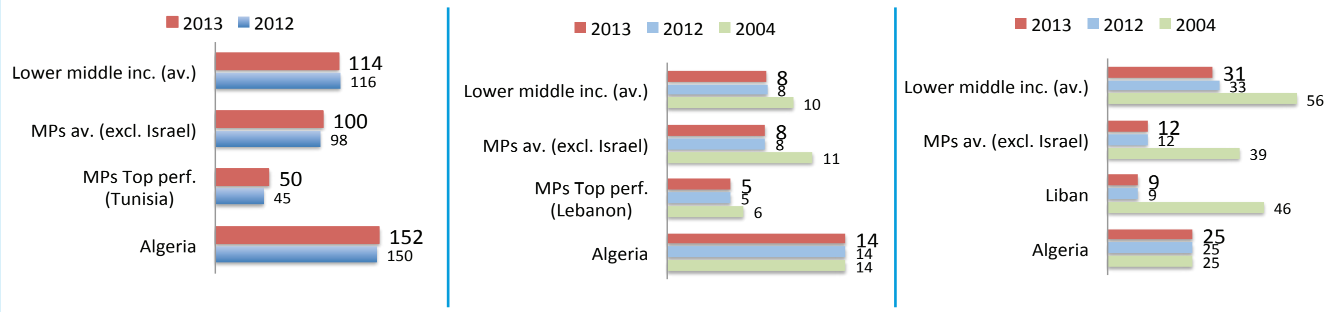
Figure 8.
Social dynamic appears to have improved (selected indicators)
HDI components related to schooling



Source : IMF, World Economic Outlook database April 2013 (latest) and EIU

Figure 9.
Evolution of selected Doing Business Indicators

a. Ease of Doing Business Rank — *b. Starting a Business (proced.)* — *c. Starting a Business (days)*



Source: Doing Business database (latest)

Last but not least, the number of scientific articles published by Algeria annually has considerably increased in the latest decade. The number of articles published by Algeria in the 1996-2011 period is slightly lower than the MPs average (excluding Israel and Turkey) but above it for 2011 alone. However, a remark in relation to quality should be made, the number of citations received per Algerian document in 2011 is about 28% lower than for an average MPs paper, an indicator that suggests that the impact of Algerian documents is low and has also decreased over the years (in 2000 citations received per Algerian document were only 8.4% lower than for an average MPs paper). Another remark, again linked to quality, confirms the observations above. The h-index (appendix), which attempts to measure both the productivity and impact of the published work, seems to be lower in Algeria when compared to the rest of the region, suggesting that scholars in the country perform worse than those in the rest of the region.

II.2. Some innovation efforts that can be deepened

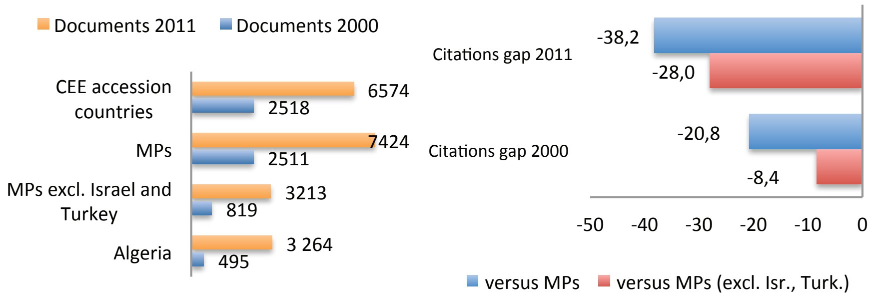
Some efforts of innovation in specific sectors have been undertaken or announced, they are those that need to be deepened and/or replicated and serve as a foundation for a pro-innovation strategy that fuels the new development model (FEMISE-EIB, 2013):

√ As part of the effort for innovation promotion and diffusion in Algeria, authorities had launched the **e-Algeria 2013 strategy,** which aimed to encourage information technology and communication and establish the country in the knowledge economy by 2013. More specifically, e-Algeria 2013 was a multi-sectoral program established to designate the objectives and initiatives to be undertaken in five years starting from 2009. The strategy was structured around 13 key areas such as increasing the use of ICT in public administration, in firms, providing access to equipment and ICT networks to both households and SMEs, strengthening the communication infrastructure, contributing to the development of human skills, of research and development innovation…

√ The **renewable energy sector** has also seen a number of initiatives contributing to the promotion of innovation in Algeria. Such initiatives include projects such as the promotion of renewable energy in rural Algeria and the Saharan region (wind farm project in Adrar) and improving the energy efficiency in the production of cement (the pilot Meftah project). In addition, other projects on renewable energy were launched such as the Zafaran wind farm, the proposed water pumping Toschka project and the Solar food dehydration project.

√ **Education** in Algeria has also seen some innovations which have contributed to an improvement in the social dynamic (more particularly with an increase in the duration of schooling). For instance, the National Center

Figure 10.
Journals and country scientific indicator:
a) No of documents (2000 VS 2011) ***b) Citations per Document gap* (%)***



Source: SCImago Journal & Country Rank (SJR)
** FEMISE calculations based on SJR, the index measures in percentage terms how many more/less citations per document the country receives when compared to the regional average. Ex. a value of -10 means that the country receives 10% less citations per document compared to the MPs average.*

for the Integration of educational innovations and development of ICT (Centre national d'intégration des innovations pédagogiques et de développement des TICE) was founded in December 2003, providing a coordinating role in infrastructure, equipment, means of communication and management and also the production of educational resources. Among the innovative initiatives that had the strongest impact, one finds Computer Aided Learning (Enseignement Assisté par Ordinateur), a technology that allows using the computer as a teaching machine brought to replace the teacher, offering content and exercises to be widely disseminated. Lastly, four operational projects structuring the development of ICT in education have been implemented: the progressive creation of a Digital Work Environment (Environnement Numérique de Travail, ENT), the establishment of a Bank of Educational Resources (Banque de Ressources Pédagogiques, BRP), the development of tools and e-learning methods provided by the ONEFD and CNEPD and the use of ICT in schools (self-training etc).

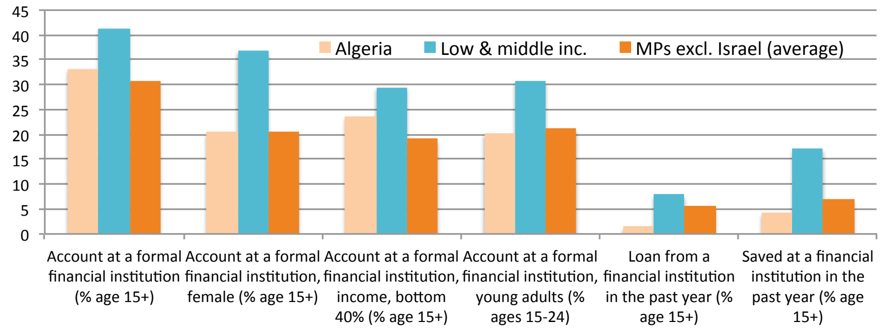
√ **The health sector** has also been marked by some innovations. Since January 1999, the «Health Algeria» network is fully operational, puting in place a number of actions for the integration of new technologies of information and communication in the health sector. Telemedicine allows "connecting" health facilities in Algeria but also allows opening-up to Europe. For hospital doctors, telemedicine can essentially contribute to the opening up of remote areas of large cities in order to bring more modern means of communication (e-mail, file transfer, etc..). Among the events related to the development of telemedicine projects in Algeria one finds the VSAT (Very Small Aperture Terminal) to put into practice space technology along with terrestrial technologies already implemented for applications such as tele-education and tele-radiology.

√ **Science and technology parks** have also been initiated. For instance, the project of Sidi Abdellah includes three technology parks that shall accommodate companies specializing in technology. The Sidi Abdellah Cyberpark will serve as a physical and virtual platform for ICT initiatives in Algeria and will provide technical assistance to businesses in the country, diversify the value chain and stimulate ICT exports. The El Bustan (EB) technopark will fit into the framework of the promotion of the following areas: electronics and biotechnology, while the Sidi Bennour Park will focus on the food industry and the Ibn Sina park shall encourage the development of sectors such as biotechnology, health, ICT, tourism and engineering.

The issue with all these initiatives is that they have either been underperforming or at still at an infant stage. They may be at an early stage or launch or not even active, thus there is a significant gap between what is sometimes proposed in theory and what happens in reality, though this phenomenon is not limited to Algeria.

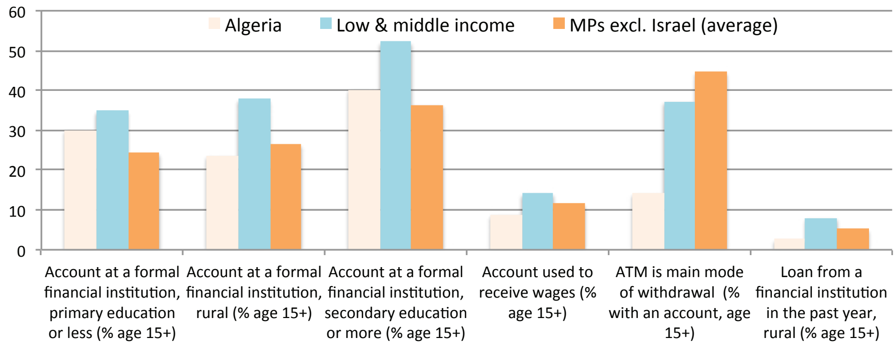
II.3. The need for financial inclusion and women entrepreneurship

Figure 11.
Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

Figure 12.
Second set of Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

But, innovation and competitiveness are only a first step; the essential need is for Algeria to efficiently be able to distribute its fruits of growth whatever the development model selected. In last year's report we highlighted that, both from an economic and social standpoint, Algeria appears to have a very low capacity in offering opportunities and its model is not particularly inclusive.

As we can see in Figure 11, limited access to financial tools is also an issue deeply connected with the inclusiveness (or lack of) of all parts of the population. As a matter of fact, the level of financial inclusion in Algeria is close to the average regional level, which is low. Most particularly, one notes that the percentage of people with an account at a financial institution is slightly higher than what one finds in the region (+2.5 percentage points) though the rate is lower for young adults compared to the region (-0.9 percentage points). Meanwhile, the share of the population that saved at a financial institution in the past year is low compared to the region (4.3% versus 6.9%). On a more positive note, when looking at the poorest 40% of the population one finds that in Algeria 23.7% of them possess an account versus only 19.1% in the region. Even so, the level of financial inclusion is very low compared to the average level to be found in low & middle-income economies. For instance, the share of women with an account is of 20.4% versus 36.8% in similar countries. The rate is also considerably lower for the Algerian youth, only 20.3% have an account versus 30.8% in low & middle-income economies. The share of the population that saved at a financial institution in the past year is comparatively four times lower while the share of people that took a loan in the past year is of only 1.5% versus 7.9% in low & middle-income countries.

Thus, in terms of financial inclusiveness Algeria needs massive efforts. When looking at a second set of indicators we can identify specific aspects of financial exclusion in Algeria. First, the share of Algerians using ATMs (14.2%) appears considerably below the MPs average level (44.7%) suggesting limited banking integration and considerable financial exclusion. Second, the more educated are also those best integrated financially, the share of people with an account rises from 30.1% for those with primary education to 40.3% for those with at least secondary education. Even so, such performance is below levels found in countries with a similar development level though it remains higher than the MPs average. Third, there appears to be a phenomenon of rural exclusion, indicators show that the share of people in rural areas having an account is close to 23.6% (versus 26.5% for MPs and 37.9% for low and middle-income countries). Moreover, the share of rural individuals obtaining a loan was among the lowest in the region (2.6%). Also, the share of people using their account to receive wages was minimal suggesting a high share of informality.

Lastly, a rare case that seemsto occur in the Algerian labour market "the only positive element to be highlighted is the increase in the participation rate for women which was of 15% in 2011 versus 11.9% in 1999" (FEMISE, 2012). Yet, the share is lower when compared to the already low regional average (20%). The truth is that the government has sought to encourage female participation; it tried to incite entrepreneurship within the private sector and amongst SMEs regardless of gender. But, women face higher barriers due to deep-rooted social and cultural beliefs.

Offering women "with business training at both the university and post-university levels is essential…by empowering them with knowledge and skills, they will be in a stronger position to manage business projects more successfully" (OxfordBusinessGroup 2012). Promoting female participation and entrepreneurship is also linked to the economic growth model and progression in terms of democratisation that is needed. In that respect, "civil society groups can be powerful tools… through both financial and legal backing, and also offer higher visibility and improved technical guidance by pooling firms or projects" (OxfordBusinessGroup 2012). The lack of participation in regional initiatives, such as the recent UfM project aimed "at motivating and training 10000 female university students to become successful entrepreneurs and future employers" (ANSAMed, 2013b), needs to be remedied as well.

III. Conclusions

III.1 Potential axes for reforms to start

In terms of macroeconomic performance Algeria is expected to perform well and even better than in 2012. GDP growth is expected to exceed 3%, above the recent post-crisis average, public spending will be resilient and hydrocarbons will keep supporting the external balance and the domestic budget. Among recent measures the country authorized documentary discount (Remdoc) as a means of payment for imports (Article 81, Finance Act 2014).

Yet, the fiscal stance is not what it used to be, inflation could be reaching a 15-year high and economic diversification is still very limited.

In Algeria "oil and gas account for around 40 percent of total GDP. 98 percent of Algeria's exports. And about two-thirds of budget revenues. At the same time, these sectors only provide jobs for about 2 percent of the population" (IMF, 2013b). Clearly, this development model cannot be a durable foundation for employment and inclusive growth. If we are to believe projections "in 2025 Algeria will no longer be in a position to rely on its oil resources, as they will be exhausted" (OxfordBusinessGroup, 2012). Therefore, finding alternative means of financing economic development is a necessity.

- √ Indicators of inclusiveness show a weak performance. Innovation performance in Algeria is also limited at best. An energetic private sector is thus needed; one with proactive behaviour that seeks unserved market segments. The private sector will need to develop so as to foster inclusive development and future jobs.
- √ The domestic policy shall be friendlier towards foreign investment. The authorities will need to progressively remove their inflexible approach vis-a-vis foreign investment. The reform of the hydrocarbons law incites foreign investment but "foreign investors remain restricted to minority stakes in investments in Algeria" (EIU, 2013).

- √ One of the major obstacles to an effective reduction in the unemployment rate is the resurging inflation risk. Expansion of aggregate demand to boost employment may cause additional inflationary pressures and/or distort the sectoral structure of prices. Algeria also remains a major importer of agricultural products; it will need to find policies to lessen its agricultural dependency if it wishes to reduce its vulnerability to swings in international food prices.
- √ Recent policies to support employment have resulted in the creation of numerous small entreprises mainly oriented towards trading and service activities. They can be a breeding ground for entrepreneur, provided they are the subject of genuine policy monitoring.
- √ The national dependence on imports is harsh and impacts both the external balance, fiscal balance and domestic prices. To remedy this situation, a better business climate will be needed with an economic policy that favors innovation, creativity and entrepreneurship.
- √ Meanwhile, one of the principal obstacles to economic reform has been political; Algeria heavily relied on oil-income and its redeployment to the "political clientele" contributing to the survival of the unfair bargain. Undeniably, any effort for change can be perceived as a threat to these interests and result in unwanted reaction.
- √ Lastly, "macro-level, informal institutions as moral codes can contribute to (or from) firm-level, superior financial performance. Societal institutions that promote social trust also promote the wealth of nations (Shelby D. Hunt, 2011). Efforts for additional transparency in governance and institutions will be a pre-requisite for growth.

III.2 Improving investment conditions and deepening integration

Progressively, Algeria has to come to terms with the fact that it will have to build a new growth strategy and focus on sectors that have the biggest likelihood to carry future jobs and growth, fiscal conditions being tighter. The potential is there, contrary to what one might expect, human capital also has been a main contributor to growth and Total Factor Productivity TFP was close to be growing at a positive rate in the 2000-2006 period (FEMISE, 2010). While productivity is conventionally the key determinant of per capita income, human capital accumulation has a major impact to productivity variation. Algeria actually bodes well in TFP terms compared to the regional average in all sectors but the food industry. Meanwhile, larger firms are usually synonyms of greater productivity but not in all sectors (FEMISE, 2010). The fact is that investment projects must be related to productivity and not strictly political criteria. This can allow for private investment, most particularly FDI, to participate in the effort as well. Which brings us to the fact that investors are attracted by "a stable climate and predictable conditions" (WiltonPark, 2012). In that front, Algeria is thus in competition with other emerging economies that seek to provide the most stable investment climate possible.

> ***investment projects must be related to productivity and not strictly political criteria,***

To create the right climate two types of policies could be needed. The first are foundation policies to produce a suitable basis for a "rules-based system" and "with legal security provided by the court system and effective competition policy" (WiltonPark, 2012). The second are active policies for skills, workforce flexibility and inclusiveness for all (especially women and the youth). To improve investment conditions authorities could start :

- √ **Limiting the frequent introduction of amendments to the complementary finance law**; it can be perceived negatively by foreign investors who must wait for additional legislation every year. A mechanism similar to the one of the Tunisian Chamber of Commerce would allow "dialogue and a debate between the government and its partners on various economic matters" (OxfordBusinessGroup, 2012), an agreement on the economic strategy to follow that induces credibility on all fronts.

√ Realizing that **red tape must once and for all be dealt with**. It takes 14 procedures and 25 days to start a business, about 451 hours each year for a business to pay its taxes and about 630 days (almost 2 years) to enforce a contract (IMFb, 2013). Widespread efforts are needed to make it easier to start and to manage an enterprise.

Creating a sound edifice for economic integration would give Algeria a greater degree of much needed "predictability" but also contribute to inclusive growth. In that respect, the issue of trade integration is an interesting one since it "can deliver growth on a scale that would create enough jobs and prosperity for Algeria's young and growing population" IMF (2013b). If we take the case of Asia for example, trade integration and most particularly intra-regional trade has greatly contributed

Creating a sound edifice for economic integration would give Algeria a greater degree of much needed "predictability"

to a fruitful development model. Yet, the situation is not as simple and integration could only be efficient if Algeria (but also other Maghreb countries) is able to "increase democracy" and to implement the structural economic reforms necessary to open its economy and allow it to become more competitive. Potential is definitely there but political will should be stronger.

Let us note first that the links between Algeria and the EU are of capital importance, the latter is by far Algeria's biggest trading partner and Algeria represents a key supplier of natural gas to the European market. Yet, progress on opening-up to trade and making progress in bilateral relations has been slow, especially when compared to relations between Morocco and the EU. The Algerian authorities even decided to postpone full implementation of the framework with the EU, in August 2012 Algeria and the EU decided to delay by three years the full implementation of the free trade zone which was envisioned. More particularly "tariffs on 82 products (including cars and electric motors) that were due to be removed in September 2012 will remain in place until 2016, while the full implementation of the zone will be delayed from the initially envisaged application date of 2017 to 2020" (OxfordBusinessGroup, 2012). In that respect, one could say that domestic authorities do not have enough faith in the process of Algeria-EU integration.

Secondly, let us highlight that non-oil exports do not exceed 3% of the overall level of annual exports annually, despite various measures that have been undertaken in the last five years. As noted by the president of the Association of Algerian exporters, companies simply do not have the will to move towards exports; only four exporters realize 83% of export earnings (nearly half by Sonatrach, followed by Fertial for ammonia products, Cevital for the agribusiness and Somiphos for phosphate goods. When excluding these four companies only 500 million US$ worth of exports remain that was shared by more than 400 exporters (Lemaghrebdz, 2013). It appears that Algeria has a huge potential for exports of agricultural products yet implementation of concrete decisions to upgrade the overall business environment and export promotion is lacking. The country has a very large capacity to export agricultural goods to the EU, yet, the country exports about 30 million US$ worth of agricultural goods, when Morocco exports more than 3 billion US$, even though the country possesses 8.5 million hectares of agricultural land. Hence, assistance must be provided to those who specialize exclusively in export activity (L'EcoNews, 2012). Meanwhile, it still remains to be seen if the EU has the determination to offer "real improved access" to the European market for Algerian exporters in case bilateral relations go forward.

Thirdly, one must also not forget that intra-regional integration is harder to achieve than in other regions, Algeria and neighbouring countries "would also need to remove some of the constraints to (Arab Maghreb Union) AMU construction and which include political will, the way AMU is organised, the communication among AMU countries" etc (CEPR, 2013). All in all, "a more open economy is certainly needed to bake a bigger pie. But what ultimately matters is that all Algerians get their fair share of the pie" IMF (2013b).

Naturally, all these things cannot happen overnight. There is definitely a "path dependency" effect related to the historic predominance of the public sector, "there are therefore new habits to be formed, substituting a proactive public market approach based on consultation and partnership for the past inhibitions of State intervention" (FEMISE-EIB, 2010). But, mentalities can evolve. A recent example of integration that allows for the creation of jobs and sustained development is the one of "SGP-manufacturières" which signed a partnership agreement with the Turkish Taypa group for the making of an integrated complex dedicated to textile trade. This project is expected to generate more than 10000 jobs and bring about 50 billion dinars (500 million €) worth of income in five years. But the agreement also seems to be part of a long-term vision; it includes the construction of eight industrial units in textile and clothing, a business center and a school for training in the textile and clothing industry. About 60% of the textile fabric will be destined for export while the rest will go to the garment industry to produce clothes for the local market (Econostrum, 2013).

III.3 Mitigating the dutch disease in Algeria through more private investment and monetary policy

According to Chekouri et al (2013) the domination of the hydrocarbon sector has played a significant role in waning domestic incentives to develop the production of other tradable goods. Through oil-price volatility, the sector contributed to the distortion of the tax structure by disregarding alternate sources of income, inducing a slowdown in non-oil activity. The authors argue that "this resource curse is best explained by the Dutch Disease hypothesis" and that they "could also apply the rentier state theory for the economic deficiencies, since both explanations are mainly due to the lack of democracy, corruption, poor institutions and a renk seeking attitude". Allegret and Ben-Khodja (2013) confirm that the Dutch disease ensues mainly in high oil dependent countries such as Algeria with the manufacturing production decreasing after a positive oil price shock.

A change in the structure of the domestic economy should not be expected in the short run, it could however happen in the longer-run if some conditions are met. Authorities need to start giving less importance to investment in the oil-sector, the 32 billion US$ attributed to raise Algeria's share of oil production in OPEC in 2009 could have been invested for diversification purposes and to increase jobs in alternative growth carriers.

Algeria needs to reduce the gap between oil and non-oil activities, the latter could improve the structure of exports and lead to the formation of several productive activities, develop SMEs, foster employment opportunities and increase growth. Furthermore, the country should invest intelligently, investment has been important in construction and public works but this is a non-tradable sector and its development cannot induce the same spill-overs effects that one finds in tradable sectors.

Meanwhile, as suggested by Allegret and Ben-Khodja (2013), monetary policy can play a key role in avoiding the Dutch-disease fall-back effect. The authors evaluate the efficiency of two policy rules, these are exchange rate (ER) and inflation targeting (IT) rules. The rational is that since the Dutch disease takes place under the influence of "spending and resource movement", it could be avoided through either the ER rule (fixed exchange rate which "locks" the spending effect) or through the IT rule (inflation stabilization and with wages indexed to prices the resource movement effect is prevented). Their findings suggest that in Algeria the inflation targeting rule is the one with a "stabilizing influence" being more efficient "to contain the occurrence of the resource movement effect" while the exchange rate rule, which may work well in other countries, bears the lowest welfare.

III.4 Movement towards better governance and institutions

A comment also needs to be first made on the characteristics of the Algerian governance system; they have considerably evolved in the last decade all the while retaining some features dating from the «socialist» period. Three periods can be identified (FEMISE, 2006) :

- √ the "Promethean" state one, in which the state has the will to profoundly transform the domestic society, with continuous efforts to move towards a form of state that is new or revolutionary;
- √ the welfare state period which appears as a benefactor to the society promising to safeguard the benefits of development and of oil revenues;
- √ the regulator state period, in which it seeks to reintroduce society in the process of political and economic decision, but all the while controlling this transition process to avoid any sorts of risks.

We could say that Algeria falls mostly in this third phase but the state needs to progressively loosen its grasp on the process. Undoubtedly, considerable progress in terms of institutions and governance has been made. Government effectiveness, which comprises perceptions of the quality of services provided by public authorities and is a measure of credibility and policy implementation quality, greatly improved in the last decade. Meanwhile, control of corruption also improved (FEMISE, 2011). But, there is still a long way to travel to fulfil the criteria for what would qualify as "good governance". The decision-making process is overly centralized, no credible political alternatives are being offered to counterbalance the authorities, information regarding the social and economic state of affairs is often limited and freedom of expression could be strengthened, as suggested by the low levels of the voice and accountability indicators (FEMISE, 2011).

The objective should be to change a mode of operation based exclusively on centralized management and hierarchical control to a more flexible and independent one that is more focused on results. Naturally, such evolution cannot be conducted without compromising certain privileges and without shaking certain bureaucratic foundations. However, the process must avoid undermining other traditional administrative values upon which the notion of the public service rests and must also allow for the necessary strengthening of the principles of equality, impartiality and continuous adjustment to new processes (FEMISE, 2006). More specifically, reforms in governance could focus on :

- √ **Bringing more transparency in public affairs**. To make credible assessments and avoid potential uprisings, the regime must evolve further away from the authoritarian bargain, authorities must strengthen the transparency of political and administrative decisions in a regular and timely way. Transparency is thus needed regarding the appointment of senior state officials as well as in public expenditures and statistical information for economic and social data.
- √ **Ensuring the judiciary system shows impartiality** by strengthening existing monitoring systems and putting in place mechanisms and incentives of impartiality of state action. Currently, the judiciary seems "neither independent nor impartial in civil matters and lacked independence in some human rights cases. Family connections and status of the parties involved influenced decisions" (State Department Human Rights Report, 2012).
- √ **Establishing a better balance in decision-making** at both the central level (between the legislative, executive and judiciary) and the local level (real decentralization, particularly in terms financial and tax for local communities) including a reflection on the emergence of possible new regional structures. A new sharing-based management should allow for more flexibility in decision making for regional actors.

√ **Strengthening a more effective participation of the opposition in policy debates** and allow a more frequent and regular access to public funding information (television and radio). Meanwhile, there is need to involve civil society more effectively in all debates of the society, including the involvement of non-governmental organizations. All in all, freedom of speech needs to be strengthened, Algerian human rights defenders and trade unionists face impediments in "exercising their right to protest" (Magharebia, 2012).

√ **Reforming the civil service** to make it more efficient, give a better sense of the public interest and the shelter of nepotism and corruption (FEMISE, 2006).

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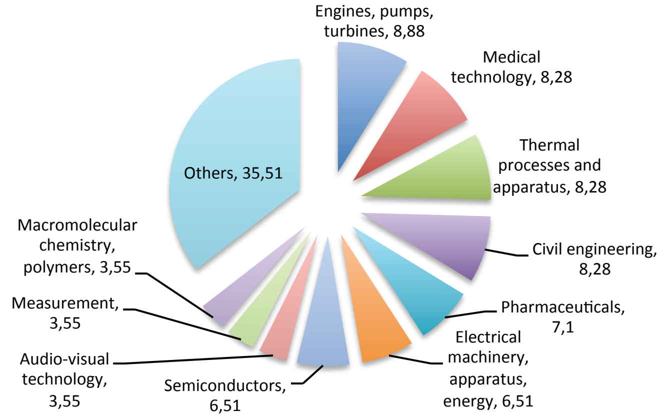
ANNEX

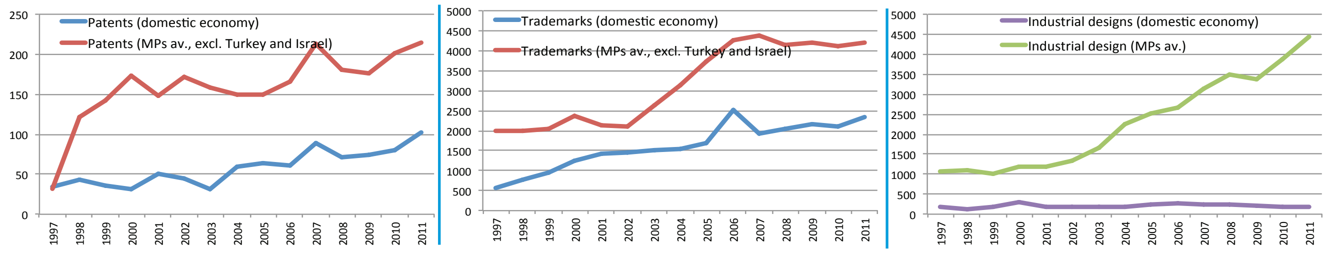
Figure A1.
Patent Applications by Top Fields of Technology (1997 - 2011)



Source: World Intellectual Property Organization

Figure A2.
Intellectual property indicators:

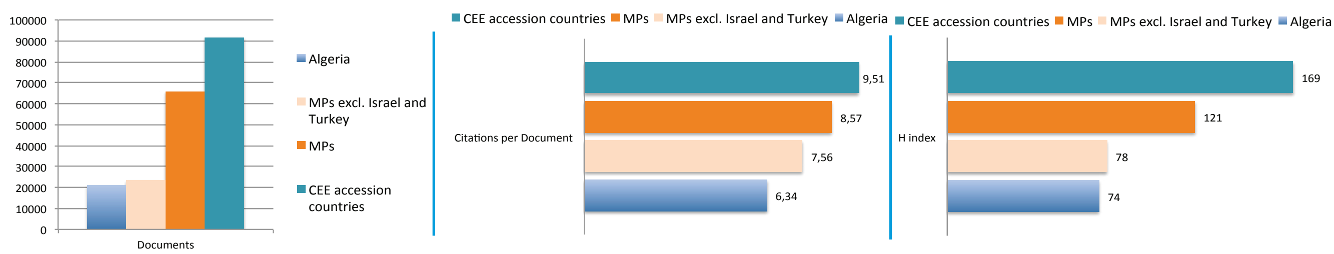
a. number of patents *b. number of trademarks* *c. number of industrial designs*



Source: World Intellectual Property Organization

Figure A3.
Journals and scientific indicators

a. H-index *b. Number of Documents* *c. Citations per Document*



Source: SCImago Journal & Country Rank (SJR), Note: Country's number of articles (h) that have received at least h citations

EGYPT

Egypt's double transition remains turbulent

Introduction

Almost 3 years after the 2011 popular uprising, Egypt's double transition, political and economic, remains complex. Achievements like ending the 16-month military rule, holding free parliamentary and presidential elections and even proceeding to write a new constitution were considered positive steps that would have put Egypt's political and economic transformation on the right track.

Yet, it is now apparent that the democratic transition is slow and is also associated with some setbacks. Free elections led to an Islamist-dominated parliament and brought to power a president, from the Muslim Brotherhood (MB). This success was due to a head start in organization and their ability to present themselves support as an alternative to the old regimes, thus securing popular support during elections. As the elected president and the MB showed signs of a lack of political inclusiveness, and as the "more secular" opposition (mainly the National Salvation Front which represent the leading opposition coalition) remain fragmented and unable to present a coherent counter proposal, competitive politics are still absent. In this context, it is clear that there is an erosion of citizen trust in governments, institutions, parties and politicians. Egyptian citizens seem to have thus resorted to "crowd democracy" to influence policy-making (Nawara, 2013) until political actors learn to present their ideas and critique those presented by others, to exercise their responsibility as opposition parties, and to govern through negotiation with others.

The most recent example of crowd democracy is the emergence of a youth movement under the name of Tamarod "Rebel", which helped mobilize nation-wide protests against the elected President on the 30th of June, 2013. For the second time, the military backed the uprising and ousted the elected president in early July 2013. These changes have increased political instability and have led to violent clashes.

The military appointed the Chief Justice of the Supreme Constitutional Court as the country's interim president and formed a new technocratic interim government. ***The following roadmap was announced for the coming 6 months:***

- √ ***Suspending the 2012 constitution and forming a new committee*** *that includes all societal segments to draft a new constitution. The new constitution is expected to be drafted by the end of October 2013.*
- √ *Urging the constitutional court to* ***approve the draft parliamentary election law*** *in preparation for parliamentary elections. Once the new constitution is drafted and approved, parliamentary elections will follow within a couple of weeks.*
- √ *Holding* ***new presidential elections,*** *a couple of month after a parliament is formed. This shall be by the end of 2013.*
- √ *Laying down a* ***media code of ethics*** *to ensure freedom of media and guarantee media professionalism.*
- √ *Forming a* ***national reconciliation committee*** *and taking immediate steps to include youth in the decision making process.*

This six-month timetable is likely to be missed, given the wide ideological gulf among the parties and the worsening violence. The political transition is likely to be protracted and challenged by *the difficulty in including all political factions in the transition. In this current set-up, political clarity is elusive.*

As the political uncertainty remains fluid and continues to unfold, the economy suffers. The time to act is now as economic challenges are a moving target. The new government must immediately develop a home-grown coherent reform agenda with clear policy objectives and the main tools to achieve them. The financing constraint has been temporarily eased following the reception of foreign aid from the Gulf. This should not be a substitute for providing more sustainable solutions to bridge financing needs. Activating the economy is an important goal but is likely to be constrained by fiscal sustainability concerns. Finally, political unrest should settle soon in order for economic reforms to reap their intended benefits.

In this context, economic growth has dropped from around 5% before the uprising to around 2% afterwards. Growth is expected to remain unchanged in FY13. The outlook for 2013 is as follows:

- √ ***Inflation*** *is expected to remain moderate at around 7% in FY13, down from 8.6% in FY12*
- √ *The* ***current account deficit*** *is expected to narrow in 2013 to 2% of GDP, down from 4% a year earlier on the back of subdued import growth*
- √ ***Exchange rate depreciation*** *is likely to accelerate. Despite receiving some foreign financing from neighboring Arab countries, downward pressures are likely to persist unless foreign exchange earnings bounce back.*
- √ *The* ***fiscal deficit*** *is expected to increase to 14% in FY13, from 10.8% of GDP in FY12 but is expected to come down afterwards.*

The new government has also announced a fiscal stimulus plan that should boost growth in FY14 to 3%. As announced by the government, this stimulus will be prudent so as not to compromise fiscal stability.

I. A 2012 / 2013 macroeconomic snapshot

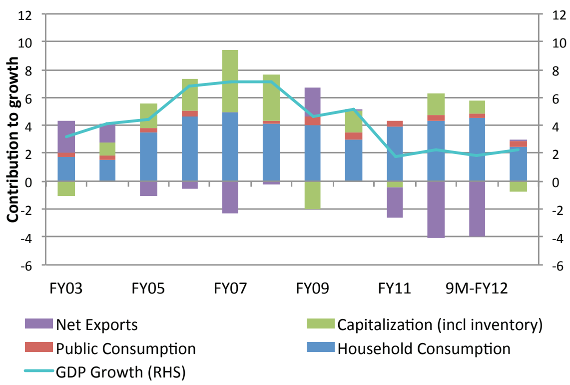
I.1. The Real sector and inflation developments

a) Private consumption is so far able to maintain some growth momentum

GDP growth in FY12 remained positive at about 2%, almost unchanged from last year's rate. A slight boost in growth in 9M-FY13 compared to last year's performance (to 2.3%, up from 1.8%) is driven by private consumption growth. The latter has started to taper-off to 3%, from 6% in 9M-FY12, though it was able to buffer the sharp drop in gross capital formation, which declined in 9M-FY13 by 4%, following a growth of 5.6% last year. In addition, the growth of net exports have waned on the back of significantly lower import growth (1.4% down from 11%) despite a small boost in export growth (by about 3% from 1.3%) due to improved growth in the Euro area, one of Egypt's main trading partners.

On the sectoral level, the services sectors have been relatively resilient to the economic downturn over the past two years, even though they still underperform compared to their pre-2011 levels. In particular, Suez Canal (which is more affected by the activity in international trade) and communications expanded respectively by 7.7% and 6%, followed by construction and real estate which on average grew by more than 3%. However, the tou-

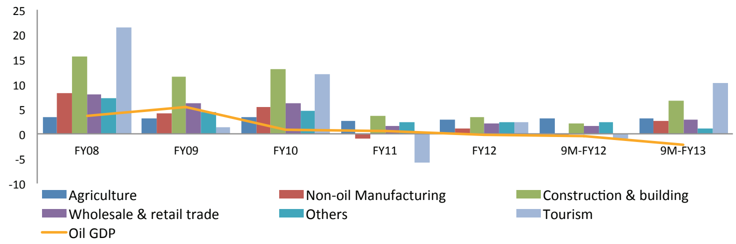
Figure 1.
Contribution to GDP growth, FY03 to 6M-FY13



Source : Calculated by author based on data from CBE rism sector continues to suffer, and has on average contracted by 2% over the past two years compared to a growth of 12% in FY10. The number of tourists who visited Egypt in 2012 went down by 22% compared to 2010. Meanwhile, the manufacturing sector performance has been very modest, with oil manufacturing sharply contracting by close to 3% and non-oil manufacturing witnessing almost no expansion over the past two years.

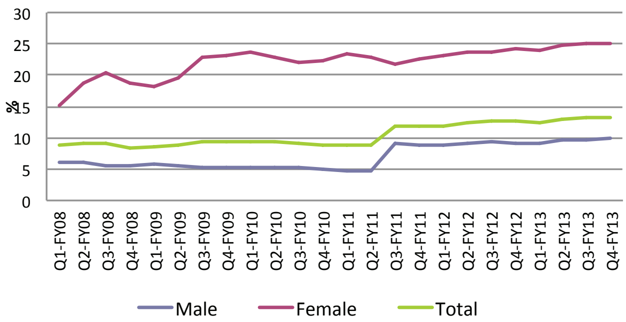
During 9M-FY13, some signs of a partial recovery were felt in some sectors including tourism (up by 10.2%, versus a fall of 1% in 9M-FY12), construction and building sector (up by 6.6% from 2%) and to a lesser extent non-oil manufacturing (up by 2.5% from -0.1%). However, oil GDP which has been witnessing a slowdown since FY10, contracting by 2.2% compared to 0.5% last year.

Figure 2.
Sectoral growth rates, FY08 to 9M-FY13



Source: Calculated by author based on data from MOP

Figure 3.
Unemployment rate, Q1- FY08 to Q4-FY13



Source: Calculated by author based on data from CAPMAS.

Growth is not likely to witness a strong pick-up in 2013. Going forward, a rebound in economic activity is really conditional upon a more stable political situation and the adoption of economic reforms that would tackle immediate concerns as well as long-term structural problems.

b) Job creation is low and unemployment is still on the rise

The slowdown in economic activity has affected job creation. Average employment growth which was about 3% before the political unrest fell to a low of -0.2% in FY12, and was almost nil in FY13 (0.4%). Similarly, unemployment has been on a rising trend since 2011. Recent estimates for FY12 show that it has reached 12.6% and further to above 13% in FY13 from about 9% before the uprising. This rise reflects a worrisome increase in male unemployment which almost doubled to 9.8% in FY13, up from almost 5% prior to the revolution. Female unemployment which has been historically significantly higher has also increased to 25% in FY13 from 22.9% before the revolution. Unemployment would be expected to surge even further if economic activity stalls.

c) Inflation is creeping-up

Inflation has been on a downward trend, declining to about 7% in FY13 from 9% in FY12 and 11% in FY11 on the back of decreasing food price inflation (which accounts for about 40% of household expenditure) to 8.5% in FY13, down from close to 11% in FY12 and 19% in FY11. However, after hitting a record low of 4.3% in November 2012 (the lowest inflation level since April 2006), this trend was reversed in the following months with headline inflation creeping up gradually and peaking at more than 10% in July 2013. This increase reflects supply chain bottlenecks and disruptions in the distribution process pushing food and beverage inflation to 14% in July 2013.

Meanwhile, core inflation, which excludes regulated prices as well volatile items such as fruits and vegetables, has remained low in FY13 at 6%, down from 7.6% in FY12, but was also subject to the same general increase over the course of the year.

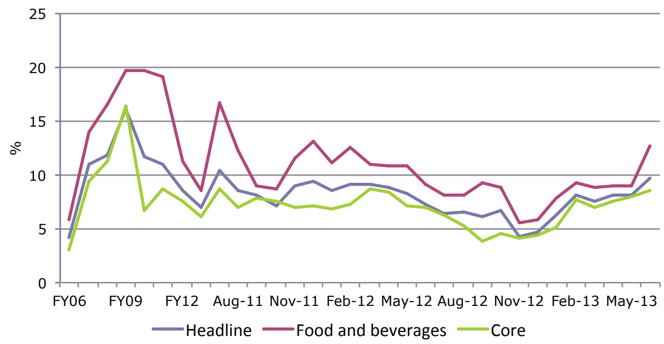
I.2. The external sector

a) Lower non-oil imports and investment income payments reduce current account deficit

The current account deficit was slashed from 4% of GDP in FY12 to 2.1% of GDP in FY13 mainly due to a large decline in the trade deficit and in services' payments. In fact, the merchandise trade deficit was cut to 11.6% of GDP from 13% of GDP a year earlier, on the backdrop of decreasing non-oil imports (from 18.4% of GDP in FY12 to 16.6% in FY13) and unchanged exports (around 10% of GDP). Meanwhile, the services surplus slightly increased to 2.5% of GDP from 2.2% of GDP in FY12, on the back of a decline in services payments, which was primarily due to a decrease in investment income payments by 0.5 percent of GDP. It is worthwhile to mention that tourism revenues (3.6% of GDP) and private transfers, mainly remittances (7% of GDP), have remained unchanged.

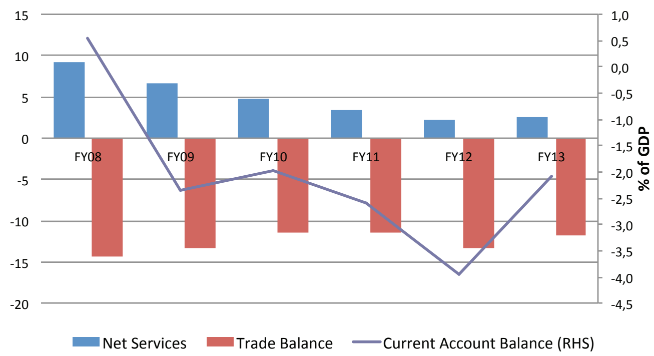
In the near-term, the current account deficit is expected to improve as export revenue picks up, import growth remains subdued and recent aid pledges from several Gulf Arab states. Remittances from Egyptians living abroad are expected to stabilize. These latter flows have reached a peak of USD 17 billion by end of 2012 (representing almost 7% of GDP).

Figure 4.
Inflation measures, FY06 - FY13



Source : Calculated by author based on data from CAPMAS and CBE

Figure 5.
External finances, FY08-FY13



Source : Calculated by author based on data from CBE, MOF

b) Portfolio inflows partly compensate for scarcity of FDI inflows

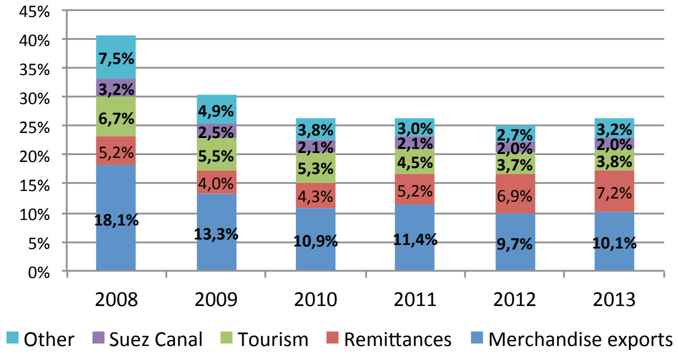
After taking a hard hit in FY11 and FY12, positive portfolio investment inflows have partly resumed in FY13 (to 0.5% of GDP from an outflow of 2% of GDP last year). Net foreign direct investment inflows remain low, at USD 3 billion (about 1% of GDP), down from USD4 billion (1.5% of GDP) and still far from pre-revolution levels of to 3.1% of GDP. FDI is expected to decline even further, as Egypt's political uncertainty has made it an unappealing place for investments. In the World Economic Forum's latest Global Competitiveness Index assessment, Egypt dropped by 13 positions to reach 107th place out of 144 countries for the year 2012-2013.

I.3. Macroeconomic management

a) Exchange rate management becomes more flexible and benefits from some capital inflows

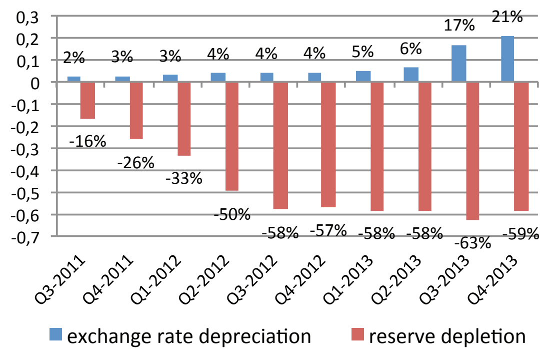
The Central Bank of Egypt (CBE) which initially implemented a tight management of the exchange rate, introduced more flexibility starting December 2012. By the end of FY13 (June 2013), the EGP depreciated against the USD by 21% compared to December 2010, with most of the depreciation occurring between December 2012 and June 2013 (14%). The downward pressure on the pound in 2012 reflected a drop in foreign exchange earnings to 25% of GDP from much higher levels in previous years.

Figure 6.
Foreign exchange earnings, 2008-2013



Source: Calculated by author based on data from CBE

Figure 7.
Cumulative change in exchange rate and net international reserves, Q3-FY11



Source: Author's calculation based on Central Bank of Egypt monthly statistical bulletin.

The CBE had increasingly resorted to the depletion of the country's net international reserves to support the Egyptian pound, countering the lack of capital inflows. By March 2013, NIR reached a record low of USD13.4 billion, falling by more than 60% when compared to USD36 billion in December 2010, prior to the revolution.

The CBE has been generally careful about not letting reserves slip below 3 months of imports and has benefited on several occasions from foreign currency deposits (and in some cases loans) made by neighboring countries. It is estimated that these deposits amounted to US$ 15 billion since May 2012, of which 7 billion were received in the wake of the second uprising wave of June 30th, 2013. Another US$ 5 billion are expected, bringing the total pledges after June 30th to US$ 12 billion. The recent boost in reserves in July 2013 to US$ 18 billion was largely due to deposits made by Saudi Arabia and United Arab Emirates to the CBE. Certainly, this type of external financing has contributed to temporarily ease the financing constraint but could not be considered sustainable and should not be a substitute for much needed reforms.

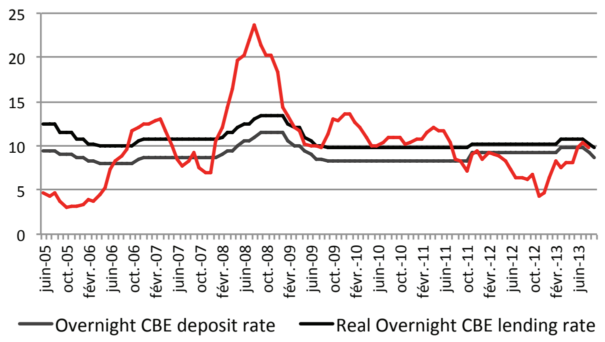
In addition to reserve depletion, the CBE introduced a new US dollar auction system in December 2012. Through the new system, a predetermined amount of USD is auctioned, and banks in need for foreign currency participate in the auctions. Through the USD auctions, the CBE has made its support to the Egyptian pound's stability more transparent to avoid speculation. The auctions did not stop the EGP from depreciating, but steadied its depreciation rate. They also did not prevent a black market for reappearing. In an attempt to rationalize the US dollar exchange, the

Table 1.
Deposits at CBE in FY12 and FY13, in US$ bill

Date	Country	Deposits/ loans
May 2012	Saudi Arabia	1
August 2012	Qatar	0.5
October 2012	Turkey	0.5 (loan)
October 2012	Qatar	0.5
November 2012	Qatar	0.5
December 2012	Qatar	0.5
January 2013	Qatar	2
January 2013	Turkey	0.5 (loan)
April 2013	Libya	2
May 2013	Qatar	3
July 2013	Saudi Arabia	2
July 2013	UAE	2
September 2013	Kuwait	2
September 2013	Qatar	-2 (returned)

Source: News sources

Figure 8.
Monetary policy indicators



Source: Official sources

CBE has raised currency exchange commission for both commercial and non-commercial purposes. Measures were also taken to control capital flight as the CBE decided to limit corporate withdrawals at USD30,000 per day. It is also still enforcing the individuals' one-time limit of EGP100,000 or its equivalent for transfers abroad, which was introduced in 2011.

The EGP is expected to keep depreciating as long as foreign exchange earnings (including tourism, exports, etc.) – which are also influenced by global economic conditions - do not rebound and Egypt's growing financing needs are not bridged.

b) Monetary policy stance oscillates between economic activity and inflation

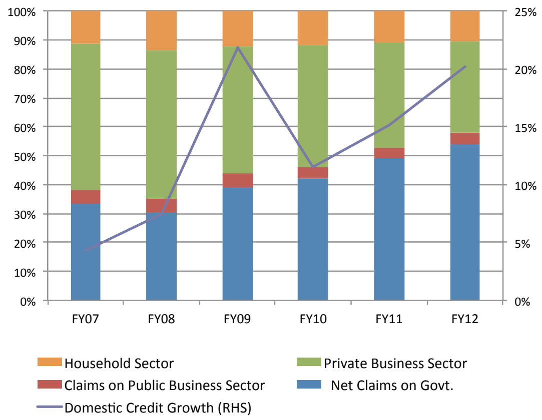
Since the popular uprising in January 2011, monetary policy was tightened only once in November 2011 and has remained rather neutral until March 2013, when the CBE raised policy rates once again to curb inflationary pressures that were induced by the exchange rate depreciation and the diesel distribution bottlenecks across the country. In fact, the overnight deposit rate and overnight lending rate were raised by 50 basis points to 9.75% and 10.75%, respectively. The CBE's one-week main operation rate was also raised by 50 basis points to 10.25%, and the discount rate was raised by 75 basis points to 10.25%. This restrictive stance was followed by a looser policy that manifested itself with two consecutive cuts in August and September 2013, each by 50 bps in order to support growth, especially in an environment where "risks to inflation outlook have moderated". Currently, the overnight deposit rate, and lending rates as well as the one-week main operation rate stand respectively at 9.25%, 10.25% and 9.75%. The discount rate was also cut by 50bps to 9.75%. With inflation creeping up close to the double-digit levels, it is not certain that the CBE will be able to accommodate this relaxed stance.

c) Liquidity and credit market developments

Meanwhile, liquidity growth (M2) in Egypt has significantly accelerated to 18.4% in FY13 from 8% a year ago. This increase in liquidity stems from net domestic assets, particularly domestic credit, which account for most of M2 growth. Meanwhile, the contribution of net foreign assets remains negative, reflecting the severe foreign currency crisis.

Domestic credit grew by 24.9% year-on-year in June 2013, compared to 20.8% y-o-y in June 2012. This year again, growth was mostly on the back of the growth in public sector credit, which contributed to domestic credit growth by 20.7 percentage points, while private sector credit contributed to growth by only 4.1 percentage points. Growth in private business sector credit was 8.5% y-o-y (compared to 5.5% y-o-y in June 2012), contributing to credit growth by 2.7 percentage points. Meanwhile, growth in household sector was 13.8% y-o-y, almost unchanged from June 2012 (13.3% y-o-y), contributing to domestic credit growth by 1.4 percentage points. It is worth mentioning that credit to the public sector reached 63% of total credit in June 2013, up from 58% a year earlier.

Figure 9.
Contribution to domestic credit, FY07 to FY12



Source: Calculated by author based on data from CBE

In an attempt to absorb excess liquidity, the CBE re-introduced deposit operations, with a seven days maturity and a fixed annual interest rate of 10.25% at the beginning of April 2013. In a parallel action, CBE decided to suspend the repurchase agreements (repo) operations. In addition, in May 2013, the CBE put regulations that limit banks' investments in local money market funds and fixed-income funds. The latter action would help direct excess liquidity into the banking sector, and reduce market risk and to decrease the pressure on government securities.

d) Is fiscal policy really expansionary?

Public finances have come under tremendous strain with the political unrest and remain so. The budget deficit surged from 8.1% of GDP in FY10 to 13.8% of GDP in FY13. With the economic downturn, revenues have sharply fallen from 22% of GDP to only 19.7%. Surprisingly tax revenues (which account on average for two-thirds of total revenues) have not been much affected and continue to account for 14% of GDP. On the other hand, non-tax revenue has sharply declined from close to 8% of GDP to 5% of GDP, due mainly to cuts in property income. Meanwhile, public expenditure has risen (from 30% in FY10 to 33% in FY13). In particular, spending on subsidies, grants and social benefits soared to 11% of GDP in FY13 (from 8% in FY10) as proposed energy subsidy reforms never materialized, interest payments also surged to 8.4% from 6% of GDP reflecting increasing cost of government borrowing and finally the wage bill increased from 7% to 8 % of GDP.

Capitalizing on the external financing that was received from the Gulf States, the Ministry of Finance intends to reduce the budget deficit to 9% of GDP in FY14, through revenue-boosting measures

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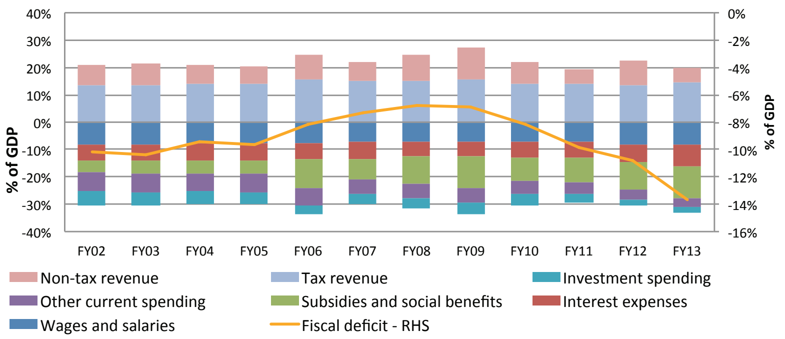
that do not entail raising new taxes. To boost revenues to 25% of GDP, the government intends to increase tax revenue to 17.5% of GDP, particularly that related to the real estate tax and to the taxes on goods and services. Non-tax revenue is also budgeted to increase to 7.2 % of GDP, thanks to higher property income. On the expenditures side, the government plans to keep them unchanged at 33.6% of GDP, but intends to change their com-

Figure 10.
Public Finances, FY04-FY13



Source :Calculated by author based on data from MOF

Table 2.
Actual and planned fiscal budget, FY10 to FY14

	Actual				Budget
% of GDP	***FY10***	***FY11***	***FY12***	***FY13***	***FY14***
Revenues	*22.2*	*19.3*	*19.7*	*19.7*	*24.7*
Tax revenue	*14.1*	*14.0*	*13.4*	*14.3*	*17.5*
Non-tax revenue	*8.1*	*5.3*	*9.2*	*5.3*	*7.2*
Expenditure	*30.3*	*29.3*	*30.5*	*33.2*	*33.6*
Wages and salaries	*-7.1*	*-7.0*	*-8.0*	*-8.0*	*-8.3*
Interest expenses	*-6.0*	*-6.2*	*-6.8*	*-8.4*	*-8.9*
Subsidies and social benefits	*-8.1*	*-8.6*	*-9.7*	*-11.2*	*-10.0*
Other current spending	*-5.1*	*-4.6*	*-3.7*	*-3.4*	*-3.3*
Investment spending	*-4.0*	*-2.9*	*-2.3*	*-2.2*	*-3.1*
Fiscal deficit - RHS	*-8.1*	*-9.8*	*-10.8*	*-13.7*	*-9.1*

Source: Calculated by author based on data from MOF

position. Given that the current composition of public expenditure is dominated by current spending items like wages, subsides and interest payments (accounting for most of the spending), the government is unable to cut spending in the short-term. Instead, the government resorted to altering the composition of spending. A mild decline in the subsidy bill to 10% of GDP is likely to save an amount of LE 22.3 billion that has now been partly injected into investments (or around 1% of GDP) bringing their share to GDP to 3% from 2%.

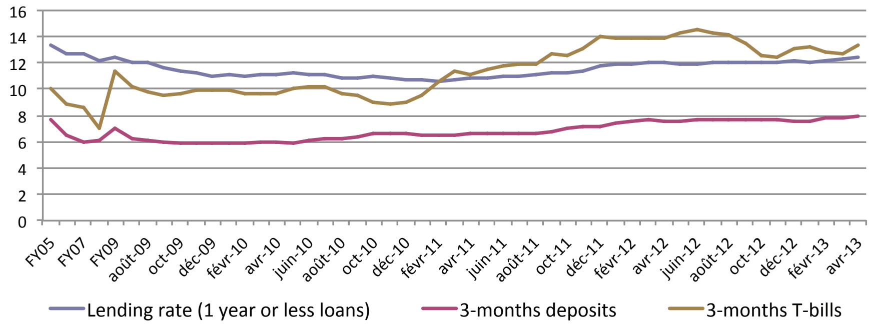
These additional investments will finance infrastructure projects in electricity, roads, construction of residential units and are likely to be implemented over the next 6-9 months and their aim is to boost growth up to 3%.

There is no official document that explains the assumptions and details of the new fiscal consolidation plan for FY14. It is therefore not entirely clear why and how the government expects a rebound in tax revenues without raising new taxes, especially in a context of subdued economic activity. The same questions apply for non-tax revenue.

Moreover, it is difficult to qualify the current fiscal policy as expansionary because the latter reflects a much-needed fiscal consolidation effort. It is difficult to assess the near-term impact of this fiscal consolidation but several factors could be at play. First, total government revenues have remained unchanged while tax revenues are expected to increase through improved collection. This could translate into a lower disposable income and may mitigate the expansionary effects of increased investments. Second, the decision to shift fiscal spending towards more investment and away from subsidies is a positive and much-needed development as it shifts sources towards more efficient and growth-enhancing spending, especially if the government undertakes investment in education, health and public infrastructure such as roads and bridges...etc.

This fiscal consolidation could theoretically lead to positive outcomes on growth and employment in the medium-term. As for the short-term, additional investments could produce some expansionary effects to the extent that they are associated with job creation but such effects would be dependent on the lags of implementation and the size of the multiplier among other factors. It is not clear whether the net effect on aggregate demand of both increased investment and higher taxes is going to be expansionary.

Figure 11.
Domestic interest rates, FY05 to April 2013



Source: Official sources

Given the ongoing political uncertainty and the successive sovereign downgrades, the cost of government borrowing has continued to increase. At the end of FY12, the 91-days T-bill rate escalated by 554 bps, compared to December 2010 (prior to the revolution), reflecting the increased sovereign risk premium. T-bill rates declined slightly since the start of FY13, averaging at 13.2 for 10M-FY13, which is still 415 bps higher than pre-revolution levels.

The growing government borrowing needs were also reflected in its issuances of T-bills and T-bonds throughout the year, which led the net budget sector domestic debt to soar to 70% of GDP in March 2013, up from 60% in March 2012.

II. Major challenges that need to be dealt with

II.1. Food insecurity: a structural issue that needs to be addressed effectively

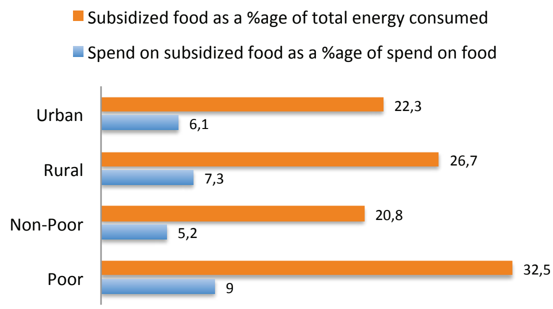
One of the most important endemic difficulties that Egypt needs to overcome is food insecurity. The later has been structural and plaguing the population's living standards for the recent decade with variations in the price of the basic food basket resulting into considerable social repercussions.

According to a recent World Food Programme (WFP) report, a series of shocks initiated in 2006 caused a rise in food insecurity and an aggravation of the nutrition situation. Most particularly, "the response to the avian influenza epidemic in 2006 saw a mass culling of poultry, damaging the livelihoods of the most vulnerable and adversely affecting their dietary diversity…the ensuing high food and fuel price crisis of 2007-08, saw prices remain high rather than return to previous norms and pushed even more Egyptians into poverty…a further rise in food prices in late 2010 has been compounded by static incomes in the wake of the January 2011 revolution".

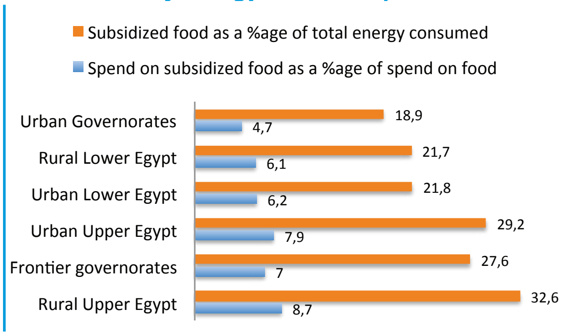
Understanding the poverty impact of these cumulative external shocks is of great importance. The existing system of food security, partly effective and not always well-targeted, has been put to the test. The most vulnerable households in Egypt have been negatively affected to say the least. Less and less people are able to cover their food needs with the increasing prices; about two-thirds of Egyptians now spend the majority of their household income on food (WFP, 2013). Average spending on food and non-alcoholic beverages amongst vulnerable Egyptian households represented 64.7% of spending by households in the second quarter of 2013 with 95.3% of households surveyed indicating that monthly income remained unchanged (Egyptian Food Observatory – EFO, 2013). As a result, poverty has noticeably increased reaching a rate close to 25%

Figure 12.
Subsidized Food

a. as % of total food expenditure



b. as total % of energy consumed)



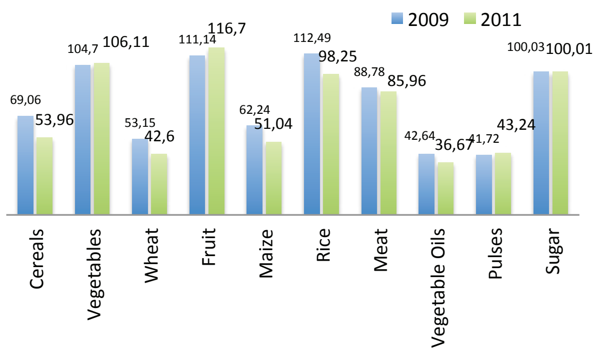
Source : World Food Programme (2013)

of the population, that is roughly 21 million Egyptians (DEVEX, 2013).

One of the main measures of protection during a crisis is the wide-ranging social safety net that includes food subsidies. The latter represented 1% to 2% of GDP in the 2000s, which is considerably less than the amount spent on fuel subsidies (closer to the 5%-7% range). Until now, food subsidies were comprised of ration cards (39% of food subsidies), allowing 80% of the population to buy set quotas of specific commodities at subsidized prices and baladi bread (61% of food subsidies) with no entitlement restrictions (IFPRI, 2013). Consuming cheaper food commodities has become the major coping strategy of poorer households in Egypt and there has been a progressive overreliance on “cheap and calorie-dense foods”, in other words mainly subsidized food. The latter accounts for 9% of poorer households food spend but about 32.5% of their energy ingestion. Subsidized food represents only 5.2% of food spend for the richer (non-poor) segments providing 20.8 of the energy consumed. This pattern can also be seen in poor rural areas and governorates in Upper Egypt. But ultimately non-poor households are the ones deriving greater gain from subsidized food due to a relatively substantial expenditure on food (World Food Programme, 2013).

Long-term perspectives are all but positive, significant challenges for self-sufficiency have appeared most particularly via an increasing population, the always-limited arable land that has been degraded and desertification. The structural issues that authorities need to deal with are primarily “the gap between long-term agricultural production potential and population growth estimates, as well as the system’s capacity to respond to shocks, and the impact of climate change and animal diseases” (DEVEX, 2013).

Figure 13.
Self Sufficiency of selected crops in Egypt



Source : World Food Programme (2013)

Past policies for promoting self-sufficiency were partly ineffective and the country still faces large gaps between food production and consumption levels for specific foodstuffs, with self-sufficiency declining by 15% for cereal and 11% for wheat between 2009 and 2011 (WFP, 2013). There were efforts in the past to increase guaranteed prices for strategic crops, yet they stayed at low levels relative to productions costs. The pricing policy was long unsuccessful, with guaranteed prices that were not aligned with the profitability of competing crops and with "a delay in announcing them before the due date for cultivating crops" (FEMISE, 2010). Efforts were also undertaken to lower agricultural costs, such as subsidizing fertilizers, seeds and pesticides. Yet, most fertilizer factories were publicly owned and distribution of fertilizers took place under Egypt's Principal Bank for Agricultural Development and Credit (PBDAC) resulting into low levels of competitiveness and fertilizers' prices 40% above world market levels. Additionally, subsidies to farmers were relatively unexceptional, well below the threshold tolerated by WTO commitments (FEMISE, 2010).

More recently, in early July, the former minister of supply reported that Egypt had less than two months' supply of imported wheat left in its stocks. Weeks later the new authorities claimed this statement was based on "incorrect calculations". Whatever the case, after the recent events Egypt resumed importing wheat to increase its grain stores enough to last until November, with the new minister of supply reporting that his ministry would increase imports "even though the government will work to increase next season's local wheat harvest to reduce dependence on imports" (Agrifeeds.org, 2013). New authorities will undeniably need some time in their efforts to combat food insecurity and implement a coherent strategy. It also remains to be seen whether the future food security strategy will build upon the long-term agricultural strategy which was already jointly initiated with the U.N. to improve response to food shocks (DEVEX, 2013).

II.2 A long path to better living standards and inclusiveness

a. Ensuring job creation especially for the youth

Until now, the rates of GDP growth have not generated enough productive employment, with an unemployment rate reaching about 21% among the youth. The issue of youth unemployment is closely tied to the lack of vocational training and the ever-present informal sector. A national action plan for youth employment was officially launched in 2009 yet no information has been provided regarding the obtained results.

Some facts in terms of participation in the labour market should be mentioned. Over the years, youth participation in the labour market evolved negatively ; for those in the 20-24 years bracket one could notice a lower participation rate of roughly 48.2% in 2011 versus 49.1% in 1999 suggesting a decrease in inclusiveness. Yet, for the young adults of the 25-29 age group one would observe the opposite trend, in 1999 they were 50.3% with a formal job while in 2011 they had reached an impressive 62.5% (FEMISE, 2012).

One of the main factors contributing to high unemployment rates is the rapid growth of the labor force that has outgrown demand for it, something that is expected to continue in the following years as well. At the same time job opportunities are too scarce, graduates in particular have to wait for more than five years on average to find a job, with unemployment among young graduates being extremely high (Egypt Independent, 2013). In recent years the situation drastically deteriorated, more than 1 million Egyptians were added to the total number of unemployed since the first quarter of 2010, bringing total unemployment to the record 13.2% in early 2013 and highlighting the failure of the previous regime in terms of employment creation. It appears that about 8 out of 10 unemployed Egyptians are under the age of 30, with more than a quarter holding at least a university degree (Bloomberg, 2013). Now, the period of transition also raises questions on how authorities will respond to

job opportunities are too scarce, graduates in particular have to wait for more than five years on average to find a job

the challenges of growth and job-creation. More precisely one must take into account some sector specific parameters (see AFD, 2013):

- √ In the primary sector, the capital-intensive mining sub-sector has yet to contribute to job-creation in a significant way, despite greatly boosting GDP growth. The textile sector is not competitive at the international level and has only partially responded to the challenges of employment. Meanwhile, agriculture remains an important source of jobs.
- √ social services have been the main source of employment for a long period yet in the recent decade their contribution to employment growth has fallen and alternatives need to be found.
- √ It remains to be seen if productive services can create enough (and decent) jobs considering that their contribution to GDP growth has been limited for a long time.
- √ Lastly, exports remain structurally weak, concentrated on low value-added products while Egyptian high-tech exports are extremely low (0.7% of total exports in the 2006-2010 period) even when compared to the MPs average (4.1% of total exports in the 2006-2010 period). Hence, stimulating job-creation and growth by exports promotion might not bring the desired results.

One must note that unemployment has also been a result of underperformance in labor markets, which is also the reason for deterioration in income. A combination of factors such as rapid technological change, global recessions, attitudes toward employers and discrimination have unrelentingly kept unemployment high (Egypt Independent, 2013). Such factors will need to be dealt with in the new employment strategy. Last but not least, the private sector needs to develop and so must mentalities towards it. Private job creation is slow and employment conditions are often indecent. Meanwhile, job applicants are hesitant towards job offers emanating from the private sector, preferring to remain unemployed with the hope of getting better job security in the public sector (Bloomberg, 2013).

Moreover, minimum wage in Egypt has not contributed much in improving the social inclusion, fixed at LE 700.0 (around US100) a month since 2011, this rate is often not enforced especially in private or informal employment. ***Consideration by the current government to increase this level to LE 1,200 (USD 170), will ease the pressure on many households*** however will increase the risk of inflation, and will add more pressure on the already suffering budget deficit, given the high rate of public employment.

b. The need to improve financial inclusion

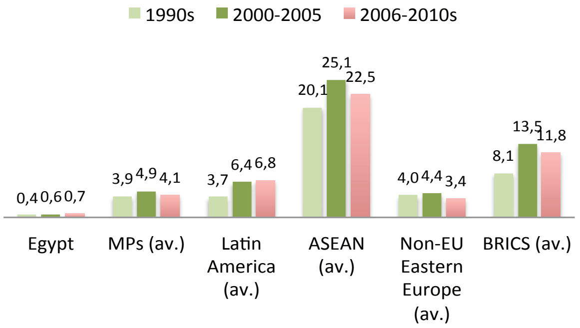
Lastly, Egypt suffers from a severe lack of financial inclusion when compared to both the average regional level and the average level of low & middle-income economies. The share of the population with an account at a financial institution is of only 9.7% (versus 30.8% for MPs and 41.4% for low & middle income economies on average).

Women are even more excluded financially, with only 6.5% of them having an account (versus 20.5% for women in MPs and 36.8% for women in low & middle income economies) and the same is valid for the Egyptian youth with only 7.8% having an account which is about three times less the MPs average level.

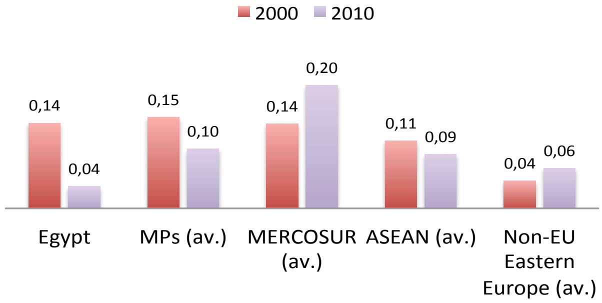
Financial inclusion is necessary, considering that 6% of the population is in multi-dimensional poverty (versus 5% for the region on average), and with an intensity of deprivation among the poor that is quite high (though lower than the BRICS and ASEAN averages). The share of the population vulnerable to poverty is also non-negligible. Yet, financial exclusion is prevalent among the less wealthy and poor (bottom 40%), in 2011 only 5.3% of them had an account, which is almost four times less than the MPs average and six times less the share observed

Figure 14.
Integration dynamic (selected indicators)

a. High-tech. exports (% of manuf. exports)



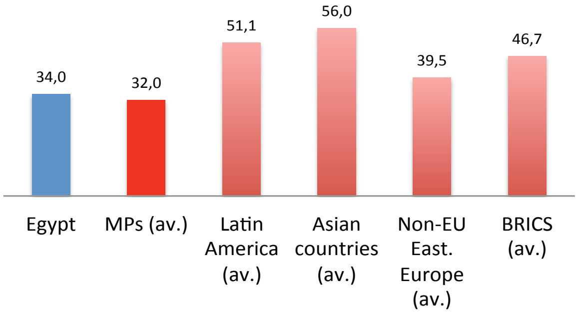
b. Trade Concentration Index



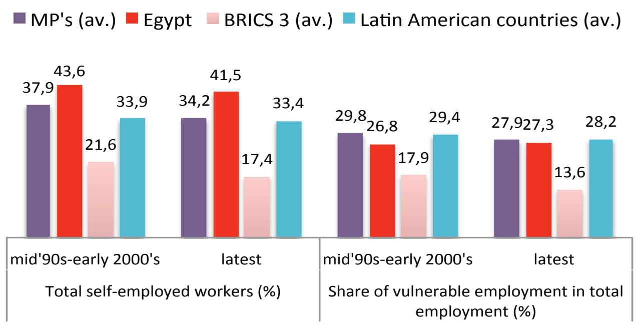
Source: WDI, FEMISE calculations using Tradesift and Comtrade data, based on SITC rev3 3-digit data.

Figure 15.
Domestic labour market dynamic, important issues remain (selected indicators)

a. Labour force participation rates, 15-24 (%)

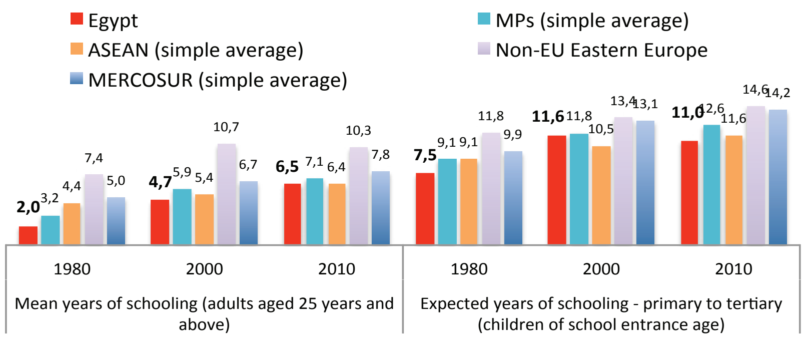


b. Informality and quality of employment



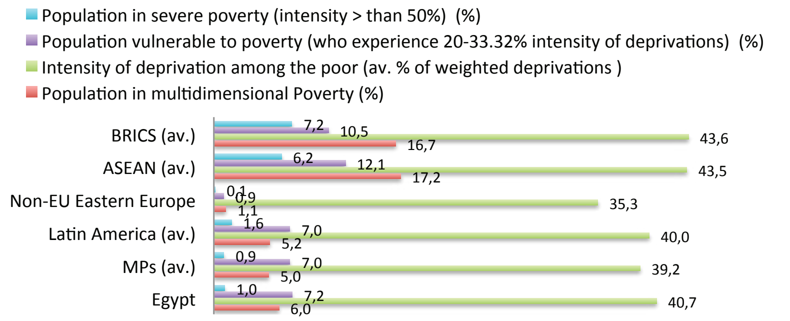
Source : IMF, World Economic Outlook database April 2013 (latest) and EIU

Figure 16.
Social dynamic that has improved but remains low (selected indicators)
HDI components related to schooling



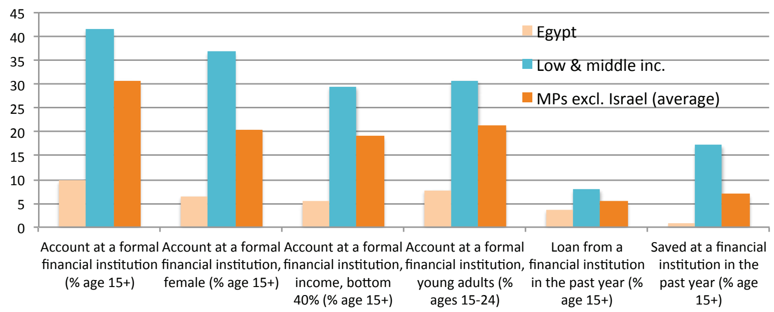
Source : HDI, FEMISE (2012) note on inclusive growth

Figure 17.
Indicators of Multi-Dimensional Poverty, latest year



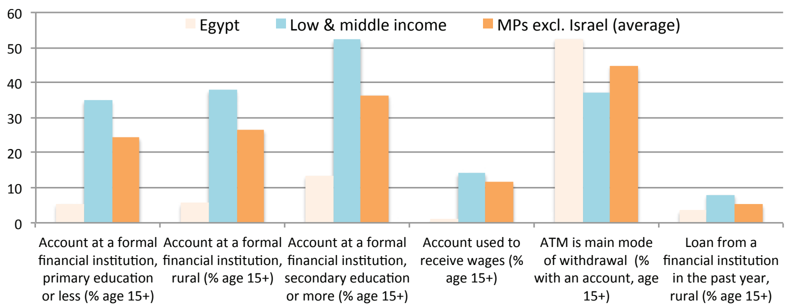
Source : Alkire, S., A. Conconi, and J.M. Roche (2013): "Multidimensional Poverty Index 2013

Figure 18.
Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

Figure 19.
Second set of Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

in low & middle-income economies. The portion of the population that saved at a financial institution in the past year is practically inexistent (only 0.7%) while the share of people that took a loan in the past year is low though closer to the MPs average (3.7% versus 5.6%).

This first set of indicators suggests that in terms of financial inclusiveness the situation is very preoccupying. But the situation is even more worrying regarding specific parts of the population.

A second set of indicators hints at the depth of financial exclusion in Egypt. First, the less educated (basic education level) are almost completely excluded, only 5.4% have an account (versus 24.4% for the region as a whole). For those with at least secondary education the situation improves but a considerable gap remains when compared to other MPs. Second, while also the case in other MPs, rural exclusion is magnified with the share of people with an account close to 5.6% (versus 26.5% for MPs and 37.9% for low and middle-income countries) and loans in rural areas are scarce (2.6% of the population). For rural areas authorities should implement measures that facilitate access to credit at lower rates to allow for more income generation and contribute to increased food security.

II.3 Innovation and creativity as a response to long-term issues

a. A fragmented and ineffective system of R&D

When looking at the "quality" component of Egyptian exports it becomes apparent that the integration dynamic needs to be improved. Indicators of the social dynamic and labour dynamic also suggest that numerous issues are yet to be resolved. Indeed, for the economy to grow in the future decades and be able to foster the jobs of tomorrow, Egypt will need to have a growth model that relies more on the innovation and creativity of its workforce. Yet, in order to do so, a number of things need to change regarding the current way R&D operates in Egypt.

The organization and governance of the R&D system in Egypt appears relatively fragmented with a great number of structures devoted to different ministries. Recently, efforts were undertaken to try and simplify the system and two new agencies were created to coordinate research activities; they are the High Council for Science and Technology (HCST) and the Science and Technology Development Fund (STDF). But, despite the creation of these new agencies, ministries still maintain control over research in their field of expertise without necessarily coordinating with other public research participants (Deniozos 2011). The most important research center in Egypt is the National Research Center (NRC) (with about 60 % of the scientists employed by the Ministry of Higher Education and Research), its researchers are dispersed among 14 major thematic departments which are themselves fragmented into 111 sub-departments. Meanwhile, this disjointed organization is complemented by centers based on public-private partnerships (eg IBM-Egypt Nanotech Research Center, Microsoft Innovation Lab in Cairo etc).

Among the main structural weaknesses of R&D in Egypt, we should note that :

√ Research centers in Egypt are often very small and research efforts are scattered which penalizes R&D effectiveness and the potential for innovation.

√ Meanwhile, the number of researchers in most areas of research is below the required threshold. In 2009, Egypt had 420 researchers in R&D per million people versus 660 for Morocco, 800 for Turkey and 1860 for Tunisia. In addition, the number of researchers fell by a third between 2007 and 2009 whereas in most other countries the trend was towards an increase.

b. Lack of private sector impulse

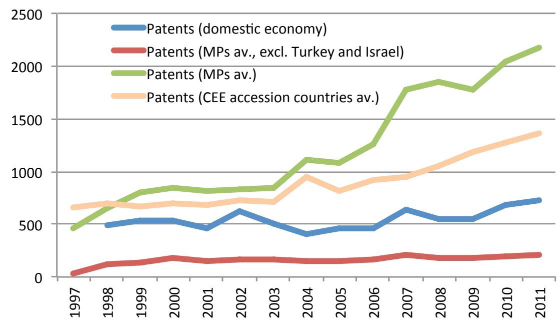
Since the early 2000's Egypt has been dedicating between 0.2% and 0.3 % of its GDP to R&D, a rate that remained relatively stable over the decade, but maintaining Egypt far behind other MP's in terms of R&D spending. Before the Arab Spring, authorities wanted to reach a rate of 1% by the end of the five-year plan in order to reach the levels of neighbouring countries. Yet, this goal seems difficult to achieve given the current conditions.

The private sector seems to be absent in R&D activity, a fact that severely hampers innovation, which almost exclusively relies on public funding (70% of R&D spending goes to universities and the rest is allocated to the various public research centers). Rarely do private-firms carry-out R&D activities, meanwhile, the decennial Plan for the development of research in Egypt gives no suggestion as to a requisite level of R & D investment by the private sector. The financing of innovation activities of Egyptian enterprises is largely provided by the company itself; only 4% of innovative companies say they have received financial support from the state. This seems inconsistent given that the country has traditionally showed willingness to attract FDI in high-tech sectors and promote international collaboration. Overall, innovation activity is lacking from Egyptian firms and when it takes place it is mainly of an organizational and / or marketing nature, but not at the product level.

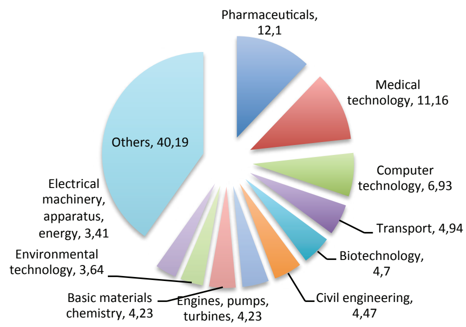
The two main science and technology (S&T) partners of Egypt during the last decade and for the current one are the USA and the EU. Both partners "place the S&T cooperation in the frame of a larger policy of economic and social development, which Egypt is planning for a decennial horizon" (Erawatch, 2013). Meanwhile, in addition to the EU Neighbourhood Policy instrument, European countries such as Germany and France invest in the R&D development of Egypt. Yet, international integration at the R&D level is low and the relationship between innovative companies and pu-

Figure 20.
Intellectual property indicator: patents

a. number of patents



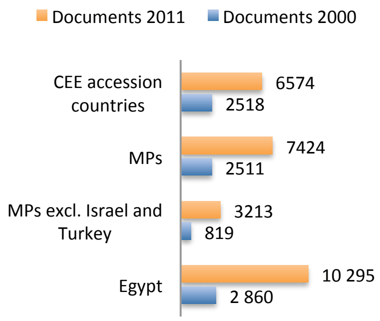
b. patent Applications by Top Fields of Tech. (1997 - 2011)



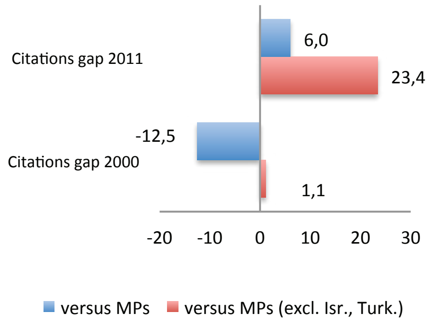
Source: World Intellectual Property Organization

Figure 21.
Journals and country scientific indicator:

a) No of documents (2000 VS 2011)



b) Citations per Document gap* (%)



Source: SCImago Journal & Country Rank (SJR)
** FEMISE calculations based on SJR, the index measures in percentage terms how many more/less citations per document the country receives when compared to the regional average. Ex. a value of -10 means that the country receives 10% less citations per document compared to the MPs average.*

blic institutions in charge of R&D support is limited at best. Only one in ten innovative firms develops an innovation with external assistance, a fact that highlights the lack of international openness of innovative companies in Egypt.

c. Yet indicators of innovation output show there is potential

Yet, a quick look at the number of patents shows that the number has grown annually over the last 15 years and has been consistently above the MPs average (when Israel and Turkey are excluded from the sample). The area in which Egyptians get the most patents is the one of agriculture and food (40% of issued patents in 2010) followed by chemistry and metallurgy (24% in 2010). The sectors of pharmaceuticals, medical technology and computer technology roughly represent a third of the Egyptian patents. Health research appeals to domestic policy makers and researchers "with focus on epidemics and other problems that tantalise the regional societies, due to the climate, the level of living and the modes of nutrition" (Erawatch, 2013). Even so, while Egypt seems to stand out compared to most neighbouring countries, the country is underperforming when compared to the number of patents produced by CEE accession economies in the recent decade. Moreover, in terms of patents and royalties Egypt is below the performance of Turkey, a country of similar size (EIB-FEMISE, 2013).

Meanwhile, high technology exports as a share of total exports increased since the beginning of the 2000s in Egypt. Yet, they remain very low, reaching barely 0.7% of total exports in the later half of the 2000's, falling largely behind the average of Mediterranean countries (4.1%) but also the average rate that is found in Non-EU Eastern European countries (3.4%).

Lastly, the number of scientific articles, also an indicator of innovation output, allows painting a more optimistic picture. It appears that the number of published articles by Egypt has considerably grown. In the early 2000s Egypt used to produce an amount of scientific articles close to (slightly above) the regional average; it now produces an amount that is about 30% more than the regional average. Furthermore, the relevance of the scientific work seems to have improved as well. The number of citations received per document increased over the years, in 2000 citations per document were about 12.5% lower than for the average MPs paper but are now 6% higher. This leads us to believe that the impact of Egyptian scientific documents is now higher than it used to.

III. Conclusions

Egypt's road to transition is still bumpy and lengthy. The political scene has been particularly volatile in 2013 and it is crucial that all political factions commit to the proposed roadmap. Despite the turbulent political and social contexts and the unfavorable external environment, the Egyptian economy has so far managed not to fall into a recession but growth dropped from 5 percent in 2010 to an average of 2% over the period FY11-FY13. Yet, as job creation remains minimal, unemployment has soared to 13 percent, up from 9 percent before the uprising. Moreover, the external position has significantly deteriorated on the back of limited export growth (especially non-oil exports) and a sharp fall in tourism revenues. Despite a record-high increase in remittances of Egyptians living abroad, the current account deficit deteriorated to 2% of GDP. More worryingly, the significant drop in major foreign exchange earnings has put the official exchange rate under pressure, losing around 20 percent of its value between December 2010 and June 2013. In order to counter that, the Central Bank of Egypt (CBE) resorted to reserve depletion, eroding close to US$ 20 billion of reserves. After having fallen to critical levels of around US$ 14.9 billion and less than 3 months of imports, reserve levels were boosted to US$ 18.8 billion thanks to aid from the Gulf states. Moreover, in an effort to respond to social demands and lessen the impact of high international prices for food and energy, the government increased spending on subsidies and civil servants' wages (which both account for more than half of total spending). The resulting large fiscal deficits (close to 13 percent of GDP) raised public debt (70 percent of GDP), which is primarily financed by domestic banks, and thus constrain their capacity to lend to the private sector. Another alarming observation is the widening sovereign spreads which contribute to increasing the cost of government borrowing: the 91-day T-bill rate increased by 436 bps between December 2010 and April 2013.

Successive governments after Hosni Mubarak's fall, including the last one, have failed to articulate a coherent economic plan to tackle Egypt's problems. What should the plan be? There is little doubt on the immediate reforms to be adopted but it seems that (i) some of the reforms may be incompatible in the short-term which means that trade-offs should be made and that (ii) the financing constraint is forceful.

The economy is in need of macroeconomic stabilization. To stop reserve erosion, which has fallen to critical levels, the CBE could introduce further flexibility to the exchange rate regime. Allowing more fluctuations in the exchange rate is not cost-free. It is likely to induce inflation, as imports will become more expensive. As for fiscal policy, Egypt needs to get its public finances under control. The new government's fiscal policy is prudent in the sense that it will not raise the deficit. To the contrary, the latter is expected to increase following revenue-boosting measures while spending will remain unchanged. The government's fiscal policy is better qualified as a much-needed consolidation effort rather than of a stimulus plan. Such fiscal consolidation that resulted from tilting the composition of spending towards more growth-enhancing spending is likely to have positive medium-term benefits. In the short-term, expansionary effects of increased investments may be mitigated by the increase in tax revenue, as the latter could reduce aggregate disposable income.

Egypt needs to activate the economy but may not have the means to do so because of fiscal sustainability concerns. Some measures can be considered but the government needs to be mindful of their impact on the budget. To boost employment, temporary fiscal and financial incentives could be given to the private sector to increase hiring particularly in the tourism sector. Additionally, training and credit subsidies could be offered to SMEs and labor-intensive sectors. Estimations by the IMF suggest that an investment in labor-intensive infrastructure of 1 percent of GDP could create about 87,000 new jobs in Egypt.

Finally, Egypt needs to finance the above reforms. The financing gap was estimated (in March/April 2012) at around US$11 billion for eighteen months. It was recently able to secure US$12bn of financial support from Kuwait, Saudi Arabia and the UAE. One quarter of the money is in the form of grants, and the bulk of the remainder will be used to prop up foreign reserves. Is this the best course of action? Certainly, this money will temporarily mitigate reserve erosion. Yet, this emergency measure is not sustainable, especially if foreign exchange earnings do not rebound soon.

In this context, borrowing from international institutions is an option to resort to. It is not yet clear if or when the current government will resume negotiations with the IMF in order to secure this external financing. The benefit of such borrowing is that it is usually associated with some adjustment to economic policies to "overcome the problems that led to seek funding in the first place." External borrowing is not likely to compromise external debt sustainability, since external debt is relatively low around 16 percent of GDP. Given the numerous downgrades in sovereign ratings since January 2011, it is also hoped that an IMF loan will act as a positive signal to boost the confidence of investors and other potential lenders. Since the January 2011 revolution, the three main international rating agencies have downgraded Egypt's sovereign credit rating a total of 17 downgrades. The most recent was by Fitch following the overthrow of Morsi, lowering the country's credit rating from 'B' to 'B-', with a negative outlook, putting Egypt at six notches below investment grade, with possible further downgrades. Similar sovereign rating cuts during 2013 were previously made by Fitch and S&P on the back of poor macroeconomic management (rising financing needs), stemming from the volatile political situation.

Table 3.
Egypt's sovereign rating

	Fitch		S&P		Moody's
	Foreign currency	Local currency	Foreign currency	Local currency	Bond ratings
Prior to Jan2011	BB+	BBB-	BB+	BB+	Ba1 stable
Jan-Feb 2011	BB+	BB+	BB	BB	Ba2 negative
Mar-11	-	-	-	-	Ba3
Oct-11	-	-	BB-	BB-	B1
Nov-11	-	-	B+	B+	-
Dec-11	BB-	BB	-	-	B2
Jun-12	B+	B+	B	B	-
Dec-12	-	-	B-	B-	-
Jan-13	B	B	-	-	-
Feb-13	-	-	-	-	B3
Mar-13	-	-	-	-	Caa1
May-13	-	-	CCC+	CCC+	-
Jul-13	B-	B-	-	-	-

Source: International rating agencies websites

A critical challenge for Egypt is to make necessary reforms (like the devaluation) socially acceptable, given the growing feeling of national identity since the uprising, and also the inherent skepticism towards reforms advocated by international institutions and implemented by the former regimes, finger-pointed to be the reason for rising inequality. To remedy that, the government needs to develop a home-grown reform agenda, launch a public debate about it and develop a good communication strategy to explain it.

III.1. Dealing with food safety and poverty should be a priority

Addressing the issue of food security and its implications on poverty has to be done in a very delicate matter. Most policy interventions can have a dampening effect on household consumption across income distribution (FEMISE, 2010). Meanwhile, maintaining the food subsidy scheme as is cannot be sustainable from a fiscal perspective, it needs to be reformed and become less costly for the budget and better targeted to the poor. The context of economic constraints needs to be taken into account and the same is true for the policy agenda that will probably keep evolving. The Table below summarizes possible food subsidy policy options that could be politically feasible in Egypt within a explicit time frame. Any reforms will need to find a delicate trade-off between popular preferences (generally in support of subsidies) and economic needs, meaning reform will probably have to be gradual. One notes that :

√ From a macroeconomic perspective there will be **need to stimulate pro-poor growth**, now more than ever authorities need to grasp the chance to make this a priority. A new investment policy that creates incentives for both local and foreign private investment could link production between all sectors and build the foundations for a "programme-based pro-poor fiscal policy" (World Food Programme, 2013).

√ For rural areas additional weight should be put on income generation initiatives, such as facilitating access to credit (which is very low) at lower rates and insurance for farmers. Meanwhile, upgraded agricultural practices are needed to support production, most importantly through the use of improved crop varieties and cultivation of higher value crops. (World Food Programme, 2013).

√ Improving supply chain effectiveness in subsidized baladi bread will be necessary. According to a relevant FEMISE study (2010) enhancing the efficiency of baladi bread production and distribution can be achieved through the improvement of wheat storage and the bread production technique via public-private partnerships, through easing access to financing that would allow bakeries to invest in more modern equipment, train their workers and via more effective implementation of health and environmental standards. Meanwhile, liberalization of wheat prices could continue. In the longer-run, plans to replace ration cards with smart national ID cards, would definitely improve monitoring and reduce costs but will be challenging to apply (IFPRI, 2013).

√ Improving targeting could be achieved with compulsory registration (self-targeting) to dissuade the less-poor from using food subsidies and better targeting criteria such as geographic targeting for Upper Egypt and "proxy means testing" for urban areas and Lower Egypt. Urban areas where "pockets of vulnerability" are rising must be included in assistance programmes and efforts should focus on real income stabilization and inequality reduction, something that can be achieved through price stabilization. For rural structural reform should contribute to raising the mean level of income (World Food Programme, 2013).

√ Authorities could also complement and substitute measures with interventions focusing particularly on maternal and child nutrition, with vouchers for specific commodities and groups to ensure the household diets get a wider variety. Emphasis should be put on promoting financial investment and capacity building for health staff to effectively detect and treat malnutrition.

Table 4.
Policy options and expected impacts on budget, poverty, and nutrition

Policy option	*Possible time frame*	*Impact on budget deficit*	*Impact on poverty*	*Impact on infant nutrition*
Follow business as usual	*Not an option*	-	**+**	***n***
Improve supply chain efficiency				
Improve storage	*Short term*	+	*n*	*n*
Reduce leakage	*Medium term*	+	*n/+*	*n*
E-system	*Long term*	+	*n/+*	*n*
Improve targeting				
Including the most vulnerable	*Medium term*	-	+	+
Excluding the least vulnerable	*Medium to long term*	+	*n*	*n*
Self-targeting	*Medium term*	+	*n*	*n*
Complement and substitute				
Targeted nutrition programs	*Short to medium term*	*n/+*	+	+
Income generation programs	*Short to medium term*	*n/+*	+	*n/+*
Targeted cash/in-kind transfers	*Medium term*	*n/+*	+	*n/+*

Source: IFPRI (2013), note: "+" = expected positive effect; "-" = expected negative effect, "n" = expected neutral effect.

Local and community-level measures could be promoted to support more generalized coping strategies. In the long-run, conditional cash transfers and vouchers could replace subsidies and be linked to price indexes to block inflationary pressures (IFPRI, 2013). Offering direct cash transfers to the poorest households (instead of food subsidies) and to the poorest farmers (instead of agricultural inputs) could eradicate dual market pricing that brings distortions and misallocation of resources (FEMISE, 2010).

Among recent developments, the new authorities have already agreed on cooperating closely to establish a unified database of all citizens, a measure which, if applied effectively, carries the potential of vastly improving targeting, being less costly and ensuring subsidies reach those in need (AhramOnline, 2013). This is in line with the recommendations of FEMISE (2010) to improve the ration card system by facilitating the registration for truly needy households currently outside the system.

III.2. An R&D strategy to support economic growth in the longer term

The level of R & D activity in Egypt is clearly insufficient given the size of the economy. Thus the potential for productive employment is not fully achieved. However, areas for development, which could result in improvement of growth and employment, clearly exist (FEMISE-EIB, 2013):

- √ First, there is room for improvement for the organization of public research centers that are too small. Better coordination of research work and regrouping into larger centers could enable efficiencies through economies of scale and positive externalities through knowledge dissemination. The establishment of the Office for Science and Technology marks the willingness of authorities to significantly improve the coordination of R & D.
- √ Secondly, the low participation of the private sector in R & D can and must be remedied. There is a need to change mentalities of both public sector researchers and private sector entrepreneurs to sustainably improve their ties. Developing the entrepreneurial and innovative spirit of firms will involve training that includes basic skills specific to initiative-taking and the will to create new products.
- √ Lastly, in relation to the previous point, the quality of education in universities needs to be improved. Students are often assigned in courses they have not chosen, educational programs are dated and poorly adapted to the current labor market in the country and critical thinking and personal initiative are not encouraged in universities. Meanwhile, vocationally oriented training are not considered

is under- funded and neglected by students. Thus, better guidance for students at the end of high school and the development of new educational practices (focusing more on critical analysis, initiative, solving of unexpected problems and the development of group work) is needed. Short vocational courses must be upgraded through greater involvement of the private sector in the definition of knowledge and know-how that students will need to acquire during their training.

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ISRAEL

A highly innovative yet socially unsound economic model

Introduction

A case apart in the Mediterranean region, Israel's economy quickly evolved into a services and high-tech based one, a by-product of the defence industry and motivated by insistent market opening. Meanwhile, contrary to the vast majority of its neighbours, the country benefited from the inflow of qualified immigrants from the former Soviet Union, capitalizing on skills in ICT. Now, the country continues to preserve its high-tech edge on the economic level, trade protocols with trading partners throughout the world are being signed (ex. last years agreement with China for the export of Israeli water technologies for agricultural use) and so are initiatives designed to increase joint research with countries in which innovation matters (ex. program with India and China to reinforce economic ties and attract researchers to Israel's research institutes). Meanwhile, macroeconomic management is tight and with strict budgetary discipline.

Still, despite impressive results on the economic front, Israel lacks three main things:

First, political stability which is always frail; political tensions are common with a countless number of non-converging small political parties having to work together, with frequent elections and relatively short-term governments. Currently, following the Knesset election in early 2013, political trade-offs in coalition-building have been again very common. Meanwhile, Israel's governance seems to have worsened in recent year, especially regarding control of corruption (FEMISE 2011).

Second, it lacks a resolution to the Palestinian issue and this does not favour the country's image in a world of globalized media. For long, the domestic economic establishment functioned "as if the conflict did not exist or as if it was a minor annoyance with which one must live with" (FEMISE, 2005). Yet, "the Israelis tend to forget the potential economic benefits of peace with the Palestinians" and the country still spends a two-digit share of its budget on defence (LesEchos, 2013). A direct benefit from the resolution of the issue would be increased trade with its Arab neighbours. But, for the time being, the recent conflict in the Gaza Strip combined with regional turmoil can only amplify instability.

population has a lower standard of living when compared to other developed countries

Third, the economic model is not the most inclusive. The population has a lower standard of living when compared to other developed countries and socio-economic inequalities have increased. Most particularly, the ultra-Orthodox and Arab Israelis have minimal participation in the labor market. Meanwhile, taxation has become less progressive which had a negative impact on well-being. Moreover, the middle classes, usually working in low productivity sectors, cannot benefit from higher wages (LesEchos, 2013).

Domestic authorities will need to provide an answer to these main limitations. Undeniably, given its geographical location and geopolitical reality, the country must try to participate in as many economic networks as it can. The country should also keep capitalizing on its skills and education, attracting brains to remain competitive in high-tech.

Key indicators	*2005-2008*	*2009-2011*	*2012*	*2013e*	*2014e*
Real GDP growth (%)	*5.1*	*3.6*	*3.1*	*3.6*	*3.9*
Consumer price inflation (av; %)	*2.1*	*3.2*	*1.7*	*1.6*	*2*
Budget balance (% of GDP)	*-2.5*	*-5.2*	*-4.7*	*-3.6*	*-3.3*
Current-account balance (% of GDP)	*2.9*	*3*	*-0.1*	*1.7*	*2.5*
Unemployment rate (%)	*9.6*	*8.2*	*6.9*	*7*	*6.5*

Source: WEO – IMF. April 2013 (latest) and EIU. estimates for 2013 and 2014

When looking at the 2012/2013 economic snapshot, one sees:

- √ *When compared to other OECD countries Israel fares quite well, real GDP growth is expected to reach 3.9% for 2013 (3.6% according to the IMF) and 3.4% for 2014, which is significantly higher than the average OECD projections.*
- √ *Total unemployment reached historic lows, falling at a 6.9% rate which is even lower than the post international crisis rate of 8.2%.*
- √ *Inflation in Israel rose by approximately 1.7% in 2012, considerably below the post international crisis average of 3.2%. The economic growth slowdown usually contributes to reducing demand-side pressures and can explain such a low inflation rate.*
- √ *The Israeli current account, though almost in equilibrium at -0.1% of GDP, underperformed last year when compared to a surplus of 3% in the 2009-2011 period. In the beginning of 2013 it had reached a slight surplus, essentially driven by an increase in exports.*
- √ *The Israeli budget deficit in 2012 was estimated to be close to 4.7% of GDP due to apathy in tax revenue and relatively high spending. This level remains about double the deficit of the 2005-2008 period. Broad spending cuts could reach 2% in 2013.*

Among the structural challenges we should note :

- √ *Israel has historically based its economic development on innovation and technology and for this reason it has an important place in world research. Yet, despite considerable performance in innovation as suggested by available indicators, youth participation in the labor market (close to 50%) is below what one finds in other regions such as Latin America and East Asia. Meanwhile, issues of inequality are persistent. There is a dual concentration of high poverty and unemployment among two large minorities, meaning the asharedi and Arab Israelis. The relatively high level of Israeli innovation has not considerably enhanced productivity and living standards.*
- √ *Israel's transport infrastructure is clearly inadequate which penalizes perspectives for future economic development. Israel's roads are more congested than those in the OECD by over two and a half times. The situation is even worse when bearing in mind the limited rail infrastructure.*
- √ *Despite low inflation, prices are too high. Automobiles and housing both seem to be lastingly expensive in Israel. In the case of housing, the Israeli cost relative to income is more expensive than housing in London or New York.*

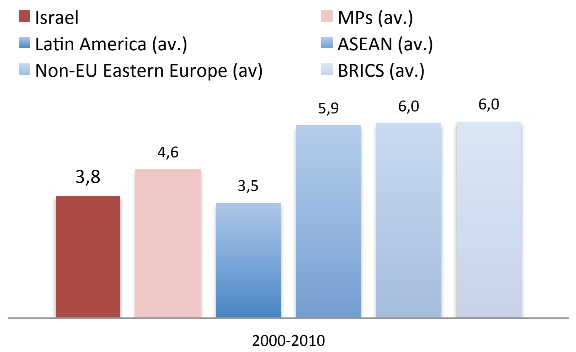
I. A 2012/2013 snapshot: macroeconomic situation and challenges

I.1. Economic growth steadily increasing after last years slowdown

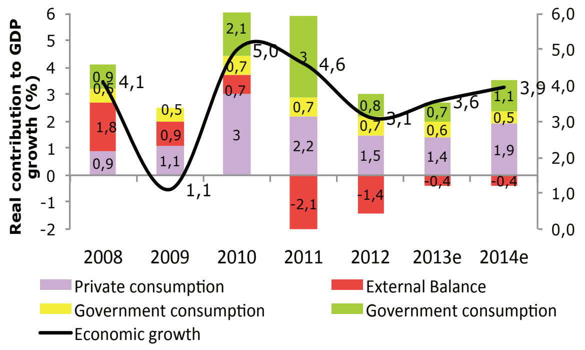
In Israel the average annual GDP growth rate of the recent decade was close to 3.8%, on par with the levels observed in Latin American economies and about double the rate of high income OECD economies. The Israeli economy grew at 3.1% in 2012 and kept a relatively moderate rate of 2.7% during the last quarter of 2012 and the frist of 2013, in the backdrop of continuously restrained econo-

Figure 1.
Gross domestic product

a) Average annual GDP growth rate by region



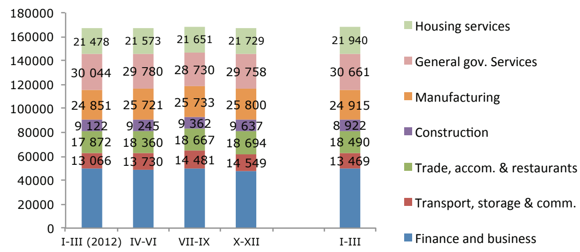
b) real contribution to growth (%)



Source: IMF, World Economic Outlook database April 2013 (latest) and EIU, national sources.

mic growth worldwide. This is a relatively weak performance when compared to a 3.6% average rate of growth in the post-crisis period and even worse when compared to the 2005-2008 average rate of growth of 5.1%, yet it still decent by developed-economy standards. Business sector activity was moderate but slightly strengthened in early 2013; meanwhile, industrial production started to slightly recover during the same period (Bank of Israel). In the first quarter of 2013 we observe a year-on-year increase of 3.5% in trade, accommodation services and restaurants, followed by a 3.1% increase in transport, storage and communications activity. Financial and business services, the greatest contributor to Israeli growth, marked an annualized fall of 1.2% in the first quarter of 2013. Meanwhile, general government services, the second largest contributor to growth, increased by 2.1% in the same period.

c. at basic prices prices, Q1 2012 to Q1 2013
(NIS million, chained data at 2005 prices)



Source : national sources

Meanwhile, consumer spending is expected to be constrained following the recent rise in VAT and other taxes. The exploitation of large gas deposits in the Mediterranean will require significant investment in infrastructure and could “provide a fillip over the medium term” and the high-tech sector will also be a “key investment driver” (EIU, 2013).

When compared to other OECD countries Israel fares quite well, real GDP growth is expected to reach 3.9% for 2013 (3.6% according to the IMF) and 3.4% for 2014, which is significantly higher than the average OECD projections respectively of 1.2% and 2.3%. On the demand side one notes how exports have been continuously struggling due to lack of international demand and especially from Europe. With exports accounting for around 40% of GDP, foreign demand always has a crucial impact on overall growth. Exports to more resilient emerging economies could counterweight the European lack of dynamism.

But, all in all the Israeli economy provides an image of solidity; while most of the developed countries are undergoing an economic breakdown, Israel demonstrates sustained growth coupled with fiscal responsibility and no “bubble” in sight ready to explode (Algemeiner, 2013).

I.2 Unemployment that remains low and labor force participation that is high

Total unemployment reached historic lows the prior year, falling at a 6.9% rate which is even lower than the post international crisis rate of 8.2%. One must note that Israel has experienced extensive gains in recent years in terms of employment. Unemployment rates have been dropping for several years and the double digit levels in the 1990s are but a distant memory.

The relatively moderate growth of exports coupled with the vigour-lacking domestic demand resulted in a labor market growth slowdown starting from mid-2012. The increase in total employee posts continued in public services (public administration, education, health, etc.), however, the increase in employee posts in business sector industries (all industries, excluding public services) stopped starting from April 2012 (Bank of Israel, 2013). In early 2013 one observes “a trend of decline in employment in business sector industries, led by a decrease in employment by companies”. For 2013, the unemployment rate is expected to reach 7%.

the real labor force participation rate in Israel is about 4 percentage points higher than previous surveys have estimated, however, unemployment among Arab Israelis is much higher than previously thought

Let it be noted that a new and more reliable methodology for calculating the labor force shows that labor force participation in Israel through all groups of society is superior to what previous statistics had shown; it seems the real labor force participation rate in Israel is about 4 percentage points higher than previous surveys have estimated. However, one should note that unemployment among Arab Israelis is much higher than previously thought. Government policy should acknowledge this fact, the issue of Arab unemployment is a serious one and more importance should be given in the appropriate means to tackle it (TAUB Center, 2012). Nuancing what unemployment statistics in Israel tell us is thus necessary. As noted by Ben-David (2012) « rates of unemployment measure the share of individuals not finding work out of those participating in the labor force. It does not include those who are not participating in the labor force altogether – and who, by definition, are not looking for work. The primary problem in Israel is the large size of this latter group ».

I.3. Inflation considerably low following recent economic slowdown

Inflation in Israel rose by approximately 1.7% in 2012, considerably below the post international crisis average of 3.2%. Throughout the year the level of inflation indicated the presence of an economic slowdown. The low rate was caused by “reduced prices in fruits and vegetables (3-29%), mobile phone tariffs (10% due to competitive market reforms), Internet services (10%) and education”, furthermore reforms in preschools also decreased average prices by 6% (The Times of Israel, 2013).

There were however noticeable increases in the prices of housing (3.4%), electricity (8.8%) and health services (5%), while the price of cigarettes increased by about 20%. All in all, the increase in the price index hit a six-year-low and was within government target projections. The economic growth slowdown usually contributes to reducing demand-side pressures and can explain such a low inflation rate. Current estimates for 2013 suggest that the inflation rate could be even lower, close to a rate of 1.6%. One could expect inflationary pressures to pick up starting from 2014 along with potential growth in domestic demand.

I.4. A current account in surplus because of positive services performance

The Israeli current account, though almost in equilibrium at -0.1% of GDP, underperformed last year when compared to a surplus of 3% in the 2009-2011 period. In the beginning of 2013 it had reached a slight surplus, essentially driven by an increase in exports (excluding diamonds and startup companies).

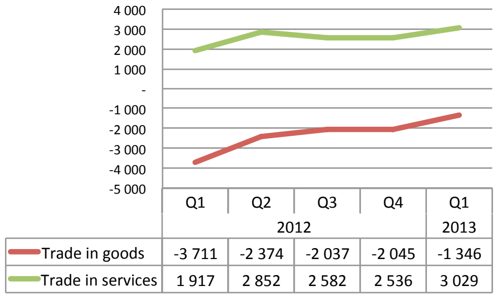
The goods trade deficit totaled NIS 18.5 billion in May 2013 with total exports of goods decreasing annually by 7.6% following an initial decrease of 6.7% in the December 2012-February 2013. It should be noted that goods trade was influenced by changes in the value of the shekel vis-a-vis other currencies (most notably NIS weakened by 0.3 compared to the Yen, by 0.2% compared to the US$ and by 0.1% compared to the Euro).

But services exports seemed to fare much better overall; in the first quarter of 2013 they had increased by almost 10% compared to early 2012. The exports of other business services, the largest contributor to total service exports, increased in the first quarter of 2013 by an annualized 12.9%. Meanwhile, exports of travel services and transport services respectively increased in the same period by 2.9% and 3.9%.

Concurrently, services imports decreased, especially those of other business services (-12.2%) and transportation services (-5.6%). The globally positive performance of the service balance is expected to contribute to a current account surplus expected to reach 1.7% of GDP in 2013. The current account could reach more substantial surpluses starting from 2014 “as the recovery in export growth accelerates and import costs are held down by a steady increase in domestic gas supplies” (EIU, 2013).

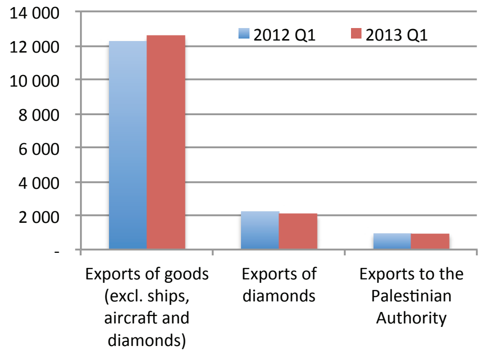
Finally, regarding FDI in Israel, in the first quarter of 2013 one could notice a spectacular annualized rise of 76.1%, owing in great part to equity capital almost multiplying by 2 in 12 months while reinvested earnings decreased by 5%. Furthermore, portfolio investment in Israel also rose considerably during the same period.

Figure 2.
Trade balance, seasonally adj., million US$



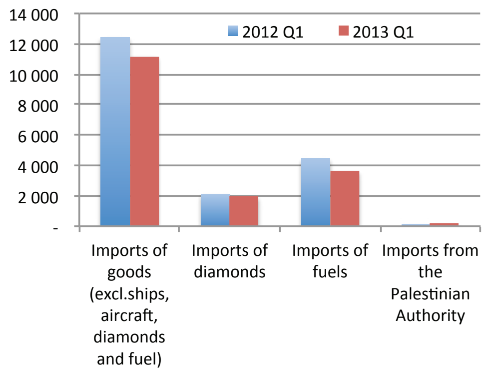
Source: Central Bureau of Statistics

Figure 3a.
Exports of goods, seasonally adjusted, million US$



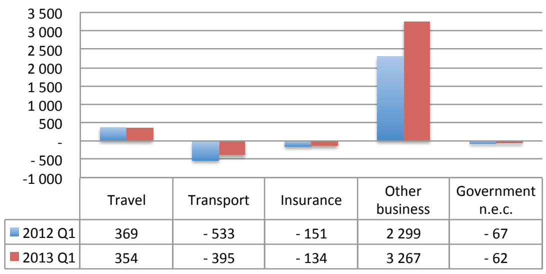
Source: Central Bureau of Statistics

Figure 3b.
Imports of goods, seasonally adjusted, million US$



Source: Central Bureau of Statistics

Figure 4.
Services balance, seasonally adjusted, million US$



Source: Central Bureau of Statistics

Figure 5a.
Investment in Israel
not seasonally adjusted, million US$

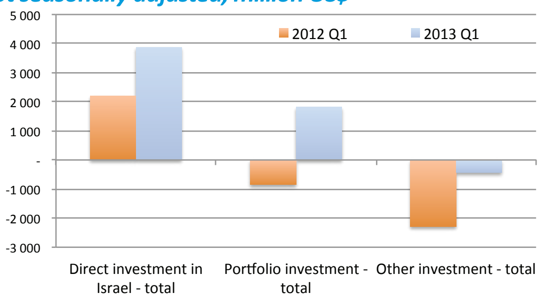
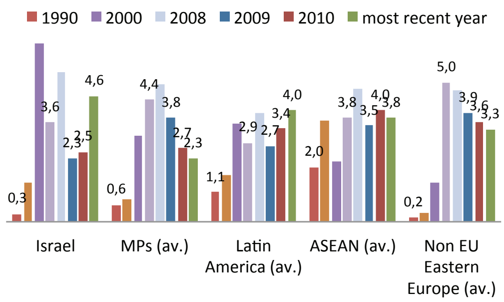


Figure 5b.
Investment in Israel
FDI by country/region, %age of GDP



Source: Central Bureau of Statistics, WDI, World Bank

I.5. Outfall on fiscal balance

The Israeli budget deficit in 2012 was estimated to be close to 4.7% of GDP due to apathy in tax revenue and relatively high spending. Though lower than the -5.2 average deficit of 2009-2011, this level remains about double the deficit of the 2005-2008 period.

The government increased the expenditure ceiling for 2013 by roughly 0.7% of GDP and set the deficit ceiling at about 4.65% percent of GDP (IMF predicts the fiscal deficit for 2013 to reach -3.6% of GDP). This target is higher than the initial one and derived from the expectation that the Knesset would approve the budget relatively late, in summer 2013. Indeed, budget approval for 2013 could not be guaranteed before the election, thus, monthly spending was expected to not surpass one-twelfth of the 2012 planned level until the Knesset endorsed the new budget.

Meanwhile, the proposed 2013–14 budget would include a reduction of NIS 18 billion in the government's expenditure in 2014 along with an increase in tax rates equivalent to NIS 15 billion. The tax increases and the marked revision in the expenditure path were considered essential; while in the short run they could impede on the rate of economic growth, without them the mid-term deficit and the debt to GDP ratio could have reached new heights and jeopardize domestic financial stability. But, even expenditure commitments are reduced, there could be a need to raise tax revenues further if economic growth does not pick-up (Bank of Israel, 2013).

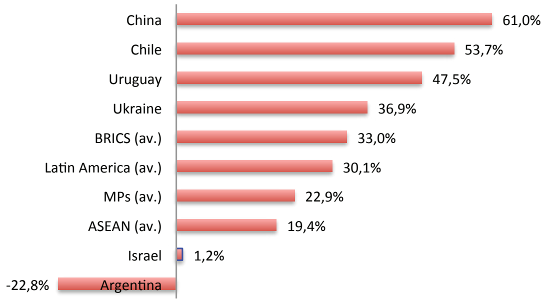
Undeniably, the 2013-2014 austerity budget has outraged many Israeli voters who believed a policy of economic relief would be applied. Broad spending cuts could reach 2% in 2013 and an additional 3% in 2014 in most ministries. Among other things one finds an increase of 1.5 percentage points in the personal income tax and a 1 percentage point increase in the corporate tax. The VAT could also rise 18%, child allowances are to be harshly reduced, and so are subsidies for after-school programs (NYTimes, 2013). Meanwhile, cuts in defence have been scaled back, a compromise was reached cutting the military budget by 840 million US$.

I.6. Monetary policy, exchange rate developments and positive agents anticipations

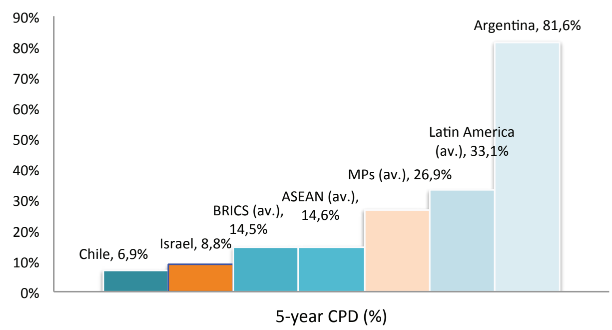
Regarding agents anticipations on the viability of the Israeli economy and its debt the situation is positive. CDS Spreads in Israel only widened by 1.2% in the second quarter of 2013, reaching a value of 126.64 in end-June 2013. The deterioration is thus minimal compared to what is observed in the region on average (CDS widened by 22.9%) or to the recent worsening in France (worsening of 29,3%). The risk of default is thus very low, the 5-year CPD reached 8.8% in end June versus 8.6% in the prior quarter. This remains much lower than both the BRICS and ASEAN countries average and relatively close to the risk observed in a developed country such as France.

Figure 6. Economic anticipations and sovereign risk

*a. % variation (Q2VSQ1 2013) of 5-year CDS Mid**



*b. 5-year CPD (%)***



*Source: S&P CAPITAL IQ, McGraw Hill Financial, * a positive variation signifies a deterioration of 5-year CDS, ** the higher the CPD the higher the risk of default, note MPs average excluding Israel*

The Bank of Israel started an easing cycle in September 2011 to counter the effects of a deteriorating international economic outlook, since then its rates have been reduced by a cumulative 175 basis points (EIU, 2013). The shekel had been appreciating continuously in early 2013 (from the monetary policy discussion on March 24, 2013, through the unscheduled discussion on May 12, 2013, the shekel appreciated by 2.9% vis-a-vis the dollar and by 2.2% versus the Euro) and the Bank decided to reduce the monetary interest rate by 0.25 percentage points to 1.5% in mid-may. Then the BoI decided to reduce the interest rate for June 2013 by 0.25% to 1.25%. The decision was explained by a series of elements such as (Bank of Israel, 2013):

√ The will to narrow the gaps between the Bank of Israel's interest rate and the ones in major economies to avoid excessive appreciation of the shekel.

√ The fact that major central banks had kept pursuing an "accommodative monetary policy", for instance the ECB had reduced its interest rate to a record low of 0.5% suggesting that more interest rate reductions would follow.

√ The moderate rate of inflation with the CPI being below the lower bound of the inflation target range.

√ Higher though still moderate growth in the first quarter coupled with a budget plan that set the deficit target for 2013 at 4.65% of GDP and 3% of GDP in 2014, a decline expected to moderate the rate of demand expansion.

√ The moderate recovery in the US and the continuous slowdown in the EU.

√ Home prices that kept increasing; in the 12 months ending in March home prices had increased by 10.5%.

Between end March and mid-May, in terms of the nominal effective exchange rate there was a 2.8% appreciation. Since May 12th, the shekel weakened by about 3.9% compared to the dollar, by 3.5% against the euro, and by 3.2% in terms of the nominal effective exchange rate. The relatively strong shekel prompted the central bank to announce a new programme of foreign-currency purchases to neutralise the impact of gas revenue on the external accounts (EIU, 2013).

Table 1. Exchange rate indicators

	2011	2012	2013e
Exchange rate NIS:US$ (av)	**3.58**	**3.86**	**3.71**
Exchange rate NIS:US$ (year-end)	3.82	3.73	3.66
Exchange rate NIS:€ (av)	**4.98**	**4.96**	**4.87**
Exchange rate NIS:€ (year-end)	4.94	4.92	4.78
Real effective exchange rate (av), CPI-based	**88.54**	**84.17**	**90.76**

Source: EIU (2013)

II. Structural developments and issues

II.1. Innovation culture that is widespread

Israel has historically based its economic development on innovation and technology and for this reason it has an important place in world research. Currently, it devotes 4.4% of its GDP to civilian R&D which is the highest figure among OECD economies. To illustrate the quality of research in Israel, one can rely on the fact that the countrys' researchers have won 7 Nobel Prizes in literature and science fields including 6 obtained since the year 2002 (4 in chemistry and 2 in economics.

Israel is also the third largest recipient of venture capital investment after California and Massachusetts, meanwhile in the year 2009 there were about 63 Israeli companies listed on the NASDAQ, making Israel the second most represented state,

to illustrate the quality of research in Israel, one can rely on the fact that the countrys' researchers have won 7 Nobel Prizes in literature and science fields

far ahead of Japan (6) Great Britain (5) or India (2). Such results are related to the increased focus since the country's inception on innovation as a driver of economic development. Understanding how public research in Israel is organized will allow to illustrate the importance of public support for innovation and discuss its effectiveness.

a. The Israeli research system

In the Israeli civilian research system one finds both business (about 80% of funding) and government; the first funds R&D activity in new and established technology companies, the second does the same for research in universities and supports commercial R&D in many of forms. One notes that:

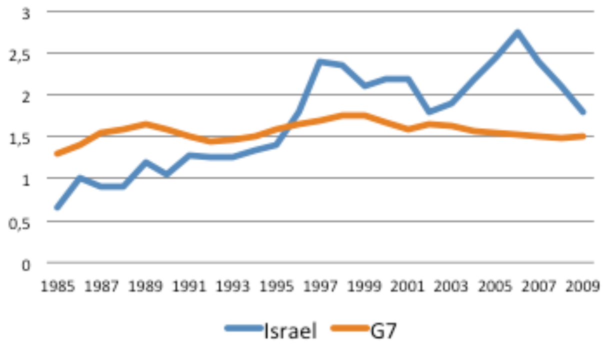
√ Two departments play an important role in the organization of research and innovation in Israel. First, there is the High Council for Higher Education (CHE) through the Vatat which is the body responsible for planning and funding of R & D for Universities. The second important player is the Office of the Chief Scientist in the Ministry (OCS) in the Ministry of Industry, Trade and Employment which is responsible for research in the world of industry. Both the Vatat and OCS manage the majority of civilian public research budgets. Finally, a third actor, the Ministry of Science and Technology, has a more modest contribution with a budget of 20 million euros and is also involved in research activities.

√ Recently, an important transformation occurred in the research system with a main overhaul of the university funding system taking place in 2011. Admittedly, Israeli universities are highly ranked, yet for long they had to face "stagnant budgets, an ageing research force, lack of investment in research infrastructure and a rising proportion of students compared to academic staff" (Erawatch report, 2011). Now, a new six year plan for the university system was introduced including an "increase in budgets which will lead to a higher education and research budget which will be about 30% higher than the current level at the end of the six year plan, over and above the usual formulas used to adjust budget owing to the growth in the student body and other economic factors" (Erawatch report, 2011).

√ Regarding the OCS we should note the existence of research grants awarded under the R&D funds subsidy which finances between 20% and 50% of research spending of a selected project (with a subsidy rate that can reach 60% if the project is a thematic priority and 75% if the project is set in a priority zone). In exchange for the grant, firms have to pay royalties (about 3% of of annual income generated) to the government if the innovation effort is materialized and commercialized. This mechanism allows the government to also benefit from the financial benefits of an innovation and then orient them to fund other projects. In a way, the OCS acts as an investor in venture capital. Yet, this mechanism has been a source of debate since it gives rise to conflicts between the OSC and innovators on the precise amount of revenue generated by innovation. Furthermore, the SCO also provides logistical and financial support to entrepreneurs who start a business on the basis of an administrative innovation aid.

√ One should also mention three other programs. First, the Magnet program which aims to foster collaborations between academic research institutions and the industry, with the objective of facilitating technology transfer between these two worlds. Grants obtained can reach 66% of the funding of the selected project without any royalties system in place. Secondly, the Matimop program which aims to facilitate international cooperation in research and industrial innovation and which has allowed signing bilateral agreements with 30 countries. Finally, Israel is part of the European EUREKA network (the sole non-European member of the Eureka network, involved in 10% of all Eureka projects) for industrial innovation, to foster collaborations between industry innovations in the 40 member countries of the project (budget of 1.5 billion euros).

Figure 7.
Patents by Israel and the G7, 1985-2009 patents filed in all 3 parts of the triad*: US, EU and Japan per 1 billion dollars GDP**



Source: Ben-David (2012),
*Notes: * Patents filed in all three constitute 20-30 percent of all Israeli patents,*
*** Constant 2005 dollars, by PPP*

Israel has never had a "formal research policy", yet all the above mentioned mechanisms form a coherent ensemble and the OCS has "changing priorities and an activist agenda" (Erawatch report, 2011).

b. Impressive results in regards to innovation output indicators

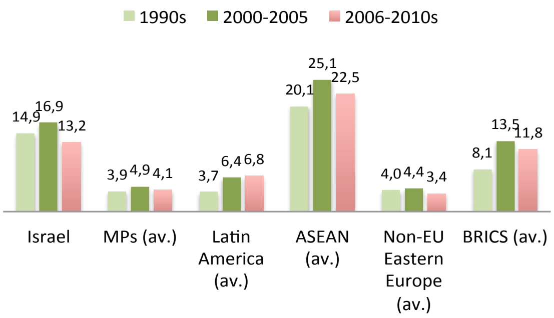
The number of patents remains an indicator for analyzing the effectiveness of research activities in an economy; it is an indicator of innovation in the business sector. For Israel, patent request is not large relative to its efforts in R & D expense; the country deposited an average of 0.2 patents per million dollars of R & D, a ratio that is two times less than the one found in France (0.56) for example, and three to four times less than for the United States, Germany or the United Kingdom.

Yet, taken into account the small size of the Israeli economy, the share of patents filed appears quite large, at the same level with France and the United Kingdom (roughly 200 patents per million inhabitants) but behind Germany (about 600 patents per million inhabitants), the United States (800 patents per million inhabitants) and Japan (2000 patents per million inhabitants). The most patents are being filed in the branches of measurement instruments and especially medical ones, followed by IT and the chemical industry. When looking at the number of patents in the "triad" of the United States, the European Union and Japan that were respectively filed by the G7 countries and by Israel between 1985 and 2009 one reaches interesting conclusions. The number of patents filed (relative to country size, thus in terms of GDP) from the leading G7 countries was significantly higher than the number of patents filed by Israelis in 1985. However, the number of Israeli patents started to increase more quickly in the following years, ultimately exceeding the G7 in the mid 90s and enduring ever since. Also, as expected, the number of patents is very high when compared to the MPs

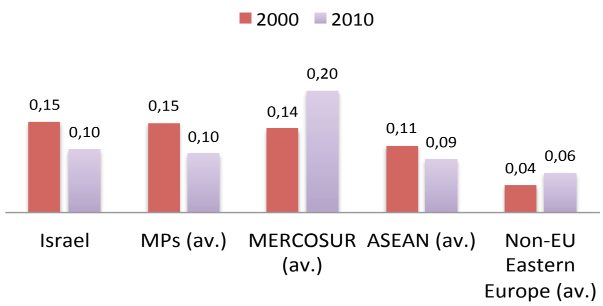
ISRAEL VERSUS THE WORLD: A GLIMPSE AT SELECTED STRUCTURAL INDICATORS

Figure 8.
Improved integration dynamic (selected indicators)

a. High-tech. exports (% of manuf. exports)



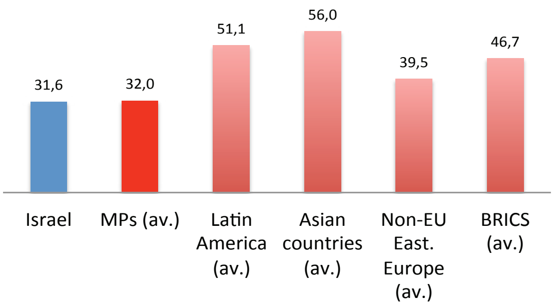
b. Trade Concentration Index



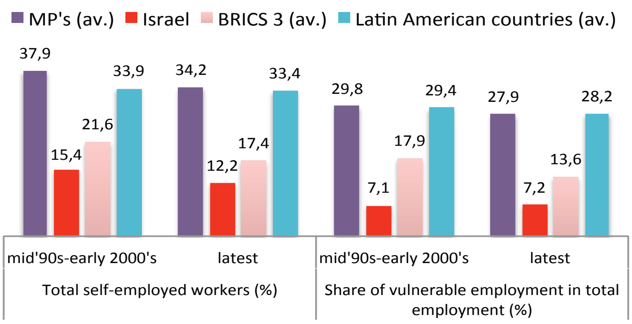
Source: WDI, FEMISE calculations using Tradesift and Comtrade data, based on SITC rev3 3-digit data.

Figure 9.
Domestic labour market dynamic, issues of vulnerability remain (selected indicators)

a. Labour force participation rates, 15-24 (%)

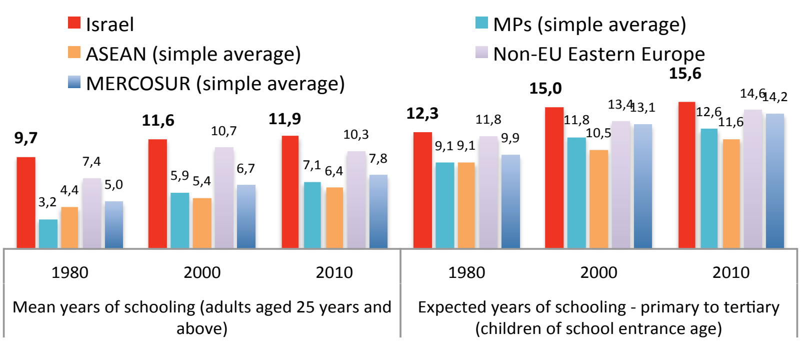


b. Informality and quality of employment



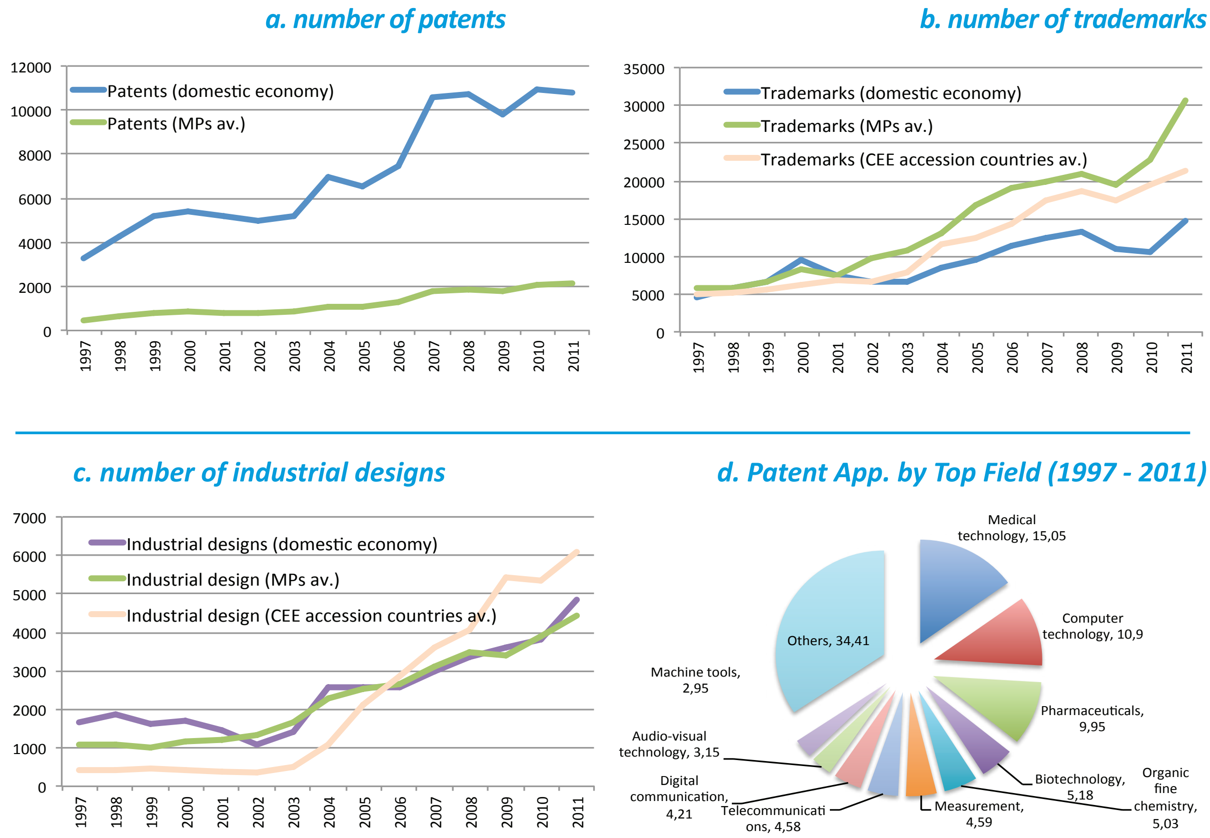
Source : IMF, World Economic Outlook database April 2013 (latest) and EIU

Figure 10.
Social dynamic that improved (selected indicators)
HDI components related to schooling



Source :HDI, FEMISE (2012) note on inclusive growth

Figure 11.
Intellectual property indicators



Source : World Intellectual Property Organization

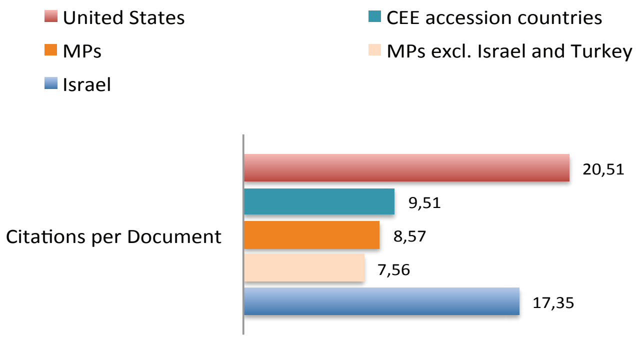
average (including Turkey which carries considerable weight).

The number of trademarks however, which was higher than the regional average until the early 2000s, is lower than the Mediterranean average and also appears lower than the CEE countries average. Statistics for industrial designs in MPs are scarce (only Algeria, Israel, Morocco and Turkey have data for the recent decade and WIPO has data for Jordan only for 2010 and 2011). The number of industrial designs is close to the MPs average, however it has progressively been lower than the CEE countries average since 2005.

More impressive are the results with respect to the share of high technology exports in total exports. High tech products of innovation represent nearly 50% of exports, in 2011 the Israeli economy has exported more than 21 billion US$ of high-tech products versus 11.5 billion US$ of imports. The important role of exports with a "high technological content" for the economic development of Israel began in the early 1990s thanks to the goods and services ICT exports boom as well as the boom in medicine and pharmacy related exports. Maintained by the rapid spread of the «new economy», Israeli start-ups found since then substantial opportunities and markets for their innovations.

Last but not least, the number of articles published by Israel is considerably high and has greatly increased in the latest decade. The number of articles published by Israel in the 1996-2011 period considerably above the MPs average and about double the average found in CEE accession countries. Moreover, in terms of "quality", the number of citations received per Israeli scientific document in 2011 is almost double compared to the number of citations received by CEE coun-

Figure 12.
Journals and country scientific indicator:
Citations per Document



Source : Ministère de l'enseignement supérieur

tries articles and close to the average number of citations received by articles published by USA scholars. This suggests that the impact of Israeli documents is considerably high. Meanwhile, such impact has also increased over the years (in 2000 citations received per Israeli document were 107.2% higher than for an average MPs paper, the gap is now of 129.7%).

The h-index in the case of Israel it suggests that scholars perform exceptionally well compared to the MPs average, though still far below the index of the USA simply because Israel does not produce the same quantity of articles.

II.2. But a considerable number of limitations from a social perspective remain

a. Financial inclusion on par with EU countries…

The level of financial inclusion in Israel is far above the average regional level and for all indicators used. This is normal since the country is at a much more advanced economic development level. In that respect we also compare with indicators of financial inclusion in the Euro economies, which show us that Israel is on par with them.

Most particularly, the percentage of people with an account at a financial institution is roughly the same but the percentage of women in Israel with access to an account is higher than the Euro average (by 3.7% points) though the rate is lower for the Israeli youth (-3.4 percentage points). It is interesting to note that comparatively there is a relatively high percentage of people that took a loan in the past year (16.7% versus only 11.8% in Euro countries) though this would probably have a lot to do with the current state of affairs in Europe and the restraint shown by European banks in granting credit. Despite that, we should note that the share of the population that saved at a financial institution in the past year is relatively low in Israel compared to Euro countries (only 24.8% versus 40.9% for the Euro area).

Thus, in terms of financial inclusiveness Israel seems to perform relatively well. An additional set of indicators allows to have a better look at the following: First, we note that people have an account regardless of the level of education with a share of account holders close to 90% for both the educated and less educated. Second, people in rural areas do not seem to be excluded, the share of the rural population that acquired a recent loan is close to 19.8%, which is above the rates one finds in the Euro area. Meanwhile, already 83.8% of the Israeli population in rural areas has an account, a figure which is close to the Euro average. Banking outreach is also relatively high with 67.8% of Israelis using ATMs as a main mode of withdrawal.

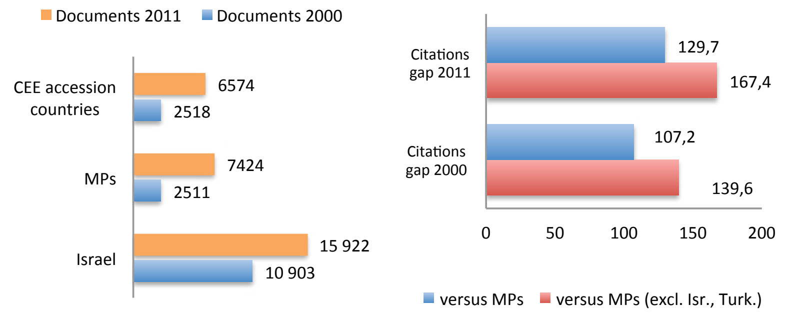
b. …But extremely high poverty and inequalities

Israel benefits from a rising number in people thriving and expressing their happiness towards the distribution of the fruits of growth, the country being 4th in the international classification of well being (FEMISE, 2012).

Yet, youth participation in the labor market (close to 50%) is below what one finds in other regions such as Latin America and East Asia. This is an important issue for a country that is economically more developed than most if not all of its neighbours. Meanwhile, issues of inequality are persistent. The country ranks worse than most EU countries when looking at the Gini index and also worse than Algeria and Egypt. Perhaps most importantly and worryingly, out of a total of 34 developed countries Israel is the most impoverished with a poverty rate of about 21% (OECD, 2013).

This can be explained by a dual concentration of high poverty and unemployment among two large minorities, meaning the asharedi and Arab Israelis. Only 48% of ultra-Orthodox working –age men were employed in 2011 while only 28% of Arab Israeli women were employed (a figure that reaches only 5% for Arab women who did not finish high school). As a result, poverty is located among households with many children and with an « inclination to go out to work » that is already reduced (TheNewYorker, 2013). For the year 2011, one could count about 270200 poor Jewish households, which represents a share of 61% of all poor households. The remaining 171900 poor non-Jewish households would represent 39% of all poor households.

Figure 13.
Journals and country scientific indicator:
a) No of documents (2000 VS 2011) b) Citations per Document gap* (%)



Source: SCImago Journal & Country Rank (SJR)
** FEMISE calculations based on SJR, the index measures in percentage terms how many more/less citations per document the country receives when compared to the regional average. Ex. a value of -10 means that the country receives 10% less citations per document compared to the MPs average.*

Figure 14.
Indicators of Financial Inclusion, latest year (2011)

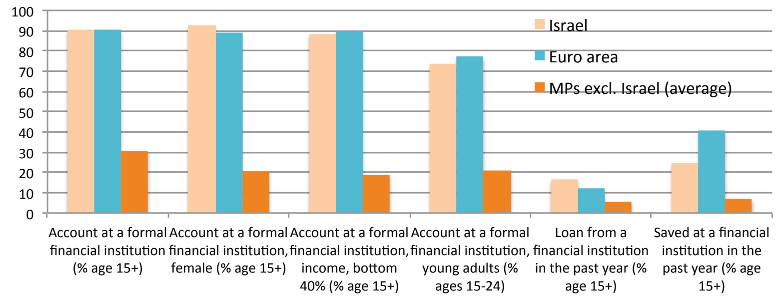
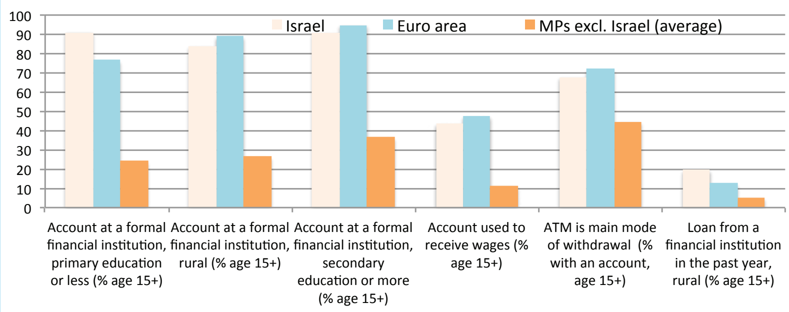


Figure 15.
Second set of Indicators of Financial Inclusion, latest year (2011)

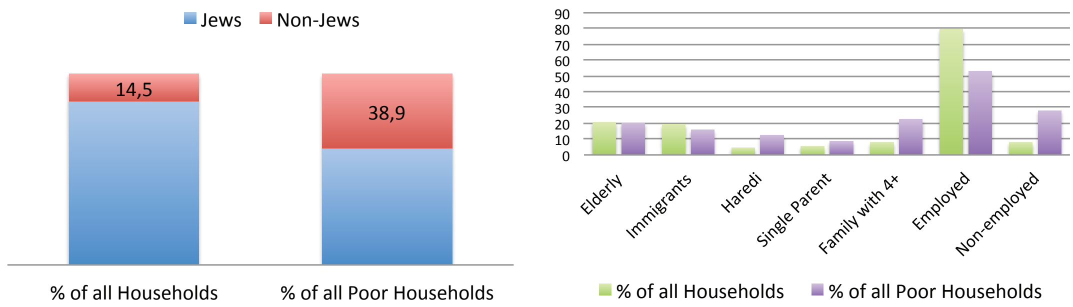


Source: Global Findex (Global Financial Inclusion Database), World Bank

The share of poor Non-Jewish households significantly surpassed the percentage of Non-Jewish households in the total population, due to the high poverty rate among non-Jewish households. Households with a non-employed head of household represented slightly less than a third of all poor households (but only 9% of the total number of households), while families with four or more children represented 23% of all poor households (but only 8% of the total number of households) (MJB, 2013). One must note that even when not taking into account the haredim and Arab populations, Israel's poverty is about 60% above the OECD average. There is thus also a view that Israel's high poverty is directly related to the « distorted structure of the state budget », both in terms of spending and of taxes. Indirect taxes that are collected from poorer households are higher than in other OECD countries, while property and income taxes which target the more prosperous households, are lower than in other developed economies (Globes, 2013). Let us stress that the government is also set

Figure 16.
Composition of Poor Households
in Comparison to the Composition of All Households, 2011

a. Jews VS Non-Jews *b. Population groups (by head of hh)*



Source : National Insurance Institute, November 2012

to push through a series of austerity measures, with a cutting of family subsidies and medical benefits. Such socialy devastating measures are expected to cause more families to fall into poverty. Estimations suggest about 30000-40000 additional children are expected to fall under the poverty line (HuffingtonPost, 2013). This is an issue not to be taken lightly, already, when looking at recipients of food aid in Israel, 61% of Israeli food aid organizations reported an increase in the requests for assistance on behalf of children, with 62% of those children lacking books or any other basic school equipment (MJB, 2013).

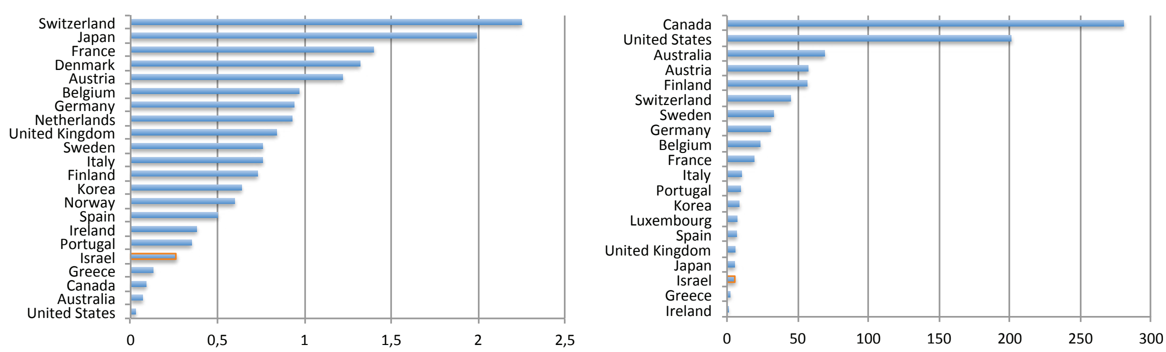
c. A limited physical infrastructure that does not allow for the benefits of innovation to spread

All in all, the relatively high level of Israeli innovation has not considerably enhanced productivity and living standards. In 2011 labor productivity in the country was lower than the labor productivity in 23 out of 34 OECD countries. As noted by Ben-David (2012), "labor productivity in Israel grew faster than the G7 average until the mid-1970s. Since then, however, productivity fell further and further in relative terms – and falling with it, in relative terms, is Israel's standard of living".

One must note that economic growth fundamentally depends on the transportation system to move workers and goods throughout the country. Yet Israel's infrastructure is clearly inadequate in that domain which penalizes perspectives for future economic development. Israel's roads are more congested than those in the OECD by over two and a half times. Development of the road infrastructure necessitates colossal investment to bring it on-par with OECD levels. The situation is

Figure 17.
Railways, passengers and freight, 2009

a. Passengers, km travelled per cap. *b. Freight, ton-km of freight per 1000$ of GDP*



Source: Ben-David (2012)

even worse when bearing in mind the limited rail infrastructure. The shortage of such an alternative means that as economic development closes on OECD levels "it is not unreasonable to assume that Israelis will rely even more heavily on their automobiles than is common in other Western countries with rail alternatives" (Ben-David, 2012).

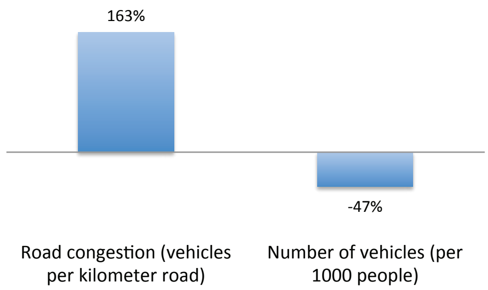
While authorities have recently tried to remedy this issue, national expenditure is insufficient to close the gaps. Overall, in the latest years spending on roads has been at best close to OECD levels, or far below the threshold for most years.

d. Prices that remain exorbitant especially for housing

Inflation forecasts in Israel might be low as mentioned earlier, but this does not change the fact that there is a price issue that needs to be dealt with, especially regarding housing. Back in late 2011, protests in Israel also erupted due to the high price of cottage cheese and dairy products. Not only were high prices detrimental to consumers, they also cost shoppers 760 million NES between 2008-2011 because of the missed opportunity for price controls on cottage cheese (Haaretz, 2013). When comparing food prices in Israel with the OECD average, the price gap in dairy products has remarkably risen (to 44% in 2008). Meanwhile, the price of other food products and non-alcoholic beverages in Israel compared to OECD was 16% more expensive in 2008 when it used to be cheaper three years earlier.

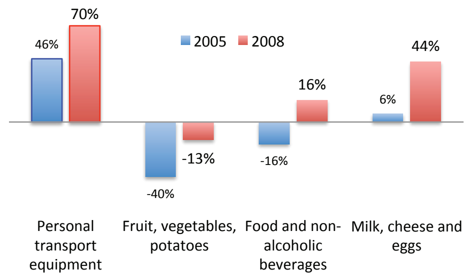
As for automobiles and housing, they both seem to be lastingly expensive in Israel. In the case of transport vehicles, heavy taxation meant that Israeli prices exceeded the OECD average by 70% in 2008 up from 46% in 2005. As for housing, the following remark by Ben-David (2012) summarizes the issue well, "7.7 years of median income are required to purchase the median apartment. In fact, the Israeli cost of housing – relative to income – is more expensive than housing in 32 of England's 33

Figure 18.
Situation on the roads, Israel VS OECD av.*, 2008



*Source: Ben-David (2012), Notes: * Average of 22 OECD countries.*

Figure 19.
Prices relative to OECD average*



Source: Ben-David (2012)
*Note: * The difference between prices in Israel and the average OECD prices.*

metropolitan areas (including London) and more expensive than housing in 174 of America's 175 metropolitan areas (including New York City)". Cheaper housing is usually found in the periphery but this means that, when taking into account the limited transportation infrastructure that connects the periphery to main cities, residents outside main cities suffer economically and partly excluded from economic opportunities.

III. Conclusions

Due to the unexpected fiscal deficit, the new government is going to follow a series of austerity measures, aiming at extra tax raising and cuts in total spending. The fiscal position should thus strengthen more meaningfully in the coming years. As noted by Stanley Fischer, «the Israeli economy is in good shape. The annual budget should reduce the deficit to 3% of GDP, which is a task that the Israeli government set itself, not the EU or anyone else. We are growing fast, and we expect 3.8% growth, 1% of which is from gas. Israel's growth is higher than in OECD countries».

Meanwhile, the quality of research in Israel is outstanding and has provided the basis for an innovation driven model of growth. Yet, Israel might be a highly innovative economy, it suffers nonetheless from high poverty rates, limited labour market participation for the youth and persistent inequalities. The high level of Israeli innovation has not considerably enhanced productivity and living standards. There are limitations regarding the degree and path towards inclusiveness of growth and there is need for a new social contract (FEMISE, 2012). The fact that less working age people work in Israel than in other countries only aggravates the issue since living standards are mirrored by GDP per capita.

The solution lies in improving both the physical and human capital infrastructures that will reduce inequalities, elevate productivity and also foster economic growth. Among the futures challenges one may note that :

the solution lies in improving both the physical and human capital infrastructures that will reduce inequalities, elevate productivity and also foster economic growth.

- √ There is considerable scope for improving the transportation infrastructure. Israel's roads are among the most congestmong developed economies and the rail system is even less developed. There is also great potential to improve human capital infrastructure. Regarding the latter "achievement in core curriculum subjects by the nation's children has been consistently below every one of the 25 relevant OECD countries since the late 1990s with all that this implies regarding the future ability of these children to compete as adults on the international economic playing field" (Ben-David, 2012).
- √ As noted once more by Stanley Fischer the Israeli challenge is « to deal with poverty, especially among Arabs and haredim (ultra-orthodox). Poverty in Israel is unique...we define it as half of the median salary. If everyone in Israel were to earn twice as much, poverty would not be reduced » (Globes, 2013b). The fact of the economy being too centralized along with the issues of housing prices and low labour productivity should also be in the reform agenda. Meanwhile, as noted by president Shimon Peres, «we mustn't accept a reality in which 900,000 children are deprived of food and tens of thousands are deprived of education»(YnetNews, 2013).
- √ According to the Israeli finance ministry, the answer to the issue of poverty is to be able to provide work, excluding however any government welfare support through allowances as a means to combat the issue. The Finance minister announced in May that the 2013-2014 state budget and forthcoming reforms would allow pushing the poor populations into the workforce. Yet, some argue that working people are also under the poverty line in Israel (JPost, 2013).
- √ Tackling the issue of labor-market participation is essential if the country wishes to at least combat poverty among the excluded. As noted by Manuel Trajtenberg, who chairs the planning and budgeting committee at Israel's Council for Higher Education, « we need a concerted effort to tackle these two populations, and that effort has to entail an investment in higher in education" (TheNewYorker, 2013). Such claim for an improvement of the quality of education is not unfounded and is complementary to the process of job creation. A study by Hanushek and Woessmann (2010) advocates that achievement in mathematics, science and reading is strongly correlated with differences in economic growth. Currently, Israel faces a gap with OECD economies on the level of achievement. When applying their model to Israel, the authors reach the conclusion that if the country's achievement levels were 50 points higher since 1980, thus covering the achievement gap with the OECD, per capita GDP growth would have been higher by 0.44 percentage points in 2010.

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JORDAN

An external position in distress and a critical fiscal position

Introduction

The Kingdom of Jordan has a small industrial base and its economy is very small among MPs because of the scarceness of natural resources. It is by nature one of the countries most dependent from international activity. Meanwhile, youth unemployment had been long thriving. Yet, the economy has progressively grown over the past 20 years, important economic reforms have been undertaken and "have been the primary motivator for foreign investment in the kingdom in the last few years" (Ahid and Ayuba, 2012). As a result, more FDI lead to more jobs and the rate of unemployment declined.

But now Jordan is currently in a crucial situation. The international crisis of 2008, the euro crisis and regional political instability since 2011 have all contributed to slowing down the growth of exports and the pace of GDP growth has been negatively affected. Following the decline in migrant remittances, weak tourism receipts and foreign direct investment (FDI) significantly altered the growth rate of the Jordanian economy has been reduced by more than half since 2008 (AFD, 2013). Furthermore, despite achieving impressive growth rates in the mid-2000s and lower though stable ones recently, the country's budget deficit reached considerable heights. In the first nine months of 2012 the loan-financed deficit represented about 16% of GDP, which forced authorities to reduce subsidies in order to preserve economic stability (MiddleEastVoices, 2012). The resulting price rises range from more than 50% for bottled gas used for cooking, 33% for diesel and kerosene for transport and heating and 14% for lower grade petrol (Reuters, 2012). The rise in prices led to protests throughout the country but this time measures are not expected to be withdrawn under public pressure.

This is a critical turning point for Jordan, considering that despite domestic protests its political climate was relatively unscathed from the Arab Spring wave. Yet, the fiscal situation was heavily impacted by the Arab spring (but also by the 2008 crisis) and the bombing of the pipeline bringing Egyptian gas forced Jordan to switch to costlier fuels (REUTERS, 2012). The country showcases a considerable energy dependence and recent events raised the cost of the energy bill and deteriorated the external balance. Now, the problem resides in the fact that financial alternatives are scarce. Furthermore,

> ***the international crisis of 2008, the euro crisis and regional political instability since 2011 have all contributed to slowing down the growth of exports and the pace of GDP growth has been negatively affected...***

the IMF agreement for a loan leaves little room for manoeuvring and authorities are also expected to follow-up on austerity including the possibility of raising electricity prices and removing other types of subsidies. Thus, while efforts to liberalise could be hindered by fears for more public discontent, authorities already agreed on «socially acceptable» cutbacks and structural reforms (EIU, 2013).

Adding to these challenges is the fact that Jordan has been, in a very short time-span, hit by the devastating consequences of the Syrian revolution. The Kingdom of Jordan now hosts about 700000–800000 Syrian refugees, which represents more than 10% of Jordan's total population. With the influx of refugees increasing, domestic authorities expect the number of refugees to reach 1 million by the end of the year. The arrival of refugees has had a direct impact on

Key indicators	*2005-2008*	*2009-2011*	*2012*	*2013*	*2014*
Real GDP growth (%)	*7.9*	*3.5*	*2.8*	*3.3*	*3.5*
Consumer price inflation (av; %)	*7.1*	*2.9*	*4.8*	*5.9*	*3.2*
Budget balance (% of GDP)	*-5.4*	*-8.1*	*-6.2*	*-5.1*	*-4.1*
Current-account balance (% of GDP)	*-13.9*	*-6.9*	*-18.1*	*-10*	*-9.1*
Unemployment rate (%)	*13.7*	*12.8*	*12.2*	*12.2*	*12.2*

Source: WEO – IMF. April 2013 (latest) and EIU. estimates for 2013 and 2014

the everyday life of the population such as the cost of rent increasing (Rental prices have gone up two to three times in the last year) and the labor market in distress from cheap offers from Syrian workers. Meanwhile, refugees have access to primary health care and schooling in Jordan, but available services are "stretched to the limit" (Oxfam.org, 2013). Meanwhile, authorities in Jordan have become increasingly nervous about the security implications of the Syrian conflict (EIU, 2013).

All in all, despite some country-specific problems, the case of Jordan is similar to that of other MPs regarding short-term concerns, especially fiscal ones, but with longer-term needs that ask for a new and more focused development strategy. Structural issues could be answered with the development of innovation and creativity, currently lacking in Jordan.

The current economic situation is the following :

- √ *The economy might still grow only modestly (estimated **growth** at 3.3% in 2013), with domestic demand growth still depressed by regional instability, fiscal constraints and the situation in export markets.*
- √ *The **budget deficit** is expected to fall to about 5.1% of GDP after the subsidy cuts and austerity measures to be introduced.*
- √ *The **current-account deficit** widened in 2012 to 18.1% of GDP, but a recovery in exports and a deceleration in import-growth should bring it to -10% of GDP in 2013.*
- √ ***Unemployment** is expected to remain close to 12.2%. But this is not enough and taking into account the prolonged period of austerity social tensions are expected to remain high.*
- √ *Despite substantial efforts of trade openness and privatisation across the economy a lot more could be done to develop the **business environment**; Jordan being only 106th out of 185 countries in the ease of doing business.*
- √ *Jordan has a very high level of **energy dependence** (over 90% of its energy resources are imported) and not much had been made in recent years to change that trend. Renewable energy currently represents less than 1% of energy generation. Yet, more funding is needed to achieve independence and the times are harsh.*
- √ ***Jordan lacks inclusiveness** in its growth model and innovation to sustain it, the lack of both penalizing employment creation. Most particularly, the country is underperforming in the "business sophistication" and "infrastructure" components of innovation. We believe that the answer to the Jordan's structural issues could lie on the development of innovation and creativity, authorities should have the ambition of developing their innovation strategy. Only them will they be able to give a new impetus to firms, lead to a new growth model less dependent on capital accumulation, allow for the development of new products and services, bring new productivity gains without loss of competitiveness in international markets and foster new jobs. Undeniably, firms, especially SMEs, need to be more invested in the process of innovation. For this to happen, efficient decentralization has a role to play towards both the public and private sector.*

I. A 2012 / 2013 macroeconomic snapshot

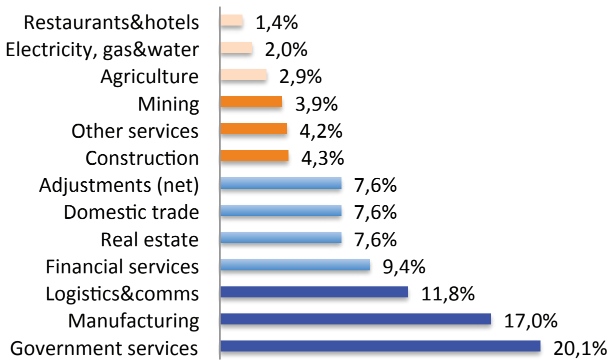
I.1. Economic growth, restrained but stable

In MP's GDP growth accelerated after 2000 but was still below the rates observed in other developing regions. This was not the case of Jordan however. The average annual GDP growth rate of the recent decade was above 6%, on par with the levels observed in Non-EU eastern European, ASEAN and BRICS economies.

Growth in Jordan has recently been somewhat restrained though stable. In 2012 the rate of GDP growth was of 2.8%, below the post international crisis rate of 3.5% and far below the 2005-2008 growth average of 7.9% (the boom years that went hand in hand with rising oil prices and thus increased remittances and investment). But growth has always remained close to the 3% mark and shown resilience. Furthermore, let us not forget that the mid 2000s were a special case, a significant boost in consumption was obtained given the influx of hundreds of thousands of Iraqi refugees. Furthermore, Jordan's position as a logistics hub for the multilateral forces in Iraq and as a base for post-conflict relief reinforced a range of services sub-sectors including transport, hotels etc (QNB, 2012).

The advantage of Jordan compared to other MPs is that it is fairly diversified, something that can be seen when breaking down the sectoral components

Figure 1.
Economic Sectors' Share of GDP (2011), (% share of total)



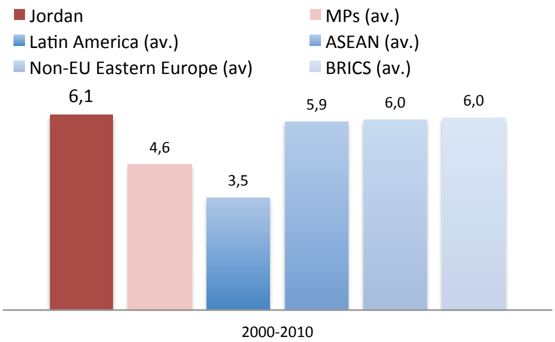
Source: QNB (Qatar National Bank), 2012

of GDP. A large share of growth is attributable to tourism activity and services in general (they make up for more than 60% of total GDP, one of the largest shares of any MP). Agriculture represents a small share, though recent unfavourable weather conditions and security concerns had an effect on agricultural activity (2.8% of GDP in 2012) and hence GDP. The agricultural sector contracted by 9.4% last year, following weak crop production. This had an effect on both the "local front within the context of slower production and on the external one within the context of weaker export growth" (Bank Audi, 2013). Mining also contracted owing to strikes in the potash and phosphate plants (IMF, 2013).

On the demand side government spending has been recently low, contributing only 0.3 percentage points of GDP in 2012, and is expected to remain

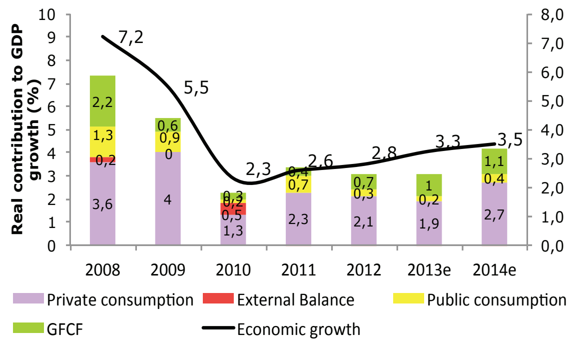
Figure 2.
Gross domestic product

a) Average annual GDP growth rate by region



Source: IMF, World Economic Outlook database and EIU

b) real contribution to growth (%)



at similar levels for 2013 as well. A slight increase in investment is expected (though cuts in capital spending shall confine it) which along with private consumption should contribute the most to domestic growth. Let it also be noted that the unpredictable effect from the situation in Syria is always something to take into account while exports will be partly hampered by sluggish growth in the economies of developed partners. Thus, all in all GDP growth is expected to reach 3.3% in 2013, still below potential echoing also the negative influence on domestic demand of the recent fuel price upsurge.

I.2. Unemployment pressures that keep the rate above two digits

Solving the issue of unemployment was one of the central objectives of the reform program adopted by the authorities since the 1990s. But, despite efforts in instigating reforms and attaining higher growth to foster more jobs, unemployment has persistently been high, remaining close to its levels of 20 years ago. In 2012, unemployment was slightly below its levels of 2009-2011, reaching a rate of 12.2%. But,

Figure 3a.
Unemployment rate (%) by region and age group (%), most recent year

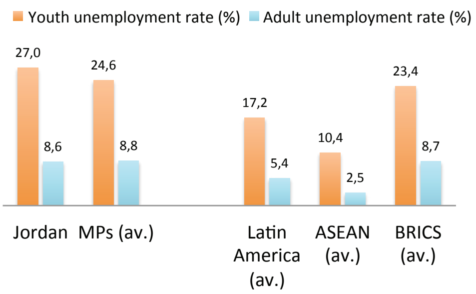
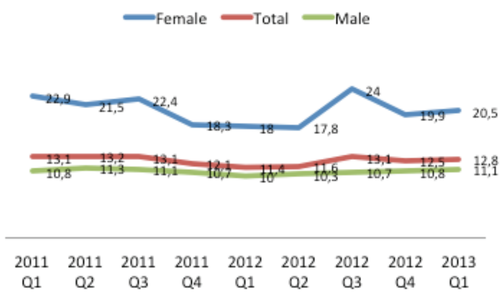


Figure 3b.
Unemployment rate (%) by gender, quarterly



Source: KILM, Department of Statistics

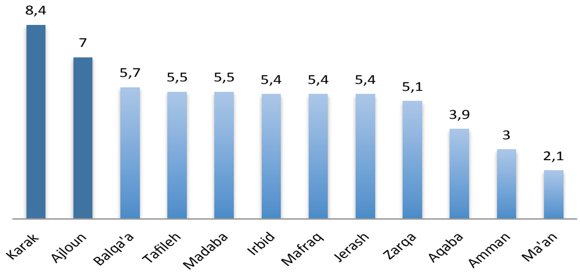
the rate of unemployment in Jordan reached 12.8% during the first quarter of 2013, which corresponds to a year-on-year 1.3% increase, then reached 14% in Q3 2013. Most affected are women (26.8%) even though they globally hold a higher level of education than men (which only face a 11.3% unemployment rate). Meanwhile, the unskilled labor suffers the most, its share representing more than half of the unemployed. However, the unemployment rate is high among the university degree holders (Bachelor degree and higher), affected by 20.6% in Q3 2013, compared with the other educational levels. Not surprisingly, the youth are hit more than others, the highest rate being found in the age group of 15-19 and 20-24 (of 37.9% and 34.9% respectively). The youth unemployment rate in Jordan is among the highest in the region (close to 27%) and is even higher than the rate observed in BRICS countries (23.4%) and more than double the rate found in ASEAN countries (10.4%).

About 29000 thousand jobs were created (more specifically 48000 thousand jobs were created and 19000 were lost) in the second half of 2012, with no real differences compared to the same period of 2011. Men were the ones benefitting the most, with net created jobs reaching 20000 versus only 8000 for women while about two-thirds of net jobs created were produced by the formal private sector. Meanwhile, the Karak governorate acquired 8 created job opportunities per each 1000 of its residents while in the governorate of Ma'an one would find only 2.1 created job opportunities per each 1000 residents (Department of Statistics, 2013). Authorities recently announced that they would stop allowing labor enter the country to help ease pressure on the job market ; the latter has seen increased competition since the arrival of hundreds of thousands of Syrian refugees which are often underpaid (ANSAMed, 2013). But Jordan needs to see the bigger picture, while already sustainable, the current rates of growth need to pick-up to provide more productive employment to the ever-increasing labour force and allow for an increase in economic participation. The latter is currently close to only 37.3% for the whole Kingdom (60.8% for men against only 13.3% for women).

I.3. Inflation dangerously rising after removal of fuel subsidies

The rate of inflation in Jordan was remarkably low after the international crisis, it reached 2.9% during the 2009-2011 period versus 7.1% on average during 2005-2008. Yet, it grew to 4.8% in 2012 and is expected to rise even more in 2013.

Figure 4.
Net jobs created per thousand of the population by governorate, the 2nd half of 2012



Source: Department of Statistics, 2013

Official data from the Department of Statistics suggested an important increase in the Average Agricultural Producers' Price Index for June 2013 compared with June 2012 by 37.8% essentially due to a rise in the prices of tomato (141.3%), cucumber (112.1%), potatoes (78.0%) and other fruits and vegetables. On the accumulative level, the Price Index of Agricultural Producers had increased by 11% for the first five months of 2013 compared with the same period of 2012.

As for the consumer price index, during the first seven months of 2013 it already increased by 6.4% compared with the same period of 2012. This rise can be attributed to specific commodities/sectors such as Transport (+14.7%), fuel & lighting (+24.2%) and foodstuffs the likes of vegetables (+12.9%) and Meat and Poultry (+5.7%) (Department of Statistics). Rare occasions of price decrease are to be found in tobacco and cigarettes (-8.8%), cereals and its products (-1.4%) but also medical care (-2.3%). Meanwhile, one could note a slight increase in the General Industrial Price Index for the first 6 months of 2013 (annualized rise 1.3%). This increase resulted from an increase in the quantities of the Manufacturing Industries (2.9%) with a relative importance of 82.5%. Meanwhile, the quantities of the Quarrying industries decreased by 4.9% (relative importance of 11%) and the quantities of the Electricity production by 10.1 % (relative importance of 6.5%) (Department of Statistics). Due to higher grants and tax proceeds Jordan's state budget gap was narrowed by 23% year-on-year to JOD 897mn in the first ten months of 2013. The IMF expected Jordan's budget deficit narrow to 4.8% of GDP in 2013 from 8.2% the year before, frequent revisions could push the threshold upwards.

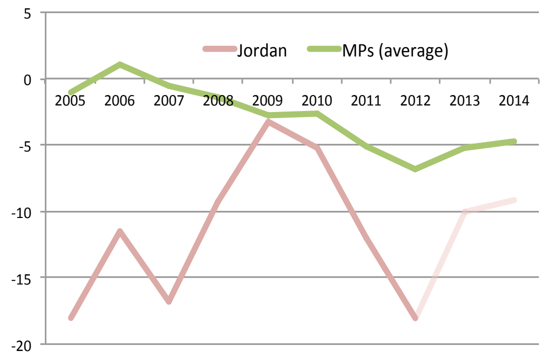
I.4. External position in an extremely crucial situation

Traditionally, a persistent deficit is the main feature of Jordan's trade balance, with goods exports representing about less than half of imports. The base of the domestic exports is now much broader than it used to, reflecting better diversification. But, imports have been considerably impacted since the turn towards a liberal trade regime. As a result, the current account has constantly registered a significant deficit since 2005 because of the high import bill. The deficit was able to fall to only -3.3% of GDP in 2009, yet it has been increasing since then and reached an unprecedented -18.1% in 2012.

Undeniably, there is a structural imbalance that is the result of the need to import fuel and foodstuffs. Meanwhile, the trade deficit has been usually counterbalanced by the surplus in services (especially tourism), by current transfers, remittances and aid (so much as to lead to a current account surplus in the late 90s). But the deterioration is sharper than ever and nothing could cover for the trade balance deterioration in 2011 and 2012. The abrupt fall in gas supplies from Egypt, forced Jordan to import oil at a high price for electricity generation, while the service surplus narrowed and FDI had been falling.

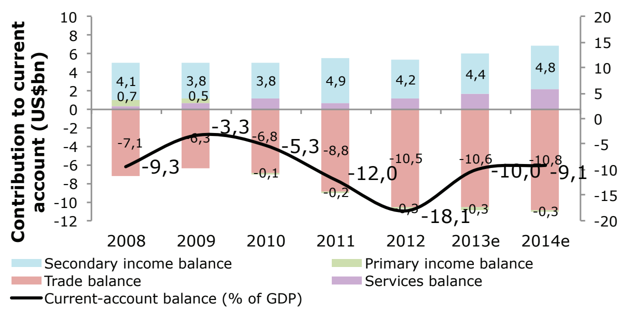
Iraq is traditionally the largest beneficiary of Jordan's exports and is also the destination of a signi-

Figure 5a.
Current account balance, as percentage of GDP



Source: IMF, World Economic Outlook database and EIU

Figure 5b.
Current account balance, in billions US$



Source: IMF, World Economic Outlook database and EIU

Table 1.
The most important exported commodities during the 1st half of 2012 and 2013. (Value in million J.D.)

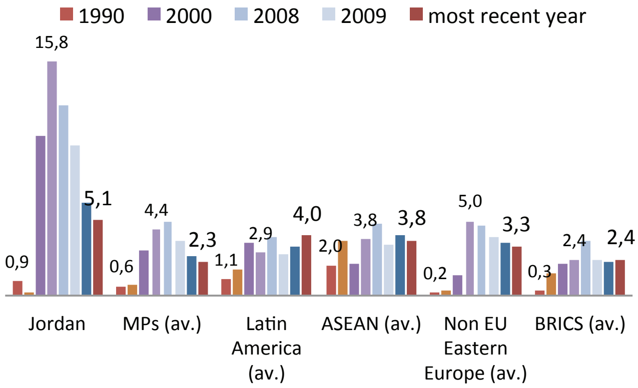
	1st half	*1st half*	
	2012	*2013*	*Annualized % variation*
Total			
Clothes	*343*	*370.1*	*7.9*
Crude potash	*278.2*	*279.4*	*0.4*
Vegetables	*215.4*	*134.9*	*-37.4*
Pharmaceuticals	*185.1*	*205*	*10.8*
Fertilizers	*172.4*	*120.4*	*-30.2*
Crude phosphates	*214.9*	*161.1*	*-25*
Others	*949.4*	*1067.2*	*12.4*
National exports	*2358.4*	*2338.1*	*-0.9*
Re-exports	*443.9*	*419.9*	*-5.4*
Sum of total Exports	*2802.3*	*2758*	*-1.6*

Source : Department of Statistics

ficant amount of re- exports coming through Jordan, using Aqaba due to the lack of capacity in Iraqi ports. The USA is the second largest recipient, showing great interest in clothing from the QIZs (QNB, 2012). In 2013, the value of total exports reached JD.2758.0 million during 1st half of 2013, that is a 1.6% fall compared with the same period of 2012. The main exported items responsible for this performance were clothes and related accessories (+7.9%), crude potassium (-0.4%), pharmaceutical products and fertilizers (10.8%), while one should also note a decrease in the value of exports of vegetables (37.4% annualized fall) and crude phosphate (25% annualized fall) (Department of Statistics). Meanwhile, the value of imports declined by 0.9% compared with the same period of 2012.

Services exports increased by 10.7% in 2012 and are expected to grow by a similar amount in 2013 as well. The tourism sector is greatly responsible for that (accounting for over 7% of GDP), registering a 15.3% increase in tourism receipts for 2012, adding US$3.47 billion to the Jordanian economy. Being among the least resource-rich countries among MPs, Jordan strengthened its tourism infrastructure and became a tourism centre in recent years, with great benefits drawn for its economic growth. Jordan actually managed to achieve « the best trading results in the Middle East, primarily due to an 18.1% increase in occupancy ». Furthermore, Amman was the best performing city in the region with 30.4% RevPAR growth (ArabianTravelMarket, 2013). It is impressive to note that the rise in revenue was accomplished despite the fall in the number of tourists, the total number falling by 7.3% in 2012. The increase in prices contributed to an increased cost of hotels and transportation but the situation in the situation had a greater influence (Al Arabiya, 2012). The Jordan Tourism Board made efforts through blogs and social media to highlight that despite the regional turmoil Jordan was a safe destination (Iambassador, 2013). Travel receipts decreased by 2% for the first third of 2013 compared to the same period in 2012. But, when excluding travel receipts from Libyans there is an apparent rise by 5.5%t during the first four months of the year (CBJ, 2013). Thus, the current account deficit is expected to remain very high but considerably narrow compared to 2012, reaching 10% of GDP owing in part to an increased services and income balance.

Figure 6.
FDI by region, %age of GDP



Source: WDI, World Bank

Regarding foreign investment, in the recent decades, Jordan tried very hard to develop its investment capacity and attractiveness to FDI. Efforts comprised implementation of a new Privatization Law to increase privatization, legislation to harmonize sales taxes on domestic and imported goods, introducing new laws on intellectual property and competition etc. After instigating pro-openess policies during the 1990s, signing the EuroMed and WTO agreements and passing new legislations to invite foreign investors, FDI inflows were given a boost. One determinant factor in attracting FDI was that there were numerous feasible projects that were available to be undertaken. Foreign capital flowed in, attracted mostly by the industrial sector, but also by the service economy and especially tourism, communications, transport and health (Bakir and Alfawwaz, 2009). In the 2000s, FDI increased exponentially; it first grew to 312 million JD in 2000 and had risen to 2 billion by 2007.

In recent years, after the international crisis, FDI in Lebanon was hindered, reaching 1.4US$bn in 2012. Inflows of foreign investment have remained steady from the Gulf Arab states, thus, a rise to 1.8bnUS$ (representing 5.3% of GDP) for 2013 is expected. This should allow FDI as a share of GDP to be above the corresponding rates of other developing regions such as Latin America and ASEAN (respectively of 4% and 3.8%). Yet, FDI is still below potential considering the constant investor concern over the regional political economy which impedes in longer term commitments and has a stalling effect on some projects.

I.5. Fiscal balance to be somewhat alleviated but debt dangerously rising

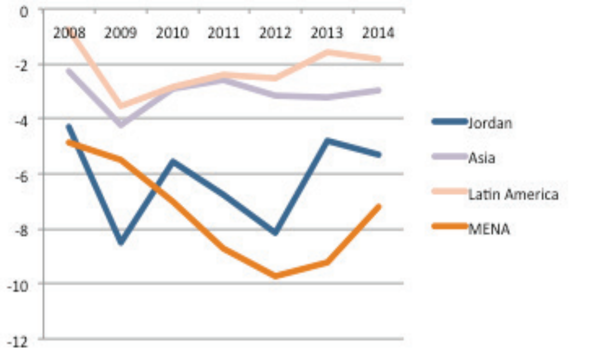
Overall, Jordan has been running a structural fiscal deficit during the recent decade, nevertheless it was somewhat contained thanks to the assistance provided by foreign grants.

The economic costs linked with a fragile regional situation, a slow-moving economic growth and rising subsidies put a toll on Jordan's accounts.

But, after the international crisis and a simultaneous fall in domestic revenue and grants, the fiscal deficit was considerably high and reached an average of -8.1% for the 2009-2011 period. The Arab Spring, the introduction of fuel subsidies and the fall in gas imports all contributed to a marked increase in current expenditure. The economic costs linked with a fragile regional situation, a slow-moving economic growth and rising subsidies put a toll on Jordan's accounts.

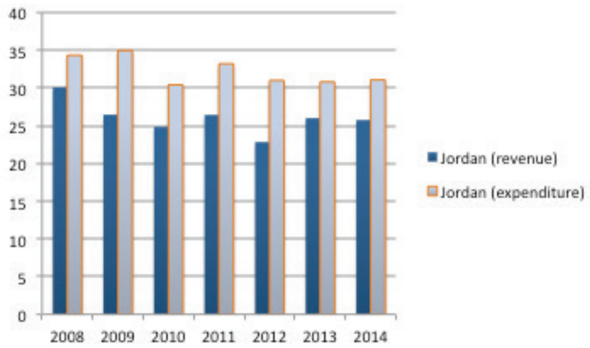
But more recently, during Q3 2012, higher oil prices contributed to a significant increase in the

Figure 7a.
General Government Overall Balance, % of GDP



Source: MF, Fiscal Monitor database, estimations for 2013 and 2014.

Figure 7b.
Revenue and Expenditure, % of GDP



Source: MF, Fiscal Monitor database, estimations for 2013 and 2014.

fuel subsidy. After failing to increase prices for fuel products, liberalization of all fuel prices (except for LPG) was decided in mid-November and the monthly fuel price adjustment was re-introduced in January 2013 eliminating the subsidy. This was deemed necessary to allow for the fiscal position to become tenable. But, recent austerity actions did not contain fiscal weaknesses as the shortfall reached its highest level since 2009. The recent authorities' efforts to contain budgetary leaks were met with impediments hindering revenue-raising, thus solidifying the presence of the fiscal constraint (Bank Audi, 2013). The additional load of the substantial influx of refugees from Syria further weighed down on a recently unstable economy.

In 2013 new austerity measures are to be expected to confine current expenditure and hopefully increase revenue. It was announced by authorities that aims are to cut the budget deficit by about a third, to limit the impact of spiralling fuel import costs and the high social expenditure after the regional turmoil. The draft 2013 budget was set at JD7.45bn, accentuating fiscal prudence to reduce the deficit to JD1.31bn from JD1.76bn. The appraisal of expenditure contains JD850m of grants from donors "traditionally used to cover some of the budget shortfalls" (ArabianBusiness, 2013). Recently, it was announced that one of the measures would be to also lift subsidies on electricity at some point (Al Arabiya, 2013). The general budget, including foreign grants, recorded a deficit of JD 19.1 million during the first two months in 2013, about half the fiscal deficit during the same period in 2012. When excluding foreign grants however, the general budget deficit would reach JD 202.4 million compared to JD 39.8 million during the same period of 2012 (CBJ, 2013). Now, the budget balance in 2013 is expected to improve and reach a -5.1% deficit in terms of GDP. Government revenue is expected to increase by about 3% percentage points. Let it be noted that taxes, which constitute the principal component of revenue, have already been growing steadily; in 2007-11, they rose by 5.4% to reach 4.3bn US$ (QNB, 2013).

But, the government's net debt should reach 79.6% of GDP, a 4.7 percentage point increase compared to 2012. Net outstanding domestic public debt registered an annual increase of JD 12.0 million at the end of March 2013, reaching JD 11,660.0 million (48.6 percent of GDP) while gross outstanding domestic public debt had reached 53.2% of GDP (CBJ, 2013). The bulk of the subsidies in recent years resulted in Jordan accumulating substantial domestic and foreign debt, with public debt reaching around 75% of GDP last year compared with less than 60% in 2008. Since 2008 (date of the Paris conference external debt agreement on Lebanon) authorities have favored relying on domestic debt. Since 2000, domestic government debt increased by 28 percentage points of GDP and the debt of independent public entities increased by 9 percentage points (AFD, 2013). In 2011 the debt increase accelerated due to the rising debt of public company NEPCO (in charge of the electricity distribution network in Jordan). More specifically, because of the repeated sabotage of the Egyptian gas pipeline in 2011, the average cost of purchasing electricity from producers more than doubled between 2009 and 2011, which generated a large amount of debt for the public company and an additional constraint for government action. In addition, high levels of domestic debt may have implications for monetary policy, the government could potentially fund its debt through inflation but this is impossible given the current policy to defend the peg to the U.S. dollar. As a result, having a ratio of debt close to 80% of GDP weakens the ability of the public sector to act as an impetus to growth (AFD, 2013). It becomes apparent that debt is not only growing in absolute terms but also in relative ones as a share of GDP. The intended decrease of the fiscal deficit in 2013 will probably not avert debt from persistently growing faster than GDP (3.3% estimated growth) and thus contribute to an escalating debt/GDP ratio.

The debt and fiscal deficit issue is the most important economic test of recent history in Jordan. The question is whether the authorities will be capable to find solutions that can lead to a situation reversal and avert debt from reaching new heights.

I.6. Monetary sector developments: Overnight interest rate rise to prevent capital flight

Foreign currency reserves held by the Central Bank of Jordan (CBJ) increased year-on-year by an impressive 46.7% (to US$ 9,727.2 million) at the end of the first four months of the current year, corresponding to 5.2 months of Jordan's imports. This is a welcome development considering how foreign reserves had been under considerable pressure, resulting from the events of the Arab Spring, falling considerably in 2012. Meanwhile, domestic liquidity grew year-on-year by 3.4% at the end of the same period, standing at JD 25,792.6 million (CBJ, 2013).

On December 3rd of last year the CBJ raised the overnight window deposit interest rate by 75 basis points to 4% and maintained the other rates unchanged. The official interest rate (re-discount rate) remained at 5%. Raising the overnight rate (for the third time in 2012) could be seen as a means to strengthen the dinar and prevent capital flight in case of rising political and social instability (TheDailyStar, 2012). Taking into account the friability of the economic recovery, further rate rises in the near term are less likely. Yet, a more "concerted anti-inflationary strategy" could be expected from early 2015 along with to match the start of rate rises by the US Federal Reserve (EIU, 2013).

Meanwhile, total deposits at licensed banks increased year-on-year by 5% at the end of the first four months of 2013 to reach JD 26,206.3 million. This resulted from the 8.7% increase in JD deposits combined with the 4.2% decrease in foreign currency deposits (CBJ, 2013). Jordan's banks are now well capitalised and have a preventive cash pile to endure "any further tremors in the international markets" (EIU, 2013).

Lastly, regarding the exchange rate, the dinar is expected to remain pegged to the US dollar since it has not significantly been harmful to competitiveness.

II. Structural challenges: The need to go forward

II.1. What remains to be done?

The Kingdom of Jordan initiated structural reforms more than 10 years ago. Measures contained investment in training and infrastructure, growth-enducing policies, increased protection for foreign and domestic companies (Albawaba, 2013). But, structural challenges in Jordan remain. Despite substantial efforts of trade openness and privatisation across the economy "economic reforms have not always been fully matched with reforms in corporate governance and transparency" (EBRD, 2012). Meanwhile, a lot more could be done to develop

Box. Some words on the demographic profile of Jordan

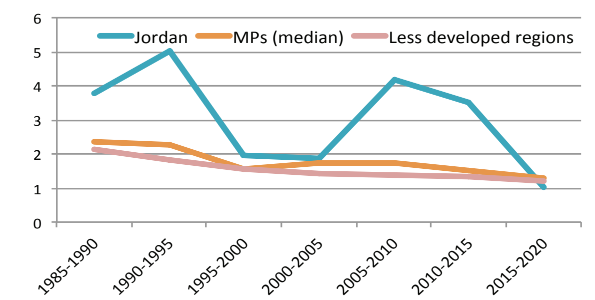
The World Population Prospects of the UN allow seeing that :

- √ *The population size of Jordan almost tripled in three decades, increasing from approximately 2.3 million in 1980 to 6.2 million in 2010. It expected to reach approximately 9.9 million by 2050.*
- √ *The growth rate of the population increased from 3.95% for the period 1985-1990 to 4.98% for the period 1990-1995. At this time it was well above the median rate of population growth observed in other MPs. This was followed by a decline in the growth rate to a level close to 2% for about 10 years (slightly above the MPs median) before it picked up during 2005-2010 to 2.94%. It is projected that the growth rate of the Jordanian population will start decreasing after the period 2005-2010 though it is still projected to remain above the regional projected rate of growth.*
- √ *As for life Expectancy at Birth, it gained 4.9 years from 1980-1985 to 2005-2010, increasing from 68 to 72.9 years and is expected to reach 78.4 years in 2045-2050. Meanwhile, the total Fertility Rate in Jordan fell from 7.05 children per woman in 1980-1985 to 3.27 in 2005-2010 and is expected to reach 2.05 in 2030-2035.*
- √ *While the share of the population under 15 years of age has been continuously decreasing since 198, the share of the working-age group (15-64) has been increasing; it rose from 47.7% to 58.6% in 2010 and could reach 68.7% in 2035 after which it could start decreasing. Meanwhile, the percentage of youth (15-24) was estimated at 21.6% in 1990 (43.4% of the working-age group), decreasing to reach 21.5% in 2010 (or 36.8% of the working-age group) and is expected to keep declining to reach 14.3% in 2050 (or 21.1% of the working-age group).*
- √ *The total dependency ratio started decreasing in the mid 1980s and is projected to continue decreasing to reach 46% percent in 2035 and remain close to this level.*

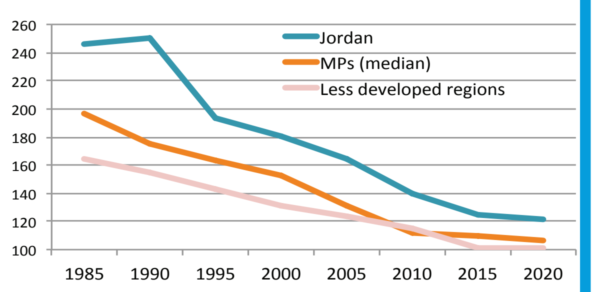
the business environment; Jordan is only 106th out of 185 countries in the ease of doing business, scoring badly in protecting investors, enforcing contracts, and getting credit (World Bank Doing Business 2013).

Also, Jordan has a very high level of energy dependence (over 90% of its energy resources are imported) and not much had been made in recent years to change that trend. Renewable energy currently represents less than 1% of energy generation. The decision to freeze fuel prices in 2011, numerous gas supply disruptions from Egypt after the revolutions etc caused as we saw earlier a considerable budget deficit. A first step was made with the Renewable Energy and Efficiency Law ("REEL") which was passed in April 2012 to encourage private investment in renewable energy and « create a 'direct proposal' provision, in which companies could submit proposals for renewable energy projects directly to the Government » (Eversheds.com, 2013). But, what is needed now is investment and new ways to entice it. For instance, within Jordan's energy strategy, one finds the plan to increase solar and wind energy's input "to the national energy mix" from 1% to 10% by 2020. But, such a goal requires up to 1 billion US$ in investment (Natural Gas Europe, 2013).

Figure 8.
Indicators of demography
a. Average annual rate of population change (%)



b. Dependency ratio*



Source : United Nations, World Population Prospects, the 2012 Revision, note : medium fertility scenarios post 2010
** (population aged 0-24 and 65+ per 100 aged 25-64)*

Last but not least, Jordan lacks three things, job-inducing growth, inclusiveness and innovation, the lack of which penalizes employment prospects and income generation. It is absolutely crucial that the country manages to provide an efficient answer to these deficiencies considering the demographic pressures that are not expected to subside in the medium-term.

II.2. The paradox of employment in Jordan

The 6.9% average rate of economic growth between 2000 and 2008 generated about 457000 net jobs (about 42% of which in the public sector) meaning the unemployment rate only marginally decreased. The employment rate in Jordan is one of the lowest in the region and contributes to a low, structurally negative, savings rate from households. As a result, the financing of domestic investment is provided by the savings of foreign workers (at 19% of GDP on average between 2000 and 2011) (AFD, 2013).

"In Jordan around 180,000 Jordanians were unemployed in 2009; at the same time, more than 335,000 non-Jordanians were working in the kingdom during the same year" (ILO, 2012). There is a grave inconsistency in the country's labour market; despite high demand for labour, most job vacancies are filled by migrant workers or remain unfilled, leading to high levels of long-term unemployment. Meanwhile, over the next few years, roughly five young people now under the age of 15 are expected to enter the labor market for every one Jordanian approaching retirement age (Jordan-Business.net, 2012). One notes that:

- √ Achieving high economic growth is not sufficient to reduce the levels of structural unemployment. Indeed, growth in both GDP and FDI has not translated into lower unemployment. Recently, the government's strategy has been to draw FDI and generate growth to be able to create 46000 additional jobs per year. As noted by ILO (2012) "in line with the government's unemployment reduction strategy, GDP growth has generated a substantial number of new jobs: from 2000 to 2005, the Jordanian economy created between 24,000 and 44,000 additional jobs per year" but, "unemployment did not decline but fluctuated around a fairly high level of 14 percent…despite the low ratio of labour force to population, which is a product of the large pre-working age population as well as low levels of female participation". A large share of newly created jobs are filled by migrant workers and this situation is only expected to exacerbate. Currently, the country hosts about 700000–800000 Syrian refugees, and with the influx of refugees increasing domestic authorities expect the number of refugees to reach 1 million by the end of the year (CarnegieEurope, 2013). The arrival of refugees has had, as in Lebanon, a direct impact on the labour market with Syrian workers often considered a much cheaper alternative.

> ***the employment rate in Jordan is one of the lowest in the region and contributes to a low, structurally negative, savings rate from households...***

- √ The severity of the unemployment problem in Jordan is to some extent disguised by the low labour force participation rate of women with less than higher education, which receive very low wages in the private sector resulting from the excess supply of labour. Thus, the high rates of unemployment is here to stay, given the quality and wage structure of the labour market, even if the rate of job creation accelerates (ILO, 2012).
- √ The gradual nationalization of jobs in the Gulf countries has translated into the return of skilled Jordanian workers in their country of origin, which joint the already high level of unemployed graduates. About, 40000 young graduates from higher education enter the labor market each year and only 15000 are absorbed, a socio-political risk with considerable implications (AFD, 2013).

√ One of the main structural characteristics of the Jordanian labour market, that needs to be considered when formulating policies to reduce unemployment, is the “job destruction” triggered by economic liberalization and stabilization packages. Fiscal consolidation and privatization might have many benefits (Jordan’s rate of privatization being also a very fast one), but they have not been “employment-friendly” in the case of Jordan. It appears that liberalization and export promotion was concentrated on low manufacturing sectors that offer poor working conditions. Meanwhile, openness can have negative effects when it is not conducted in a controlled manner; in the case of Jordan “inflow of cheaper imports has undermined many domestic producers, pushing them out of business or directly affecting the employment and wages of their workers” (ILO, 2012). This ILO study shows that jobs destroyed by imports exceed those created by exports. The reasons for that can be found in a policy of openess that only targets further integration in the region. Let it be noted that all theories on international trade and its positive impact on welfare make the unrealistic assumption of full-employment. Future policies need to take this into account, they need to be reformulated and include an additional dimension dedicated to fostering more jobs for the population. Meanwhile, Qualifying Industrial Zones (QIZs) with the US have had disturbing effects on domestic employment with more than half of the workers in QIZs being migrant workers. Meanwhile, since most of the goods produced are low value-added products they do not embody a real diversification of the productive structure that could lead to the creation of new productive jobs. All in all, the current level of unemployment is “practically the same today as it was early in the last decade, when the FTA with the US was signed, and around the time when QIZs began to become an important element in Jordan’s external sector” (Jordan-Business.net, 2012).

II.3. An economy that needs to become more inclusive

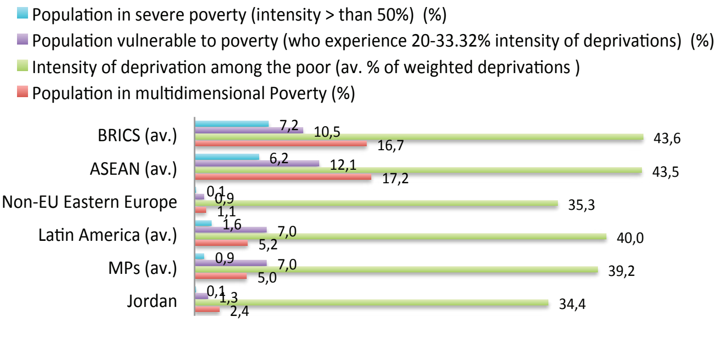
Indicators of poverty suggest that **Jordan performs rather well compared to MP’s on average and also compared to other regions**. Only, 2.4% of the population is in multi-dimensional poverty (versus 5% for the region on average) while the intensity of deprivation among the poor is among the lowest.

Yet, the lack of inclusiveness in Jordan is apparent, it takes the form of exclusion in the labour market, in access to finance and in other dimensions.

a) Low labour market participation

The labour market participation rates remain very low in absolute terms; in 2011 about 59% of the working age population in Jordan was not participating in the labour market, something that was already the case almost 15 years ago. This is lower than in the rest of the region and considerably lower compared to other emerging regions. The female participation is extraordinarily low (15.6%) and explains the tremendous gap with other emerging countries. Meanwhile, youth participation, while slightly better than in MPs on average, is very low compared to other emerging regions such as MER-

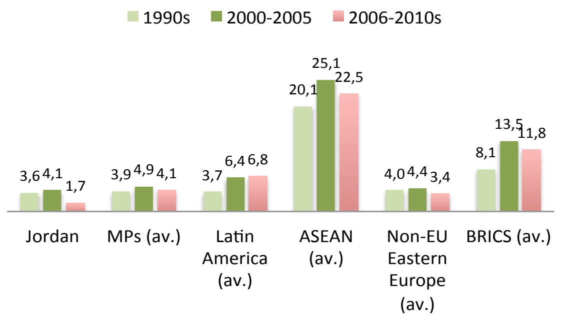
Figure 9.
Indicators of Multi-Dimensional Poverty, latest year



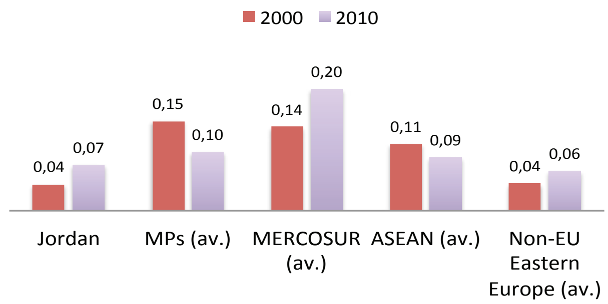
Source: Alkire, S., A. Conconi, and J.M. Roche (2013): “Multidimensional Poverty Index 2013

Figure 10.
Integration dynamic that can be improved (selected indicators)

a. High-tech. exports (% of manuf. exports)



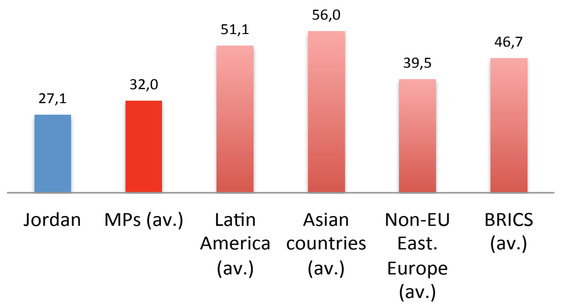
b. Trade Concentration Index



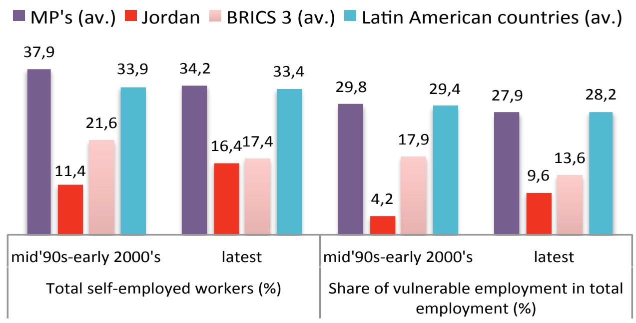
Source: WDI, FEMISE calculations using Tradesift and Comtrade data, based on SITC rev3 3-digit data.

Figure 11.
Domestic labour market dynamic, issues of vulnerability and youth participation remain (selected indicators)

a. Labour force participation rates, 15-24 (%)

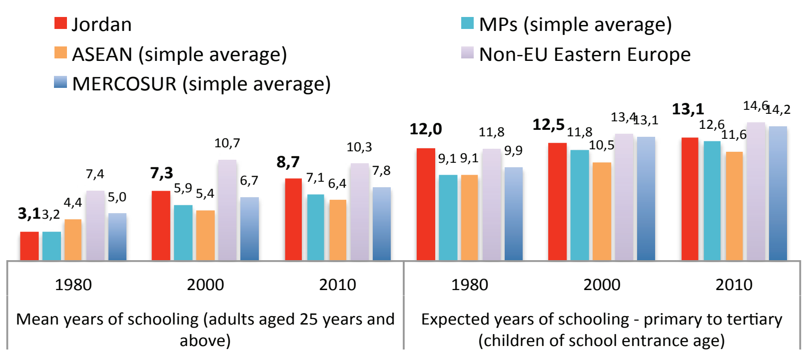


b. Informality and quality of employment



Source : IMF, World Economic Outlook database April 2013 (latest) and EIU

Figure 12.
Social dynamic that improved (selected indicators)
HDI components related to schooling



Source :HDI, FEMISE (2012) note on inclusive growth

COSUR or ASEAN (by 25-30 percentage points nowadays). Implementing a development strategy based on inclusive growth is thus far from a done deal. The involvement of the entire population is needed and this refers to equal access to opportunities for all, paying particular attention to women and the youth.

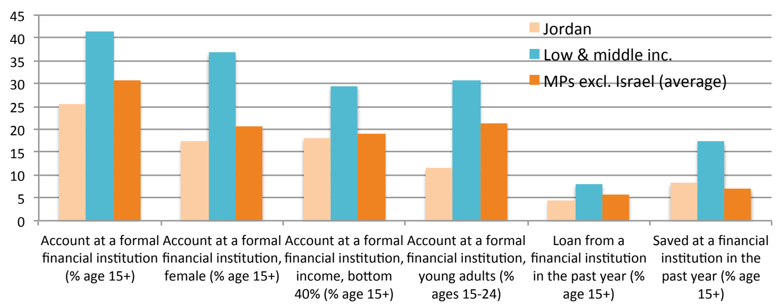
b) A lack of financial inclusiveness

Meanwhile, for growth to be labelled inclusive everyone (individuals, firms etc) should be able to "catch opportunities"; to do so they every actor needs financing which would ultimately increase the potential of productive job creation. But, in the case of firms, the percentage of them using banks to finance their investment is unpardonably low (8.6%), lower even than the MPs average share (12.3%), while the corresponding share found in MERCOSUR or ASEAN economies is more than double. But also at the individual level, the people of Jordan somewhat lack financial inclusion when compared to the average level of low & middle-income economies, the level is closer to the average regional level though still slightly below. The share of the population with an account at a financial institution is of 25.5% (versus 30.8% for MPs and 41.4% for low & middle income economies on average). Women are more excluded financially though the gap with the MPs average is not as marked (17.4% versus 20.5% for women in MPs), however exclusion of the Jordanian youth is more apparent, with only 11.5% having an account which is about half the MPs average level and three times less what one finds in low & middle income countries.

For the rest of the indicators of financial inclusion Jordan appears on par with the rest of MPs. Most particularly, the level of financial inclusion among the less wealthy and poor (bottom 40%) is close to what one observes in the region as a whole (18.1% versus 19.1% for MPs on average), the share of people that took a loan in the past year is also close but still below the MPs average (4.5% versus 5.6%) while the share of the population that saved at a financial institution in the past year is above the MPs average (8.3% versus 6.9%).

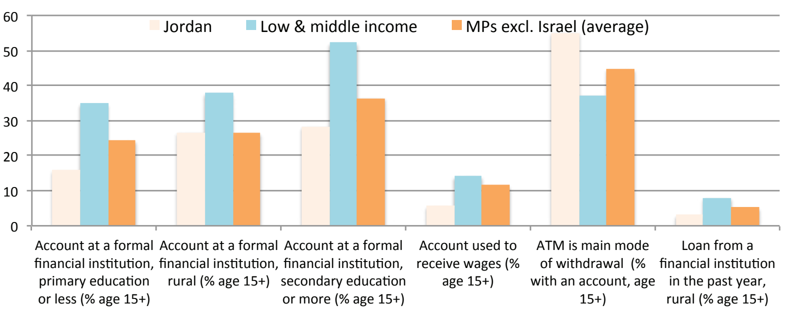
A second set of indicators better illustrates how people are financially excluded in Jordan. First, the less educated (basic education level) face important exclusion, only 15.9% have an account (versus 24.4% for MPs as a whole). For those with at least secondary education the situation improves but the gap with developing countries increases (23.8 percentage point gap). Second, rural inclusion is close to MPs levels but remains low in absolute terms. The use of ATMs is widespread, however the use of accounts to receive wages is not.

Figure 13.
Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

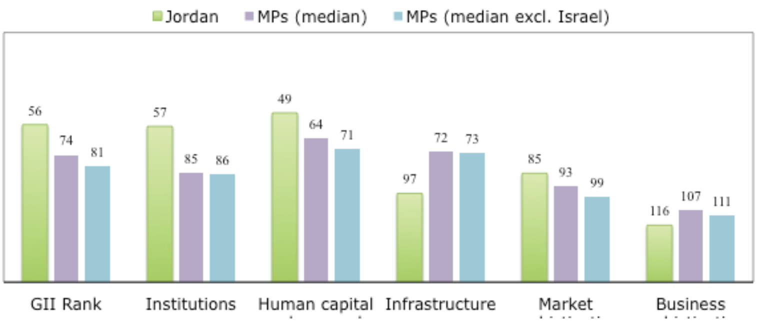
Figure 14.
Second set of Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

II.4. Innovation is needed

Figure 15.
Rank by GII components



Source: Global Innovation Index database

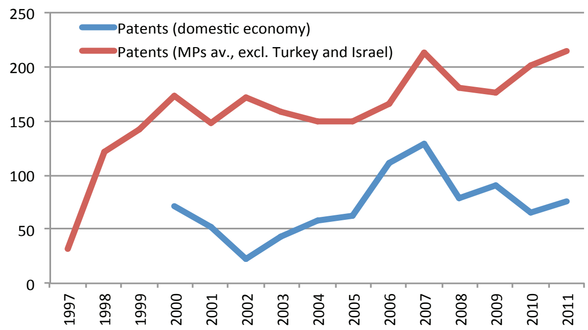
A quick look at the Global Innovation Index (GII) allows placing Jordan among a sample of more than 140 countries. Interestingly, among emerging MPs, Jordan stands out (along with Tunisia and Lebanon) ranked 56th and ahead of neighbouring countries such as Turkey and Morocco. Specifically, Jordan seems to fare comparatively well on the sub-indices of "human capital and research" and "institutions". However, the country is underperforming in the "business sophistication" and "infrastructure" components of innovation.

The relatively poor infrastructure performance might explain why despite having a qualified human capital, High technology services exports as a share of total exports have massively fallen since the beginning of the 2000s, going from a share of 8% of total exports in 2000 to about 0.9% in 2008 and 2.5% in 2011. Thus, the level of high technology exports went from being above the MPs and South Asia averages in the late nineties and early 2000s to being practically irrelevant.Furthermore, the number of patents has been consistently below the regional average during the last 15 years, suggesting a limited innovation output. However, one must note that the share of patents in the pharmaceutical sector is impressive and represents roughly 38% of total patents. As for the number of trademarks it has fallen in recent years, also below the already limited average found in the Mediterranean.

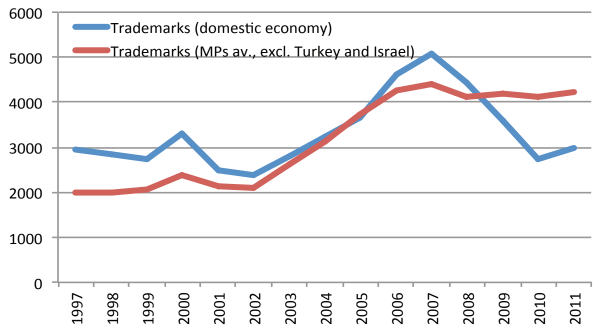
Last but not least, the number of scientific articles published by Jordan annually is considerably low. One must note forget that academic articles in renowned reviews are published in English, which is not the native language of most researchers, hence someone from Jordan will have greater difficulty to publish an article in an Anglo-Saxon review while an article published in a non-english speaking review might not be captured by statistics. Yet, this is an issue that most MPs are facing and Jordan cannot be considered an exception. Even by MPs standards, the number of articles published by Jordan is considerably low. Meanwhile, a remark in relation to quality should be made, the number of citations received per document in 2011 is about

Figure 16.
Intellectual property indicators

a. number of patents

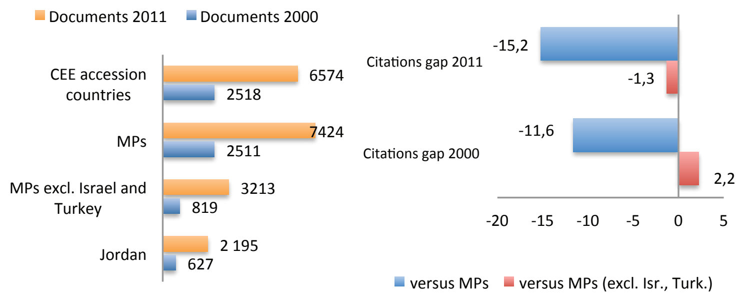


b. number of trademarks



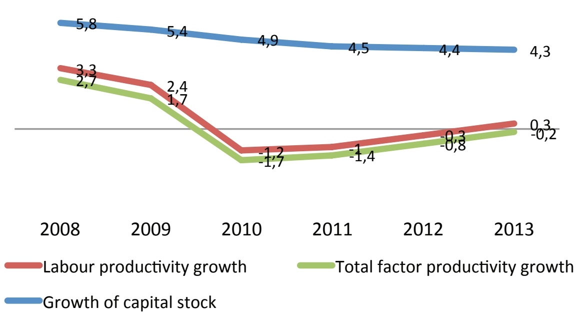
Source: World Intellectual Property Organization

Figure 17.
Journals and country scientific indicator:
a) No of documents (2000VS2011) b) Citations per Document gap (%)*



Source: SCImago Journal & Country Rank (SJR)
** FEMISE calculations based on SJR, the index measures in percentage terms how many more/less citations per document the country receives when compared to the regional average. Ex. a value of -10 means that the country receives 10% less citations per document compared to the MPs average.*

Figure 18.
Growth and productivity indicators



Source : EIU

1.3% lower than for an average MPs paper, an indicator that suggests that the impact of Jordanian documents is low and has also decreased over the years (in 2000 citations received per document were actually 2.2% higher than for an average MPs paper). Another remark, again linked to quality, confirms the observations above. The h-index (appendix), which attempts to measure both the productivity and impact of the published work of scholars, seems to be lower in Jordan when compared to the rest of the region.

III. Conclusions

III.1 Issues that need to be addressed : unemployment, low productivity and inclusiveness

Jordan has always been affected by regional developments whether it be through the situation in Palestine, the war in Iraq and most recently with the situation in Syria that has had a significant deteriorating impact on unemployment and has affected growth. That being said, there are a series of factors not attributable to the regional situation, more particularly:

√ The **weak labor productivity** and total factor productivity is a contributor to the weak economic performance of the Jordanian economy. Recent statistics indicate that the TFP has been continuously declining since 2008 and reached negative levels during the last three years (despite a slight improvement in 2012). The main driving force for GDP growth seems to have been the increase in physical capital, while labor productivity has not contributed to growth in a positive way. Thus, any effort for future growth must pass from an effective reform of the labor market. Such reform should a) reverse the low economic participation rates, especially among women, and take into account the imbalanced distribution of the labor force across sectors, b) fight against territorial exclusion, Jordan currently suffering from unbalanced regional distribution of labor (Amman having more than half of the entire labor force), c) have a clear strategy to better integrate the labor it "receives" (primarily Syrian refugees) and d) ensure a better match between education and labor market demand.

√ Until now, compared to the public sector, **the private sector has generated very few alternative job openings**. About 98% of private firms are micro and small enterprises; they employ only 1–4 and 5-19 workers respectively. Meanwhile, wages and social security benefits are not similar to those in the public sector. Authorities tried to tackle the issue by developing export-oriented production, however corresponding enterprises in Qualifying Industrial Zones offer low wages and working

Table 2.
Near-term policies for SME facilitation that are "pro-inclusive"

Improving Women Entrepreneurship (and youth)			Improving access to finance		
A. Concrete measures undertaken since 2011	**B. Additional measures, can be implemented within a year**	**C. Additional measures, can be implemented beyond a year**	**A. Concrete measures undertaken since 2011**	**B. Additional measures, can be implemented within a year**	**C. Additional measures, can be implemented beyond a year**
i) Supporting female employment, innovation and competitiveness through **SME financing programme,**	i) **Increase technical and financial assistance to entrepreneurs** (incl. Women)	i) **Implement national entrepreneurship education programmes**	i) **Increasing access to finance through The Banking Window Programme;**	**i) Develop and implement a Loan Interest Support Programme;**	i) **Improve the regulatory framework for start-ups** and micro, small and medium enterprises;
ii) **Facilitating access to finance and training for women-led SMEs;**			ii) Launching a major national **SME Financing Programme;**	**ii) Establishment of Partial Loan Guarantee Funds for microenterprise**	ii) **Facilitate the development of capital markets** and other financial intermediaries and instruments
iii) **Upgrading women's vocational and entrepreneurial skills,**			iii) Creating **two venture capital funds dedicated to support SMEs** in early stage and growth phases;		
iv) **Supporting entrepreneurship education and training measures**			iv) Promoting **SME access to finance** in cooperation with international financial institutions;		
			v) Supporting **micro businesses' access to finance**		

Source: The Deauville Partnership with Arab Countries in transition, February 11th 2013.

conditions that are not always decent (CDPR, 2011). The Government's strategy will have to place more emphasis on the diversification of the economy towards higher value-added sectors that can sustain higher-quality jobs for the skilled Jordanian labour force and promote inclusiveness. But, one must bear in mind that the country's budget deficit has reached alarming levels so the state has little room for manoeuvring. Thus, for future jobs and economic growth to be strong the private sector will also have a major role to play. One should note that the Government of Jordan recently drafted with OECD assistance a near term plan for SME development in Jordan, in the context of the Deauville Partnership. Thus, some steps have been taken towards a path for inclusive development. First, among these steps one could note near-term policy actions for SME facilitation that appear to be "pro-inclusive". More specifically, two are coherent with an inclusive vision of growth, they are i) those improving the entrepreneurship of women and the youth and ii) those improving access to finance (see Table 4). Such measures need to serve as a basis and be developed further. Facilitating access to capital markets for SMEs still has a long way to go. Meanwhile, institutional structures to promote women's participation in entrepreneurship are often lacking.

As noted earlier, when compared to other education levels, the unemployment rate is extremely high among the university degree holders (17.2%). Which brings us to a crucial point that is the need to develop an "employment generation process" for the youth. Let it be noted that the Jordan Engineers Association recently organized the First Young Engineers Conference intended to uncover practical solutions to unemployment among engineers (about 40000 Jordanian engineering students presently enrolled in local universities, 17% of the number of graduates). Some initiatives were launched during the conference such as «Engineer online», helping build a virtual society connecting engineers to help them in job-seeking, or «Qudurati» intended to develop interpersonal skills "via free technical and administrative courses" (ANIMA, 2013).

Yet, what is truly needed is the development of training programmes that improve graduates skills and pave the way for jobs. The needed process should go through an orientation towards scientific and technical studies, fostering skills and incentives for the creation and management of firms and efficiently training the local workforce.

> ***what is truly needed is the development of training programmes that improve graduates skills and pave the way for jobs...***

Recently, Jordan was part of the UNDPs « Youth Employment Generation Programme in Arab Transition Countries » a programme established to respond to the growing need to provide tools to tackle the issue of unemployment. The Jordanian component of the programme targeted three Governorates (Mafraq, Ma'an and Madada) and was "structured through three principle components to be implemented by the Jordan CO: (i) a national implementation plan designed to define the priorities, capacity gaps and technical assistance requirements for the project at the national level; (ii) increased opportunities for internships in private companies and other institutions for youth (women and men); and (iii) youth employment generation policies formulated through the provision of high-calibre advisory services to concerned public and private institutions" (undp-jordan.org).

This type of approach clearly needs to be generalized since it lets:

- √ the **development of workshops**, which allow sharing experiences among the various participants (ministries, public institutions, private sector representatives…) and lead to recommendations to be integrated in the national implementation plan.
- √ **internship schemes** such as the one accomplished under the programme for 6 months and for at least 75 recent unemployed young people (at least have of them being women). Prior to attending the internships, selected interns attended workshops on employability skills, IT skills and English courses, hence skills development is also an achievement to be retained.
- √ **initiating a mapping on Youth employment policies and programmes,** in this case with the support of the International Labour Organization (ILO). This serves for identifying bottlenecks in the different sectors of the economy (focusing on Tourism, Trade and ICT) in supplying jobs for the new graduates and contribute to drawing a clear strategy for the development of innovative Youth employment programmes. Moreover, skills gaps needed by these sectors would be identified and training activities to overcome such gaps would be developed (undp-jordan.org).

Such an approach should be relatively flexible, a key for allowing for the training system to be able to reallocate resources to new businesses in promising sectors whose development is planned. In that respect, the organizational structure in universities is also important; they need a core of specialized people constantly linked with the business sector, something that is still underdeveloped and with staff often unfamiliar with the procedures of firms.

III.2. Fostering a culture of innovation across all spheres is key for growth and jobs

We believe that the answer to the Jordan's structural issues could lie on the development of innovation and creativity, which are currently deficient in Jordan. Authorities should have the ambition of developing their innovation strategy. Only them will they be able to give a new impetus to firms, lead to a new growth model less dependent on capital accumulation, allow for the development of new products and services, bring new productivity gains without loss of competitiveness in international markets and foster new jobs.

Due to a relatively stable political situation compared to its neighbours, which has also contributed to a more stable growth path, Jordan has attracted international capital and collaborated with foreign stakeholders on innovation-inducing projects. Furthermore, students and researchers seem to display a relatively strong international mobility. Lastly, the authorities have made some efforts to support innovation activities. Yet, several important shortcomings persist, most notably one notes (see also FEMISE-EIB, 2013):

- √ Research activities in Jordan are based on very few people, mainly concentrated in public universities and to a lesser extent in small research centers.
- √ Firms hardly participate in the activities of innovation and financing of innovative activities by firms is a major issue with the activity of R & D being almost non-existent.
- √ Public universities suffer from a lack of resources, which goes along with the growing number of students.
- √ Meanwhile, access to university is limited by the lack of space and students are oriented to the lower level Community College. Furthermore, there is a very limited access to the most wanted training; half of the seats are prebooked for different categories of individuals beyond competition entry.

In that respect a number of urgent solutions are needed, they involve authorities as well as other partners :

- √ Undeniably, **firms, especially SMEs, need to be more invested in the process of innovation**. For this to happen, efficient decentralization has a role to play towards both the public and private sector. Innovation will not be able to spread if territories do not adhere to the project; they need to contribute in developing creative businesses and new forms of innovation. This is not an impossible task considering that Jordan is fairly diversified and services oriented. Innovation efforts at the decentralized level could focus on tourism services for instance.
- √ Additionally, to remedy the lack of applied research, **the relationship between private firms and public research should be reinforced**. A two-step approach could be implemented that includes i) identifying the most innovative projects and ii) creating partnerships of public-private research into areas of interest for both parties. Examples such as the Faculty for Factory Program can significantly improve this public sector and private business relationship but need more funding. Furthermore, a solution to the issue of financing innovation might be found in a policy that favours venture capital, one that stimulates the process and takes risk.
- √ Public research centers are too small to be able to have an impact on innovation. Thus, **authorities need to think on ways of strengthening cooperation** among them or regroup them thematically in a bigger structure. Increasing their size and concentration will allow for a wide array of choice and inter-disciplinarity, giving the opportunity to undergraduate students to choose additional modules in disciplines of their liking. Meanwhile, there is a need to make the system of access to university fairer by limiting the seats reserved for quotas and by streamlining it with the aspirations and skills of students. Moreover, Jordan needs to take more students in Master cycles if it wishes to have a more qualified human capital for research and innovation activities.
- √ Meanwhile, **all academic actors need to keep being open towards the international scene,** which shall allow for better integration and progressive spill-overs on domestic creativity.

Recent efforts such as the University of Jordan signing three cooperation agreements (The University of Jordan, 2013) with major Polish universities are welcome. The terms of such agreements include the exchange of students and professors, joint research projects and joint supervision on graduate students in fields such as language, culture, Islamic studies, law and medicine. Such cooperation efforts need to be generalized and expanded to other fields; they can facilitate the integration of the role of academic institutions (ex. the University's Strategic Plan is to become a global institution within the top five hundred universities in the world by 2015), strengthen cooperation and joint academic work which can later yield innovative projects.

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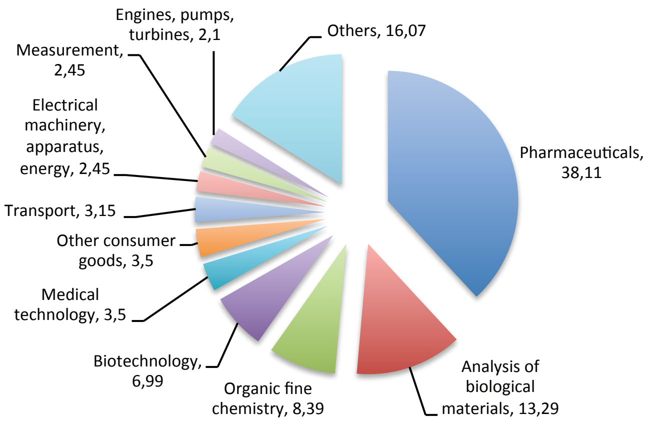
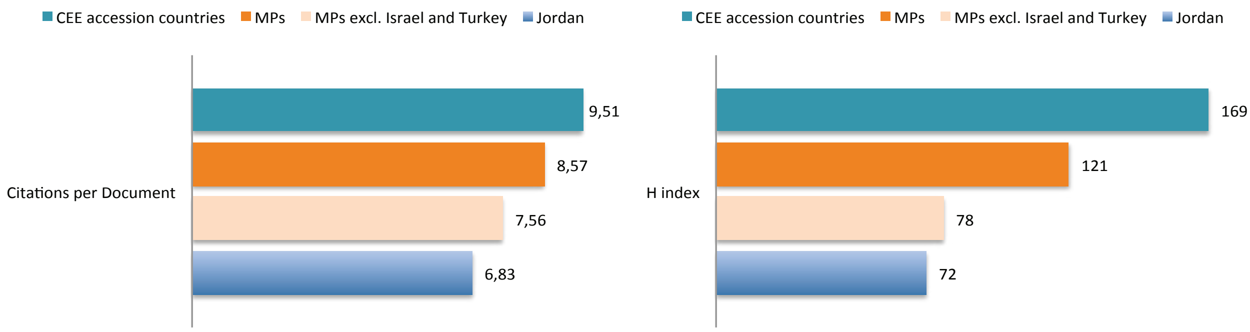
ANNEX

Figure A1.
Patent Applications by Top Fields of Technology (1997 - 2011)



Source: World Intellectual Property Organization

Figure A2.
Journals and scientific indicators



Source: SCImago Journal & Country Rank (SJR), Note: Country's number of articles (h) that have received at least h citations

LEBANON

Several structural issues and a macroeconomic situation that is uncertain

Introduction

After recent years of strong GDP growth, macroeconomic performance has followed a downward trend and the country entered a low growth cycle. The economy only grew by 1.5% in 2012, down from 5.8% in 2009-2011 and 4.8% in 2005-2008 and is not expected to record considerably high rates of growth in 2013. GDP is expected to grow by only 2% since there is neither an internal or external positive shock that could rise, given the current political conditions.

The severe slowdown in growth in recent years should be attributed to internal political strains and the worsening in security, which both harmed prospects for FDI, trade and tourism. Granted, lower growth prospects can be influenced by the on-going Eurozone crisis, the relative low growth of the US economy and the current state of affairs in the Arab world. But, one could say that the country "is more affected by the fact that there has been some slowdown in investment within Lebanon due to policy paralysis there, and less so from the direct effect from Syria". One must note that growth dynamics in Lebanon have also been driven for years by reconstruction efforts that have considerably aggravated the budget deficit. Last year's fiscal expansion is being felt in the 2013 budget, mainly due to the increase in public salaries; the rising deficit is thus expenditure-driven.

Meanwhile, the service-based economy still has an underdeveloped industry and the economy lacks productivity. The industrial sector has difficulties to bypass a number of problems and is thus unable to grow and cultivate an export orientation, impeded by inadequate infrastructure and generally low levels of investment. Granted, Lebanon started to take advantage from the value chain restructuring and saw the emergence of high tech firms with innovation potential, Yet, Lebanon's trade activity in high technology products, an indicator of innovation potential and competitiveness, recently seems to have reverted to low levels. A reason for failing to efficiently deal with these challenges could be found in the unceasing political instability and the structure of the party system.

> ***growth dynamics in Lebanon have also been driven for years by reconstruction efforts that have considerably aggravated the budget deficit...***

Now, Lebanon's economy is in a vulnerable state. A reverse to a more cautious budgetary policy should not be excluded, to send a positive message to foreign investors.

- √ ***Real GDP growth** in 2013 was close to last year levels. Political tensions between the Muslim communities and the war in Syria are the reasons hampering Lebanon's economic potential. Neighbouring Arab states are the principal consumers of Lebanon's services and their current limited performance means Lebanon's growth prospects are on the negative side.*
- √ *The **current-account deficit** should peak in 2013 to more than 16% as the country is heavily import dependant, relying on imports of energy, industrial raw materials as well as foodstuffs.*
- √ *The rate of **consumer price inflation** reached 6.6% in 2012, a level almost double than during the post crisis 2009-2011 period. It is expected to remain to similar levels in 2013 as well before*

Key indicators	*2005-2008*	*2009-2011*	*2012*	*2013e*	*2014e*
Real GDP growth (%)	*4.8*	*5.8*	*1.5*	*2*	*4*
Consumer price inflation (av; %)	*4.9*	*3.6*	*6.6*	*6.7*	*2.4*
Central government balance (% of GDP)	*-10.5*	*7.4*	*-8.7*	*-8.3*	*-7.5*
Current-account balance (% of GDP)	*-8.8*	*-10.6*	*-16.1*	*-16.1*	*-14.6*
Unemployment rate (%)	*18.5*	*9.2*	*n.a*	*n.a*	*n.a*

Source : IMF WEO and EIU

reaching a much more manageable rate in the next few years.

- √ *Among the most important challenges Lebanon has to face is the* ***mismanagement of the subsidy system****. For instance, Lebanon heavily subsidizes energy consumption (electricity and petroleum), spending an amount that is equivalent to 8.3% of GDP putting the country well ahead the world average costs. Yet, the weak macroeconomic conditions that the country is currently facing (low growth, higher than usual inflation, two digits current account deficit) might postpone the whole process of reform.*
- √ *Meanwhile, the issue of* ***unemployment*** *is as important as ever. The recent influx of Syrian refugees is a destabilizing factor for the job market. Attitudes towards refugees have been contradictory: the Lebanese have been remarkably hospitable but on the other hand increased labour competition and aid to Syrians produced "ambivalent attitudes and resentment" (FAFO, 2013). Independently of this issue, the unemployment problem has deeper causes. Despite their qualifications, young Lebanese often lack experience and do not have "realistic expectations". Employment creation is also very low, during the last decade only 3400 jobs were created annually versus roughly 19000 new entrants into the labor market every year.*

I. Macroeconomic evolutions

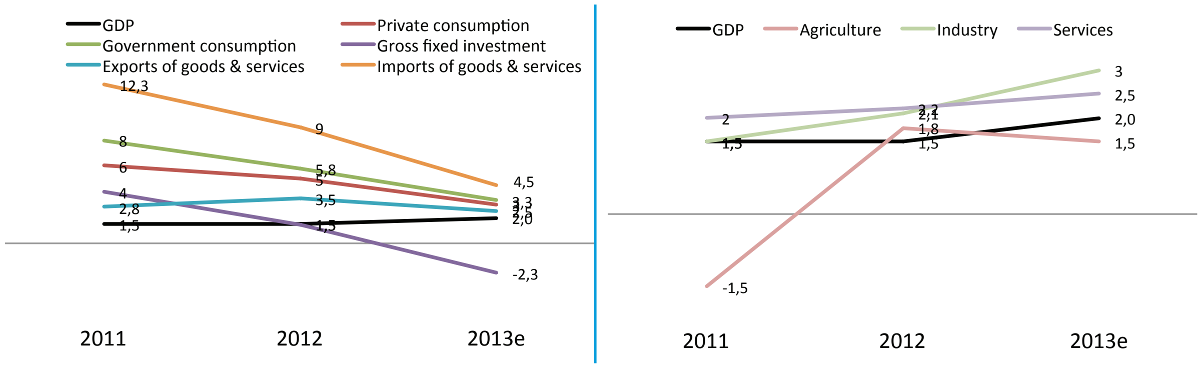
I.1. Economic growth will continue to be weak

In Lebanon, the average annual GDP growth rate of the recent decade was close to 4.8%, making the economy a relatively good performer compared to the regional average. This annualized rate would place Lebanon above Latin American countries (3.5%), yet below the performance observed in Non-EU eastern European, ASEAN and BRICS economies (close to 6% annually).

Lebanese growth essentially relies on the service sector which represents about two thirds of GDP. But the sector is underperforming and should not

Figure 1.
Economic growth

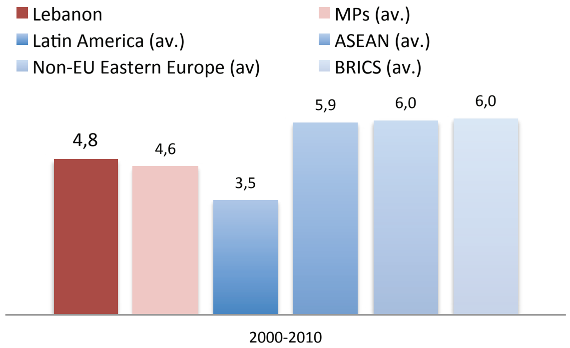
a) Demand-side (in %) ***b) Supply-side***



Source: EIU, for growth rates World Economic Outlook database grow by more than 2% - 2.5% in 2013. Arab neighbours are the main consumers of Lebanon's services and the current regional tensions mean that services such as tourism will take a hit. Already, tourism has kept underperforming this year, down by 13.8% year on year in the first four months of 2013 (EIU, 2013). As for agriculture, its rate of growth is expected to decelerate.

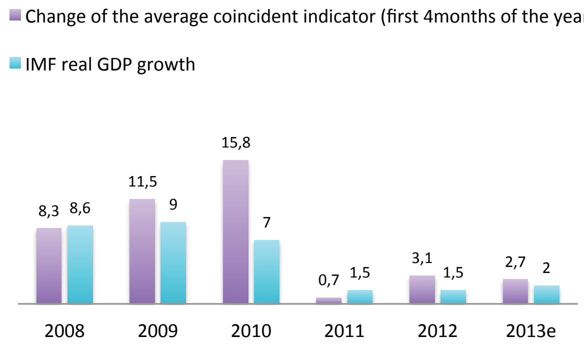
One should note that domestic political instability and regional unrest harmed the Lebanese economy in recent years. Low investment growth (only +1.5% in 2012) has largely contributed to that. In fact, in the case of Lebanon one notes "that it is more affected by the fact that there has been some slowdown in investment within Lebanon due to policy paralysis there, and less so from the direct effect from Syria" (BankMed, 2013). In 2013, gross fixed investment is even expected to recede by -2.3% before eventually picking up in the following years. Meanwhile, trade activity has been growing at a slower pace, export growth is expected to slow to 2.5% from 3.5% in 2012. Private and public consumption growth, which had started to decelerate in 2012, is expected to follow the same trend.

Figure 1c. Average annual GDP growth rate by country/region



Source : EIU, for growth rates World Economic Outlook database

Figure 2. Lebanon's economic activity



Source: Bank Audi (2013)

Thankfully for growth prospects, import growth is also expected to sharply drop from 12.3% in 2011 to 9% last year and an anticipated 4.5% in 2013. Moreover, there are "mitigating factors" that have aided Lebanon in escaping a recession and maintain a positive albeit low rate of growth. The support from Lebanese expatriates and Syrian refugees has been of help (Bank Audi, 2013).

The average coincident factor which measures "economic momentum" already increased by 2.7% in the first four months of 2013. This could be attributed to both political/ regional events and the slower activity in tourism and investment; as a result the monthly rise of this indicator was progressively lower (2.9% in January, followed by 1.3% in February, 0.8% in March and only 0.2% in April) (Bank Audi, 2013).

A better domestic climate coupled with advancements in the resolution of the Syrian situation would be pre-requisites to provide a much-needed boost. There were many scenarios for 2013, putting growth estimates between 1% and 3%. In a first scenario based on an "optimistic lookout" GDP growth was expected to reach 3%, relying on an improving security, impartiality vis-à-vis the situation in Syria, but also "the approval of draft wage increase by $0.8 billion to $5.1 billion with appropriate means of financing, BdL incentives to promote private lending and the foreseen funds allocated by the international community to assist Syrian refugees" (see BlomInvestBank, 2013). In an alternative, less optimistic scenario, political uncertainty and failure to generate sufficient revenues would impede on growth. It appears the second scenario was closer to reality. After revising Lebanon's credit outlook downwards, Fitch highlighted that it expected GDP growth to be close to 1.5%.

Domestic growth could then increase (anticipated to 2.5% in 2014 and 4.8% in 2015 according to EIU), but the projected growth rate would still continue to be the third slowest growth rate in the region and the slowest one amid developing oil importers in each year (Libanon.um.dk, 2013). Some estimates suggest growth could pick up substantially afterwards and reach a rate of 5.3% in 2015-17 driven by progressively stronger private consumption and recovery in services (EIU, 2013).

I.2. Inflation still higher that in recent years

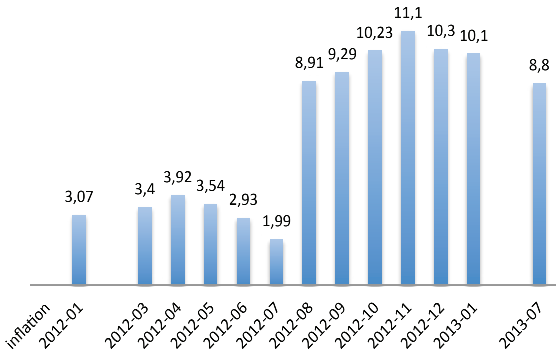
The rate of consumer price inflation reached 6.6% in 2012, a level almost double than during the post crisis 2009-2011 period. It is expected to remain to similar levels in 2013 as well before reaching a much more manageable rate in the next few years. Limited inflationary pressures should be expected due to, among others, restrained international commodity prices, small appreciation of the nominal effective exchange rate and the relatively cheap foreign laborers (BlomInvestBank, 2013). Higher minimum wages for workers in both the public and private sector are expected to be the driving force for inflation, which reached 8.8% in July. Lebanon's high level of dollarization means domestic authorities trail US rates (albeit with a positive variance), in that respect the Central Bank of Lebanon shall keep its alignment with the Federal Reserve in raising rates in 2015 (EIU, 2013).

I.3. Continuous pressures on the current account that will register a two-digit deficit

In early 2012 one could already see how Lebanon was facing short-term risks in great part because of a deteriorating situation in Syria. As known both countries have had long lasting political and economic ties, but the current state of affairs in the neighbouring country ultimately affected the Lebanese economy as was feared (IMF, 2012), through lessened FDI activity due to limited confidence, disturbed tourism activity and increased costs of bilateral trade among other reasons.

Lebanon is expected to keep having wide current-account deficits in the medium run as well (16.1% in 2013, 14.6% in 2014 according to IMF). Export earnings have proved relatively resilient in 2013, in spite of the political uncertainty, but the trade deficit (about 15bn US$ in 2013) is still massive given how the country is a heavily importing (especially energy, industrial raw materials and foodstuffs). Lebanon's trade deficit increased by roughly 7.2% in the first half of 2013 to reach 8.48B US$ and the annualized trade deficit to GDP ratio reached 39.3% in June 2013 versus 37.9% in 2012. Exports covered slightly more than a fifth of imports (21.4% of imports) in the first six months of 2013. Pearls/precious stones (23% of total exports) and mineral products (14% of total exports) were the main exported commodities, though the former registered an annualized fall of 37% while the latter massively increased (from 22M$ to 318.11M$ by June 2013). As for imports, mineral products formed the majority of imported goods, followed by machinery and mechanical appliances (BlomInvestBank, 2013b). The trade balance will thus continue to weigh heavily on the current account and be in deficit as the projected investment in offshore hydrocarbons projects attracts capital inputs (EIU, 2013).

Figure 3.
Lebanon Inflation rate

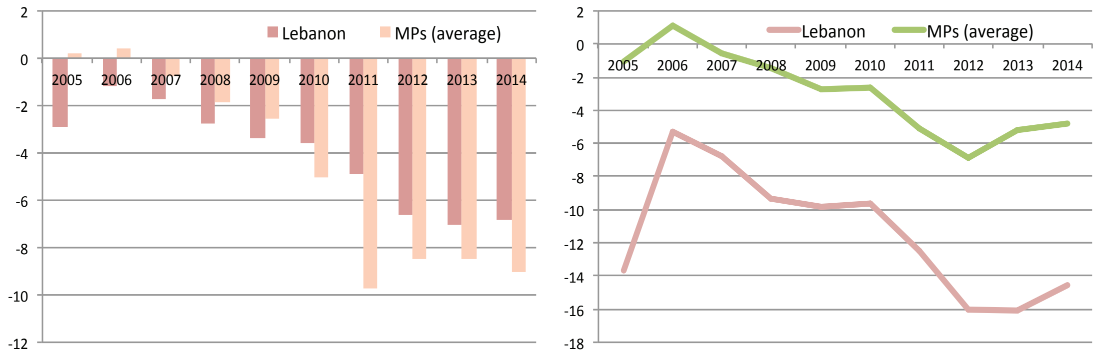


Source: www.tradingeconomics.com, CAS Lebanon

Figure 4. Current account balance

a) in billions US $

b)as percentage of GDP



Source: IMF, World Economic Outlook database and EIU

Estimates for the service balance are healthier though, with tourism from the Lebanese diaspora being resilient and inflows into the banking system continuing to grow. Indeed, there were some initially positive signs regarding tourism as seen by the number of passengers at the Hariri International Airport, which increased by 7.8% year-on-year in the first half of 2013. The number of arriving passengers in particular rose by 2.3% over the period (Bank Audi, 2013). However, the continuous local and regional turmoil did have an impact during the summer, meaning the overall passenger growth was diminished (airport passengers in total were down by 9.8% in July 2013 compared to last year). When July is taken into account, arrivals in Lebanon for the first 7 months of 2013 grew by 6.2% (BlomInvest, 2013b).

One of the factors that needs to be addressed is also the relative shortage of FDI. Current statistics are inconsistent and do not allow to draw a clear picture as to the exact state of foreign capital in Lebanon. Most reports claim Lebanon recorded a fall in FDI in 2012, some claim the fall was equal to 84% year-on-year to $96.5 million in the first half of 2012, others show FDI to Lebanon dropped by 68% for the entire year making the country the fifth-lowest recipient of FDI in the MENA region. Yet a recent report suggests FDI actually rose by 18.75% in 2012 starkly contradicting the other figures (The Daily Star, 2013c).

Independently of the actual figure of FDI for recent years, it appears that Lebanon's real economy "is not benefitting as much as it could from the capital due to the absence of a strategy that would channel the funds to specific productive sectors, such as agriculture, industry, tourism and banking". Instead, FDI is oriented to sectors such as real estate, which inflates housing prices, instead of servicing a comprehensive development strategy that may focus on job creation and productivity (The Daily Star, 2013c).

I.4. Fiscal position to marginally improve

One must note that the evolution of the Lebanese fiscal balance has been a chaotic one in the last 20 years. In the early 1990s, the budget deficit was somewhat contained, being mostly financed by domestic sources. The sales of treasury bills to commercial banks and the non-banking private sector would exceed the domestic financing needs and the Central Bank of Lebanon (BDL) would use the surplus for sterilization. Slightly after, fiscal policy became more expansionary following the reconstruction efforts (mid 1990s) with an increase in the fiscal deficit leading to a deficit rate of 20% of GDP, mainly due to an increase in capital expenditure and the increasing cost of debt-servicing.In 1997 in particular, the deficit was extremely high (close to 25% of GDP), reflecting the deterioration of budgetary revenue and increasing public expenditure. Public finances were weakened by low import growth, a high debt-service ratio, but also because of factors such as increasing teacher salaries.

It was not until the introduction of VAT and the Paris II conference in 2002 that the Lebanese economy

Table 1.
Public sector operations: revenues and expenditures (in billions of LBP)

	2012 q1	2012 q2	2012 q3	2012 q4	2013 q1	% variation y-o-y (Q1)
Budgetary Revenues	**3352.1**	**3980.2**	**3007.6**	**3133.4**	**3156.7**	**-5.8**
Tax revenues	2532.6	3113.2	2259.6	2281.9	2390	**-5.6**
Tax revenues	1130.4	1746.1	874.6	909.1	1055.1	**-6.7**
Custom Revenues	529	564.3	583.9	573.9	532.8	**0.7**
VAT revenues	873.2	802.8	801.1	799	802.2	**-8.1**
Non tax Revenues	819.6	867	748	851.4	766.6	**-6.5**
Telecom revenues	520.2	545.6	541.6	548.3	524.6	**0.8**
Budgetary expenditures	**3765.9**	**3953.9**	**3516.8**	**4069.2**	**3723.3**	**-1.1**
o/w General expenditures	2490.4	2357.2	2306.5	2399.7	2550.7	**2.4**
o/w interest expenditures	1209.2	1527.5	1130.9	1589.5	1123.9	**-7.1**
Domestic Interest expenditures	813.9	901.7	754.7	863	794.9	**-2.3**
Foreign interest expenditures	395.3	625.9	376.2	726.5	329	**-16.8**
o/w Foreign debt principal repayment	66.3	69.2	79.4	79.9	48.6	**-26.7**
Budget Primary Balance	**861.7**	**1623**	**701.1**	**733.7**	**606**	**-29.7**
Budget deficit	**-413.8**	**26.3**	**-509.3**	**-935.8**	**-566.5**	**36.9**
Total deficit	**-1008.7**	**-699**	**-1396.3**	**-2813.6**	**-1179.8**	**17**

Source: Ministry of Finance

received a much needed easing. The introduction of the VAT allowed for a significant improvement in government revenue which regained its pre-war level. Meanwhile, the government appealed to foreign capital and the Paris II conference generated funding worth 10.1 billion US dollars. This allowed to both revitalize economic growth and reduce the average cost of total debt. In the next couple of years there were significant improvements, for instance in 2003 growth reached 3%, the primary surplus was of 2.7% of GDP and the deficit lowered to 15% of GDP. The increase in tourism activity, the relative decline in real interest rates and favourable public finances were determinants of economic dynamism in the next couple of years (FEMISE, 2005). Yet, the 2006 conflict interrupted that trend; the general government structural balance deteriorated by about 37% in that sole year. Since then the fiscal deficit stabilized to a still high 9%-10% level (2007-2009) before falling in 2010 and bouncing back in the more recent years in part due to regional instability.In early 2013 one notes that revenue decreased year-on-year by about 5.8% due essentially to a 5.6% fall in tax revenues while non-tax revenues also decreased (-6.5%). However, expenditure also seems to have decreased, by about 1.1% in the same period owing to a 7.1% decrease in interest expenditures. All in all, early figures suggest an worsening of the total deficit close to 17% between Q1 2013 and Q1 2012. The general government balance deficit is expected to remain close to 8.3% of GDP in 2013, a slight improvement compared to 2012 yet far from the lows of the 2009-2011 average (7.4%).

In terms of fiscal policy and prior to the cabinet's dissolution, the finance minister had submitted a revised 2013 budget with spending lowered at US$14.1bn. However, given the current situation, the budget is unlikely to be passed (EIU, 2013).

I.5. Debt remains an issue as much as ever

The public debt problem in Lebanon is one that has been around for decades, after 1992 "the debt started increasing at alarming rates which seemed uncontrolled and not proportional…the net public debt of the gross domestic product (GDP) would have increased from about 50% in 1992 to more than 100% in 1997" (see Campaign for Good Governance in Lebanon).

Lebanon's government debt to GDP then averaged 152.5% from 2000 until 2012, reaching an all time high of 175.05% in December of 2006. Recently, Lebanon's public debt increased by nearly $5 billion during the term of the former Cabinet, 60% of which was foreign currency, the total debt in April reaching $59.1 billion (The Daily Star, 2013d). This led Moody's to revise its outlook for Lebanon from stable to negative and downgrade the three main banks in the country due to "wide exposure to public debt and the government's failure to implement reforms".

Perspectives for 2013 are not particularly encouraging with low GDP growth, higher than usual inflation and political ineptness for crucial reforms. Meanwhile, the high cost of maintaining Electricite du Liban seems to be one of the major reasons for the current debt surge (The Daily Star, 2013d).

I.6. Fragile anticipations, financial markets and banking sector perform moderately

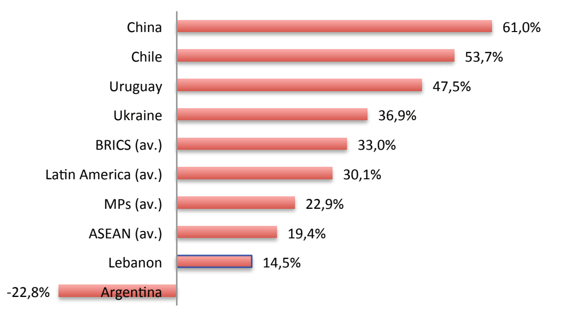
Regarding agents anticipations on the viability of the domestic economy and its debt the situation is still somewhat worrying. CDS Spreads in the Mediterranean region widened 22.9% as emerging markets assets sell off in the second quarter of 2013, in Lebanon they reached a value of 478.6 in end-June 2013 which represents a 14.5% worsening. The deterioration might be lower than for the region on average but the risk of default still remains relatively high. With the latest increase, the 5-year CPD reached 29.6% in end June versus 26.3% in the prior quarter. This remains higher than both the Mediterranean, ASEAN and BRICS averages (respectively of 26.9%, 14.6% and 14.5%) an and only slightly below the Latin American average (33.1%).

Meanwhile, the Business Monitor International's (BMI) risk rating ranked Lebanon in 112th place among 159 countries in 2013 (12th place among 20 Arab countries), with Lebanon receiving a score of 46.3 points which is lower than the global average of 54.8 points and the Arab average of 48.8 points. Most importantly, Lebanon ranked in 144th place among 173 countries on the short-term economic rating, an early warning system of financial vulnerability. This performance underscores Lebanon's exposure to shocks, both external and domestic. Let it be noted that among MPs, Lebanon currently has a better ranking than only Syria.

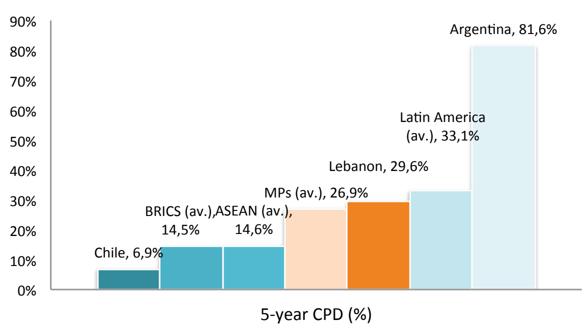
The instable political situation, contributed to the vigour-less performance of the BLOM Stock Index (BSI), which settled at 1,145.54 points in mid-August as most active stocks on the were on a negative note. The financial stocks captured 81.64% of total market share, while the real estate sector and the industrial sector took the remaining 18.15% and

Figure 5.
Economic anticipations and sovereign risk

a. % variation (Q2VSQ1 2013) of 5-year CDS Mid*



b. 5-year CPD (%)**



*Source: S&P CAPITAL IQ, McGraw Hill Financial, * a positive variation signifies a deterioration of 5-year CDS, ** the higher the CPD the higher the risk of default, note MPs average excluding Israel*

0.21%, respectively (BlomInvest, 2013b). Activity on the Beirut Stock Exchange is probably going to remain unstable as investors remain unconvinced about the future political prospects and security situation.

Commercial banks' total consolidated assets reached 157.95B$ in June, an 8% annualized growth. Even so, slower lending growth was registered and banks still prefer holding Eurobonds rather than Treasury bills in local currency as the latter decreased by 5% year to date while the former increase by 19%. Meanwhile, foreign assets registered a 3% decrease since early 2013 to reach 25.48B$ by June (BlomInvest, 2013b).

II. Important challenges

II.1. A need to reform the subsidy system in the near future

As we saw earlier the Lebanese fiscal position has faced a wild evolution over the years and reached considerable heights in the past. Part of this problem is to be found in the unsuccessful management of the subsidy system.

For instance, Lebanon heavily subsidizes energy consumption (electricity and petroleum), spending an amount that is equivalent to 8.3% of GDP (IMF, 2013). Subsidies to electricity consumption roughly represent 4.6% of GDP (for the year 2011) putting the country well ahead the world average cost of 0.26% of GDP. In 2011 alone, electricity subsidies accounted for roughly one fifth of government revenue versus a share of only 0.77% for the world average. The pre-tax cost of subsidies to the electricity sector in Lebanon is the sixth largest in the world and the highest in the MENA region (L'Orient-LEJOUR.com, 2013). Meanwhile, the remaining subsidies are destined to the consumption of petroleum products and represent about 3.6% of GDP versus a world average of 1.26%. They represent about 15.2% of government revenue versus a world average rate of 3.77% in 2011.

The magnitude of the effect on the budget deficit is thus apparent. Granted, authorities favour such subsidies due to administrative ease compared to other instruments of social policy. But, this argument alone does not suffice to justify the heavy burden on the fiscal position. The rationale for energy subsidies can be found in the will to protect poorer households from high costs. Governments may target energy/fuels widely used directly by the poor, they can target the poor indirectly and they can also do so through subsidies to producers, on the ground that production costs will be reduced and lower costs will be passed on to consumers (Fattouh and El-Katiri, 2012).

But, subsidies « are not really a well-targeted way of supporting the poor » and since richer households have a propensity to consume more than the poor, in developing economies « 43 percent of energy subsidies (before taxation) go to the richest 20 percent of the population » (IMFDirect, 2013). A comprehensive reform plan with clear objectives is going to be needed along with pro-poor initiatives to ensure equity is maintained.

Yet, is it the best time to reform the subsidy system in a profound manner? One could argue that the weak macroeconomic conditions that the country is currently facing (low growth, higher than usual inflation, two digits current account deficit) might postpone the whole process. Public resistance to subsidy reform is higher when macroeconomic conditions are not met. Cases of successful subsidy reforms such as of the electricity sector in Turkey overlapped with a period of economic growth and convergence which reduced public opposition to the necessity of reform (IMF, 2013). One could also argue that the reform of energy will inevitably contribute to considerable fiscal adjustment. For instance, the fiscal deficit in Armenia declined from 16.5% of GDP in 1994 to 9% of GDP in 1995 and to 6.3% by 2000 following electricity subsidies reform (IMFb, 2013). Meanwhile, the impact of electricity price increases on inflation was moderated by effective macroeconomic stabilization.

In the end, in Lebanon's case issues linked to political uncertainty will probably have to be dealt with first before proceeding to substantial reform in the subsidy system. But when it happens, decisive action will be needed; history has proven that subsidy reform in Lebanon might not be permanent as suggested by the case of agriculture. More specifically, the government had pledged to get rid of all agricultural subsidies in return for loans at the Paris I Donors Conference in 1998, but only the beet subsidy was revoked in 2001. Now, even the agricultural subsidy on sugar beets has been reinstated (October 2012) to stimulate sugar beet production in 2013 (TheDailyStar, 2013).

II.2 Tense youth unemployment situation, exacerbated with Syrian influx

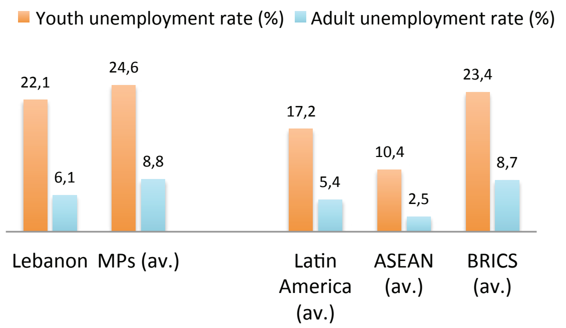
Estimates as to the rate of unemployment vary in Lebanon and reliable unemployment statistics for recent years are difficult to obtain; the most recent year provided by the World Bank is 2007 with a rate of 9% while recent ILO statistics suggest a 8.8% rate for the year 2010. While the exactness of estimates regarding total unemployment is uncertain, there seems to be a generalized agreement that the Lebanese youth is the one suffering the most from this phenomenon. The unemployment rate among the Lebanese youth appears to have been close to 23.2% in 2010 (ILO) with a rate of 23.4% for young men and 22.7% for young women (LeCommerceduLevant, 2013). The rate is close to 22.1% according to KILM, if this value is taken then this would put the youth unemployment rate in Lebanon slightly below the regional average (24.6%) but considerably higher than the rate observed in ASEAN countries (10.4%) and Latin America (17.2%).

However, other sources suggest a harsher reality, with unemployment figures varying between 27% and 30% and going up to 35% for the Lebanese youth (LaLiberté, 2013). There seems to be a «failure" on the behalf of authorities and certain employers in estimating phenomena such as «duplication», where people are registered as unemployed in a sector but are working in an "uncontrolled" one. The effect of unemployment is limited by the large inflow of remittances, especially from Gulf countries, that represent about 20% of GDP. This might explain how domestic consumption maintains some dynamism that is disproportional to the generated income.

The recent influx of Syrian refugees, estimated at about 250000 to 300000 in early 2013, is undeniably a destabilizing factor for the job market. But, the unemployment problem has deeper causes and appears to be twofold. First, it seems that "the size and structure of the Lebanese economy have historically been too narrow in relation to the aspirations of young graduates" (Sawtbeirut, 2013). The truth is that the domestic market is unable to absorb the high number of graduates.

Meanwhile, demand emanating from the private sector is trapped in a low wages and low productivity cycle due to macroeconomic uncertainty, corruption, inefficient policies and lack of infrastructure. Most jobs created are in low value-added sectors (ex. wholesale and retail trade, repair and maintenance, transport and storage…) and employers have little apprehension about skills and are reluctant to pay high wages. Second, there seems to be a «negative attitude» and inflexibility on the behalf of the Lebanese youth that lacks

Figure 6.
Unemployment rate (%), by region and age group, most recent year



Source: KILM

awareness of the realities of the labor market. Most try to find work abroad, often before even obtaining their degree, believing that there is nothing for them domestically. Education does not seem to be an issue, at least not at first glance, in international comparisons of student learning Lebanon comes at the top in the Arab region (Executive-Magazine, 2012). Yet, despite their qualifications, they are often incapable of writing a resume or prepare an interview, they lack experience and do not have "realistic expectations" (Sawtbeirut, 2013). Important structural deficiencies have thus translated into the following phenomenon: during the last decade only 3400 jobs were created annually versus roughly 19000 new entrants into the labor market every year. This ample labor supply is already sufficient to reduce wages, letting aside the presence of low-skilled migrant workers ready to work for low wages (Sawtbeirut, 2013). Thus, the Syrian influx, while not responsible for these structural issues, risks becoming «an explosive factor», one that may lead to unbearable poverty and violence (LaLiberté, 2013).

Lebanese hospitality towards Syrians has been remarkable though it has given place to relative bitterness in some instances, with bigger competition for infrequent employment. Many Lebanese seem to believe that Syrian refugees are taking their jobs and causing wages to decline (FAFO, 2013). The competition has indeed become devastating, with aid to Syrian refugees allowing them to complement income from work, an opportunity that poorer Lebanese households do not have. As a result, the Change and Reform bloc proposed measures to address the growing Syrian refugee crisis, involving ending Lebanon's open door policy at the borders (The Daily Star, 2013b).

a roadmap that answers the structural problems of youth unemployment is needed...

However, it is doubtful that such measures provide an answer to structural issues regarding the Lebanese labour market. A roadmap that answers the structural problems of youth unemployment is needed instead, while regarding the Syrian issue authorities should seek the assistance of the international community.

II.3. Some noteworthy innovation efforts, despite uneven performance

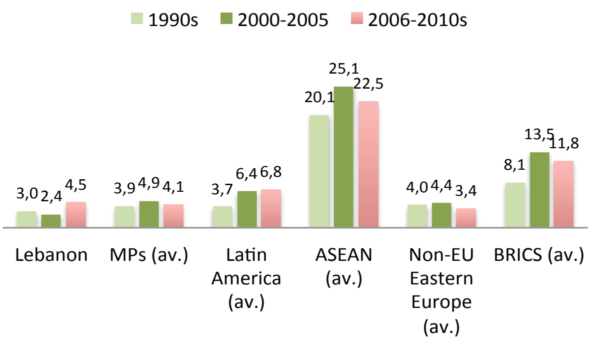
Lebanon started to take advantage from the value chain restructuring and saw the emergence of high tech firms with innovation potential, essentially specializing in sectors with "high growth dynamics", such as the manufacturing of electrical equipment, clean technologies and the design of hardware components & semi-conductors. Lebanon's trade activity in high technology products is an indicator of innovation potential and competitiveness. While low in the early 2000s, the share of high tech products surged in the latter years going from 2.2% of GDP in 2007 to 4.5% in 2009 and an impressive 12.8% in 2010.

Yet, in 2011 the share fell back to its early 2000s average level. The growth of high-tech exports was outstanding compared to other MPs and Lebanon recorded the highest increase in both percentages and export values (InvestinLebanon, 2012). It thus seemed that Lebanon's start-ups found new markets and extensive opportunities for their innovations. Yet, the growth of high-tech exports seems to have receded, in 2011 the share in total exports reverted to its early 2000s average.

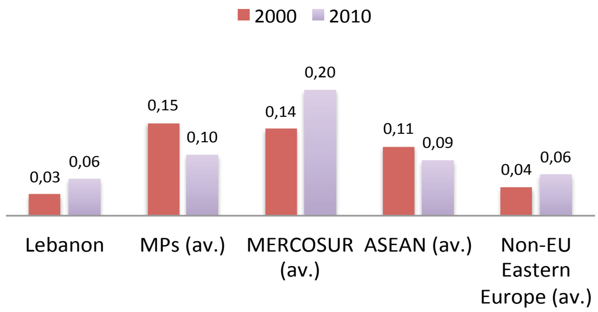
Other indicators that could be an indication of the degree/absence of a "culture of innovation" also show a mitigating picture. The number of scientific articles published by Lebanon annually is considerably low (about half the regional average and infinitely less than what is observed in CEE countries, see Appendix) even though it practically tripled in the latest decade. However, an important comment in relation to quality should be made. While in volume terms Lebanon seems to be lagging, the number of citations received per Lebanese scientific document in 2011

Figure 7.
Improved integration dynamic (selected indicators)

a. High-tech. exports (% of manuf. exports)



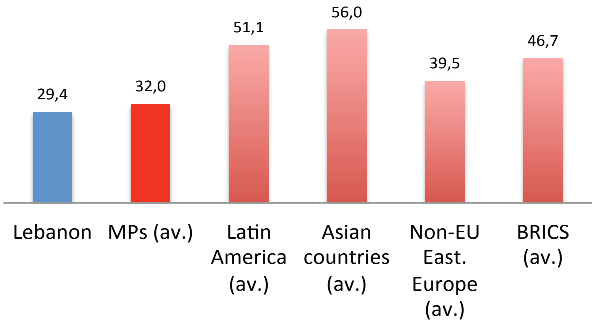
b. Trade Concentration Index



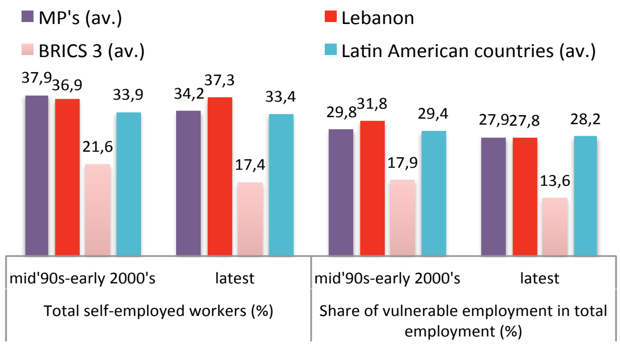
Source: WDI, FEMISE calculations using Tradesift and Comtrade data, based on SITC rev3 3-digit data.

Figure 8.
Domestic labour market dynamic, improvements but unresolved issues remain (selected indicators)

a. Labour force participation rates, 15-24 (%)

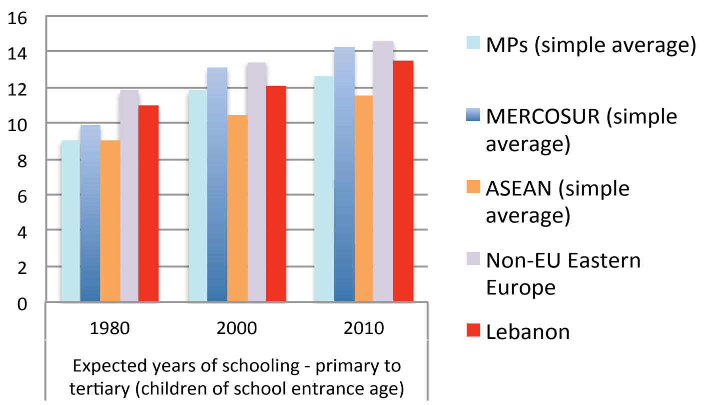


b. Informality and quality of employment



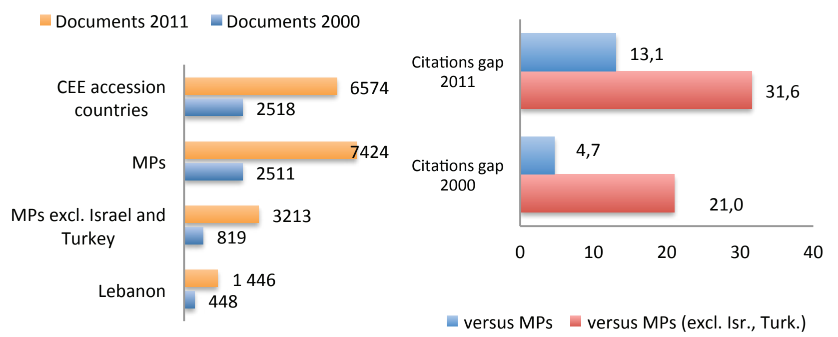
Source : IMF, World Economic Outlook database April 2013 (latest) and EIU

Figure 9.
Social dynamic that improved (selected indicators)
HDI components related to schooling



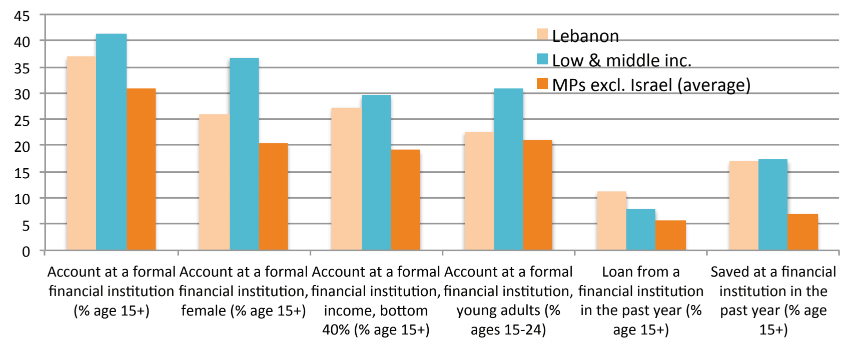
Source : HDI, FEMISE (2012) note on inclusive growth

Figure 10.
Journals and country scientific indicator:
a) No of documents (2000 VS 2011) ***b) Citations per Document gap* (%)***



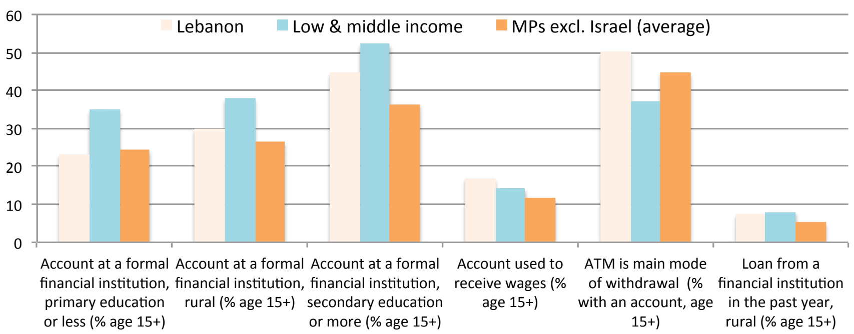
Source: SCImago Journal & Country Rank (SJR)
** FEMISE calculations based on SJR, the index measures in percentage terms how many more/less citations per document the country receives when compared to the regional average. Ex. a value of -10 means that the country receives 10% less citations per document compared to the MPs average.*

Figure 11.
Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

Figure 12.
Second set of Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

is about 13.1% higher than for an average MPs paper (including Turkey and an innovative economy such as Israel), an indicator that suggests that the impact of Lebanon's documents is comparatively high and has also increased over the years (in 2000 citations received per document were only 4.7% higher than for an average MPs paper). Furthermore, while CEE scholars publish much more, Lebanon's documents receive almost as many citations on average, a testament as to their relevance.

Undoubtedly, the potential is there and authorities should focus more on pro-innovation efforts that will give a much-needed boost to Lebanon's productivity. Again, the issue of properly channelling FDI is of great importance, a strategy that favours innovation and creativity should allow for foreign funds to be oriented towards productive sectors.

II.4. Despite some positive signs, financial inclusiveness should be improved

The level of financial inclusion in Lebanon is above the average regional level. First, the share of account holders is close to 37% (versus 30.8% for the Mediterranean), meanwhile the percentage of women account holders is also higher than the regional average (25.9% versus 20.5%) and the Lebanese youth is more financially integrated though their level of financial inclusion is still lower than the level of low & middle-income countries. Remarkably, when differentiating across income groups, one notes how the bottom 40% of the population are better included, with 27.3% having an account versus 19.1% in the region (but 29.5% in the low & middle-income countries group).

Furthermore, people in rural areas seem better integrated than in other MPs, while the share of Lebanese using ATMs is considerable for such a development level (similarly the share of people in Lebanon in possession of a debit card is high in relative terms, 21.4% versus 19.1% for the Mediterranean on average). Even so, one notes that those with basic education are excluded; only 23.2% of them possess an account, a figure below the MPs average. The situation improves with more educated individuals but the share of account holders remains low when benchmarked against other countries/regions. All in all, in terms of financial inclusiveness more needs to be done especially when compared to countries of a similar development level.

III. Conclusions

As noted in the FEMISE (2010) report « the country is in need of a new growth policy that allows for continuous reduction of the huge debt…potential reforms include reductions in red-tape and business barriers, streamlining of tax procedures, budget accountability, income tax legislation and privatisation efforts in key infrastructure sectors such as telecommunication, electricity and transport services ». Now, three years later, one could say that while some efforts have been pursued, the situation and needs are largely similar; some could even say that more necessities have risen.

- √ One should note **Lebanon greatly suffered from political division and uncertainty and recent years are no difference**. From early 2011 when the coalition government collapsed, to the events of March 2013 with the resignation of the prime minister and finally to current attempts to form a cabinet one notes that political turbulence has been a redundant constant. The Hizbullah coalition has claimed a power of veto in any upcoming cabinet, a point resisted by the nationalist «March 14th» bloc which is under the leadership of a former prime minister. The current stalemate is expected to continue in the short term especially given opposite views on the situation in Syria. Parliament activity was also postponed for two weeks in July because of a dispute over extending the head of the army's term beyond the legal retirement age. All in all, the unrest in Syria is has led to internal clashes and could aggravate sectarian tensions, particularly between Muslim communities and with marginalization of Christian communities (EIU, 2013). As a result of all this tension growth prospects are inhibited, the fight against unemployment is problematic to say the least and the fiscal position remains critical.
- √ With a current account deficit persistently rising, one could say that **the trade liberalization process in which Lebanon is committed has not been successful.** There is thus urgent for boosting exports to reduce the trade deficit. Meanwhile, authorities should increase productive capacity through further development of the domestic industry but also through a "more intelligent" mix of regulation and openness to allow for infant industries to achieve the levels of productivity and competitiveness necessary to cope with international competition. Allocating national investment from FDI or domestic savings to the productive sector should be a pre-requisite as well.
- √ But, Lebanon risks of losing the economic support of some of its neighbours (ex. Saudi Arabia and Qatar) if it maintains its current policy towards Syria. Whatever the composition of the finalized government, **authorities will shall make endeavours to maintain ties with Gulf countries** since their tourists are essential for economic performance (tourism indirectly supporting one-quarter of jobs and generating demand for the construction sector) (EIU, 2013). To alleviate tensions vis-à-vis refugees, domestic authorities could introduce cash for work programs for refugees to ease social tensions. They could target both poor Lebanese and Syrian households in aid operations at the same time which should provide for an image of inclusiveness, strengthen a coordinated registration

process when refugees arrive locally to have a better overview of aid received and provide additional support to vulnerable refugees in their first months of stay (FAFO, 2013).

√ The analysis of the working conditions and unemployment figures, limited as they may be, suggest a **return to higher rates of employment creation is doubtful.** The political and social instability, whose resolve requires further reforms, is prevailing. There are important issues of inequalities, regarding income distribution among others, that need to be taken care of. We should note:

√ If the country does not develop its industrial base and does not diversify more then it will be unable to absorb an ever increasing labor force, comprised of both low-skilled as well as qualified individuals. To tackle the issue efficiently Lebanon needs industrial competitiveness. Low investment and high input costs (see energy) are important impediments to private sector development and consequently to a fostering a steady employment framework between the public and private sector. A strategy is needed to encourage industrial development and provide the much needed financial and human resources. Maintaining social cohesion is a must and this can be achieved by creating new opportunities that will allow to progressively deal with adjustments related to both internal macro-economic constraints and international competitiveness. All stakeholders, especially from the private sector, should have a key role to play in helping the unemployed youth, often characterized as qualified but lacking specific skills, to develop soft skills and the much needed self-assurance to use them. Moreover, it is vital for authorities to dedicate more resources to public education in order to meet the needs of poorer households, who are excluded due to inadequate access to “proper education” (Executive-Magazine, 2012).

√ The existence of territorial disparities is often linked to institutional-related causes that affect youth unemployment. For instance, the lack of an efficient transport infrastructure that links households to employment may often impede on the frequency and quality of opportunities for the young Lebanese. This fact may ultimately exclude them from a range of prospects and should be taken into account from policy makers if they wish for a more inclusive development model. Improving governance and public infrastructure should be prioritized to create a competitive and inclusive business ecosystem. This would add a range of much needed high value-added activities and increase demand for skilled labor (Executive-Magazine, 2012).

if the country does not develop its industrial base and does not diversify more then it will be unable to absorb an ever increasing labor force...

Last but not least, as mentioned earlier the Lebanese fiscal needs to be alleviated with better management of the subsidy system. Lessons from other countries should also serve as an example or counter example of what to do or not do (see IMF, 2013):

√ For instance, an effective public information campaign along wih important dissemination efforts to the public is crucial to the success of reform. In Nigeria, there was a dynamic government campaigned but it was too short and there was no real popular discussion and efforts such as producing short briefs arrived too late. In the Philippines reform was also supported by an in-depth communication strategy.

√ Meanwhile, undertaking reform during a period of macroeconomic prosperity can improve results. In Peru, the decision to proceed with reform was taken in early 2010 during a period of stable prices and GDP growth, a fact that helped push the reform and make it more acceptable. In that respect Lebanon could wait for a short period of time before falling back to higher rates of growth before going forward with deeper cuts. In the case of Turkey, the economy grew increasingly steadily and inflation was lowered, hence, the immediate fallout of energy reforms on household welfare was limited since income had considerably grown during the prior decades.

√ In Lebanon authorities fear social reaction given the current regional and domestic climate of instability. But, compensatory measures such as cash transfers and other programs can alleviate poverty efficiently and thus allow for reforms to pass without social repercussions. Measures need to be well designed and well-timed, the example of Yemen comes to mind where a number of instruments (Social Welfare Fund cash transfers, the Public Works Project and the Social Fund for Development) allowed reducing hostility towards reforms.

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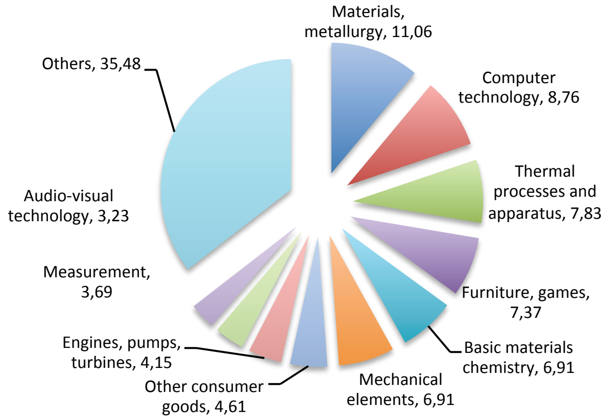
ANNEX

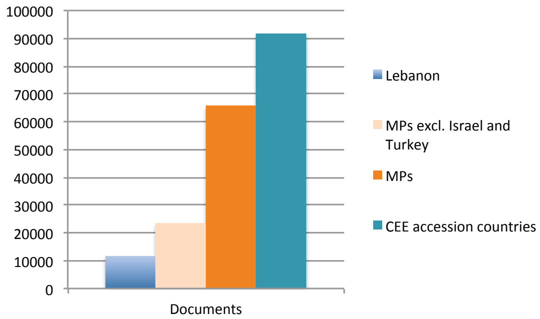
Figure A1.
Patent Applications by Top Fields of Technology (1997 - 2011)



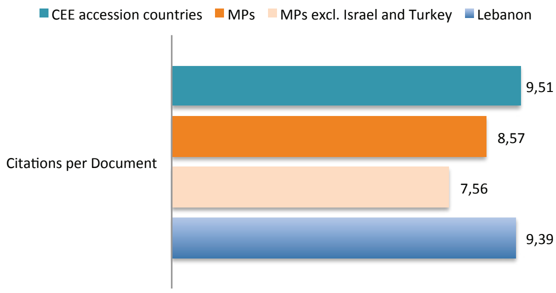
Source: World Intellectual Property Organization

Figure A2.
Journals and country scientific indicator:

a. Number of Documents



b. Citations per Document



Source: World Intellectual Property Organization

MOROCCO

One of the best results among MPs
but fiscal constraints that need to be adressed

Introduction

If we look at the evolution of Morocco in recent years we could say that it achieved important steps in its economic and social development. Economic growth has been continuous and the domestic economy's reliance to climatic conditions has been lessened, furthermore the economic crisis is a distant memory. Meanwhile, the rate of investment has been consistently high and consumption has been increasing. Adding to that, on the political front there were free elections with promises on tackling the issue of corruption and achieving inclusive growth. All of these factors should be a reason for optimism.

Yet, the situation is not as clear-cut. Maintaining public investment at such high level along with domestic consumption has come at the price of an increased budget deficit. The latter has kept deteriorating in recent years and so has the trade deficit, owing to the relatively low competitiveness of the Moroccan economy. Also, the control of inflation through price subsidies has led to an increased level of debt and has hampered the financing of the private sector. As for expectations after the elections, they remain to be materialized and have up till now been disillusioned, with numerous reforms that have not yet taken place. In 2012, economic growth in Morocco was below its medium term average (4.8% in 2005-2008 and 4.5% in 2009-2011) and fell to 2.7% because of an adverse international economic situation, especially in Europe with a declining demand for Moroccan exports, but also because of a rather narrow reform on the fiscal front.

In recent years Moroccan fiscal strategy seemed to be based on four pillars (FEMISE, 2004):

- √ *managing the consequences of trade liberalization, researching alternatives to tariffs being lowered,*
- √ *reducing direct state intervention in the economy, promoting development of the private sector and developing the tax system,*
- √ *improving the mobilization of domestic resources and increasing public savings through a significant increase in the share of tax revenues in GDP and reduction of specific expenses all the while increasing the financial performance of public enterprises,*
- √ *developing the means for a more efficient management of public resources sector with clearer and better targeted policy choices, supported by assessment methods, more efficient resource allocation and by monitoring procedures that show the budgetary impact.*

> ***maintaining public investment at such high level along with domestic consumption has come at the price of an increased budget deficit....***

But, long gone is the period of relative budget stability of the 2005-2008 period (-1.6% budget deficit), now the government seeks "to repair its finances after spending heavily to ensure social peace in the wake of the Arab Spring uprisings elsewhere in the region" (REUTERS, 2013). Contemplation is thus needed on the authorities' behalf. The new government needs to identify the structural reforms that must be implemented very carefully; it shall reassess its growth strategy and macroeconomic sustainability, encourage capital holders to invest in sectors that will be the "new growth and employment carriers", follow a policy that increases savings and pinpoint the ideal means for efficient resource reallocation. More importantly, the youth need to be at the forefront of change, it is the time *for this determined generation to be empowered and allowed to grasp the fruits of an innovation based strategy.*

For Femise the strategy that seems better suited is one that firmly establishes a development model based on key factors: innovation and inclusiveness. But, these issues must be analyzed by taking into account fiscal constraints. Authorities also need asking the question of whether the Euromed in its current version is likely to allow entering such process. Perhaps, the partnership needs to be modified to drive such dynamics. One must not lose sight of the priorities that countries like Morocco must respond to, namely job creation. Thus, there is need to consider the potential for structural impact in terms of jobs when studying these key points.

Prospects should not be negative; EU-Morocco negotiations for a Deep and Comprehensive Free Trade Agreement (DCFTA) were recently launched and Morocco has a unique chance at negotiating a deal that would strengthen its position regarding products in which it has a comparative advantage but that were never the focus of discussions in prior negotiations. Yet, the process should be conducted intelligently, further integration with the EU should not come to the detriment of regional integration and collaboration. Obtaining distinguished and advanced treatment should not damage the cohesion with neighbouring MPs and should definitely not increase the dependence of Morocco to the EU. Meanwhile, it is positive to note that the Arab Spring never hit Morocco, which also means that foreign investors will not lose incentives in the kingdom, provided that reforms do take place.

***The current economic situation is the following** :*

- √ ***Real GDP growth** in 2013 is expected to increase but not quite reach its prior trends, close to 3.5% and helped by an improved agricultural performance; even though Morocco will still be dependent on export performance (and tourism from) to Europe which remains limited.*
- √ ***Consumer price inflation** will remain low to 2.1%, though higher than in recent years, with subsidies (still not reformed but that might) on energy and food keeping prices at an artificially low level.*
- √ ***The current-account deficit** peaked in 2012 as import costs remained high and economic problems in the euro area constrained growth in goods exports, tourism receipts and remittances. Now it is expected to narrow to 5.3% of GDP, in part because exports of phosphates to markets such as Brazil, India and the US could grow. The Renault car plant and a new hydrocarbons terminal could positively stimulate the current account.*
- √ ***Unemployment** is expected to slightly fall to 8.8% in 2013 from 9% in 2012. But, youth exclusion has always been a concern. Contrary to other countries, education increases the risk of unemployment and does not seem to bring integration in the job market. The most affected are young urban graduates and most specifically women.*

***Among the structural challenges we should note** :*

- √ *Morocco realized that to combat unemployment and the lack of inclusiveness it should embrace an **innovation and creativity-based growth regime**. Despite performing better than the regional average in terms of high-technology exports, there are still numerous shortcomings in terms of innovation. Patents produced are lower than the regional average and statistics for industrial*

Key indicators	2005-2008	2009-2011	2012	2013	2014
Real GDP growth (%)	4.8	4.5	2.7	3.5	3.9
Consumer price inflation (av; %)	2.5	1	1.2	2.1	2.5
Budget balance (% of GDP)	-1.6	-4.3	-8.3	-7	-6
Current-account balance (% of GDP)	-0.3	-5.9	-9	-5.3	-4.8
Unemployment rate (%)	10	9	8.8	8.7	8.6

Source: WEO – IMF. BAM. EIU estimates for 2012. 2013 and 2014 *designs show that Morocco still has a long way to go compared to CEE countries.*

- √ *In last year's report we noted that Morocco needed to* ***go towards a more inclusive growth model****. In that respect, financial inclusion contributes to lowering income inequality and supporting strong economic growth; and Morocco needs to do more. The level of financial inclusion in Morocco appears higher than the average regional level. Even so, it is lower than the average level to be found in low & middle-income economies. Also, the share of people with basic education that have an account is somewhat excluded, below the level found in countries with a similar development level.*
- √ *A* ***spatial inclusion policy should also become a priority****, women are generally more excluded than men and face considerable exclusion in regions such as Oued Ed-Dahab- Lagouira – Laâyoune, Oriental and Rabat-Salé-Zemmour-Zaer. Measures to reduce disparities between provinces should be strenghtened. A new participatory management that allows more leeway in decision making for regional and local actors is needed and so are needs for improved managerial skills in decentralized units in the periphery.*
- √ *Morocco will definitely have to* ***limit the fiscal burden of food subsidies*** *to allow for more fiscal space and better targeting of government spending towards more growth-inducing initiatives. Currently, there are "nominal downward rigidities" linked to inefficiencies in the food chain with costs kept high even when world food prices fall.*
- √ *Meanwhile,* ***harmonization of non-trade measures can prove beneficial to the productivity of Moroccan firms.*** *By easing the entry of goods from developed economies and limiting access to those originating from developing ones, new NTMs could change the structures of the internal market. They could also induce convergence between the institutional and legislative environment of firms, but also vis-a-vis production standards.*

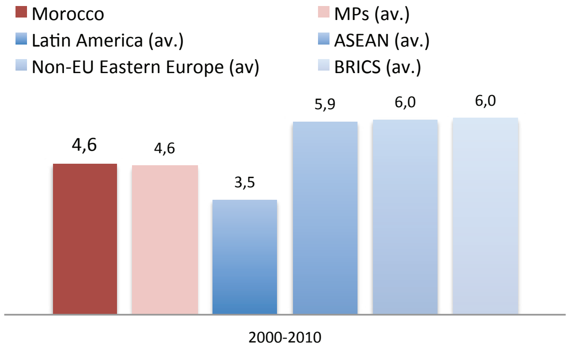
I. A 2012/2013 snapshot: macroeconomic indicators and estimates

I.1. Economic growth slow down in 2012, to slightly bounce back in 2013

The rise in private consumption and gross fixed investment allowed Morocco to maintain growth at a high level two years ago. But, the growth rate of final consumption significantly slowed down in the fourth quarter of 2012, to stand at 2.6%, versus 9.7% at end 2011. The decline in household consumption could be attributable to the decline of primary activities and weaker external revenue. Consumer spending on food seems to have been constrained by the decline in agricultural supply and a price increase of 3.2%. But, in the third quarter of 2013, domestic consumption seemed to increase (by 3.7% versus roughly 2.8% during the same period in 2012).With this increase, domestic final consumption was the main contributor to economic growth; households' final consumption expenditurecontributed by 2.2 percentage points to growth (versus 1.6 points in the same period last year). As for government consumption, in early 2013 it showed an increase of 4.3% (considerably lower than the 8.1% increase during the third quarter of 2012) with a contribution to growth equal to 0.7 points. The consumption of Moroccan households should benefit also from an improvement in household income, linked to the positive evolution in consumption loans and an improved situation in the domestic labor market. Regarding gross capital formation, it only showed an increase of 0.5% versus 2.6% a year earlier, among others due to a decline in investment on the sector of construction products. All in all, domestic demand contributed by 3 percentage points to GDP, verus 2 percentage points a year earlier.

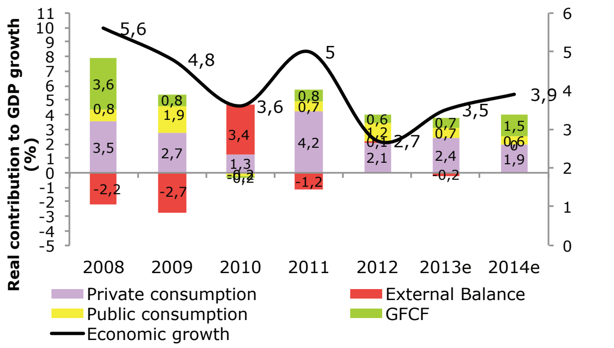
Economic growth had initially slowed-down significantly, reaching 2.8% in the fourth quarter of 2012, versus 4.9% in end 2011. This is due to a decrease of almost 9.2% of the agricultural value added during that time. The non-agricultural activities are those

Figure 1a.
Gross domestic product,
average annual GDP growth rate by region



Source : IMF, World Economic Outlook database and EIU

Figure 1b.
Gross domestic product,
real contribution to growth (%)



Source : IMF, World Economic Outlook database and EIU

that are continuously supporting economic growth, rising by 4.8% year-on-year. In the first quarter of 2013, the agricultural crop was expected to be above average helped by better weather conditions and non-agricultural activities were expected to keep positive momentum to contribute to a higher GDP growth (Source: HCP). Eventually, GDP growth accelerated and reached 4% in the third quarter of 2013 up from 2.9% 12 months before and with a 4.7% increase of nominal GDP. The agricultural value added volume increased by 19.9% in the third quarter of 2013 compared to a decline of 8.5% in the same quarter of the previous year , while that of non-agricultural activities marked a slowdown (growth of 1.6 % instead of 4.7% in 2012).

Already, by mid-April 2013 the cumulative rainfall was up by 27% compared to « normal periods » and by 91% compared to April 2012. The propice climatic conditions had resulted in a good situation of the agricultural value added in early 2013, according to the Department of Agriculture, the national production of the three major grains was estimated at 97 million quintals over 5.17 million hectares. Meanwhile, at the end of the first quarter of the current year, the fishery volume had strengthened by 32.5% compared to the first quarter of 2012.

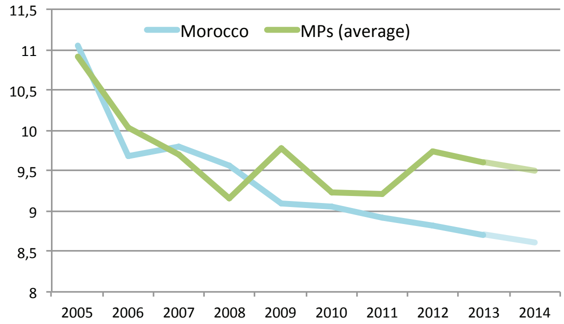
The value added of the secondary sector decreased by 0.5% in Q3 2013 (versus a 2.3% increase over the same period last year) owing to the decline in the value-added of construction and public works (-0.2%), decceleration in the electricity and water sector (1.9% instead of 9.9% a year before), the decline in the mining industry (-3.2%) and stagnation in the transformation industry (after a 1.4% increase).

As for the tertiary economy, it grew by 2.8% (still below the 5.8% in the same quarter of 2012) with important growth rates in sectors such as « Post and Telecommunications « (8.9% versus 27.1% 12 years ago), «hotels and restaurants « (4.4% versus 2.7% last year), “services to households and businesses» (2.4% versus 4.9% a year ago), lower growth in finance and insurance (only 0.2% versus 4.2% 12 months ago), public administration services (2% versus 6.3%) education and health services (2% versus 4.9%) while trade services increased considerably (3.1 %) (HCP).

I.2. Unemployment trends : young urban graduates and women are the most affected

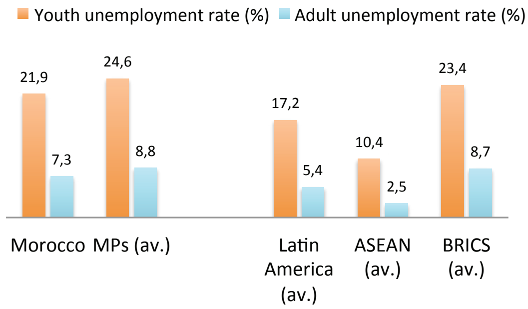
The unemployment rate in Morocco stood at 8.7% in late 2012 slightly below its 8.5% rate twelve months earlier. Despite the return of Moroccan immigrants after the regional turmoil, the annual rate of unemployment remained below the 2006-2008 average (9.6%) and was close to the 2009-2011 average of 9%.The late 2012 fall in the rate could be explained by a decrease in urban unemployment (from 14.4% in the first quarter of 2012 to 13.2% in late 2012) while rural unemployment fell from 4.8% in early 2012 to 3.5%. Later on, between the second quarter of 2012 and the same period of 2013, the Moroccan economy created about 144000 job positions (63000 urban and 81000 rural) with the vast majority (136000 jobs) created in the field of «agriculture, forestry and fishing» and 37000 in the sector of industry. The construction sector lost about 38000 jobs and services only created 5000 positions versus 85000 in annual average over the last five years. The loss of jobs in the sub-sectors of «storage, transport and communication» and «banking, insurance and real estate activities» is greatly responsible for that trend. All in all, in Q2 2013 the number of unemployed increased by 100000 and the unemployment rate stood at 8.8% (from 12.3% to 13.8% in urban areas and 3.5% to 3.2% in rural areas). The latest figures suggest that the unemployment rate declined in the third quarter of 2013 to 9.1% from 9.4% during the same period in 2012.

Figure 2a.
Unemployment rate (% of total labor force)



Source: IMF, World Economic Outlook database, KILM

Figure 2b.
Unemployment by region and age (%), most recent year



Source: IMF, World Economic Outlook database, KILM

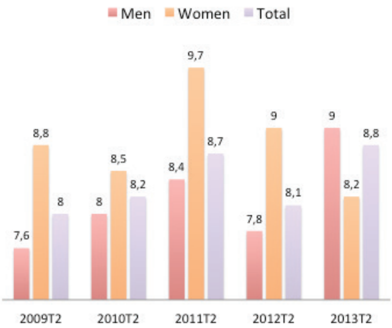
It appears that, contrary to other countries, educationhas not yet brought sufficient integration in the job market. Indeed, the most affected are young urban graduates and most specifically women (OxfordBusinessGroup, 2013). About 18.4% of the 15-24 years are unemployed (up from the already high 17.1%), among those with no degree only 3.5% were unemployed in late 2012 but the share of the jobless among those with higher education would reach 17.6% (though such value is lower than the 20% average unemployment rate they faced in 2006-2008).

Regarding the gender issue, one must note that the labor force participation of women is significantly lower than that of men in all age groups, "in urban areas about 75 percent of all non–school-attending young males are in the labor force, only 28 percent of young women are. In rural areas, young women's labor force participation is less than 10 percent"(World Bank, 2012). This poses an issue of coming-up with necessary policies to combat the limited "freedom of action" of women in rural areas that impede them from engaging in jobs.

The unemployment rate might be higher for women (HCP), however about 25% of the male youth is inactive versus only 16% for young women. This raises an issue of confidence that needs to be taken into account by the authorities "most of the inactive young males are in fact discouraged workers—those who are inactive because they believe they stand little chance of getting a suitable job" (World Bank, 2012). Undeniably, job creation could be considered slow-moving, in 2012 about 127000 jobs were created but almost the

education increases the risk of unemployment and does not seem to bring integration in the job market...

Figure 3a.
Unemployment rate (quarterly), by gender

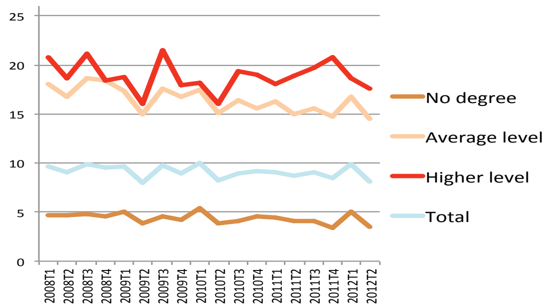


Source: Haut Commissariat au Plan

Figure 3b.
Unemployment rate (quarterly), by age group

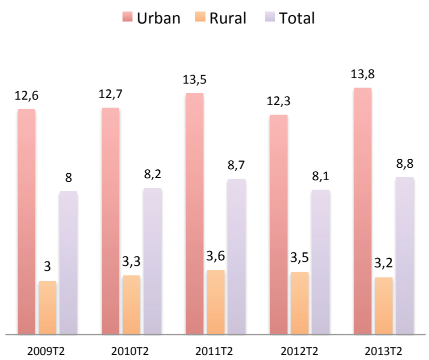
Source: Haut Commissariat au Plan

Figure 3c.
Unemployment rate (quarterly), by education level



Source: Haut Commissariat au Plan

Figure 3d.
Unemployment rate (quarterly), by region



Source: Haut Commissariat au Plan

same amount of jobs (126000) was eliminated the same year and especially in rural Morocco (111000) (HCP). Meanwhile, education and training appear to still be disconnected from the actual needs of the Moroccan labor market which seeks but cannot find a labor force with the necessary skills.

I.3. Low inflation with a subsidy system to be maintained

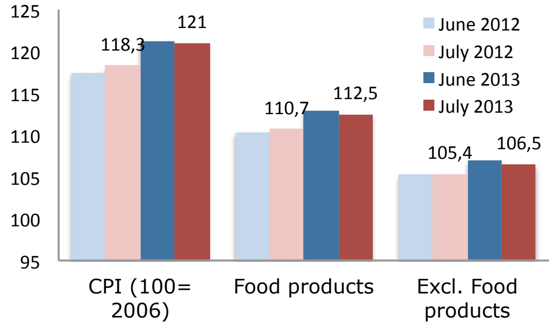
Inflation should remain low close to its 2006-2008 average (expected at 2.1% in 2013), considering that government subsidies on energy and food will be maintained thus keeping prices artificially low. The domestic CPI fell by 0.6% year-on-year in November 2013 owing to a 1.2% fall in the index of food products and a 0.1% fall in non-food commodities.

It remains to be seen for how long the subsidy system will still be manageable, since it places a considerable burden on the public finances and needs reform. Obviously, such reform might not advance in the short term since it could fuel unrest among the most disadvantaged shares of the population.

I.4. External position: Some easing to be expected on the current account, FDI carries great job potential in specific sectors

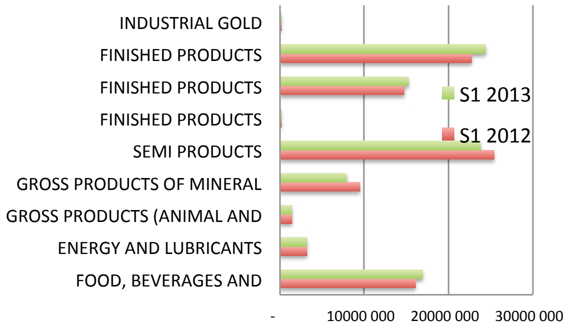
The value of goods exports rose in the fourth quarter of 2012, by 4.9% year-on-year, adjusted for seasonal effects, benefiting mainly from a price effect. Sales of equipment (electric cables) and consumer goods (clothing) contributed the most to this increase. In contrast, exports of other products, such as semi-finished products (electronic components and phosphate derivatives) fell during that period, suffering from weak external demand. In the first quarter of 2013, mining exports remained below their trend levels in the medium term, this decrease was expected to continue until the spring of 2013, combined with the increase of imports of major global buyers. Apart from sales of phosphates and derivatives down by 18.3% during the first seven months of 2013, and textile and leather which fell by 3.8%, other sectors performed vastly better since the beginning of 2013. Exports excluding phosphates and derivatives annually increased by 4.2% in the first seven months of 2013 with notable performances in the FDI heavy automotive sector (18.4% or 2.7 billion dirhams). Meanwhile, aeronautics exports also kept rising (+25.3%). In terms of agricultural and food trade, at the end of March 2013 exports had already improved by 1%, driven by higher exports of the food industry of about 16.2% (to 4.9 billion dirhams) offsetting the decline in the value of exports of citrus of 14.3%. In the first seven months of the year, agriculture and food ended up increasing by 5.4% or 1 billion DH. But overall the latest official estimates for 2013 suggest a decline in exports of 3.9% yoy, driven by the contraction in shipments of phosphate and derivatives.

Figure 4. Consumer prices



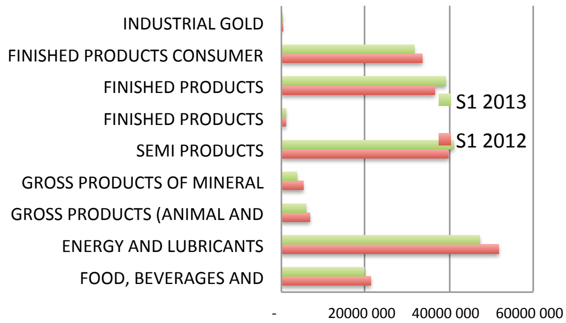
Source: Ministry of Economy and Finance

Figure 5a. Exports, by products, S1 2013 VS S1 2012 (1000DH)



Source: Office des Changes

Figure 5b. Imports, by products, S1 2013 VS S1 2012 (1000DH)



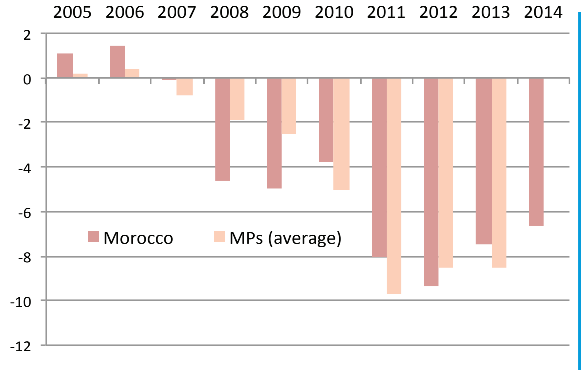
Source: Office des Changes

For 2012 as a whole, the value of goods imports grew faster than that of exports, respectively increasing by 6.3% and 4.7%. This resulted in a widening trade deficit of 7.9%. However, it should be noted that this decline is less pronounced than the one recorded in 2011 (Source: HCP). Yet, Preliminary figures for the first seven months of 2013 suggest that at the end of July 2013, the trade deficit had kept declining due to a fall in imports by 7.9 billion dirhams versus a fall in exports of only - 1.8 billion dirhams. The evolution of imports was marked by a decline in energy supplies but also reduced purchases of raw materials, consumer goods and foodstuffs. However, imports of capital goods and semi-finished products kept increasing (Office des Changes).

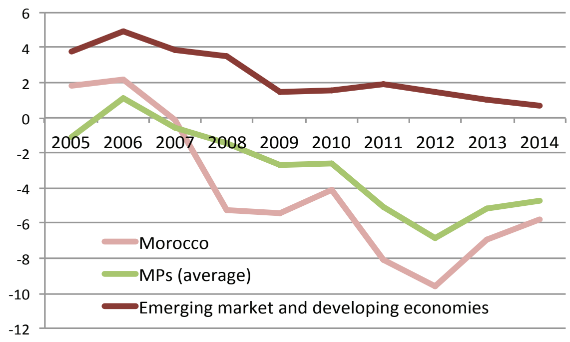
At the end of March 2013, exports of services had increased by 1.9% and imports by 1.8%, resulting in a surplus of 8.9 billion dirhams that is a 2% year-on-year increase, primarily attributable to the positive performance of travel services. The tourism industry could improve throughout the year, growing quarterly in Q1 2013 in revenue terms by 1.5%, in conjunction with the expected improvement of tourist arrivals, particularly of European tourists. At the end of the first quarter of the current year, the number of tourist arrivals reached 1.8 million, an increase of 3% year-on-year after a decline of 5% a year earlier. One should pay particular attention to the number of arrivals from

Figure 6.
Current account balance

a) decomposition (in billions US$)



b) as percentage of GDP



Source : IMF, World Economic Outlook database and EIU

Spain which increased by 5%, from the UK which was the second largest contributor (+9%), followed by arrivals from the U.S. (+13%). Total nights spent in Moroccan establishments amounted to 4 million nights, an increase of 11% after a decrease of 11% at the end of March 2012. The nights spent by French tourists increased by 10%, contributing by about a quarter to the evolution of total nights. In terms of location, the overnight stays in all main Moroccan destinations increased, except for the city of Rabat who witnessed a 4% decrease. Yet, in March 2013 tourism revenues marked a slight decrease of 0.7% year-on-year to amount to slightly more than 11.8 billion dirhams (Ministry of Economy and Finance, 2013). After a sluggish start, tourism activity picked-up in the second quarter of 2013, the value added of the sector of hotels and restaurants improved by 2.3%. Meanwhile, for Q2 2013 travel receipts and arrivals of foreign tourists respectively rose by 2.2% and 2.7% on a quarterly basis (HCP). The value-added of the tourism sector kept increasing until the end of the year, showing a 4.6% annualized growth rate n the fourth quarter of 2013.

All in all, if trade performance continues to improve the current account should reach -5.3% of GDP for 2013. This is still far from the achievements of the pre international crisis period when the current account was close to equilibrium and much closer to the post-crisis 2009-2011 average. Thankfully, FDI inflows increased by about a third annually, in March 2013 they reached 10.6 billion dirhams against 7.3 billion dirhams at the end of March 2012.

Lastly, regarding FDI activity trends are greatly correlated with the regional political scene. Inflows are hit by a slow recovery in global demand “with the government having to bear the burden of some projects” (EIU, 2013). But, one should note that Morocco is doing much better than many of its neighbours, in fact Morocco ranked first for attracting foreign direct investment (FDI) in 2012 among North African countries according to the UNCTAD, the first time that the country has ranked first. Automotive, aeronautics and solar energy are the sectors responsible for attracting the most investment.

In the case of the former sector, authorities recently signed in early August a series of contracts to accompany its development and which could create up to a thousand jobs. More specifically, the Ministry of Industry, Trade and New Technologies and the Hassan II Fund signed contracts with a series of private stakeholders (Leoni Bouskoura, Leoni Ain Sebaa, Yazaki Morocco, Process Industriels Delsur, Centrale d’Equipement et de Carrosserie Industrielle and SNOP) on the expansion or creation of production sites in the automotive sector. The signing of a total of six industrial projects follows the recent announcement of the intention to build three training centers for automotive jobs; the three institutes would dispose of nearly 40 M €

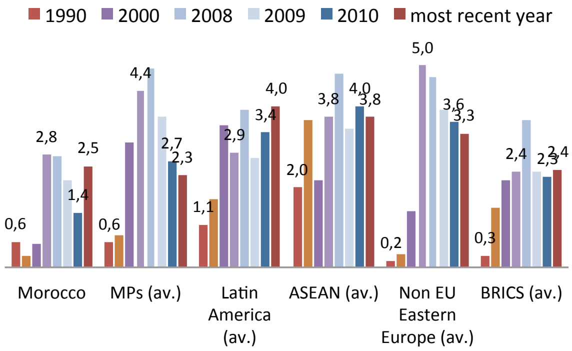
of public money, be located in Kenitra (Atlantic Free Zone), Casablanca and Tangiers, forming annually more than 3000 individuals (Econostrum, 2013).

Overall, FDI has been effective in Morocco for a long time, be it "from the joint ventures that Boeing spawned to support its fleet sales to Royal Air Maroc, to the latest clusters of auto parts suppliers that service the growing automotive industry in Casablanca and Tangier". Meanwhile, numerous Moroccan companies have been founded exclusively because of such decisions to attract foreign capital that invests locally. Morocco's attitude towards FDI could serve as an example for many of its neighbours. Many "corollary benefits" are drawn in terms of human development and "newly trained workers not only acquire skills, they are acquiring confidence...growing capabilities engender a sense of empowerment to make decisions in and outside of work...they are growing in the courage to take risks, learn from their mistakes, and take on new challenges and responsibilities" (MoroccoontheMove, 2013).

Figure 7a.
FDI in Morocco, in US$m

Source: EIU (2013), WDI, World Bank

Figure 7b.
FDI by region, %age of GDP



Source: EIU (2013), WDI, World Bank

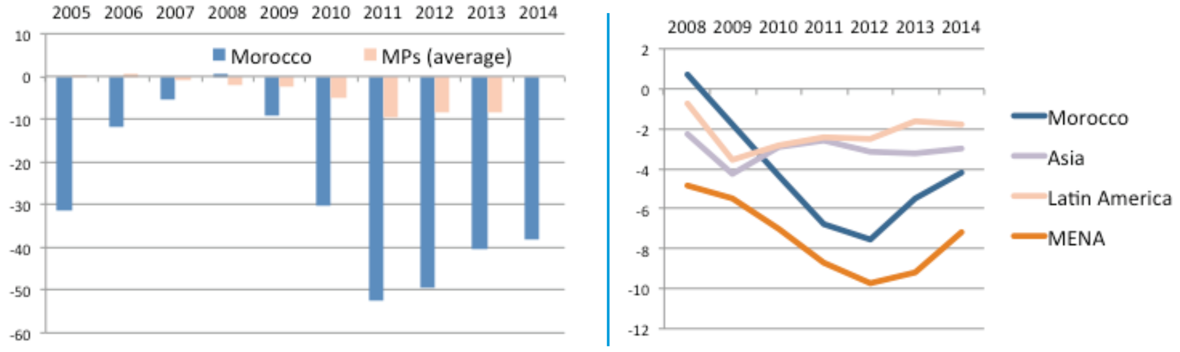
A 12.5% increase in FDI inflows is expected for 2013, in terms of GDP FDI should reach about 2.9% which is a five year best, while in the medium term future the government is expected to seek investment from beyond the EU and the Gulf countries all the while trying to move up the value chain (the priority sectors being textiles, electronic components, offshore services and tourism) (EIU, 2013).

I.5. Outfall on fiscal balance, debt

Pressures on public finances were relatively strong in 2012. The budget deficit reached -8.3% of GDP which constitutes a severe deterioration compared to its 2009-2011 average of -4.3% and its pre-international crisis average of -1.6% in 2005-2008. Undeniably, the fallout from the international crisis on the national economy was severe and there was also a second « post-Arab-spring » effect to further increase public expenditure in an effort to ease potential social tensions. Meanwhile, persistently high commodity prices on the international market contributed to this increased deepening of the budget deficit.

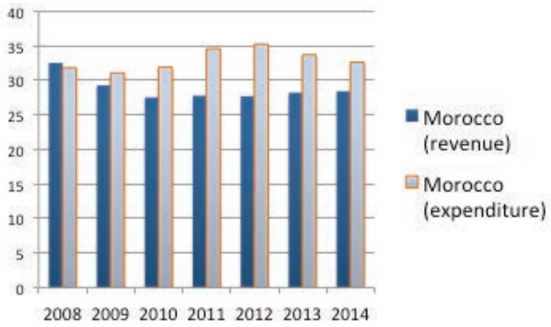
In more detail, at the end of November 2012 there was a disproportionate development between budget resources and expenditures, the latter marking a considerable surge. Revenue increased by 4.4% compared to November 2011; this rise was partially offset by lower year-on-year non-tax revenues (-9.3%). All in all, tax revenues increased by 6.3% owing in great part to direct taxes which met an increase of 10.4%, while indirect taxes rose by 4.3% following increased VAT revenues. Meanwhile, expenditures marked a surge of 16.4%, resulting from a significant increase in compensation expenses (in part because of higher prices of raw materials in the international market). Consequently, the fiscal deficit widened significantly, reaching 47 billion dh in late November 2012 (HCP, 2013).

Figure 8.
General government balance
a. (billions US$) *b. % of GDP*



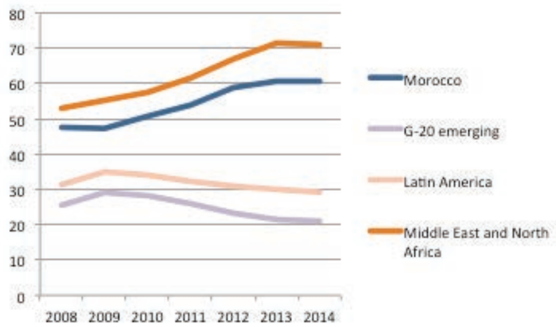
Source : IMF, World Economic Outlook database

Figure 8c.
Revenue and Expenditure (% of GDP)



Source : IMF, World Economic Outlook database

Figure 9.
General Government Net Debt (Percent of GDP)



Source : IMF, World Economic Outlook database

Morocco is currently on a very difficult spot in terms of fiscal space, which is only exacerbated by the record trade deficit; hence, there is a cruel lack of liquidity. The country is expected to post fiscal deficits in the coming years, with expensive subsidies on basic commodities (representing 6.5% of GDP in 2012) still representing an important burden on public spending. Subsidy reform has been slow, some cuts are planned for the remaining of the year though different opinions within the coalition government stall the entire process of reform (see more on section II.4). As a result public expenditure is still high. Nevertheless, the budget balance in 2013 is expected to improve slightly and reach a -7% deficit in terms of GDP. In terms of fiscal space Morocco will thus be in a better position after a difficult year and also compared to the regional average. Domestic efforts should allow Morocco to gradually converge towards the fiscal deficit threshold found in Latin American and Asian economies. Government revenue is already expected to increase to 28.2% of GDP in 2013, meanwhile expenditures should reach 33.7% of GDP, a 1.5 percentage point decrease compared to 2012.

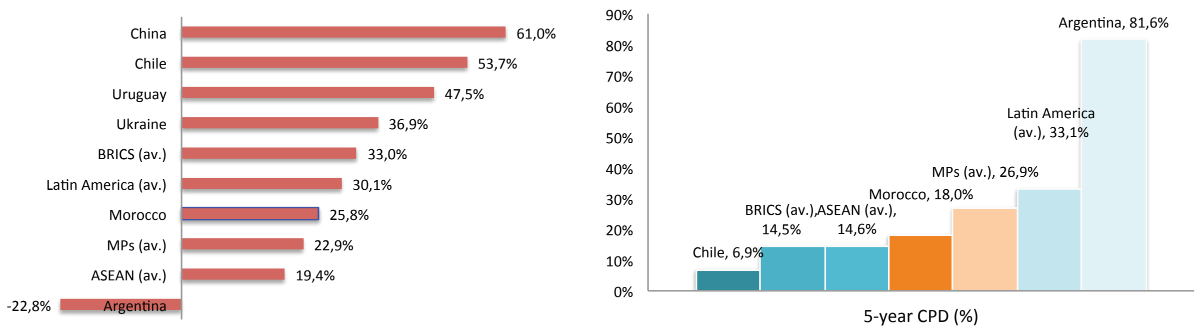
The level of the government's net debt should reach 60.6% of GDP, a 1.6 percentage point increase compared to 2012, before stabilizing starting from 2014. It is expected to constantly remain below the regional average though still roughly double the level found in Latin American economies.

Can Morocco sustain such increased debt? One must note that most of this debt consists of domestic debt (around 77%), and medium and long maturities, meaning that in the short term there is little risk of default. Furthermore, the country still enjoys from some confidence by international markets and from investors seeking less risky investments. Yet, anticipations may always change,

Figure 10.
Economic anticipations and sovereign risk

*a. % variation (Q2 VS Q1 2013) of 5-year CDS Mid**

*b. 5-year CPD (%)***



*Source: S&P CAPITAL IQ, McGraw Hill Financial, * a positive variation signifies a deterioration of 5-year CDS, ** the higher the CPD the higher the risk of default, note MPs average excluding Israel*

while reduced, the risk of insolvency is not eliminated. Meanwhile, while domestic debt prevails on external debt, reducing dependence, this has a "crowding out" effect on investment with interventions by the Treasury (46 billion dirhams in the first three months of 2013, a 40% year on year increase) drying up liquidity available to banks. Finally, when taking into account secured debt (debt owed by public institutions and local authorities and guaranteed by the State) and pension obligations, the Moroccan debt is higher (Afrik.Com, 2013).

I.6. Agents anticipations are stable and monetary policy is used to inject liquidity

Regarding agents anticipations on the viability of the Moroccan economy and its debt the situation is globally positive. CDS Spreads in the Mediterranean region widened 22.9% as emerging markets assets sell off in the second quarter of 2013, in Morocco they reached a value of 274.8 in end-June 2013 which represents a 25.8% worsening. The deterioration is thus higher than for the region on average and higher than for the ASEAN region. Yet, the risk of default still remains low despite its increase in the second quarter, the 5-year CPD reached 18% in end June versus 14.6% in the prior quarter. This remains much lower than both the Mediterranean and Latin American average (respectively of 26.9% and 33.1%) but above the relatively low risk found in BRICS and ASEAN countries. Morocco's sovereign rating currently stands at a BBB-/stable.

Meanwhile, four financial institutions received positive evaluations by Fitch ratings agency. Société Générale du Maroc (SGMA) and BMCI (BNP-Paribas group) were rated AAA/stable perspectives for the long term, while AttijariWafa Bank (AWB) was rated AA-/stable perspectives and SGMA's credit subsidiary Eqdom was rated AA/stable perspectives (MenasAssociates, 2013). Yet liquidites and sovereign debt ratings should be at least preserved to their current ratings for major Moroccan banks to keep benefiting from such grading.

The deficit of liquidity remained at a relatively high level during the first half of 2013, but, the Central Bank has kept its efforts at regularizing the banking system through injections of liquidity in the form of cash advances to defuse tensions on interest rates.

Among the recent evolutions in monetary aggregates one notes that in June 2013 the M3 monetary aggregate increased by 2.6% due to the acceleration in the growth rate of bank loans. Consequently, cash loans and equipment loans rose respectively by 6.6% and 2.6% and the growth rate of real-estate loans stabilized around 0.5% and consumer loans slowed down from 1.1% to 0.6% (Bank Al-Maghrib). Private-sector lending had hit a ten-year low during the past year as banks reduced their exposure to

Table 1.
Key indicators of monetary statistics

	outstanding amount (June 2013)	*year-on-year variation*
M1	*621756*	*5.4*
M2	*737639*	*5.9*
M3	***1005962***	***5***
Liquid Investment aggregate	*379857*	*5*
Currency in circulation	***166959***	***5.2***
Banking deposits included from broad money (1)	***701914***	***5.6***
Demand deposits with the banking system	*410081*	*5.5*
Time accounts and fixed-term bills	*149170*	*4.6*
Securities of money market UCITS	*58423*	*-4.9*
Net international reserves	***151607***	***4***
Net claims on central government	***136028***	***14.7***
Lending to the economy	***842154***	***3***
Loans of other depository corporations	***734861***	***2.9***
Bank loans	***728464***	***2.7***
By economic purpose		
Real estate loans	*228832*	*6.4*
Debtor accounts and overdraft facilities	*183713*	*1.7*
Equipment loans	*138798*	*0.5*
Consumer loans	*40366*	*5.8*
Miscellaneous loans	*97649*	*-4.9*
Non-performing loans	*39107*	*12*
By institutional sectors		
Other financial corporations	*86182*	*-3.8*
Public sector	***46120***	***6.1***
Private sector	***596161***	***3.4***

Source: Bank Al-Maghrib

the housing market (EIU, 2013). Bank al-Maghrib proceded to lower its policy rate to 3% in March 2012 and reduced its reserve requirement ratio from 6% to 4% in September 2012.

One also notes that there was a noticeable slowdown in bank credit in June 2013 because of the deceleration of cash loans and fall of financial loans but consumer loans rose by 5.8% and so did real-estate loans. The deceleration in bank loans affected all business activities but extractive industries with loans assigned to this sector up by 31.5% from 6.8% a year earlier (Bank Al-Maghrib). Provided that inflation remains close to current levels in the near term (below 3%), the central bank will maintain an expansionary monetary policy.

II. The long-term challenge

In last year's report we noted that Morocco needed to go towards a more inclusive growth model. It needs to do so if it wishes to be able to reduce inequalities, foster jobs and cover for the needs of a growing population (expected to surpass 33 million in 2014).

Here we try to look into more detail on the specific needs of the Moroccan economy and argue that strengthening the innovation-based efforts could be an important catalyst for inclusivity and sustained economic development. We also make a distinction regarding the prerequisites for inclusiveness and focus on both financial inclusiveness and spatial inclusiveness identifying specific needs. Furthermore, we argue that for Morocco to be able to free-up the necessary resources for a new development strategy, it will probably have to deal with the long-term issue of reforming its costly system of subsidies.

II.1. Efforts needed to foster a culture of innovation

a. Applied and industrial research innovation indicators

Morocco is one of the MPs that realized that to combat unemployment and the lack of inclusiveness it should go towards an innovation and creativity-based growth regime. Thus, its centres of innovation and technology are a step ahead than the rest of MPs because of stronger institutions . Meanwhile, incubators have been established to provide support for innovative projects and out of a total of 90 incubators in the entire region about 15 are localized in Morocco (second only to Tunisia) (ANIMA, 2012), which has tried to favour innovative technological entrepreneurship.

When looking at the share of high-technology exports in manufacturing exports (an indicator of the presence or lack of innovation), Morocco performs rather well; the country has achieved a higher share compared to the rest of MPs. Even so, the share of high-technology exports is lower than it used to, representing 7% in 2011 versus more than 11% in 2003 when it was even above the corresponding share observed in CEE accession countries; still the share is higher than the one found in South Asian economies.

Despite performing better than the regional average, there are still numerous shortcomings in terms of innovation; Morocco is one of the countries in the Mediterranean with the weakest contribution of firms R & D and relatively undeveloped relations between firms and universities (FEMISE-EIB, 2013).

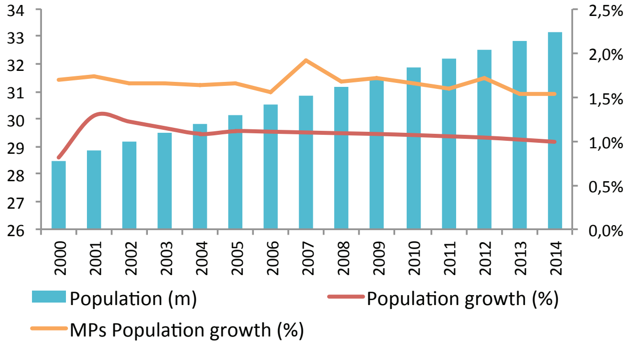
However, more indicators to express the effort of innovation are needed. Measuring innovation is not simple since it is by nature a qualitative concept. The OECD (2004) tries to offer a credible response and highlights that patents can be a good means to foster innovation; they can have "a positive and structuring effect" on companies. Such influence can be conveyed through a variety of channels and one of such channels is technical knowledge. More specifically, if patents were not available "enterprises would have significant difficulties finding information about the state of the art". Furthermore, "about 80% of the technical knowledge used in applied and industrial research comes from patents" while the rest comes from publications, professional and technical journals, and conferences.

In absolute terms, as suggested by World Intellectual Property Organization (WIPO) data, the number of patents in Morocco seems to be low. Between 1998 and 2005 the number of patents was consistently below the MPs average, but since then the gap with the rest of the region narrowed and now the number of patents that Morocco produces is close to the MPs average. All in all, Morocco went from producing annually 98 patents (in 1998) to roughly double in recent years (191 in 2011). Yet, we can say that the Moroccan development model did not sufficiently benefit from a knowledge-based boost that could have allowed for a significant leap in applied and industrial research. The limited number of patents is diversified among "other" sectors, while a non-negligible share can be found in the pharmaceutical sector (about 8%) and in civil-engineering (7%) (see appendix).

A "patent user" firm can establish regular meetings among its staff to study competitors' new patent applications which can result in a key source of inspiration for new inventions by the firm. In that respect, how does Morocco bode in terms of patents?

Meanwhile, the number of trademarks has increased and has been above the MPs average since 2001, though the gap with CEE economies has been increasing throughout the decade. Finally, statistics for industrial designs show that Morocco still has a long way to go, while until 2003 the country's performance was close to the one in CEE countries, the situation is now different and despite an important increase the gap is more than considerable.

Figure 11.
Population, in millions and %age growth

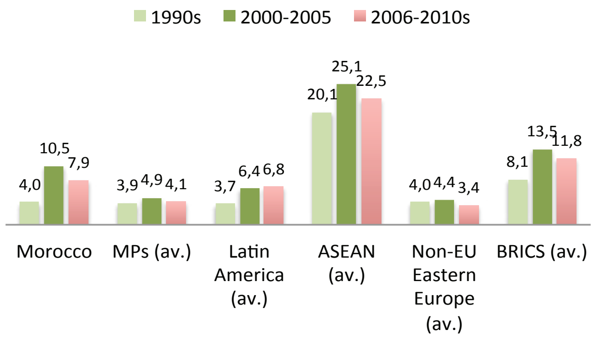


Source : IMF, World Economic Outlook database

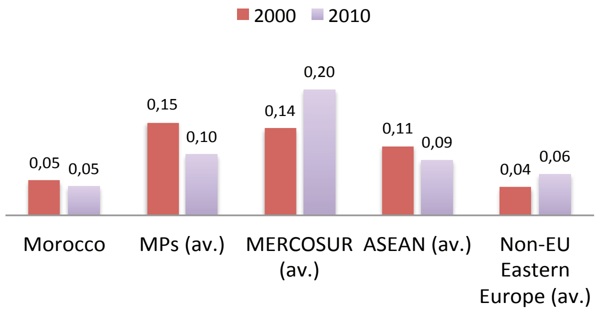
MOROCCO VERSUS THE WORLD: A GLIMPSE AT SELECTED STRUCTURAL INDICATORS

Figure 12.
Improved integration dynamic (selected indicators)

a. High-tech. exports (% of manuf. exports)



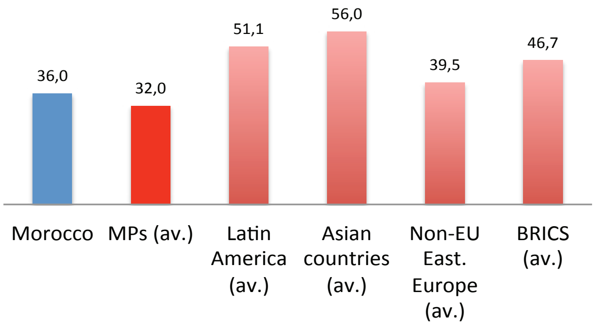
b. Trade Concentration Index



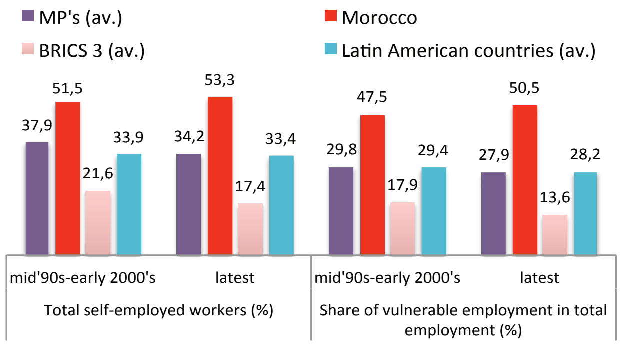
Source: WDI, FEMISE calculations using Tradesift and Comtrade data, based on SITC rev3 3-digit data.

Figure 13.
Domestic labour market dynamic, important issues linked to informality and job quality

a. Labour force participation rates, 15-24 (%)

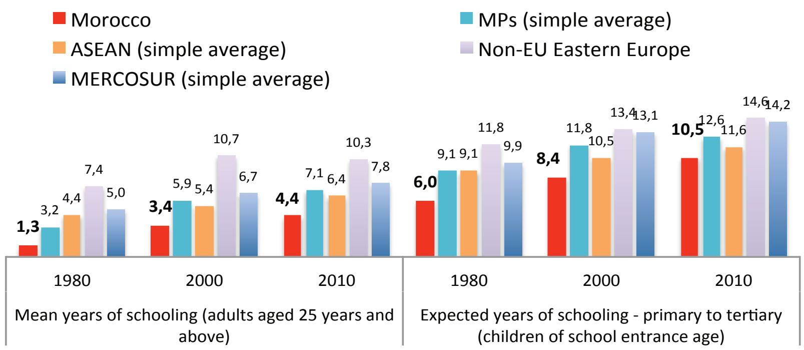


b. Informality and quality of employment



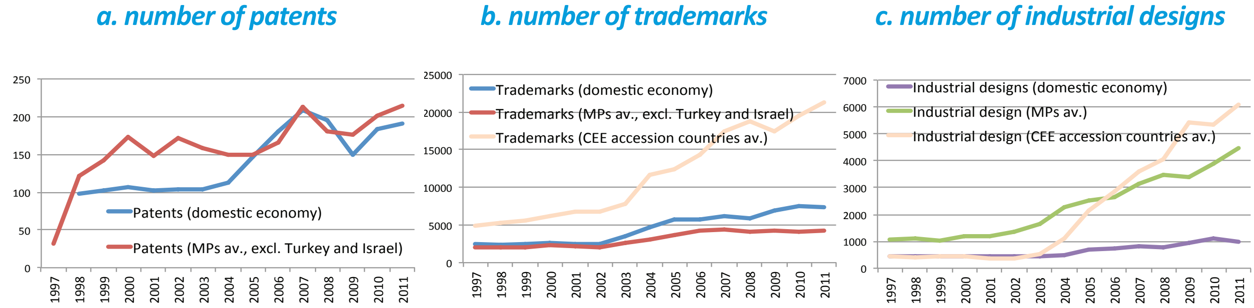
Source : IMF, World Economic Outlook database April 2013 (latest) and EIU

Figure 14.
Social dynamic that has not sufficiently improved
(selected indicators)HDI components related to schooling



Source : IMF, World Economic Outlook database April 2013 (latest) and EIU

Figure 15.
Intellectual property indicators



Source : World Intellectual Property Organization

b . Innovation impact: Journal citations reveal a Moroccan quality component

As noted earlier, the remaining share of the technical knowledge used in applied and industrial research originated from publications and journals. In that respect we focus on Morocco through a comparative regional approach, using the SCImago Journal & Country Rank (SJR) which includes country-specific indicators of scientific impact.

The first remark to be made is a quantitative one, the number of articles published by Morocco in the 1996-2011 period is low, even lower than the MPs average (excluding Israel and Turkey) and much lower than the CEE accession countries average. The second remark is related to quality, in terms of citations the situation is different, the number of citations received per document is higher than the MPs average, an indicator that suggests that the impact of Moroccan documents is higher than in neighbouring MPs (see appendix).

The figure above allows to see how “scientific production” has evolved; clearly Morocco now produces more articles than the rest of the region, though much less than CEE accession countries. Meanwhile, in 2011 Morocco produced a number of scientific articles that is less than half its production of 2000. Yet, there is a “scientific quality differential” to be found that favors Morocco. One could say that quality has been favoured instead of quantity; a Moroccan article in 2000 used to receive 10.8% less citations than one from the region but a Moroccan article in 2011 now receives 9% more citations than a regional one.

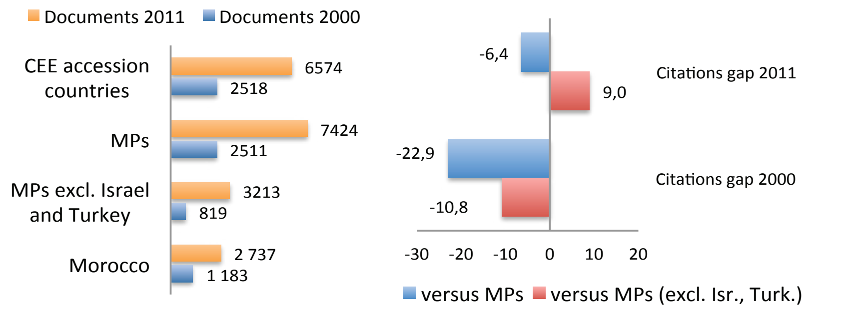
A final remark, again linked to quality, confirms the observations above. The h-index (appendix), which attempts to measure both the productivity and impact of the published work, seems to be higher in Morocco when compared to the rest of the region (though low in absolute terms). This ultimately suggests that scholars in the country perform worse than those of CEE countries though still better than MPs on average.

c. Pro-innovation efforts

Innovation efforts can ultimately bring considerable gains both of an economic and social nature. For instance, the development of an innovative framework for renewable energy development could lessen dependency on external sources for energy supply and reduce inequalities. Efforts of innovation in specific sectors have been undertaken, they are those that need to be deepened and/or replicated and serve as a foundation for a pro-innovation strategy that fuels the new development model. One finds (FEMISE-EIB, 2013, forthcoming):

√ The Technopolis park, part of the recognition of the new vocation of Rabat - Salé in technology. Technopolis has six poles, which are the promotion of research, an academic center, one for offshoring, a media center, one for microe-

Figure 16.
Journals and country scientific indicator:
a) No of documents (2000 VS 2011) b) Citations per Document gap* (%)



Source: SCImago Journal & Country Rank (SJR)
** FEMISE calculations based on SJR, the index measures in percentage terms how many more/less citations per document the country receives when compared to the regional average. Ex. a value of -10 means that the country receives 10% less citations per document compared to the MPs average.*

lectronics, and centers for research and development. The University Center offers several types of training on issues such as technology multimedia, software engineering, telecommunications, electronics and microelectronics, nanotechnologies and nanomaterials, biotechnology, information technology... Regarding the off-shoring center, it possesses world-class infrastructure and services meeting the highest international standards. In addition, there is a large pool of human resources that includes young people sensitive to European culture and a service for recruitment.

√ The Casablanca Technopark, center of ICT in Morocco. Its objective is to position itself as a facilitator, accelerator and catalyst; economic and social development is based on four pillars: The STIC (Sciences et Technologies de l'Information et de la Communication), Innovation and Technology Transfer, creativity, responsiveness and flexibility of «start-ups» and SME's and finally attractiveness for international business leaders in ICT.

√ Various initiatives in innovation, for example the Morocco Innovation Initiative is a plan conceived in the framework of the promotion of innovation. It has 4 axes declined in 13 sites: the governance framework, infrastructure, funding and support, and finally mobilizing talent. Other initiatives taken by various government agencies and departments are there to reward the work of an innovative nature. Among these initiatives, it is necessary to quote the Hassan II prize for Innovation (Agriculture, Environment, etc.).

√ The technological infrastructure framework, the objective here is to stimulate the creation of value and skilled jobs, improve the potential of Moroccan researchers nationwide. This process is included in the different regions of Morocco (Casablanca Technopark, Rabat Technopolis, Meknes Agropolis, Tanger Tanger-Med and the production of cars, Berkane: Agriculture and Agadir Halieutis).

√ Advanced Technologies efforts, mobilized through the centers of excellence of which Technopolis or Mascir, the Moroccan Foundation for Advanced Science.

√ Among the things authorities need to focus on is the issue of human capital. The analysis of the human capital in Morocco suggests that the country has made significant progress in terms of infrastructure and operation of the institutional system. However, a deficit and dysfunction persists, one that affects the qualitative aspects and essentially the system's ability to respond to market demand. Meanwhile, vocational training in Morocco differs markedly from education, it has a specific ministry and government structure for management and training services: the Office of Vocational Training and Promotion (OFPPT). Vocational training has been the second priority of the country and has long been regarded as a countermeasure to school failure by absorbing part of the workforce.

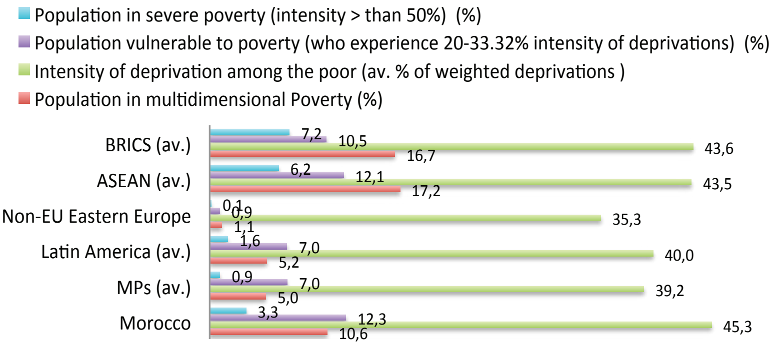
II.2. The need for financial inclusion

In last year's report we highlighted that for growth to be labelled inclusive, firms should be able to "catch opportunities", which would ultimately increase the potential of productive job creation. But, in order to do so, firms need to have access to finance and unfortunately firms financing has not been among the most exemplary in Morocco. The share of firms using banks to finance investment was found to have decreased by more than half between the early 2000s and the late 2000s and considerably lower than in other developing regions.

But the subject is not solely linked to firms, limited access to financial tools is also an issue that is profoundly connected with the lives of the populations. More specifically, financial inclusion is a quintessential component of inclusive growth. As noted by Brookings (2013) "Inclusive financial systems—allowing broad access to appropriate financial services—are especially likely to benefit poor people and other disadvantaged groups. Without inclusive financial systems, people must rely on their own limited savings to invest in their education or become entrepreneurs—and small enterprises on their limited earnings to take advantage of promising growth opportunities".

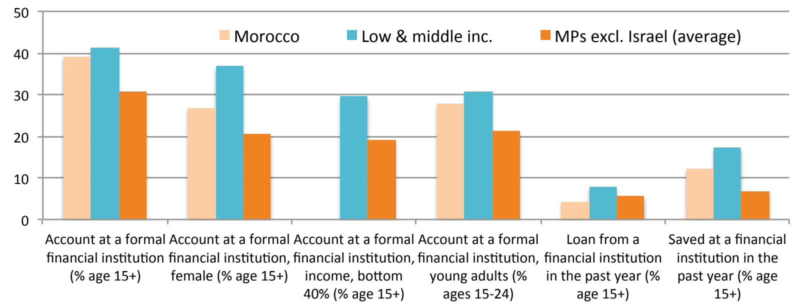
Financial inclusion is necessary for Morocco, especially considering that 10.6% of the population is in multi-dimensional poverty (versus 5% for the region on average) and with a relatively high intensity of deprivation among the poor. Financial inclusion contributes to lowering income inequality and supporting strong economic growth. Based on the way they are performed, their formal or informal nature, borrowing and savings decisions of households have a considerable economic and social impact and "people with access to savings accounts or simple informal savings technologies are more likely to increase consumption, productivity and income, increase investment in preventive health, and reduce vulnerability to illness and other unexpected events". In that respect, the level of financial inclusion in Morocco appears higher than the average regional level. Most parti-

Figure 17.
Indicators of Multi-Dimensional Poverty, latest year



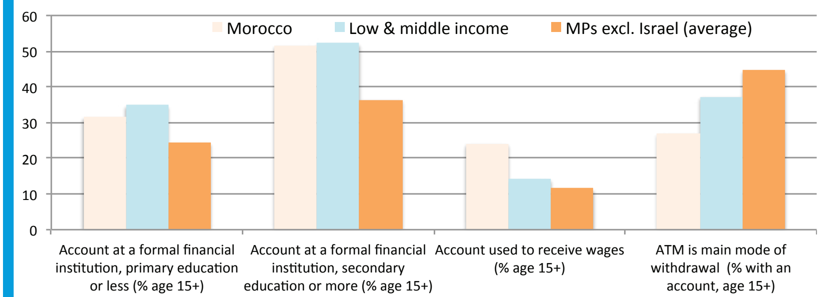
Source: Alkire, S., A. Conconi, and J.M. Roche (2013): "Multidimensional Poverty Index 2013

Figure 18.
Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

Figure 19.
Seconde set of Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

Box. New cities: The AFD backed Zenata initiative as a stepping-stone for sustainable development

In recent decades Morocco experienced rapid urbanization under the combined pressures of population growth and of rural exodus. Thus, new urban issues emerged particularly in the region of Great Casablanca, the latter was an economic success but a failure in terms of uncontrolled urbanization.

To cope with the rapid urbanization the Moroccan government embarked on an ambitious program to create 15 new cities by the year 2020. The best example of this program is the city of Zenata which is part of this framework all the while carrying future ambitions for planning. This new city in the Great Casablanca region is the first eco-city in Africa, designed for a population of 300000 inhabitants and to sustain 100000 jobs in the next 30 years. To make this project a reality, a financing agreement between the AFD and Société d'Aménagement de Zenata was signed in April 2013.

The urban project is guided by the principles of sustainable development and has the ambition to raise the economic capital of Morocco to with international standards and the ranks of a great international metropolis. Zenata will be a city of services and destined to the emerging middle class. Regarding the jobs that will be created, the question is not one of simply creating a specific "quantity of jobs", but the 100000 jobs created will be in high value-added activities (ex. Exhibition park, Health and Education Centres, Logistics division etc) while employment in the construction sector (nearly one million direct and indirect jobs in Morocco) will also be stimulated.

Source: AFD.fr (2013), "Zenata, une éco-cité marocaine, première du genre en Afrique", published on 04/04/2013

cularly, the percentage of people with an account at a financial institution is considerably higher than what one finds in the region (+8.3 percentage points) and the rate is also relatively higher for women (+6.2 percentage points) and young adults (+6.6 percentage points). Meanwhile, the share of the population that saved at a financial institution in the past year is roughly double the one found in the region on average (12.2% versus 6.9%).

Even so, the level of financial inclusion in Morocco is lower than the average level to be found in low & middle-income economies. For instance, the share of people with an account is slightly lower than what one finds in economies of a similar development level (-2.4 percentage points) and the rate is considerably lower for women (-10.1 percentage points compared to low & middle income countries) and the youth (-29.5 percentage points). The share of the population that saved at a financial institution in the past year is comparatively lower by about 5 percentage points and the share of people that took a loan in the past year is also lower (-3.6 percentage points).

A second set of indicators highlights some specific points that merit attention regarding the level of financial inclusion in Morocco. First, the share of Moroccans using ATMs is well below the MPs average level suggesting a lack of familiarity compared to some of their neighbors with such modern-day means of withdrawing and inefficient banking penetration. Second, the share of people using their account to receive wages is much higher than both the MPs and low & middle-income countries average (24.2% versus 14.2% for similar development level countries). This suggests that higher transparency and formalization has been achieved regarding the payments made and further efforts should be encouraged. Lastly, education appears to make a difference, the share of people with basic education that have an account is somewhat excluded, below the level found in countries with a similar development level, but for those with secondary education and above the levels are similar with those of low & middle income level countries.

All in all, in terms of financial inclusiveness more needs to be done especially vis-à-vis the less educated, the youth and through offering more attractive loan opportunities. Women are generally more excluded than men and face considerable exclusion in regions such as Oued Ed-Dahab- Lagouira – Laâyoune, Oriental and Rabat-Salé-Zemmour-Zaer (see annex). Meanwhile, it appears that exclusion has increased during the recent years, the case of Oued Ed-Dahab- Lagouira – Laâyoune is striking, the unemployment rate of women was close to 19.5% in 1999 and reached 35.1% in 2011 (versus only 10.9% for men).

The development of renewable energy is a major challenge for Morocco which is completely dependent on external sources for its energy supply (AFD, 2013).

II.3. Reforming the subsidy system

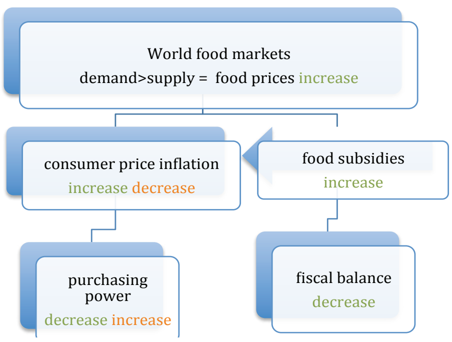
The figure below demonstrates the two-fold effect of commodity prices in the short run, in this case a rise in world food prices . Food and energy subsidies have proven to be extremely costly in Morocco; they reached 57 billion dirhams (roughly 6.6 billion US$) in 2012 representing 15% of total public spending. Peeters and Ambers (2011) estimate the pass-through of world food prices and empirically test for the impact of world food prices on food subsidies. It appears that increasing world food prices significantly push up government food subsidies, however, decreasing world food prices does not have a statistically significant effect on food subsidies. This means there are “nominal downward rigidities” linked to inefficiencies in the food chain with costs kept high even when world food prices fall. Subsidies did not fall during the global recession of 2009 when world food prices severely decreased. Hence, for countries like Morocco “the sword of rising world food prices cuts badly twice…firstly, on consumer price inflation, and therewith consumers’ purchasing power, and secondly, on the public budget and therewith leaving less room for other needed public expenditures”. Morocco will definitely have to limit the fiscal burden of the subsidies to allow for more fiscal space and better targeting of government spending towards more growth-inducing initiatives.

Subsidy reform has been slow since social peace needs to be maintained in this difficult period, but some efforts have been undertaken (ex. Subsidy-cut on imported wheat and on fuel prices for 2012) and evolutions are expected for 2013 with the authorities announcing in early 2013 that they will shift the focus of spending to the poorest Moroccans (about 2 million) through monthly cash payments of 1,000 dirhams (REUTERS, 2013b). The technical modalities for reform appear to be in place and «once talks are concluded and the political decision is taken, it will be launched». The reform would be expected to be carried out in a 4-year time span and could save up to 24 billion dirhams though it would probably raise inflation and impoverish the middle class.

Yet, reform is far from a done deal, with the conservative Istiqlal party threatening to quit the current coalition unless cuts to subsidies on food and energy are moderated. Instead, Istiqlal favored introducing bigger efficiency savings and import control measures. The implementation of such a delicate reform will not be easy. Morocco managed to sustain an average inflation rate below 2% during the last 10 years and a possible increase in prices could trigger unwanted social turbulence.

Meanwhile, it seems “the political establishment around King Mohammed is anxious to avoid a drop in living standards and prevent a return to street protests for political and economic reforms that he managed to stifle in 2011 with social spending, harsh policing, and constitutional reforms that pa-

Figure 20.
Flow chart : World food prices, consumer price inflation and government subsidies



Source : Peeters and Albers (2011)

ved the way for the PJD to come to power" (REUTERS, 2013c). As a result, the "political sensitivity" of such an issue led to the expected measures being pushed back beyond the scheduled June 2013 start. In end June the minister of general affairs highlighted that Morocco would begin deregulating prices for some basic goods, activating automatic price adjustment for energy products and sugar, except cooking gas (REUTERS, 2013d). This would already allow to cut subsidies spending by roughly 20% and was a move that had been agreed by the coalition government.

III. Conclusions

III.1 Fiscal sustainability is a pre-requisite for the future

Undeniably, **Moroccan authorities will be facing important challenges in this year and the subsequent one, related to structural issues and fiscal constraints.** One must note that the nature of the fiscal deficit in Morocco has changed, it is not a result of slow growth as in the last decade but caused by the exuberant rise in government spending which cannot be covered by current revenue. Hence, if nothing changes, the country may have to enter a spiral of external borrowing. Authorities must not hypothecate the future prospects of the youth to finance consumption and the poor management of public institutions.

if nothing changes, the country may have to enter a spiral of external borrowing...

Until now, economic growth has not created the requisite amount of jobs especially among the youth and in urban regions. Debt should be used to engage into creative investment that generates income and employment and structural reforms should be undertaken or deepened as soon as possible. The following constitute priorities that need to be faced by the authorities in view of a more inclusive, but most of all fiscally viable, development model.

a. Measures that foster entrepreneurship but do not weigh on the budget deficit

There is need to foster more entrepreneurship in Morocco and cultivate a more business-oriented climate. In that respect authorities ought to progressively reform taxation on firms and provide exemptions especially for new firms in emerging sectors all the while maintaining higher taxation for enterprises with relatively high revenue levels. Domestic saving should be encouraged and issues such as companies registration ought to be facilitated and costs reduced. Yet exemptions should not become too generalized.

Authorities undeniably need **broadening the tax base**, which shall lead to lower rates of taxation, yet of equal importance is ensuring transparency and simplicity of procedures. A simplified tax system and simpler administrative procedures may bring greater adherence of firms to the tax system and better administrative effectiveness. Efforts for greater transparency in the preparation of the tax law also need to be continuously deepened, the assessment of the budgetary cost of the various proposed tax measures should be carried out systematically before examination to allow legislature and the executive to be familiar with the fiscal impact of measures often wrongly considered as trouble-free (FEMISE, 2004).

In the current context of fiscal tightness one shall never forget the importance of efficient tax forecasting and the integration of taxation in the medium-term strategy. Taxes are sensitive to economic conditions and modern methods of forecasting are more than ever fundamentally important. Methods may depend on the sophistication of the methodology apprehension of taxation, but the high variability of growth for nearly a decade clearly implies a questioning of the role of fiscal policy in the regulation of economic activity. As noted by FEMISE (2004), knowledge links between taxation and growth (production) call for the development of operating medium term models. The establishment of analytical and explanatory econometric relationships based both on taxes paid by households and those paid by firms is essential since they are able to determine the rate of investment, which is at the core of the growth process.

The Moroccan authorities seem to be on the right path and have undertaken noteworthy efforts for a more sustained budget for 2013. Among the numerous fiscal measures for 2013 one finds:

- √ In the case of custom duties, several reductions in import quotas in agricultural products, a redesign of the domestic consumption tax applicable to manufactured tobacco and an increase in the share of the domestic consumption tax on tobacco that is directed towards the Social Cohesion Fund (from 1.6% to 4.5%).
- √ Regarding taxes on Moroccan enterprises, the threshold for exemption of cooperatives processing of raw materials is raised from 5 million dirhams to 10 million dirhams excluding VAT. Meanwhile, a tax system for securities lending transactions is introduced to ensure tax neutrality in their favor, while a tax system for securitization operations is also introduced. The authorities also established a reduced tax rate of 10% applicable to SMEs with earnings lower or equal to 300000 dirhams. Meanwhile, 2013 sees the implementation of a social solidarity contribution on net accounting income varying from 0.5% to 2% based on the amount of earnings realized.
- √ Measures on income taxes, include encouraging saving by employees through the introduction of a tax incentive system for the « Plan d'épargne entreprise » (PEE), an increase in the rate of standard deduction applicable to pensions going from 40% to 55% as of 1 January 2013, an increase in the rate of tax withheld at the source regarding stocks and assimilated income from 10% to 15%, extension to late 2014 of incentives for newly identified taxpayers that were active in the informal sector and the establishment of a social solidarity contribution based on income.
- √ In the case of value added tax, extension of the exemption from VAT of credit operations carried out by micro-credit associations and the exemption for the import of equipment and materials to be used exclusively for operation until December 31st 2016, exemption from VAT on equipment, goods and services acquired by the Mohammed VI Foundation for the edition of the Holy Quran, extension of import taxation at the reduced rate of 10% of calves for fattening until late December 2014, exemption of certain goods imported by the administrations of public security under the Ministry of the Interior, establishment of a special tax on the margin of sales or delivery of used goods carried by merchant dealers with a turnover that exceeds two million dirhams.
- √ Regarding registration fees, exemption from registration fees for acts of constitution and increase of companies capital with the status «Casablanca Finance City» (CFC), expansion of the exemption for the "Fonds de placements collectifs en titrisation » (F.P.C.T.), establishment of a fixed fee of 1.000 DH on constitutions and capital increases of companies instead of the proportional duty of 1% when the share of capital does not exceed 500,000 dirhams.
- √ Regarding stamp duties, a suppression of provisions relating to the method of collection of stamp duty.
- √ A diversification of the mode of recovery of the TSAVA with the given ability to pay that tax on behalf of the competent public accountant, with other organizations other than the tax administration or public accountant duly authorized by the administration.
- √ Common measures to all taxes include exemption of unions from any taxes for property necessary for unions to exercise their activity and for transfers of individuals, extension of benefits to housing with low property values, total cancellation of penalties for late fees and collection of taxes, duties and taxes under the Tax Code, as well as those that have been deleted or incorporated in said code.

- √ Other measures, include the establishment of a special tax of 50 dirhams per cubic meter of sand dunes and wadis dredging and 20 dirhams per cubic meter of sand crushing in order to contribute to the supply of the « Fonds spécial routier », implementing an environmental tax on plastics of 1.5%, exemption for purchasers of housing (middle class) of the registration of land title rights, changes to thresholds of proceeds of the tax on insurance contracts (50% for the General Budget, 25% for the solidarity fund insurance, 25% for the « Fonds d'appui à la cohésion sociale »)

b. Reforming social protection subsidy system is a crucial need for fiscal stability

To alleviate pressures on the budget there is definite **need to reform the current social protection and subsidy systems**, which remain too costly. Currently, the gap between the pensions being disbursed and the contributions made by employees is estimated to reach a deficit of 7.4% of GDP by 2050 compared to a 1% surplus in 2005 (Achy, 2013). The three pension systems fluctuate in their contribution rates and in the method used to calculate retirement benefits; there is great disparity among employees depending on the sector. According to Achy (2013), three factors describe the current situation that may become untenable:

- √ Only 45% of the working-age population is actually employed with women and the youth having very low workforce participation rates,
- √ the pension system covers barely one-third of the working population in Morocco (versus 60% in middle-income countries) in large part because of informality, the FEMISE report (2009) had recognized how unemployment coverage is far from generalised in Morocco,
- √ the system is fragmented with a limited number of subscribers.

The financial deterioration of pension funds functioning on old distribution scheme had already led public authorities to undertake reforms (FEMISE, 2009). Yet there is still "urgent need for a comprehensive, financially viable, socially acceptable, and politically feasible approach to addressing Morocco's pension system imbalances" (Achy, 2013).

Recently, plans for structural reform of the state pension system were announced, they should take place during the five-year term of the current government. Among the known measures to be taken Moroccans should expect an increase in the age of retirement, which should help avoid the deterioration of the deficit of the Moroccan Pension Fund (CMR) which is about to reach 1.28 billion dirhams ($151 million) by the year 2014 and then respectively 24.85 billion dirhams in 2021 and 45.66 billion dirhams in 2030 (REUTERS, 2013).

All in all, the authorities need to push for a "broad-based" system of social protection but also need to clearly communicate the economic and social benefits that such reform will bring. It cannot go unnoticed that demonstrations have already started against the announcement of social and economic reforms to the pension system and subsidies (POMED, 2013). Indeed, the latter are to be revised to allow for fiscal stability; authorities might start reforming food and energy subsidies thoroughly if a political decision is taken (REUTERS, 2013).

In the case of food subsidies, one could think of numerous ways of pursuing reform, essentially through improved targeting, which appears to be the authorities' orientation. In September 2013, the authorities decided to apply partial indexing of fuel prices on international prices, to be revised every month. Thus, thanks to this measure, which had already been used in the 1995-2000 period, prices of fuels globally rose (rise of 0.59 dirham for "Super", by 0.69 dirham for gasoil and industrial fuel increases by 662, 88 dirhams).

The government hopes to ease the burden of compensation charges while avoiding a significant rise in inflation (Econostrum, 2013b).

III.2. Smart trade regulation to support firms development

A central issue is finding a way for the productivity of Moroccan firms to be boosted.

According to Augier et al (2013) **a possible way is through non-trade measures.** These should not be seen as an impediment to trade through the increase of production and transaction costs, they are also a solution to the rising demand from consumers / producers for providing "input relating to quality and safety issues" and answering "to the collective interests of a society while also contributing to boosting trade" .

Contrary to tariffs NTMs can benefit trade, as the authors note the EUs acquis communautaire, is a perfect example of how a "takeoff in trade" can occur when NTMs are implemented within regional trade agreements to allow for convergence between countries on both the institutional and legislative front.

Focusing on how NTMs adopted by Morocco have had an impact on Moroccan firms, the authors reach a series of conclusions. First, different categories of NTMs seem to affect the performance of domestic firms in different ways. For instance, results show that sanitary and phytosanitary measures have a positive and significant effect on profitability, but have no impact on productivity. Likewise, technical barriers to trade seem to have no impact on productivity. However, NTMs such as licenses, quotas, prohibitions and other quantity control measures seem to have a positive and extremely significant effect both on productivity and profitability of firms. Thus secondly, when an NTM has a positive effect on firm productivity, then it usually relates to a measure employed for harmonization purposes with international standards. Thirdly, firms that benefited the most of the positive effects are not necessarily those furthest from the efficient frontier. Hence, the set of positive effects of NTMs cannot be simply credited to greater domestic protection vis-a-vis international competition. It appears that, in the Moroccan case, by easing the entry of goods from developed economies and limiting access to those originating from developing ones, new NTMs will change the structures of the internal market. Additionally, NTMs can induce convergence between the institutional and legislative environment of firms, but also vis-a-vis production standards. All in all they can be a tool for deeper integration and should not be merely assimilated with trade barriers.

> ***the set of positive effects of NTMs cannot be simply credited to greater domestic protection vis-a-vis international competition...***

III.3. Spatial imbalances must be considered and the education system needs to be more « quality oriented »

Thirdly, economic convergence is at the heart of Moroccan regional development policies. But, the country suffers from regional imbalances, the problems being found especially in poor regions where school performance is low and in the periphery (see also the section on spatial disparities in the first part of the report). A recent paper by Ibourk and Amaghouss (2013) seeks to identify the relationship between spatial location and disparities in education in Morocco. The rationale being that taking into account spatial disparities will renew the debate on the effectiveness of regional development policies. Educational performance could be related to patterns of distribution of educational services throughout the territory .

This analysis highlights the strong spatial disparity in education between Moroccan provinces as well as the poor performance of the Moroccan educational system. Among the authors more interesting findings is the fact that two « poles » emerge. The first pole (center) mainly consists of the provinces of the Rabat-Casablanca axis. The second pole consists of some provinces of the High Atlas and Rif mountains

(mountains). The other provinces constitute the periphery. «Beta-convergence» would seem to take place, with poor regions growing faster than rich ones. Meanwhile, the worst performing provinces in the field of education appear being the less poor. This confirms that in Morocco there is reproduction of spatial inequalities à-la Bourdieu (1979), the social position of the individual being determined by its economic capital (income and assets), cultural capital (knowledge and skills), social and symbolic capital (possession and recognition of other forms of capital).

The **education system in Morocco does not suffice,** while improving as a whole, the illiteracy situation remains alarming for those outside the system and there is scarcity of qualified human resources that reduces the potential for economic development. A study by Ibourk (2012) analyzes the determinants of the poor performance of the Moroccan educational system (as witnessed by international standard tests such as TIMSS, PIRLS). The main conclusions highlight the danger of focusing on the average level and on guiding educational policies in a purely quantitative manner. First, focusing on the average level tends to blur the existing disparities in the educational system. Furthermore, policies that are limited almost exclusively to mass education will only consolidate inequalities.

Measures to reduce disparities between provinces (periphery educational programs, community schools) should also be strenghtened. As noted by Ibourk and Amaghouss (2013), the issue of education is generally seen only from a national perspective and a «top-down» approach has many limitations. They suggest a new participatory management that allows more leeway in decision making for regional and local actors, establishing an independent management of institutions. In that respect, determination is needed to efficiently go from a centralized to a decentralized organization. Furthermore, there are needs for improved managerial skills in decentralized units in the periphery. Policy makers ought to rethink their goals based on the spatial nature of each province, investing not only in schools, but also in infrastructure and basic services, the lack of which often hinders the development process.

III.4. Structural transformation: Renewable energy development as a means for sustainable development

The **development of renewable energy is a major challenge for Morocco** which is completely dependent on external sources for its energy supply (AFD, 2013). Morocco seems to be on track with its renewable energy orientation and adoption of a new energy mix strategy. The development of renewable energy projects has very attractive environmental and economic impacts while social impacts are also significant, particularly in relation to social inclusion of rural populations (Atouk, 2013).

Meanwhile, a recent FEMISE study (FEM35-05, 2013) evaluates the macroeconomic impact of a gradual development of a national industrial Renewable Energy Cluster for producing Concentrated Solar Power (CSP) technology, connecting to economy policy issues related with structural transformation. Despite progress made to encourage investment in energy, there are still many impediments that hinder the entry of foreign capital. It appears that the most important barriers are of a political nature, linked to the lack of a legal and legislative framework for the development of renewable energy and an insufficient level of public support. Meanwhile, business barriers that refer to uncertainty, informality and high capital costs are also important.

The study suggests that attracting FDI should be reinforced by policies that favor medium and long term strategic actions based on improving the perception of uncertainty and insecurity shown by foreign investors. Meanwhile, “due to how strong an influence this barrier has on the rest, these actions would generate a multiplier effect on the reduction of the presence of other barriers". Reducing informality would also be an essential factor in promoting the entry of foreign companies that have not developed activity in the CSP sector of the country. For companies that have partial relationship with Morocco in the field, greater activity could be achieved by removing/limiting financial and legal barriers.

In terms of GDP impact the authors stress "a total effect on Moroccan GDP that moves from 1.27% to 1.77% for 2050". Meanwhile, in a scenario of a semi-complete industry of CSP components being created in Morocco an average of around 85000 jobs could be created.

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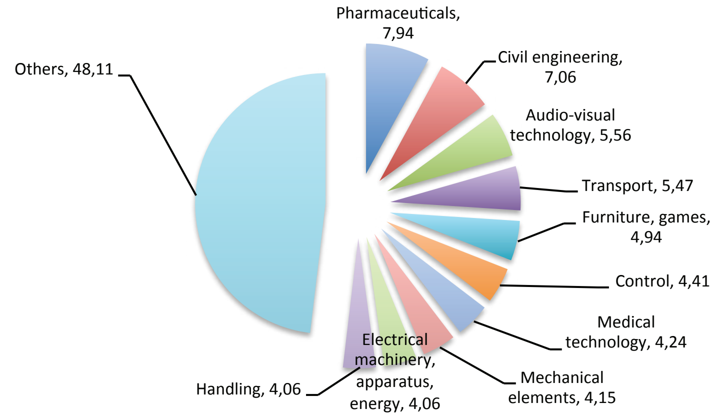
ANNEX

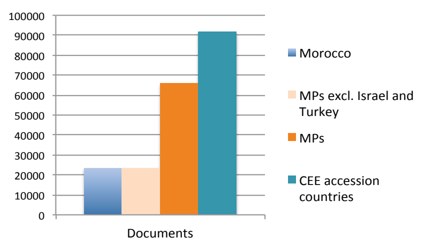
Figure A1.
Patent Applications by Top Fields of Technology (1997 - 2011)



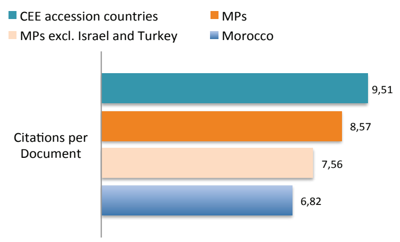
Source: World Intellectual Property Organization

Figure A2.
Journals and scientific indicators

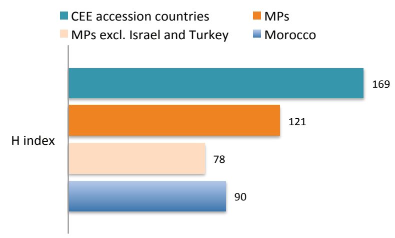
a. Number of documents



b. Citations per Document



c. H-index



Source: SCImago Journal & Country Rank (SJR), Note: Country's number of articles (h) that have received at least h citations

Table A1.
Evolution of unemployment by region

	Tanger-Tétouan			Taza-Al Hoceima-Taounate			Fès-Boulemane		
Year	Men	Women	Total	Men	Women	Total	Men	Women	Total
1999	12.6	7.7	11.7	11.8	4.7	9.9	13.3	14	13.5
2005	8.1	8.5	8.2	5.5	6.4	5.8	7.2	7.9	7.4
2008	8.7	12.1	9.2	7.8	5	7.1	7.3	6.6	7.1
2009	8.5	11.4	8.9	8.9	5.3	8	7.1	6.8	7
2010	8.6	13.1	9.2	6.6	4.7	6.1	5.8	7	6.1
2011	8.7	15.7	9.7	7.5	5.1	6.9	5.2	6.6	5.5
	Meknès-Tafilalet			Tadla-Azilal			Doukkala-Abda		
	Men	Women	Total	Men	Women	Total	Men	Women	Total
1999	15.9	12.3	14.9	8.6	6.9	8	11.1	15.3	12.4
2005	10.9	13.2	11.4	5.6	5.5	5.6	6.1	8.7	6.8
2008	9.4	10.1	9.6	5.4	6.6	5.8	7.2	7.8	7.3
2009	7.8	10.2	8.4	5	5.1	5	6.8	9	7.4
2010	10.3	10.3	10.3	6.8	4.9	6.2	7.1	10.2	8.1
2011	9.5	13.3	10.4	6.3	9	7.1	7.3	11	8.5
	Rabat-Salé-Zemmour-Zaer			Grand Casablanca			Oriental		
	Men	Women	Total	Men	Women	Total	Men	Women	Total
1999	16.2	20.8	17.4	23	25.8	23.8	17.8	19	18.1
2005	15.1	21	16.6	19.3	22.7	20.3	16.9	19.1	17.3
2008	12.2	19.6	14.1	12.2	13.4	12.5	19.2	24.4	20
2009	10.9	16.9	12.5	11.1	13.1	11.6	17.5	22.6	18.2
2010	10	18.2	12.2	10.1	12.7	10.8	17.4	22	18
2011	10.1	20.1	12.8	9	13.6	10.1	17.3	20.4	17.7
	Marrakech-Tensift-Al Haouz			Chaouia-Ouardigha			El Gharb-Chrarda- Beni Hssen		
	Men	Women	Total	Men	Women	Total	Men	Women	Total
1999	8.1	7.7	8	11.4	13.2	11.9	13.7	12.3	13.3
2005	6.1	5.4	5.9	8.7	11.4	9.6	12.1	8.8	11.1
2008	4	5.1	4.3	5.8	7.6	6.4	11.2	11.5	11.3
2009	4.5	5.8	4.9	5.4	7.8	6.1	11.4	11.2	11.3
2010	5.7	6.2	5.8	5.6	8.4	6.4	11.7	9.2	10.9
2011	4.3	5	4.5	5	7.9	5.9	10.2	8.2	9.5
	Souss-Massa-Draâ			Oued Ed-Dahab- Lagouira - Laâyoune					
	Men	Women	Total	Men	Women	Total			
1999	12.1	5.9	9.8	21.7	19.5	21.1			
2005	11.4	5	8.9	19.6	30	21.9			
2008	8.4	4.9	7.1	16.8	26.9	19			
2009	8.4	5.2	7.2	12.3	20.4	13.7			
2010	8.4	4.5	7	8.8	23.2	11.4			
2011	7.4	4.9	6.5	10.9	35.1	15.2			

Source: Haut Commissariat au Plan (latest)

TUNISIA

Against a background of political crisis, a third year of transition marked by major vulnerabilities in the macroeconomic policy but a capacity for resilience in the medium term

Introduction

Three years after the revolution, Tunisia is in the throes of a volatile crisis where the climate of instability and political uncertainty, amplified by an unprecedented wave of terrorist attacks and assassinations of opposition leaders, has become juxtaposed with increasingly harsh constraints affecting the scope for conducting economic policies. The success of the process of democratic transition, so eagerly awaited in light of the complexity of the experiments conducted in the other Arab Spring countries, has become increasingly problematic. It is, effectively, dependent upon the conjunction, not only of endogenous and exogenous economic factors, but also of social, security and institutional challenges threatened by recurring rifts between political decision-makers as the forthcoming elections loom ever larger.

However, one could not fail to be delighted at the challenge taken up by the Assembly which approved the main articles in the draft Constitution, including two setting forth 'equal rights and duties for men and women' (Article 20), 'guaranteed freedom of thought, opinion, expression and information', the rejection of the reference to religion as a source of law and the reincorporation without changes of Article 1 of Bourguiba's Constitution, which defines Tunisia as 'A free and independent State, whose form of civil government is that of a Republic, whose language is Arabic and whose religion is Islam'.

However, leaving politics aside, a brief retrospective analysis reveals the recurrence of the same latent economic dysfunctions and structural weaknesses that gave rise to the waves of protest and social upheaval.

I. The structural transformations of the economic growth pattern during the transitional period

Following on the heels of an unprecedented recession in 2011, with a GDP growth rate at constant prices of (-1.9%)[1], a rapid resumption of economic activity began in 2012 with a growth rate of 3.6%. Despite a considerably uncertain political and social context, the updated forecast for 2013 is much the same[2]. However, apart from their structural fragility, the transformations in the growth pattern during the transitional period can also be put down to other latent weaknesses.

I.1. A resumption of growth due to market activities

Based on market activities which contributed 76.7% on average to the value added at market prices during the period 2011-2012 (Table 1), this recovery is largely due to the resilience of the agriculture and fisheries sector (8.45% of the VA on average as against 7.47% in 2010) and other traditionally competitive sectors:

- √ The manufacturing industry (16.31% of the VA as against 16.83% in 2010), such as the agri-food industries (2.95% on average as against 2.92% in 2010), the textile, clothing and leather industries (3.23% on average as against 3.35% in 2010), the mechanical and electrical industries (5.48% on average as against 5.45% in 2010),
- √ The non-manufacturing industries (12.54% on average as against 12.51% for the year 2010) particularly the building sector and civil engineering (4.07% on average as against 4.16% in 2010),

Table 1.
Value added and sectoral contributions to current prices (MDT)

	2010		2011		2012	
	Value	*%*	*Value*	*%*	*Value*	*%*
Agriculture and Fisheries	***4741.3***	***7.47***	***5459.4***	***8.43***	***5979***	***8.48***
manufacturing	***10680.1***	***16.83***	***10766.2***	***16.63***	***11278***	***16***
Agro-food industries	*1851*	*2.92*	*1942.4*	*3*	*2051.2*	*2.91*
Textiles. clothing and leather	*2122.8*	*3.35*	*2186.4*	*3.38*	*2177.6*	*3.09*
various industries	*1020.8*	*1.61*	*1101.1*	*1.7*	*1193*	*1.69*
Oil refining	*56.7*	*0.09*	*74.3*	*0.11*	*118*	*0.17*
chemical industries	*1307.4*	*2.06*	*893.9*	*1.38*	*1109.5*	*1.57*
Construct materials. ceramics and glass	*866.9*	*1.37*	*878.8*	*1.36*	*913.9*	*1.3*
Mechanical and electrical industries	*3454.5*	*5.45*	*3689.3*	*5.7*	*3714.8*	*5.27*
Non-manufacturing industries	***7933.9***	***12.51***	***8155.8***	***12.6***	***8802.5***	***12.49***
Oil and natural gas	*4016.5*	*6.33*	*4285.3*	*6.62*	*4641.1*	*6.58*
mines	*486.8*	*0.77*	*271.5*	*0.42*	*338*	*0.48*
Electricity and gas	*616.5*	*0.97*	*732*	*1.13*	*820.8*	*1.16*
water	*175*	*0.28*	*179.5*	*0.28*	*187.7*	*0.27*
Building and civil engineering	*2639.1*	*4.16*	*2687.4*	*4.15*	*2814.9*	*3.99*
Trade service activities	***26095.5***	***41.13***	***26269.8***	***40.58***	***28833.9***	***40.9***
Maintenance and repair	*226.3*	*0.36*	*232.5*	*0.36*	*247.3*	*0.35*
trade	*4909.8*	*7.74*	*5201*	*8.03*	*5578.7*	*7.91*
Hotel and restaurant services	*3163*	*4.99*	*2626.3*	*4.06*	*3211.8*	*4.56*
transport	*5430.7*	*8.56*	*4767.7*	*7.37*	*5315.2*	*7.54*
Post and telecommunications	*2863.9*	*4.51*	*3221.9*	*4.98*	*3517.7*	*4.99*
financial Services	*2279.8*	*3.59*	*2415.6*	*3.73*	*2565.4*	*3.64*
Other market services	*7221.9*	*11.38*	*7804.7*	*12.06*	*8397.9*	*11.91*
FISIM	***-822.2***	***-1.3***	***-874.6***	***-1.35***	***-941.8***	***-1.34***
market activities	***48628.7***	***76.65***	***49776.5***	***76.9***	***53951.6***	***76.54***
Nonmarket activities	***9815.5***	***15.47***	***10982.7***	***16.97***	***12295.3***	***17.44***
Public administration services	*9552.1*	*15.06*	*10696.8*	*16.53*	*11987.5*	*17.01*
Services provided by organisms. associative	*67.1*	*0.11*	*73.6*	*0.11*	*79.3*	*0.11*
domestic services	*196.2*	*0.31*	*212.3*	*0.33*	*228.5*	*0.32*
Total Value added (GDP c.f)	***58444.1***	***92.12***	***60759.2***	***93.86***	***66246.9***	***93.98***
Taxes net of subsidies	*4996.7*	*7.88*	*3971.4*	*6.14*	*4243.8*	*6.02*
P.I.B (to p.m)	***63440.9***	***100***	***64730.6***	***100***	***70490.7***	***100***

Source: National Institute of Statistics. August 2013.

√ Market services (40.7% on average as against 41.13% in 2010), such as trade (7.97% on average as against 7.74% in 2010) and tourism (4.31% on average as against 4.99% in 2010).

However, the growth rates seen during the transitional period also reveal a rising preponderance of public administration services in the non-market activities (16.78% on average as against 15.06% in 2010) as well as a recession or transitory decline in the contributions made to the added value by other productive sectors and, in particular, the chemical industries (1.47% on average as against 2.06% in 2010) and mining (0.45% on average as against 0.77% in 2010).

Table 2.
VA growth by sector. price of the previous year (yoy%)

	2010	2011	2012	2013 (**)	2013 T1	2013 T2
Agriculture and Fisheries	**-9**	**10.3**	**3.9**	**-1.5**	**-2.8**	**-3**
manufacturing	**4.5**	**-1.4**	**1.8**	**3.2**	**2.5**	**4.8**
including agro-food	2.3	1.2	3.7	3.3	7	4.2
including oil refining	-63.9	219.8	47.7	na	-6	9.6
whose chemical	6.8	-38.9	15.3	8	0.2	18.9
including mechanical and electrical ndustries	3.7	-4.3	3.2	5	3.4	3.1
Non-manufacturing industries	**5**	**-12.9**	**-2.2**	**4.4**	**0.1**	**-1.4**
Oil and natural gas	7.5	-18.7	-7.2	2.8	0.7	-6
mines	10.8	-52.2	1.4	9.7	-12.6	14.2
Electricity and gas	-5.2	8.5	10.3	na	2.6	4.3
water	6.8	2.6	4.6	na	7.4	6
Building and civil engineering	3.5	-2.8	1.5	na	-0.5	2.2
Trade service activities	**4.9**	**-3.4**	**5.5**	**4.7**	**3.8**	**4.3**
Maintenance and repair	3.3	1.5	2.9	na	3.5	3.8
trade	3.6	0.6	0.7	3.5	2.3	3
Hotel and restaurant services	3.4	-20.7	11.7	3	-0.9	2.9
transport	4.5	-14.6	9.7	2.5	3.5	3.9
Post and telecommunications	13.4	10.4	9.4	10	9.5	9.7
financial Services	8	6.1	3.8	5	5.2	5.4
Other market services	2.6	1.3	2.9	na	3.8	3.5
FISIM	**4.8**	**5.3**	**4.3**	na	**6.2**	**6.3**
Nonmarket activities	**4.8**	**7.2**	**6.3**	na	**6.1**	**6.3**
Public administration services	4.9	7.2	6.4	na	6.2	6.4
Services provided by membership organizations	2.3	5.8	4.6	na	7	7.5
domestic services	2	4.1	3.8	na	4	4
GDP at market prices	**3.2**	**-1.9**	**3.6**	**4**	**2.6**	**3.2**

Source: National Institute of Statistics. August 2013.

(**) Updated previsions of the economic budget following the negotiation of credit standby Forecast - IMF. April 2013. In August 2013. the Ministry of Development and International Cooperation. again. lowered its prevision of the growth rate to 3.6%

An additional analysis of the value added growth rates by sector of activity (Table 2) sheds greater light on the profile of the pattern of the offering. It can be seen, therefore, that despite the apparent resumption of growth, the post-revolutionary period has essentially been marked by a decline in the value added growth rate in two key sectors, specifically mining (-52.2% in 2011 as against an expected recovery of 9.7% in 2013) [3] and tourism (-20.7% in 2011 as against an expected recovery of 3% in 2013).

In turn, the public administration non-market services, expecting an average of 6.8% as against 4.8% in 2010, contributed artificially to the growth dynamic through massive recruitment in public administration (48,000 new employees) and substantial increases in public sector wages and salaries in the wake of multiple wage demands to which the authorities acceded. At the same time, the majority of market service activities not taken into account in this breakdown operate informally. According to the World Bank (2012), the proliferation of in-

Table 3.
Sectoral contributions to the growth rate of GDP at constant prices (yoy%)

	2010	2011	2012	2013 (**)
Agriculture and Fisheries	**-0.67**	**0.87**	**0.33**	**-0.1**
manufacturing	0.76	-0.23	0.29	0.5
Indus. non-manufacturing	0.63	-1.62	-0.20	0.6
total industries	**1.39**	**-1.85**	**0.09**	**1.1**
Act. merchant services	**2.02**	**-1.38**	**2.23**	**1.9**
FISIM	-0.06	-0.07	-0.06	-0.06
Total market activities	**2.74**	**-2.43**	**2.59**	**2.9**
Nonmarket activities	**0.75**	**1.22**	**1.1**	**1.19**
GDP at factor cost	**3.49**	**-1.21**	**3.69**	**4.09**
Net indirect taxes of Grant.	-0.29	-0.69	-0.09	-0.09
GDP at market prices	**3.2**	**-1.9**	**3.6**	**4**

Source: Calculations of the study using data from the National Institute of Statistics. August 2013

(*) Average baseline

(**) Updated economic forecast of the budget. April 2013

formal activities in post-revolutionary Tunisia apparently represents nearly 40% of GDP and 53.5% of the workforce. No specific measures have been taken in this respect by the transitional governments. This is, therefore, a sector which poses a number of problems, particularly due to the loss of income from tax revenue, on the one hand, and, on the other, the working conditions and lack of

the shortfall in growth can be explained by two factors: on the one hand, the low accumulation of fixed capital and, on the other, an inadequate return on the capital..

any kind of social security scheme for the workers. And yet, certain business sectors affected by this phenomenon, such as handicrafts and agriculture, or even some professions in the building sector, could have considerable potential in terms of job creation, if they were to be structured.

I.2. The key role of private consumption in thwarting falling investment

An analysis of the contributions of the components of demand to the GDP growth rate at constant prices clearly shows the significant role played by the policies to stimulate consumption (Table 4).

Consumption in both the private and public sectors represented, respectively, 67.7% and 17.6% on average over the period 2011-2013, in comparison to the stagnation or paralysis of the other key components of demand and, in particular, investment, where the contribution to GDP decreased to 22% on average as against 24.5% in 2010. This strategy has impacted the increase in the trade deficit, with a faster growth in imports from 2012 onwards and, consequently, a negative contribution in terms of net external demand averaging (-15.4%) as against 13% in 2010 (Table 5). In particular internal demand and household consumption have stood their ground thanks to the increase in the real wage, but at the cost of inflationary pressures from the second quarter of 2012 onwards, particularly in respect of food products.

I.2.1. Low levels of investment at the root of the shortfall in growth

Despite a transitory recovery, the shortfall in growth can be explained by two factors: on the one hand, the low accumulation of fixed capital and, on the other, an inadequate return on the capital. From the experience of the emerging countries it would appear that both are needed to get a process of sustained growth underway. During

Table 4.
Contribution of demand components to GDP at market prices

	2010		2011		2012		2013 (*)	
	in MTD	in %	in MTD	in %	in MTD	in %	in MTD	in %
private consumption	39729	62.6	42847	66.1	47237	67.1	52276	66.7
public consumption	10315	16.3	11512	17.8	12479	17.7	13601	17.4
total consumption	**50044**	**78.9**	**54359**	**83.9**	**59716**	**84.8**	**65877**	**84.1**
GFCF	15544	24.5	14084	21.7	15683	22.2	17319	22.1
domestic absorption	**65588**		**68443**		**75399**		**83196**	
Change in inventories	6151	9 .6	4890	7.8	6727	9.5	8001	10.2
domestic demand	**71739**		**73333**		**82126**		**91197**	
Imp. Goods and Serv. (CIF)	-31817	-50.1	-33695	-52.1	-38183	-54.1	-42384	-54.1
Exp. Goods and Serv. (FOB)	23519	37.1	25092	38.7	26548	37.6	29521	37.7
Dem. net foreign	**-8298**	**-13**	**-8606**	**-13.4**	**-11635**	**-16.5**	**-12863**	**-16.4**
GDP at market prices	**63441**	**100**	**64730**	**100**	**70491**	**100**	**78334**	**100**
Rate of growth. GDP (pc)	**3.2**		**-1.9**		**3.6**		**4**	

Source: Calculations of the study based on data ITCEQ. Ministry of Development and International Cooperation (2013)

(*) Updated economic forecastof budget. April 2013

(**) Based on a growth rate of imports B & S (current prices) estimated by the economic budget up to 11.0%

(***) On the basis of a rate of growth of exports B & S (current prices) estimated by the economic budget up to 11.2%

Table 5.
Evolution of the components of demand. prices of the previous year (yoy%))

	2010	2011	2012	2013 (*)
Imports of goods and services (CIF)	**17.5**	**-2.3**	**5.3**	**2.4**
private consumption	4.5	4.2	4.4	4.6
public consumption	4.4	6.3	4.2	4.5
GFCF	5.5	-12.6	8	6.4
domestic demand	**5.6**	**-1.1**	**4.3**	**4.3**
Exports of goods and services (FOB)	**12.6**	**-4.3**	**3.9**	**1.4**
GDP at market prices	**3.2**	**-1.9**	**3.6**	**4**

Source: Central Bank of Tunisia (2013)

(*) Updated economic forecast of budget. April 2013

the transitional period, the average rate of gross private investment remained moderate, to the order of 22% of GDP on average, as against 25.6% previously.

This decrease, concomitant with the substantial decline in growth (at constant prices) and accelerated by new constraints and rigidities which have emerged in the business and investment climate, is accompanied by a poor ICOR performance (Table 6), one of the weakest among the reference and competitor countries in the MENA region.

The poor performance in net return on investment suggests that the main constraint is connected to an insufficiency in savings, although the structural deficit of gross savings in relation to gross investment increased during the post-revolutionary period by an average of (-5.7%) of GDP as against (2.7%) during the previous reference period (Table 7).

Table 6.
Incremental Capital Output Ratio

	2010	2012	2013 (*)
GDP at market prices (*)	**63441**	70 491	78 334
Gross Fixed Capital Formation	15 544	15 683	17 319
ICOR	**3.25**	**2.72**	**2.21**

(*) Current prices (in MTD)

Table 7.
Deficit savings - Investment

	2008-2010 (*)	2011	2012	2013 (**)
Gross domestic savings (% of GDP)	22.4	16.8	15.5	16.5
GFCF (% of GDP) (***)	25.1	21.7	22.2	22.1
Gross savings deficit / Gross Investment (% of GDP)	**-2.7**	**-4.9**	**-6.7**	**-5.6**

Source: Calculations based on data from the National Institute of Statistics and BCT (2013)

(*) Average baseline

(**) Updated economic forecast of budget. April 2013

(***) Investment rate

I.2.2. Limited access to bank financing, penalising SMEs/SMIs

According to data gathered for a survey conducted on SMEs/SMIs during the transitional period, bank credit covered an average of only 9.6% of financing needs for long-term assets, compared to 65.3% self-financing, which thus remains the main source of financing for SMEs/SMIs in Tunisia (Table 8).

As such, in the context of the global business environment, Tunisia is ranked only 87th in the Doing Business Getting Credit Index. In particular, in the legal environment of bank credit, Tunisia is poorly rated particularly in respect of mechanisms to guarantee and record current assets. The other forms of non-bank financing (factoring, leasing, stock market, capital risk, etc.) appear to play a minor role.

As regards the perception that businesses have of the major obstacles they face in accessing sources of bank financing, the major and recurring problems are limited, apart from the high borrowing costs with significant demands and constraints in terms of collateral. The guarantee rates, essentially mortgages, demanded as collateral against bank loans in Tunisia are, in effect, comparably much higher than in other countries. All sectors taken as a whole, the most recent data available show an average rate of 169% of the value of the loans granted as against an average rate of 59.8% in Morocco, for example, for the same period. The obstacles in terms of access to bank financing sources for SMEs/SMIs are in line with the 'missing middle' paradox, which is caused by: (a) in terms of offer, (i) the difficulty banks have in moving away from credit based on guarantees

Table 8.
Breakdown of funding to SMEs

	Sources of financing							
	Self-financing (*)	Bank credit	Leasing	SICAR	Financial market	MFIs (**)	Others (***)	Total
manufacturing	62.0%	13.0%	21.0%	1.0%	0.0%	0.0%	1.0%	**100.0%**
Non-manufacturing industries	68.0%	9.0%	13.0%	5.0%	0.0%	0.0%	5.0%	**100.0%**
Trade service activities	66.0%	7.0%	15.0%	2.0%	0.0%	3.0%	7.0%	**100.0%**
average	**65.3%**	**9.6%**	**16.4%**	**2.6%**	**0.0%**	**1.0%**	**5.1%**	**100.0%**

Source: Mouley (2013)

(*) Including current accounts. savings accounts. credit facilities. capital increase. other internal funds. reinvested earnings or retained earnings

(**) Microfinance Institutions

(***) Informal sources (loans between individuals) to credit based on cash-flow; and (ii) the lack of capacity to assess non-traditional customers offering limited information about their financial situation and their operations; (iii) the perceived high risk of giving credit to SMEs/SMIs; (iv) the lack of suitable instruments; (v) the lack of long-term funds raised from insurance companies/pension funds and lenders due to the weakness of the financial market; (b) in terms of demand: (i) the SMEs/SMIs' lack of transparency reflected in the difficulty they experience in presenting reliable financial statements and solid business plans; and (ii) the lack of acceptable guarantees.

In particular, Tunisia does not yet have a deposit guarantee and insurance mechanism capable of limiting the effects of moral hazard. At the same time, the SME/SMI credit guarantee system, while based upon a developed textual support, is confronted with several major obstacles. In effect, the dedicated support mechanisms available, in the form of an investment bank for SMEs (BFPME) and a guarantee company (SOTUGAR), remain limited by a number of operational constraints. This is the case, for example, of financing via SICARs (risk capital). Equity transfer operations are carried out to the benefit of project promoters in the form of cost of carry contracts which in fact are akin to bank credit operations since the transfer price is calculated in reference to the money market rate associated with a maturity date. Furthermore, the complements to bank financing by the BFPME require guarantees from SOTUGAR, which itself depends on collateral payable by the promoters in the form of mortgages. This has led to the system becoming totally biased and ineffective.

I.3. The quality of growth and the delays in inclusion

I.3.1. The contribution of production factors to growth: falling productivity

An assessment of production factor quality shows a decline in their contribution margins in respect of economic growth during the transitional period. The decomposition of real GDP growth using a multivariate econometric estimation method (average output elasticity in relation to capital estimated at 0.37) underlines a decrease in the contribution of the TPF to growth, which was already low and which subsequently became negative.

Table 9.
Contribution of TFP (in%) in GDP growth

	2010	*2011*	*2012*	*2013*
real GDP	***3.2***	***-1.9***	***3.6***	***4***
Capital productivity	*1.6*	*1.1*	*1.9*	*2.1*
Labor productivity	*0.9*	*-2.1*	*1.4*	*1.7*
PGF (residues)	*0.7*	*-0.9*	*-0.3*	*-0.2*

Source: Calculations of the study

I.3.2. Main changes that have occurred relating to chronic poverty, social transfers and unemployment

a. A reduction in poverty but persisting regional inequalities

In 2012, the National Institute of Statistics (INS) conducted a comprehensive review and update of its poverty measuring methods in collaboration with the African Development Bank and the World Bank. It is worth noting here that for the ILO, populations that official statistics consider as being non-poor are so in fact because they are kept artificially above the poverty line thanks to support programmes.

To truly grasp the significance of the definition of poverty or the determination of the poverty line in limiting the number of poor people, a new standard was used to calculate the poverty line by setting it at 1,277 dinars per person per year in the big cities as against 820 dinars per person per year in rural areas. In contrast, the extreme poverty threshold is set at 757 dinars per person per year in the big cities as against 571 dinars per person per year in rural areas.

Table 10.
Poverty rate by governorate (2011)

Governorate	Poverty rate	Governorate	Poverty rate
Tunis	13.4	Jendouba	41.0
Ariana	10.1	Kef	42.0
Ben Arous	12.8	Siliana	50.1
Mahdia	11.0	Kairouan	34.0
Nabeul	17.8	Kasserine	46.4
Bizerte	23.8	Sidi Bouzid	42.3
Zaghouan	31.0	Gafsa	30.9
Sousse	14.9	Tozeur	38.7
Monastir	15.8	Kébili	32.8
Mahdia	29.8	Gabès	28.9
Sfax	17.8	Médenine	24.5
All Tunisia	24.7	Tataouine	38.3

***Source** : Ministère des affaires sociales (2012)*

Table 11.
Compensation expense (MTD)

Désignation	2010	2011	2012	2013(a)
compensation	1500	2.869.2	3.624.1	4200
including:				
(Commodities)	-730	(1.100.0)	(1.242.0)	(na)
(Fuels)	-550	(1.536.0)	(1.688.0)	(na)
(Transport)	-220	-233.2	-278	(na)
GDP at market prices	63441	64730	70491	78334
State budget (b)	17907	20750	23287	26792
Memory:				
Compensation (% of GDP)	-2.36%	-4.43%	-5.14%	-5.36%
(Compensation as% of budget)	-8.37%	-13.83%	-15.56%	-15.67%

***Source** : Ministère des finances (2012)*

(a) Projections Finance Act (2013). and economic budget (2013)

(b) cf. Infra.

Using the new method, the poverty rate was re-estimated at 15.5% in 2010 as against 23.3% in 2005 and 32.4% in 2000. The extreme poverty rate was re-estimated at 4.6% in 2010 as against 7.6% in 2005 and 12% in 2000. The drop in the poverty rate between 2000 and 2010 may be explained by the rise in consumption, which was higher during this period among the lowest income deciles of the population. Nevertheless, despite a drop in the poverty rate over the last decade, significant disparities still exist. Thus the drop in the poverty rate did not benefit the various regions of the country that have seen the rift between themselves and the rest of the country widen over the last decade. The fact that inequalities decreased at national level, with a Gini coefficient which dropped from 0.37 in 2000 to 0.35 in 2010, can be explained by the decrease in intra-regional inequalities, where the figure dropped from 0.21 in 2000 to 0.17 in 2010. Conversely, inter-regional inequalities increased over the same period, rising from 0.16 in 2000 to 0.18 in 2010. The increase in polarisation from 77.7 in 2000 to 103.2 in 2010 confirms that the sentiments of identification and alienation of citizens in the disadvantaged governorates heightened over the period between 2000 and 2010.

This Table shows that the coastal area taken as a whole has a poverty rate below the national average (24.7%), with the exception of Gabès and Mahdia, which is probably due to the weight of the rural milieu in these two regions. There is, therefore, a real correlation between unemployment and poverty.

b. The discriminating role of the social transfer mechanism

Created in 1970, the Caisse Générale de Compensation (General Compensation Fund – CGC) is an important social transfer mechanism whose goal is to stabilise fluctuation in staple food prices and maintain families' purchasing power. Schematically, the CGC's expenditure essentially concerns basic products such as cereals and their derivatives, vegetable oils, milk, sugar and other foodstuffs, but its field of intervention has progressively expanded to include energy products and transport. The prices of the subsidised products are set by the government and adjusted periodically in order to attenuate the effect of increased costs in production factors, world prices and the exchange rate of the dollar.

It can be seen that direct subsidies represent 4.97% of GDP on average during the transitional period (as against 2.36% in 2010) and 15.1% of the State budget (as against 8.37% in 2010). In addition to these, there are other transfer costs such as low-cost or free healthcare and a number of other services provided free of charge to needy families. It is estimated that the average total cost of social transfers is in the region of 18% of the State budget, which is the equivalent of one minimum wage per household.

c. Structural unemployment and shortfall of decent jobs

With an increase in the unemployment rate of the active population estimated at 17.6% in 2012 and 18.3% in 2011 (as against 14.8% in 2010), together with an even higher unemployment rate among young graduates, which rose from 30.7% in 2010 to 30.9% in 2011, the challenge of employment is at the forefront of the social and political priorities revealed by the revolution. The slight easing in 2012 nevertheless conceals significant regional disparities (28.6% in the centre-west, 26.9% in the south-west, 24.8% in the south-east and 11.1% in the centre-east).

This unemployment, which tends to be structural, is the result of a mismatch which is simultaneously quantitative (between higher education and the needs of the private sector) and qualitative (graduates not having the skills required to enter the labour market). A first programme, 'Amal', aimed at those seeking their first job, higher education graduates and holders of the 'Brevet de Technicien Supérieur' vocational qualification, got underway in 2011. This programme encountered a number of shortcomings associated with the inadequate targeting of the poorest unemployed.

Against this background, the transitional authorities adopted a decree that modifies and complements the decree of 9 February 2009-349 establishing the programmes for the National Unemployment Fund (21/21 Fund) and the conditions and arrangements applicable to the benefits provided. The reform aims to address the challenges of unemployment through the creation of the Programme d'Encouragement à Emploi (Employment Promotion Programme) in substitution of the AMAL programme, with a view to enabling better targeting of the most vulnerable among the unemployed. Alongside these programmes focusing on employment, health (the Tunisian Union for Social Solidarity was responsible for running the programme) is currently high on the list of priorities. As a result, a charity medicine bank has been set up since the revolution. Healthcare cards have been distributed to the neediest. In the past, these cards were obtained by cells close to the regime, sometimes excluding the populations who needed them most.

I.3.3. Deterioration of the business climate and competitiveness

According to the latest Doing Business report, Tunisia's position makes it possible to identify a number of areas which became even more problematic during the transitional period. These are, in particular, the creation of businesses, the obtaining of loans, the transfer of property and the protection of the investors, which explains the drop in the investment rate as well as the lack of attractiveness in terms of foreign direct investment.

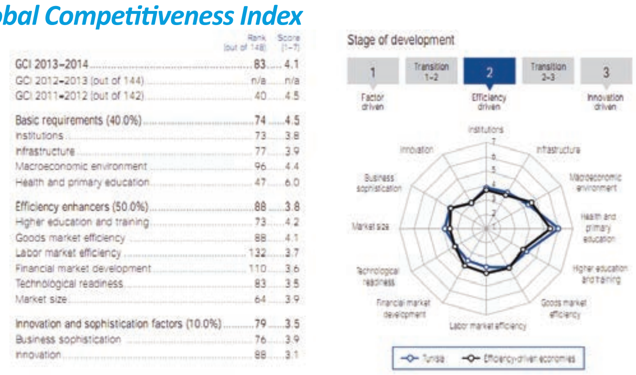
At the same time, the recent Global Competitiveness Report (2013-2014 version) relegated Tunisia's global competitiveness from 40th place to 83rd. In particular, the weaknesses in the competitive climate are to be found largely in the combined poor performance in terms of factors relating to efficiency (ranked 88th with

Table 12.
Doing Business in Tunisia (rank by indicators)

Ease of...	*Doing Business Rank 2013*	*Doing Business Rank 2012*	*Variation in rank*
Entrepreneurship	*66*	*54*	*-12*
Granting of planning permission	*93*	*87*	*-6*
Electricity connection	*51*	*48*	*-3*
Transfer of ownership	*70*	*64*	*-6*
Obtaining loans	*104*	*97*	*-7*
Investor protection	*49*	*46*	*-3*
Paying Taxes	*62*	*60*	*-2*
cross-border trade	*30*	*31*	*1*
Enforcing Contracts	*78*	*77*	*-1*
Regulation of insolvency	*39*	*38*	*-1*

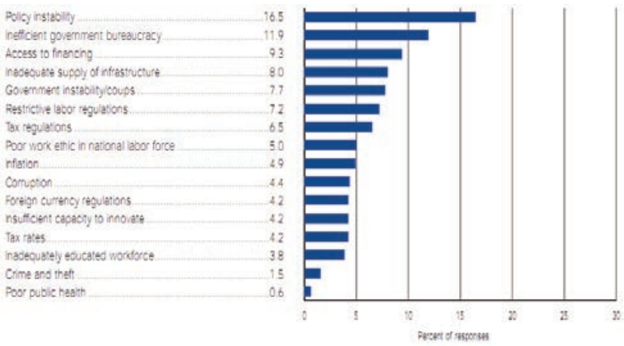
Source: *WEF (Global Competitiveness Report (2013-2014)*

Figure 1.
Global Competitiveness Index



Source: WEF (Global Competitiveness Report (2013-2014)

Figure 2.
% Of business leaders judging problematic key factors influencing investment



Source: WEF (Global Competitiveness Report (2013-2014)

a score of 3.8 as against 4.1 in the previous ranking) and business innovation and sophistication (ranked 79th with a score of 3.5 as against 3.9 previously).

II. Vulnerabilities of the macroeconomic policy in the short term

II.1. Internal fragility factors

II.1.1. The opposing trends of the monetary policy

The management framework for the monetary policy has seen two virtually opposing trends. With an initial goal of managing a liquidity deficit in the banking system and resuming activity, the first occurred during the first two phases, from January 2011 to June 2012. It involved a totally accommodative procedure, disarming the instruments of the monetary policy and contributing to some extent to the return of inflationary pressures. The second, which took place over the two subsequent phases starting in July 2012, focused on an active monetary policy, in the sense of a gradually restrictive policy, in light of the recurring inflation, supported by better coordination with a countercyclical fiscal policy.

Phase 1: Management of the systemic liquidity crisis in the banking sector, but excessive disarming of the monetary policy

At the start of the transitional period, the banking system was indeed confronted with the known risks of a systemic liquidity crisis. The cause was the unprecedented deceleration of autonomous factors, i.e. a sharp rise in the number of banknotes and coins in circulation, brought about by household hoarding in conjunction with the downturn in net assets abroad in relation to the drop in net foreign currency assets, which went from 827 million Tunisian Dinar (MTD) in 2010 to (-2,040 MDT) in 2011.

The Central Bank of Tunisia (BCT) then instigated a strategy of monetary easing throughout 2011.

Table 13.
Evolution of autonomous factors of bank liquidity

	Period before revolution (2006-2010)						Post-revol. period
	2006	**2007**	**2008**	**2009**	**2010**	**Av.**	**2011**
Banknotes and coins in circulation	**-3745**	**-4021**	**-4414**	**-4916**	**-5485**	**-4516**	**-6716**
Net balance of public admin.	**154**	**175**	**-22**	**-132**	**-240**	**-13**	**26**
including:							
Current account balance of the treasury	-428	-421	-542	-660	-663	-542	-540
Net assets abroad	**5334**	**6974**	**8124**	**9859**	**10344**	**8127**	**7772**
including:							
Net foreign assets	6799	8924	10264	12550	12963	10300	11098
Net other factors	**-1662**	**-2795**	**-2588**	**-3221**	**-3586**	**-2771**	**-3122**
Autonomous liquidity factors	**81**	**333**	**1100**	**1590**	**1033**	**827**	**-2040**

Source *: Banque Centrale de Tunisie*

(*) Data expressed as daily averages in millions of DT

Firstly, in respect of bank refinancing with massive liquidity injections on the money market (quantitative easing) through the weekly tender mechanism. Secondly, in respect of unprecedented simultaneous decreases (credit easing) in the reference rate of 100 basis points overall (in two stages of 50 basis points each) and reserve requirements of over 10% (from 12.5% to 2% on deposits with a maturity of less than three months; from 1.5% to 0% on deposits with a maturity of between 3 and 24 months; and from 1% to 0% on special savings accounts).

Nevertheless, focusing the monetary policy on managing the risks of tightening bank liquidity had the further effect of contributing to the reappearance of stagflationary pressures. In fact, the strategy of monetary easing and holding the nominal interest rate down are only valid in the case of a deflation trap, which essentially means a drop in prices that does not generate a recovery in consumer demand, leading to a slowing-down of activity as a result of shrinking internal demand. In other words, lower inflation risks would be just what the central bank needed to be able to relax and ease monetary policy through an unprecedented cut in the key interest rate. In Tunisia, the prevailing circumstances during this phase were entirely the opposite to that of a deflation trap as described above. The priority was to address a situation of stagflation as opposed to one of deflation; in other words, a particular context of weak growth or even a profile of technical recession associated with a high inflation rate, which, year-on-year, reached a mark as high as 4.5% in October 2011 (and, indeed, this was the highest monthly rise recorded in 2011).

However opportune the strategy of monetary easing might be for managing the risks of global liquidity in the banking system, it thus proved inadequate in stimulating economic activity. In effect, the output gap has been negative since 2011, dropping from 1.82 in 2010 to -2.31 and -1.95 respectively in 2011 and 2012. A priori, a drop signifying shrinkage in aggregate demand and justifying a stimulus through consumer demand. Nevertheless, an increase of 0.36 points was seen between 2011 and the third quarter of 2012 (year-on-year), which means overall an upturn in aggregate demand and risks of inflationary movements due to increasing demand. A tightening of the monetary policy therefore became imperative.

Phase 2: The inflationary impact of the monetary factors

The monetary easing measures employed in phase 1 produced a fairly large autonomous 'money gap' on the M3 aggregate, with a recurrence of inflationary pressures starting in the first half of 2012. The massive refinancing of the banking system by the BCT at the start of the transitional period was undoubtedly in response to the global liquidity crisis of the banks.

However, the tightening of bank liquidity has, at the same time, increased the costs of resources associated with deposit mobilisation, due to the pressure on the interest rates applicable to certificates of deposit and commercial papers, particularly after the BCT took the measure, early in 2012, of capping the rates on fixed-term deposits at the monthly average rate + 1%. In effect, the structure of the bank deposits, the preponderance of quasi-monetary deposits (fixed-term deposits, certificates of deposit, special savings accounts, etc.) is the root cause of high funding costs for the banks, insofar as their average annual rate of return exceeds the average nominal interest rate as a result of the banks' overbidding on institutional deposits, leading to weaknesses in the mobilisation of liquidity and bringing pressure to bear on bank profitability.

Thus, the mobilisation of funds is particularly centred on the mobilisation of fixed-term deposits and certificates of deposits. Furthermore, the volatility of the macroeconomic environment has exacerbated the difficulties of reimbursement and an increase in payment default by customers, leading to the need for debt rescheduling and massive recourse to the consolidation of bank credits, thus increasing the banks' liquidity requirements.

At the same time, while a large portion of the bank liquidity supplied during this period by the BCT through the tender mechanism should, in principle, have been allocated to covering unfunded risk associated with irrecoverable loans, circular no. 2011-04 authorised the banks to reschedule debt worth an estimated total, at end April 2012, of over five billion dinars, i.e. 7.7% of GDP, or almost 5% more than the global non-performing loans ratio, artificially reducing it to 13% instead of 18%. This earlier antagonism enabled the banks to free the funds allocated to consumer credit, which was probably also the source of the upturn in inflation.

Phase 3: Monetary tightening to reduce inflationary pressures

Since July 2012, a series of gradual measures have been instigated to contain the inflationary pressures that were global and structural in nature during the last period. In effect, the year-on-year figure in the general price index rose to 5.6% in July as against 5.4% during the month of June 2012. In addition to monetary factors, inflationary pressures became inert (permanent or persistent) during this period, with recoveries attributable to:

- √ Cyclical factors: increased prices for raw materials and imported energy,
- √ Factors that had become structural to internal demand: rising food prices due to excessive demand on the Libyan market and, correlatively, the cross-border smuggling of agri-food products to Libya, anti-competitive speculation on the wholesale and retail markets, deviation and lack of control on the distribution circuits and the proliferation of generalised informal funding.
- √ Correlatively, to the risk of inflationary movement due to increasing internal demand. This diagnosis stems from the evolution of the output gap (or the difference between actual production and potential production). The output gap has been negative since the post-revolutionary period, dropping from 1.82 in 2010 to -2.31 in 2011 and -1.95 in 2012. Nevertheless, an increase of 0.36 points was seen between 2011 and the third quarter of 2012 (year-on-year), which means overall an upturn in aggregate demand. A priori, this increase in demand no longer justifies a recovery through consumer demand.
- √ Pass-through effects associated with imported inflation because of the effective nominal depreciation in the exchange rates, in particular with respect to the euro. A dyna-

mic which is in fact unavoidable in light of the extent of the deterioration of the trade and current account deficit since the transition began over two years ago, as a result of the limited effect of the exchange rate on the competitiveness of exports in a transitional period that coincided with a recession in the eurozone. Nevertheless, the BCT has made undeniable efforts to support the exchange rate by intervening on the foreign exchange market in order to adjust the inflation differential in relation to its partners.

- √ Exogenous factors (uncertainties about the business, regulatory and investment climate, in particular).
- √ The wage-price spiral because of the successive salary increases in the wake of union demands during the transitional period.

This is why the BCT's board of directors initially decided, at the end of August 2012, to raise the key interest rate by 25 basis points, bringing it to 3.75%. Year-on-year, there was little movement thereafter in the general consumer price index, which stood at 5.7% in September, 5.3% at the end of October, 5.5% in November and 5.9% in December 2012. Generally, and as an annual average, the inflation rate hit 5.6% in 2012 as against the 2011 figure of 3.5%, mainly as a result of the increased prices in every product group and, in particular, food products, which had risen in price by 8.4% at the end of the previous year.

In other words, this first adjustment of the reference rate was still insufficient in light of the delays and the adjustment periods known for inflation. Thus, the board of directors' next step, in March

Table 14.
Decomposition of the determinants of inflation

	Cœfficients (a)	In %	Inflation rate (b)
exogenous factors	*0.267850*	*+26.78%*	*1.49%* ***(c)***
inflation, inherited	*0.467102*	*+46.71%*	*2.61%*
Output gap	*0.051234*	*+5.12%*	*0.28%*
Pass-through effect	*0.139111*	*+13.91%*	*0.77%*
currency effect	*0.080906*	*+8.09%*	*0.45%*
imported inflation	*0.058205*	*+5.82%*	*0.32%*
Other monetary channels	*0.099425*	*+9.94%*	*0.55%*
bank loans	*0.065961*	*+6.59%*	*0.36%*
Autonomous money gap on M3 (from the adjusted monetary base)	*0.033502*	*+3.35%*	*0.19%*
Interest rate	*-0.024661*	*-2.46%*	*-0.13%*
	Total	***100%***	***5.6% (d)***

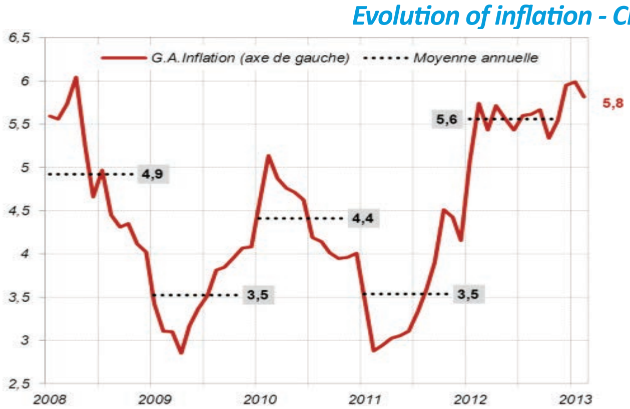
(a) Estimates of the study on the basis of a VAR model (1) level

(b) In terms of annual average

(c) Almost equal to the gap between headline and core inflation (core inflation), excluding food and subsidized products to approximately 4.1% in 2012 in terms of annual variation against 3 6% in 2011.

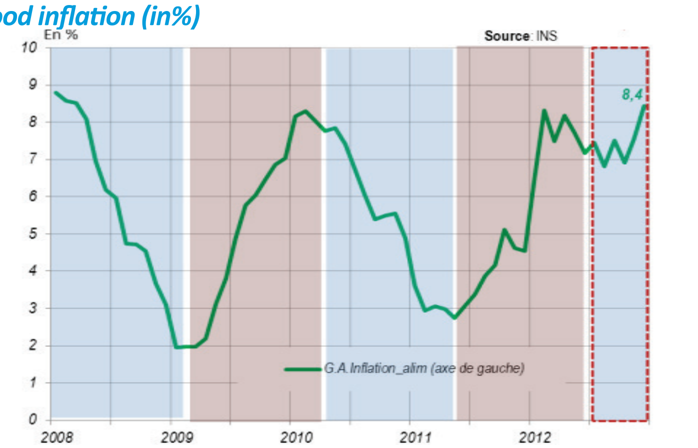
(d) average at the end of 2012 against 3.5% in 2011 (related primarily to the increase in prices of all commodity groups, particularly

Figure 3.
Evolution of inflation - CPI (in%)



Source: Comité de politique monétaire – Banque Centrale de Tunisie (2013)

Figure 4.
Food inflation (in%)



Source: Comité de politique monétaire – Banque Centrale de Tunisie (2013)

to the corridor of the standing lending and deposit facility rates.

Thus the standing facility rates were modified in such a way that the interest rate on the overnight bank lending facility would be equal to the BCT's reference rate (3.75%) plus a margin of 75 basis points (i.e. 4.5% per annum instead of the previous 4.25%). Conversely, the rate applied to the overnight deposit facility meant it would be equal to BCT's reference rate minus a margin of 25 basis points, i.e. 3.50% per annum.

2013, was to instigate a series of additional measures, raising the key interest rate by a further 25 basis points to bring it to 4%, while deciding to uncap the remuneration on fixed-term deposits, increase the minimum remuneration rate on savings and gradually ease the measures taken in October 2012 relating to the rationalisation of consumer credit through a reduction in the rate of the associated compulsory reserve.

These essential adaptations in the monetary policy were imposed by the intrinsic specifics of the time period required for monetary policy to impact inflation in Tunisia. With only the monetary channels (bank credits, exchange rate and interest rate) actually being operational, the channel of the key interest rate (tender rate) sometimes remains neutral or even inflexible if it is not accompanied by an action to increase the average money market rate.

An analysis of how the average interbank rate has evolved shows that it stood at 4.25% in February 2013, as against 4.14% in January 2013 and 4.10% in December 2012, converging on and actually passing the lending facility rate previously set at 4.25%. The overall consequence was a money market rate which was actually higher than the old reference rate (3.75%) by an average of 50 basis points. It was in light of this that, at its February 2013 board meeting, the BCT initially passed on the entire average net spread of 50 basis points

This measure being advantageous to the upward adjustment of the money market rate, it was complemented, by way of a signal and anticipation, by a second increase in reference rate of 25 basis points. This monetary tightening is all the more opportune given that there is currently no longer any point in stimulating growth through a recovery in consumer demand brought about by the monetary policy in a situation of inflationary pressures. A countercyclical fiscal policy would be much more efficacious in such circumstances.

Furthermore, the decision to raise the key interest rate came along with an increase to 2.75% in the minimum rate of remuneration on savings as against the previously permitted 2.5%. This last measure will undoubtedly have a positive bearing on the structure of the banking system's funds. In effect, it will strengthen the banks' capacity to attract stable funds and, above all, to counteract their earlier overbidding on institutional deposits, certificates of deposit and commercial papers, which resulted in high costs for funds. Besides, and from the same perspective, the other decision to uncap the fixed-term deposit rate beyond the current money market standard + 1% will enable, on the one hand, a reduction in pressure on the interest rates applicable to certificates of deposit and commercial papers and, on the other, to cut the structural deficit of savings in relation to investment.

Phase 4: Circumventing unpleasant monetarist arithmetic

Although the BCT has gradually abandoned the full allotment policy (which consists in refinancing banks' liquidity requirements in their entirety), by recalibrating its refinancing operations on the basis of its own forecasts of banks' liquidity requirements, it has continued to use the automatic stabilisers to fine-tune autonomous factors, by conducting a three-level programme as part of a sequential strategy to move away from unconventional measures:

√ Continuing effort to return banknotes and coins circulating in the banking sector: as a result of good performance in terms of managing the banking sector's overall liquidity since the end of the third quarter of 2012 associated with successive decisions to withdraw and convert certain banknotes, it has been possible to continue with the effort to return banknotes to the banking sector. As a result of this strategy, the BCT's intervention on the money market dropped substantially from 4,786 MDT in December 2012 to 2,774 MDT in March 2013. The monetary component of inflation was therefore practically halved.

√ Consolidation of net foreign assets and in particular net assets in foreign currency.

√ Greater vitality in the Treasury current account: this was the case in the last period, with the State supplying the banks, which allowed a substantial reduction in refinancing.

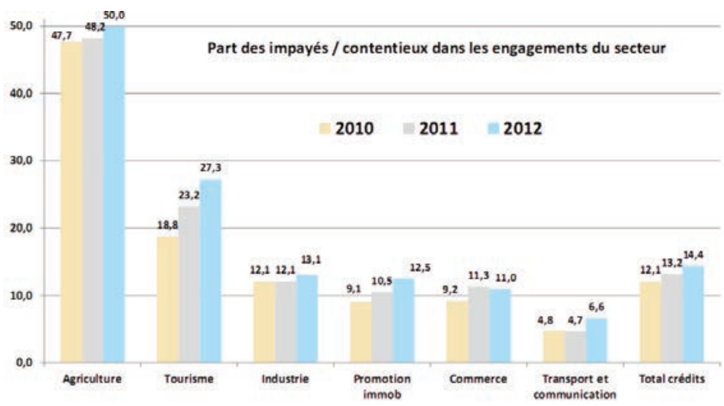
II.1.2. Latent vulnerabilities in the banking sector

Despite the efforts made and programmes addressing this issue during the transitional period, the known weaknesses of the banking system are still numerous. Apart from certain innovative aspects in terms of governance (in particular, circular 2011-06, under which risk management committees are instituted as support structures for banks' boards of directors), the vulnerabilities of the banking sector remain largely restricted to the relative extent of non-performing loans, a relatively weak level of bank profitability, a two-fold lack of compliance with certain principles which are essential for effective banking control and financial stability standards, and the weakness, if not the actual absence, of an institutionalised security mechanism.

a. Exacerbation of bad debt

Although the banks do not depend on external financing and their activities are largely financed by internal deposits (nearly 80% of bank funds), the size of non-performing loans (NPL) and their provisioning are still a problem. A large portion of bank liquidity is allocated to covering unfunded risks associated with irrecoverable loans. A reduction in NPLs would enable banks to devote more funds to covering risk on new credit flows thereby supporting the productive sector.

Figure 5.
Non performing loans, NPLs



Source: Comité de politique monétaire – Banque Centrale de Tunisie (2013)

Despite the results noted in recent years with regard to soundness indicators and the quality of portfolios, the proportion of classified or non-performing loans is still high in relation to comparators and emerging countries. Thus gross unproductive debt (as a percentage of gross assets) rose from 13.2% in 2011 to 14.4% in 2012. The agriculture and tourism sectors, in particular, saw the most severe exacerbation in the proportion of default or disputes on loan repayments.

Nevertheless, and in accordance with the conclusions of the latest FSAP from 2012, if loans authorised for rescheduling as a result of circular no. 2011-04 were to be reclassified, it would add at least 5% to the overall non-performing loan ratio, which would bring the percentage of unproductive debt to more than 19.4%.

b. Banking supervision in transition

The assessment of compliance with the Basel Committee's 25 core principles for effective banking supervision reveals non-compliance with certain principles and, in particular, with regard to shortcomings in bank credit policy (principles 7 and 8). In particular there is an issue of major deficiencies and distortions in respect of the conditions for granting credit, risk assessment, insufficient provision for classified loans, the complexity of the current mechanism of mortgage guarantees and especially their overvaluation, the inefficiency of portfolio quality control methods and the unsuitable means of debt recovery.

Meanwhile, the migration process to Basel II is still underway. As regards the first pillar, the monetary authorities' initial orientation was geared towards the implementation of the standardised ratings approach for credit risk and the basic approach for operational risk. These two rating techniques are not yet operational at a time when the work on the necessary reform for the applicability of the second and third pillars is not yet underway.

Furthermore, and although current regulations relating to internal control and credit management by the banks was recently reformed under circular no. 2011-06, which the BCT sent out to credit establishments revising circular no. 2006-19, the fact remains that the new requirements for internal control and supervision of the credit risk appear to be based even more on conformity and not on genuine risk management.

At the same time, the monetary authorities have a central information source supported by a credit bureau at their disposal, but a regulatory framework applicable to other channels capable of conducting an independent external assessment of borrowing companies needs to be implemented; this would enable better management of operational risk and improve internal control. Furthermore, the supervisory authorities are still hampered by the lack of a central balance sheet office.

c. Other non-conformities

Particularly at issue here are the cumulative delays in conforming to the recent Financial Stability Board standards for the soundness of the financial system, based on the standardised international mechanism that resulted from the April 2009 G20 summit in London. The same is true of the material non-conformity to the main criteria and prerequisites of a formal inflation-targeting framework.

Lastly, and with regard to security mechanisms, Tunisia does not yet have an institutionalised security mechanism, such as a lender of last resort function (LLR) in the case of systemic crisis or a deposit guarantee and insurance system capable of limiting the effects of moral hazard. Furthermore, there is no mechanism for managing and/or simulating liquidity crises.

d. Downgrading of bank risk ratings

Standard & Poor's also conducted a bank risk assessment in accordance with the Banking Industry Country Risk Assessment (BICRA), which covers rated and unrated financial institutions that receive deposits, grant credit or are engaged in both activities simultaneously. BICRA ratings are given on a scale of 1 to 10, with group 1 ratings being the lowest risk in the banking system and group 10 the highest. Between October 2007 and November 2011, i.e. well in advance of the January 2011 revolution and the period of transition to democracy that followed it, the bank risk rating (and, for that matter, the economic risk rating) was already in group 8. In fact, this rating was based on the last joint IMF/World Bank programme for assessing the stability of the financial system (FSAP – Financial Stability Assessment Programme), which has not been updated since 2006 for the assessment, in particular, of compliance with the Basel core principles for effective banking supervision.

Because the FSAP had not been updated at the time, in November 2011 S&P gave the monetary authorities (BCT) a bank risk rating (foreign currency BBB-/Negative/A-3, local currency BBB/Negative/A-3) in accordance with the BICRA mechanism, keeping it in group 8. It did, however, revise the economic risk rating downwards from 8 to 7, considering that the Tunisian economy's capacity for resilience presented an intermediate risk in the management of global imbalances and the conducting of macroeconomic and sectoral policies.

A new FSAP assessment on the stability of the financial system, following a joint mission conducted by the IMF and the World Bank in Tunisia from 11 to 25 January 2012, drew preliminary conclusions on the inherent risks to any unilateral policy of bank refinancing without operational procedures to apply the Basel II risk identification rules, as well as structural weaknesses in the supervision of the banking sector. It was mentioned, in particular, that it would be difficult for the BCT to maintain the same bank refinancing mechanism in the future without the implementation of a real strategy to recapitalise certain banks. Consequently, in its report dated 23 May 2012, S&P revised its BICRA, noting that the risk rating for the banking sector, which remains unchanged at 8, is based on S&P's opinion that the banking sector is facing high risk in its institutional and regulatory framework, as well as high risk in the dynamics of banking competition. It nevertheless held the economic risk rating at 7.

In its report dated 28 June 2012, published in July 2012, S&P once again kept the banking sector risk rating unchanged at 8 but decided to revise Tunisia's economic risk rating of 7 (high risk) upwards to 8 (very high risk), based on its revised assessment of economic resilience. The new argument put forward concerns the risks to the banking sector of negative transmission and contagion due to the weakening of economic perspectives (deterioration in the macroeconomic indicators and the external position).

Lastly, and despite the risk rating for the banking sector remaining unchanged at 8, S&P's most recent updating of the BICRA methodology, in September 2012, allowed the conclusion to be drawn that the intermediate resilience of the monetary authorities in respect of refinancing and supplying liquidity to the banking system must not obscure the need to establish new financial flexibility rules in order to support banks in the event of systemic crisis.

The institutional risks in the banking sector

The insufficient level of regulation during the post-revolutionary period can be explained by inappropriate choices in terms of solvency and non-performing loan classification requirements. In particular, this relates to the direction taken by the monetary authorities in authorising the banks to not classify as unproductive new but doubtful loans arising from credit transformation (rescheduling, consolidation, etc.) granted to the productive sectors.

Besides, the BCT, pursuant to circular no. 2011-04, but contrary to circular no. 1991-24 relating to prudential standards, authorised the banks reschedule non-performing loans without classification. This was in addition to monetary policy measures focusing on a low refinancing cost which were not accompanied by sufficient provisioning against past due debt.

Paradoxically, it was not until January 2012, pursuant to circular 2012-02, which was aimed at credit institutions and whose object was to assess commitments in the context of contingency measures to support economic undertakings, that the BCT invited the banks to constitute supplementary collective provisions against the latent risks related not only to doubtful commitments but also to healthy short-term debt. A circular about which the approved intermediaries had reserves.

The inherent risks to the dynamics of banking competition

The competitive dynamics of the banking sector have been characterised in the post-revolutionary period by the increase in distortions associated with the mobilisation of deposits and the cost of banks' resources. Since the refinancing measures conducted by the BCT on the money markets were unsuccessful in resolving the liquidity crisis affecting the banking sector, anti-competitive practices followed in their wake, associated with overbidding on certificates of deposit and commercial papers, resulting in the same procedures used for institutional deposits being adopted here too. This led to poor margins and equally poor profitability.

II.1.3. The limits of the expansionary fiscal policy in light of the deterioration in public finances

Due to the paralysis of the main driving forces behind growth (external demand and private domestic investment), the boosting of internal demand (private and public consumption) through a countercyclical fiscal policy acting essentially by means of increased running costs (particularly salary increases) and compensation was instrumental in the deterioration in public finances. (Table 15). Fiscal expansion thus resulted in a simultaneous increase in the budget deficit (estimated at 5.9% of GDP in 2013, much more at 7.3% according to the IMF framework, as against 1.1% in 2010) and the public debt (estimated at 51.1% in 2013 as against 40.4% in 2010). In particular, a higher proportion of the public debt was in foreign currency (as a percentage of the total debt), increasing from 58% in 2011 to 61.4% in 2012, and a greater proportion of the public debt was exposed to exchange rate risk.

Thus, in terms of current or operational expenditure, remuneration in the public sector has literally gone through the roof, rising from 6.8 billion dinars in 2010 to 7.7 billion in 2011, with an estimated figure of 10 billion for 2013; in other words, an increase of 47% in three years. Today, this item represents 53.4% of the State's current budget.

As regards own resources, the increase in tax revenue is due only to the rise in income tax brought about by the salary increases and the massive recruitment into the public sector; revenue from VAT and corporate tax on companies in the formal economy fell due to the unfair competition these companies faced from an informal sector that saw unprecedented growth not only in geographical terms but also in respect of sectors of activity and financial capacity.

Conversely, expenditure on investment (or equipment) remained relatively stationary at the level already reached in 2010, i.e. between four and five billion dinars. With certain analysts considering that the latter is therefore disproportionate and insufficient to meet the needs of the interior regions, the delivery rate of the development budget for the 2013 financial year, particularly in respect of investment planned for the interior regions, was no more than 16.9% at end May.

Table 15.
Balance of the state budget (MTD)

	2010	2011	2012	2013 (*)
Own resources and donations	**14822.5**	**16620**	**18562.5**	**19975**
revenue	12698.7	13667.8	15037.8	16650
Non-tax revenue	2123.8	2952.2	3524.7	3325
Borrowing resources	**1859.1**	**3731**	**4764.2**	**6817**
Cash resources	**1226.1**	**399.3**	**-39.5**	**-**
total resources	**17907.7**	**20750.3**	**23287.2**	**26792**
Off Main Estimates	**15443.6**	**18333.4**	**20436**	**23932**
operation	8501.2	9633.4	11020.2	12772
compensation	1500	2869.2	3624.1	4200
Interest on debt	1152	1190.1	1267.6	1360
Equipment	4326.1	4729.4	4768.4	5500
Net lending Treasury	-35.7	-88.7	-244.3	100
Amortization of principal	**2464.1**	**2416.9**	**2851.2**	**2860**
total expenditure	**17907.7**	**20750.3**	**23287.2**	**26792**
primary balance	**530.9**	**-523.3**	**-605.9**	**-2597**
(% of GDP)	0.8	-0.8	-0.8	-3.3
Budget deficit (excluding grants and privatization)	**675.2**	**2303.9**	**3611.8**	**4657**
(% of GDP)	1.1	3.5	5.1	5.9
funding				
Privatization. gifts and forfeited assets	54.1	590.5	1738.3	700
Net domestic financing	851.2	1313.4	553.2	495
Net external financing	-230.1	400	1320.3	3462
Reminder:				
Total debt (% of GDP)	40.4	44.6	44.9	51.1
including:				
(External public debt)	-24.5	-25.6	-27.7	-29.5
(Internal public debt)	-15.9	-19	-17.2	-21.6
Public debt in foreign currency (in% of total debt) (**)	60.6	57.4	62.5	57.8

(*) Forecast (finance law and economic budget)

(**) IMF - Staff Country Report & PIN (2013)

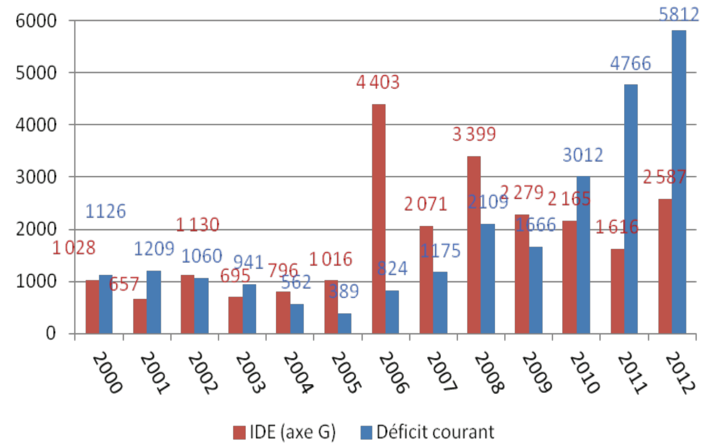
Source: Ministry of Finance (2013). Central Bank of Tunisia (2013) Economic and Budget (2013)

II.2. External fragility factors

II.2.1. The growth of the current account deficit and the shortfall in net capital inflow

The fragility factors affecting external balances are largely associated with the size of the current account deficit (8.1% of GDP in 2012 as against 4.7% in 2010) under the effect of the rise in imports. There was, in fact, a widening of the trade deficit, which rose from 8,298 MDT in 2010 to 11,635 MDT in 2012. In this context, and although the balance of capital flows showed a good recovery in 2012 (with net inflows amounting to 7,830 MDT) after collapsing in 2011 (2,279 MDT as against 2,632 in 2010), it remains clearly insufficient (particularly in respect of FDI) to finance the current account deficit (graph 6).

Figure 6.
Evolution of FDI - versus - current account deficit



Source: BCT (2013)

Table 16.
Evolution of sovereign ratings

Date de modification	*Long-term rating in foreign currency / Perspective / Rating in long-term local currency*		
	Moody's	*Fitch rating*	*Standard & Poor's*
April-95	*Baa3/ -*	*-*	*-*
Sep-95	*-*	*BBB-/ -*	*BBB-/ -*
Sep-96	*-*	*BBB-/ - /A-*	*-*
April-97	*-*	*-*	*BBB-/stable/A*
Jun-99	*Baa3/stable/Baa2*	*-*	*-*
Feb-00	*Baa3/positive/Baa2*	*-*	*-*
Mar-00	*-*	*-*	*BBB/stable/A*
Sep-00	*-*	*BBB-/positive/A-*	*-*
May-01	*-*	*BBB/stable/A-*	*-*
April-03	*Baa2/stable/Baa2*	*-*	*-*
April-09	*-*	*-*	*BBB/stable/A-*
Jan-11	*Baa3/negative/Baa3*	*BBB/negative/A-*	*BBB/negative/BBB+*
Mar-11	*-*	*BBB-/negative/BBB*	*BBB-/stable/BBB*
July-11	*-*	*-*	*BBB-/negative/BBB*
May-12	*-*	*-*	*BB/stable/BB*
Sept.12	*Baa3/negative/Baa3*	*-*	*-*
Dec-12	*-*	*BB+/negative/BBB-*	*-*
Jan-13	*Baa3/negative/Baa3*	*-*	*-*
Feb-13	*Ba1/negative*	*-*	*BB/negative/BB*
May-13	*Ba2/negative*	*-*	*-*
Aug-13	*-*	*-*	*B/negative*

II.2.2. The downgrading of sovereign ratings and the risks of default

a. Account of the motives and evolution of the ratings

In 2011, the main ratings agencies downgraded Tunisia's sovereign ratings or placed them on negative watch. Thus, Standard & Poor's (S&P) downgraded the local currency rating from A-/stable to BBB+ and placed it on negative watch, and affirmed the foreign currency rating of BBB also placing it on negative watch. Moody's Investors downgraded the sovereign rating from Baa2 to Baa3 and placed it on negative watch. R&I downgraded the foreign currency rating from A/-stable to BBB Negative and placed it on negative watch. Fitch affirmed the BBB foreign currency rating and placed it on negative watch.

Nevertheless, Tunisia maintained its investment grade until May 2012 when S&P once again downgraded the country's long-term debt rating in local and foreign currency by two levels, from BBB(-) to BB, as well as that of the Central Bank of Tunisia's issue credit rating from BBB(-) to BB stable, which means that the country is henceforth classed in the speculative category. Conversely, in September 2012 (and then again in December 2012), Moody's maintained the Baa3 rating with negative watch, while, in December 2012, Fitch Ratings downgraded Tunisia's long-term foreign currency debt rating (IDR) from BBB- to BB+ and the long-term local currency IDR from BBB to BBB-. In February 2013, S&P once again downgraded Tunisia's sovereign rating to BB- along with a negative outlook. Moody's immediately followed suit and, in the same period, also re-downgraded the rating of Baa3 to Ba1 with negative outlook, relegating the country to the speculative category. Fitch and R&I also revised their ratings downward. In the month of May 2013, Moody's once again revised Tunisia's rating downwards from Ba1 to Ba2, with a negative outlook. Finally, in August 2013, S&P again downgraded the long-term sovereign rating by two levels, from BB- to B, with a negative outlook.

For S&P, Tunisia's loss of its investment grade essentially means that the agency considers the country to be at risk of being incapable of honouring its external commitments, which implies a potential scenario of payment default on the external debt incurred on the international financial markets, due to the unavoidable increase in the corresponding risk premium. In particular, the downgrading of the rating is especially connected to Tunisia's economic circumstances during the transitional period, insofar as the increase in the trade and current account deficits, dwindling foreign exchange reserves, the increase in external debt stocks, particularly short-term, the resumption of inflationary pressures, the pressure on the budget and public deficits, and the galloping depreciation of the dinar have been highlighted by the financial ratings agency as the main fragility factors. Indeed, elements of vulnerability which had already been highlighted in S&P's assessments throughout 2011.

At the time of its February 2013 press release, S&P also made mention of the fact that, in addition to the exacerbation of the socio-political risks, the fragility of the Tunisian banking sector had reached such an unprecedented degree that the rating of the bonds issued on the international market by the BCT on the State's behalf had been downgraded to the same level as that of its sovereign rating. The agency pointed to several contributing factors, in particular the undercapitalisation of the banks, the failure to apply prudential rules, especially by the public banks, and the level of doubtful debt. Additionally, it pointed to the country's political, security and social situation as justification for the August 2013 downgrading, underlining that the popular legitimacy of the transitional institutions was being increasingly contested, compromising the approval of the new constitution, the holding of elections, the resumption of economic growth and the implementation of reform (banking sector, investment code and tax system).

For Moody's, the decision to initially maintain the Baa3 rating with negative watch was the result of a qualitative assessment based on four main factors – economic soundness, institutional soundness, vulnerability to event risk and financial soundness (understood as that of government and not the banking and financial sector) – as well as the interaction between them. The rating is essentially motivated by a conservative estimate of all these components combined, due to the latent climate of economic uncertainty, security problems, the slow speed of reform and uncertainty about the holding of the forthcoming elections and the results of the poll.

Furthermore, the main vulnerability factors mentioned are associated with the deterioration in growth prospects and the decline in foreign direct investment intentions, since the current account deficit is considered high in relation to the historical average (3.2% over the period 2000-2010). At institutional level, the agency noted that despite efforts in terms of transparency and accountability brought about by the change in the political regime and having led to an improvement in the responsibility indicators, the transitional government's relatively short term of office could result in insufficient coordination and a slowing down of the speed of reform.

Vulnerability to event risk is also seen as moderate due to the decline in unemployment and regional disparities. As regards the government's financial soundness, the negative assessments essentially concern the size of the budget deficit and public debt. On the occasion of the May 2013 downgrading, Moody's pointed to four factors, specifically: the persistent political uncertainty, the risk of instability, the fragility of the undercapitalised public banks and the considerable external pressure on Tunisia's balance of payment and public finances.

Lastly, Fitch Ratings' downgrading of Tunisia's sovereign rating by one level reflects the agency's opinion that the country's economic and political transition is going to be longer and more difficult and the anticipated risks are therefore greater. Furthermore, the twin budget and current account deficits are leading to deterioration in the external public debt ratios. Fitch considers that social unrest

even with monetary tightening, the persistent twin deficits will provide a hard test for the official foreign exchange reserves.....

and political tension persist, alongside uncertainty about the country's political transition. The elections, both parliamentary and presidential, have been postponed. Uncertain economic policies, combined with high oil prices, have driven up deficits. Besides, even with monetary tightening, the persistent twin deficits will provide a hard test for the official foreign exchange reserves.

b. Potential impacts: increased risk of default on sovereign debt and other collateral

The downgrading of the sovereign risk led to an aggravation in the risk of default measured by the credit default swap (CDS) spread. This first consequence was predictable due to the symmetrical and proportional relationship between the sovereign downgradings and the costs of mobilising external funds in foreign currency.

Thus, as an example, at the time of S&P's second downgrading in February 2013, Tunisia's bond rates spread increased by 38 basis points, from 376 bps to 414 bps. It should be noted that the spread had already increased from 121 basis points before the revolution on 10 January 2011 – the date on which the wave of protest began – to 223 basis points in April 2011. Despite the satisfactory outcome of the elections for the Constituent Assembly, the latent climate of economic uncertainty resulted in two further increases in the spread of the rate, the first to 257 bps in November 2011 and then to 376 bps. Since Tunisia's external debt is incurred at an average of 27.8% for bond issues on the international financial markets and 9.5% for private bank loans, the widening of its sovereign rate and risk premium (CDS) spread will certainly have a direct impact in terms of making the planned new mobilisations of external borrowing more costly and tightening the conditions for funding.

Furthermore, with regard to the evolution of the volatility of Tunisian bond issues allowing credit risks to be assessed (EMBI index), the risk premiums have also increased due to the downgrading, reflecting a tightening of the conditions for funding the sovereign debt on the financial markets, which would limit any new issue while making any measures to restructure the debt more complex.

At a time when Tunisia intends to approach the international financial markets with a view to mobilising external financing resources, it is essential that the country recovers its investment grade with a stable outlook in order to obtain financing on favourable terms. The higher cost of credit could make the resolution of Tunisia's problems even more difficult by driving up the budget and external deficits, so the consequences arising from the downgrading of the country's sovereign rating are not limited to the financial markets.

Thus the export credit agencies will impose higher guarantee rates on foreign companies investing in Tunisia as well as lower credit lines. Under such circumstances, there could be a risk of a considerable loss of attractiveness to foreign direct investment, which would lead to a reduction in growth and, consequently, in job creation.

II.2.3. The difficulties in mobilising external financial resources

a. External resources aimed primarily at financing budget and current account deficits

In 2012, Tunisia issued sovereign bonds allowing the mobilisation of 485 million dollars (nearly 730 million dinars) with a seven-year maturity, associated with a coupon of 1.686% per annum under guarantee from the United States Treasury (acting through the intermediary of the US Agency for International Development). In November 2012, the World Bank also granted Tunisia a loan to the value of 500 million dollars (nearly 775 million dinars) under the Governance, Opportunity and Jobs Development Policy Loan programme. In December 2012, the AfBD granted budget support credit to the value of 387.6 million euros (nearly 805 million dinars) to balance the 2013 budget.

Additionally, in May 2012, the governors of the EBRD approved the allocation of one billion euros to an EBRD-SEMED Special Investment Fund relating to the countries along the southern and eastern coasts of the Mediterranean (Morocco, Tunisia, Egypt and Jordan), which joined the EBRD in 2011. Similarly, and despite a context of fragility in the MENA region, the BCT was able, in December 2012, to issue bonds on the Japanese market to

Table 17.
Model of external funding (MTD)

	Achievements			*Projections*
	2010 (a)	***2011***	***2012***	***2013 (b)***
Financing the current account deficit	*1716.6*	*4746.5*	*5307.5*	*5325.0*
Amort. main external debt and other expenses	*3200.0*	*3345.1*	*2974.7*	*2925.0*
Change in foreign exchange reserves (c)	*-130.0*	*-2391.0*	*800.0*	*300.0*
External financing needs	***4786.6***	***5700.6***	***9082.2***	***8550.0***
IDE and holdings	*2400.0*	*1711.3*	*2400.0*	*3000.0*
donations	*113.6*	*217.5*	*612.2*	*424.5*
public debt	*1651.4*	*3104.0*	*2900.0*	*3399.0*
Private debt (commercial & financial)	*621.6*	*667.8*	*3170.0*	*1726.5*
Mobilization of external resources	***4786.6***	***5700.6***	***9082.2***	***8550.0***
External resources mobilized at August 30, 2013				***3329.0***
including:				
Mobilized external debt				***2390.0***
Standby agreement - IMF (d)				*(1190.0)*
PAR3 - World Bank (e)				*(825.0)*
Bond issue - Japan				*(375.0)*
Other (f)				***939.0***
(IDE)				*(823.2)*
(Participations)				*(115.8)*
Requirement for additional external financing (net)				***-5221.0***

Source: Economic Estimates (2013) and Balance of Payments - BCT (2013)

(a) Baseline

(b) Economic Projections 2013 budget

(c) Min. 100 J. Imp.

(d) Given only early drawing made

(e) Given only a commitment not yet disbursed on draft budget additional support

(f) On the basis of the figures available at 30 June 2013 relating to FDI income and portfolio investment in equities.

the value of 25 billion yen (473 MDT) associated with a guarantee from the Japanese Bank for International Cooperation (JBIC) with very advantageous maturity (10 years) and coupon rate (1.19% per annum) conditions.

This effort has been continued in 2013, from three angles; firstly (i) by means of a standby arrangement with the IMF, as a preventative measure, to the value of 2.7 billion dinars (to finance the current account deficit) or 1.7 million dollars; (ii) ongoing negotiations with the World Bank for a second loan of 500 million dollars as further budget support (PAR-3) ; and by (iii) a further BCT bond issue on the Japanese domestic market, in August 2013, to the value of 22.4 billion yen (375 MDT) along with the JBIC guarantee.

Nevertheless, the undeniable efforts made thus far by the public authorities, and by the BCT in particular, enabled funds to be mobilised that are primarily intended to be used to finance the budget and current account deficits. It should be remembered that the external financing requirements for the 2013 economic budget were calculated at 8,550 MDT, over 62% of which (5,325 MDT) to finance the increase in the current account deficit (estimated at 8.1% of GDP in 2012 and 7.9% in 2013, as against 4.8% in 2010), while a sum of 3,462 MDT was set aside for the net external financing requirements of the budget deficit (estimated at 6.8% of GDP in 2012 and 5.1% in 2013, as against 1.1% in 2010).

There follows a paradox known as the Missing Middle consisting of inadequate foreign exchange reserves, corresponding neither to foreign trade operations nor to long-term capital inflow, but to external borrowing for the purpose of financing the twin budget and current account deficits.

II.2.4. Sustainability constraints on the external debt

In light of the extent of the external debt stock (Table 18) during the transitional period, tests on the resilience or strength of its sustainability show, in particular, that its profile is extremely vulnerable to exchange rate instability and especially to real growth shocks.

In effect, the tests focusing on the ratio of external debt as a percentage of GDP using the IMF methodology indicate, in particular, that a permanent negative growth shock (3% instead of the 4% forecast) increases the external debt by 4% of GDP (Graph 7). It should be noted that, by contrast, a shock combined with real depreciation of 30% and a 10% deterioration in contingent liabilities in relation to GDP would increase the public debt to 12% of GDP (Graph 8).

Otherwise, the short-term external debt faces high refinancing risks since the gross foreign exchange reserve stocks do not provide sufficient cover for all the short-term commitments (55% of the short-term debt in 2012 as against 137.7% in 2007).

II.2.5. Exchange rate depreciation

By May 2013, the exchange rate of the euro, the reference currency for the Tunisian economy, had depreciated by almost 10% over two years, standing at 2.16 dinars as against the May 2011 rate of 1.96. At the same time, the dollar exchange went from 1.377 dinars to 1.619 dinars, a depreciation of 15%. When it passed the symbolic barrier of two dinars, the dinar's parity with the euro prompted controversy aimed at blaming exogenous factors for the dinar's depreciation.

It is true that in response to the sovereign debt crisis in the eurozone, the implementation of the European Financial Stabilisation Mechanism with an unprecedented bailout budget, along with the programme for the European Central Bank to repurchase public debt securities, resulted in an appreciation of the euro starting in the final quarter of 2011, and which became all the more pronounced in the wake of the second Greek bailout approved by the Eurozone Heads of State.

Nevertheless, the international context cannot be held solely responsible for the appreciation of the euro against the dinar. While the value of Tunisian dinar may be determined on the interbank market, the floating exchange rate regime with no predetermined direction or official fluctuation range actually allows the Central Bank of Tunisia (BCT) to make discretionary adjustments since they are based on a basket of currencies whose composition and weighting have not been made public.

In fact, after the revolution of 14 January 2011, the BCT continued to follow the same exchange rate policy adopted in early 2000 and, above all, the same proactive, deliberate policy of competitive over-depreciation of the dinar. The argument constantly put forward revolves around the two questions of (i) support for exports and (ii) correction of productivity deficits that the Tunisian economy has accumulated in relation to its main European partner. This strategy has become counterproductive in light of the endogenous causes associated with the size of the trade and current account deficits, very poorly compensated by the capital account due to the slowing down of foreign direct investment and the portfolio flows, and having mechanically set in motion a continued over-depreciation of the dinar exchange rate in nominal terms.

Moreover, the real exchange rate is no longer based on the fundamentals

According to the IMF's CGER (Consultative Group on Exchange Rate Issues), the real effective exchange rate is no longer based on the fundamentals. In particular, according to the macroeconomic balance approach, it should depreciate further by more than 6.7% to compensate for the swelling current account deficit during the transitional period.

Conversely, according to the external sustainability approach, the stabilisation of Tunisia's position, in terms of net external assets, to its pre-2010-crisis

Table 18.
External debt (% of GDP)

	2010	2011	2012	2013 (*)
External debt	37,1	38,8	39,9	na
including:				
(External public debt: State) (**)	-24,5	-25,6	-27,7	-29,5
(Other econ agents. Nonfinancial)	-12,6	-13,2	-12,2	(na)
External short-term debt	10,6	14,5	15,9	na
Total external debt (% of GDP) (*)	47,7	53,3	55,8	na

(*) Projections (IMF, 2013).
(**) Calculated on the basis of outstanding external debt in the medium and long term with the excluding credit institutions.

Figure 7.
Negative growth shock (in% per annum) on the external debt

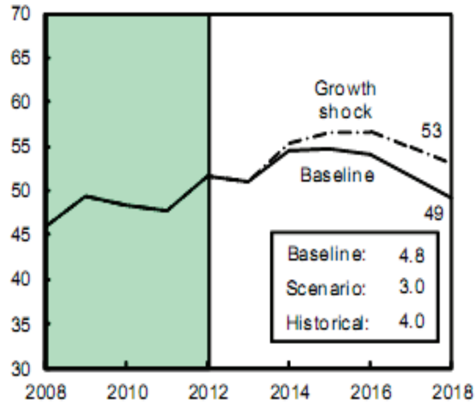
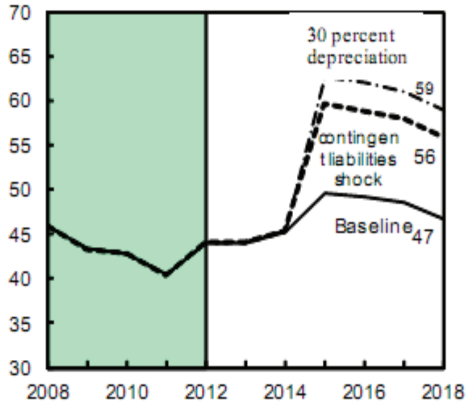


Figure 8.
Combined impact of real depreciation and contingent liabilities on the public debt (*)



Source: Baseline scenario using the data from the IMF's 2013 Article IV consultation report

(*) One-time real depreciation of 30% and 10% of GDP shock to contingent liabilities occur in 2013, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

level, would require the real effective exchange rate to depreciate by at least 1%. In other words, despite the sharp nominal depreciation of the dinar against the euro (and the dollar), it remains overvalued in real effective terms by an average of 5.1% in respect of the fundamental balance.

Parity protection constraints

During the second half of 2012, the BCT reformulated the operational framework of the Tunisian dinar foreign exchange policy. Prior to this, the BCT had actually been intervening daily, for information purposes, to correct the value of the nominal effective exchange rate in a range of 1% between the buying and selling rates of the dinar in relation to the main foreign currencies.

Recently, a more flexible active management of the exchange policy has been introduced, insofar as the BCT now calibrates its reference exchange rate on the basis of the average interbank market exchange rate and not on a fixed basket of currencies. It intervenes on the exchange market by means of bilateral transactions when the market prices deviate considerably from the daily fixing. This is how the BCT attempted to sustain the dinar exchange rate by means of repeated interventions on the exchange market, in order to adjust the inflation differential in relation to its main trade partners in the light of internal inflationary pressures.

The potential consequences?

The direct result would be a rise in stocks denominated in dinars servicing the debt incurred in euros especially, as well as a rise in mobilisation costs for new external borrowing.

In effect, since the breakdown by currency of the medium- and long-term external debt stands at around 63% in euros (with the Japanese yen at 16%, the US dollar at 13% and the remainder in a variety of currencies), and since the majority – over 70% – of servicing payments are also denominated in euros (nearly 9% for the Japanese yen, nearly 14% for the US dollar and the remainder in a variety of currencies), Tunisia is suffering exchange losses on its debt servicing resulting in appreciation of the euro and, to a lesser degree, the dollar against the dinar.

Similarly, the depreciating exchange rate also contributes to higher prices on imported intermediate goods (1 TND invested corresponds in value to around 0.750 TND in imports) and, consequently, to imported inflation (pass-through effect). This is, therefore, one of the explanations for Tunisia's chronic trade deficit.

Conversely, on the stock market, the depreciation of the dinar has very little impact due to the fact that floating capital makes up a negligible proportion (2.5%) of foreign shareholdings (nearly 20%). Consequently, there is no risk of capital flight.

II.2.6. The juxtaposition of the risks of contagion and negative transmission from the international environment

Tunisia's economic and democratic transition is occurring in a post-Arab Spring international context marked by latent dysfunctions that compromise the recovery of external demand and the means to mobilise financing resources:

- √ A recurring economic recession, especially in the eurozone, with a deceleration of unprecedented dimension in EU imports (+2% in 2012 as against +9.5% in 2010),
- √ A marked slowing down in international trade: reduced growth in 2011 (+5%) and 2012 (+3.7%) in the wake of the sharp acceleration in 2010 (+13.8%). A very poor growth forecast in 2013 (+1.6%),
- √ A resumption of inflationary pressures due to the rising prices of raw materials and hydrocarbons,
- √ A sovereign debt crisis, with spill-over effects on bank fragility and credit dynamics.

III. Resilience capacity in the medium-term and reform priorities

The challenges posed by the closure of the budgetary period for the current year (2013), and for which the exit strategy will depend in the first instance on a political consensus on the remainder of the schedule for this third (and final) year of transition, will essentially concern emergency measures and, especially, (i) the option to convert short-term external debt into own funds (FDI) or grants or, possibly, rescheduling it; (ii) the use of available international guarantees to attempt a supplementary bond issue; (iii) the consolidation of the low tourist season; (iv) the vital resumption of production potential in the mining industry; (v) the rationalisation of the vital recovery of tax revenue; and (vi) the stabilisation of the dinar at its historical pre-crisis value.

Nevertheless, were Tunisia to achieve political stability, she could develop her resilience and capacity to rebound by implementing a package of medium-term structural reform. In this context, she should particularly focus on (i) innovation as a factor of inclusive growth. Other than the revision of the development mechanism in general and the questions of spatial and financial inclusion, innovation is effectively a crucial factor in the new sought-after dynamic of inclusive growth; and (ii) the creation of greater opportunities for private investment through public-private partnerships (PPPs).

A framework of subsidies for greater social equity

The current social security mechanism does not seem to be working in terms of attenuating inequalities and reducing poverty in Tunisia. The safety nets and the system of food subsidies are in fact inadequately targeted to be able to combat poverty effectively. Data from the most recent national survey on budget and consumption show that Tunisian households received 888 million dinars in food subsidies, but only 107 million dinars benefited poor households. Thus, the families benefiting most from the social transfer and social assistance programme are the less needy ones. Consequently, only 9.2% of subsidies are reaching the poorest households, with 60.5% going to middle class families, 7.5% to the wealthy population and 22.8% being transferred away from households (cafés, restaurants, tourists, illegal cross-border trade), i.e. 262 million dinars. While poor families represent almost 15.5% of the Tunisian population, they are receiving only 9.2% of the total amount set aside for subsidies.

The subsidy is therefore being distributed unequally between the poor and non-poor. This focal question lies at the heart of the vital reforms needed in the subsidy and social transfer systems. A recent study on 'the performance of the subsidy system in Tunisia' thus proposed that the universal nature of the compensation and food subsidies (independent of earnings) be replaced by a more targeted model to ensure a reduction in poverty.

Restructuring of the banking system

In order to radically circumvent the constraints associated with the banking system's overall lack of liquidity, the option of recapitalising certain banks (especially public ones) is under study. In particular, a full pre-audit has been instigated for three public banks which are estimated to need 3.2 billion dinars (the equivalent of 5% of GDP) in additional own funds for recapitalisation and to improve their management methods. For the banking sector as a whole, and according to the last FSAP (IMF – World Bank) from 2012, recapitalisation will require heavy funding estimated at approximately 7% of GDP.

Tax reform

The revision of the tax system is an import issue for the forthcoming period. An analysis of the data on comparable or more developed countries shows that Tunisia's tax regime, similar to that of other southern European countries, has a major flaw. It penalises employment through hefty social security contributions (graph 9). Similarly, while the tax burden is relatively moderate, (consolidated) corporate income tax is high. It should also be noted that the number of taxes in Tunisia is relatively high in comparison to the tax regimes in other countries (graph 9 bis).

In addition to the ongoing reform of the investment code, greater flexibility in the exchange rate regime to attract more external investments brings us back to our initial assessment. The financial market's lack of attractiveness for foreign investment in equity and bond portfolios comes down to three factors: (i) an as yet excessive exchange control for foreign investors on the main and alternative equity capital markets on the stock exchange; (ii) low amount of authorised capital available to foreign investors on the stock exchange bond market; and (iii) tax provisions which have become restrictive in terms of capital gains realised by foreign investors.

In effect, the current exchange regulations on the main and alternative equity capital markets on the stock exchange include only the following measures for loosening exchange controls for foreign investors. Since 1997, investments in equity portfolios conferring voting rights no longer require approval from the Commission Supérieure d' Investissement (Higher Investment Board) (which could do with reformatting) but for listed companies they are liberalised only to the extent of 50%.

Conversely, in Morocco and Egypt, foreign investors may hold up to 100% of the equity of listed companies and there are no other restrictions on sectoral choices. In Tunisia, certain sectors are closed to foreign investment, such as distribution, property and the financial sector (except where authorised by the BCT). Foreign shareholding in the automotive industry, for example, is capped at 30%.

The following have been introduced since 2005: (i) foreigners may freely acquire shares in Tunisian companies from each other; (ii) full convertibility of the Tunisian dinar for regular capital transactions by non-residents on the condition that they make investments in Tunisia by importing currency; and (iii) the complete liberalisation of underlying transactions (including SICAVs) and portfolio investments in the form of shareholdings in non-financial sectors. However, these measures have proven still to be insufficient in boosting the market due to the restrictions of right of access, considered, at 50%, still to be insufficient in comparison to other emerging markets, which does explain why, over recent years, foreign participation in market capitalisation has amounted to a lowly 21.7% on average, compared to that of comparator and emerging countries.

At the same time, several other restrictions are still in place affecting the amount that foreigners can invest on the stock exchange bond market. The exchange regulations set forth certain measures loosening exchange control for foreign investors. Effectively, since 2003, foreign investors have been allowed to acquire government bonds with a 5% limit on each line, with a guaranteed transfer of funds invested in this manner. In 2005, the authorised amount was increased to 10% of issues and was even extended at the same rate to non-resident foreigners allowing them to subscribe, by means of currency imports, to each bond issue made by companies listed on the stock exchange or having obtained a rating. In 2007, the bond market was further energised when the amount that foreigners could invest in government bonds and bonds issued by resident or rated companies was increased to 20% per issue.

Nevertheless, apart from the restricted access for foreign investors to the primary market via the primary dealers in government securities, even with an increase in the authorised amount it will not be possible to attract foreign capital until such time as the secondary market of public and private debt securities becomes more developed. Furthermore, non-residents require approval to invest in public debt securities, government bonds and debt issued by resident companies and are restricted to the limit dictated by the regulations, i.e. 20% of each issue, which considerably reduces remittances and undeniably makes it more difficult for the income balance to finance the current account deficit, as is the case with Morocco, for example.

Consequently, and as regards the progressive loosening of exchange control, the following strategic plan prioritising monetary targets is essential for greater attractiveness to foreign investment. The priority targets for this first stage could be the following:

√ Measures capable of being taken immediately to finalise the implementation of the complete liberalisation of the current account.

√ Loosening of the limits on amounts and the restrictions applicable to transfers to cover accommodation costs abroad for residents.

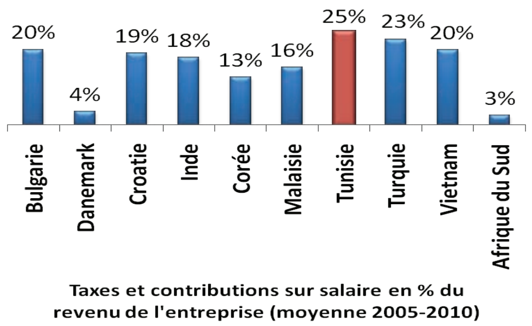
√ Lifting of the ceilings imposed on resident export and non-export companies for transfers to cover the financing of representation or liaison offices abroad, subsidiaries or branches, as well as for investments financed by their income from exports deposited in business accounts.

√ Faster liberalisation of the capital account by prioritising capital flow in the medium and long term and, in particular, foreign direct investment in non-financial sectors by non-residents in Tunisia, long-term debt incurred abroad by companies listed in Tunisia, and investments by non-residents in government bonds denominated in dinars.

√ Higher limits on the amounts that foreigners (non-residents) are allowed to invest in debt securities (or government bonds) issued by the State or bonds issued by resident companies listed on the stock exchange or which have a rating (to above the current limit of 20% of each issue).

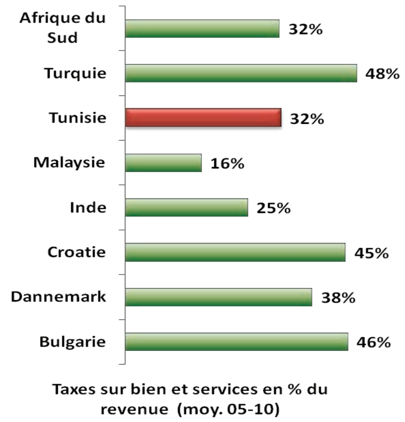
√ Gradual liberalisation (raising of ceilings) on trade and financial credits incurred abroad by credit establishments and other resident undertakings.

Figure 9.
Indicators of taxation



Source: World Development Indicators, World bank (2011-2012)

Figure 9b.
Indicators of taxation



Source: World Development Indicators, World bank (2011-2012)

√ Immediate intervention of Islamic products and windows (especially sukuk).

Raising the level and quality of the financial system's intervention and deepening capital markets

The current level of saving is insufficient to give new impetus to investment and economic growth. Similarly, and in light of the low level of capital accumulation, the density of the informal sector and the still relatively high level of poverty, the financial system is faced with a number of demands for which it is not yet adequately prepared. The fundamental problem for the SMEs/SMIs is that of access to credit due to the guarantees required and the high interest rate.

If one takes into account the high concentration of risks typical of the banking system, particularly the public one, another problem which is just as important is the poor long-term funding raised, for example, through insurance companies, pension funders, lenders or on the financial markets. As for the informal survival sector, the problem is the availability of microcredit which would make it possible to meet minimum funding requirements for a number of viable production units to appear.

Similarly, the improvement of financing conditions and the mobilisation of internal sources of funding can be optimised. A Deposits and Consignments Fund (Caisse des Dépôts et de Consignation – CDC) set up in 2011 after the revolution serves to complement the capital investment solutions offered by the SICARs and the Venture Capital Funds (FCPR). At the same time, a new law on microfinance was enacted in 2012. Nevertheless, the additional mobilisation of long-term funds may be permitted by the sovereign wealth funds for the funding of medium- and long-term lending. In this respect, moreover, new regulations governing sukuk and Islamic windows will be completed in 2013.

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Notes:

(*) The author would like to thank Chedly Ayari, Governor of the Central Bank of Tunisia, for his pertinent remarks. This work also benefited from the useful comments made by Mohamed Salah Souilem, General Manager for Monetary Policy. The author is, of course, solely responsible for the

analyses and opinions expressed in this report.

1. In 2010, the authorities adopted a new system of national accounts in order to conform to the United Nations' system of national accounts, by revaluing the figures of the main macroeconomic aggregates to current prices, i.e. GDP, gross fixed capital formation, consumption, investments, savings, etc. The overall effect of introducing the new system was to increase the nominal GDP figures by around 10% every year. Consequently, the statistics relating to the aggregates at constant prices are henceforth calculated on the basis of the previous year's prices, and particularly the overall growth of real GDP which is no longer calculated using a fixed base year (chain weighting).

2. While the economic budget (2013) initially projected a growth rate of 4.5%, the forecast was revised downwards twice, the first time to 4% in May 2013, following the negotiation of a standby arrangement with the IMF (2013), and then again in August 2013, this time to 3.6%.

3. Production in the mining sector slowed as a result of constraints that prevented optimal exploitation of reserves (sit-in, union demands, etc.)

TURKEY

Domino effect fuelling unrest in a rocky economic environment

Introduction

Despite being immune to the political unrest in neighboring Mediterranean economies since late 2010, Turkey witnessed massive protests in mid-2013. Protests started at the end of May 2013, environmentally-driven by a small group of young protesters in Taksim Square, blocking the removal of trees in Gezi park. Yet, the government's confrontational and violent response to the protests has triggered further and more widespread protests which lasted for around three weeks. Even though these protests have calmed down, these developments have increased polarization and more importantly pose the questions of their implications on future political and social stability. The political uncertainty hovering around the country makes it also more difficult for the economy to recover, especially under the current global market developments.

On the backdrop of the current events, the economic outlook for 2013 is as follows:

- √ ***Growth*** *is expected to be between 3-4%, up from 2.3% in 2012.*
- √ ***Current account deficit*** *is expected to widen further, reaching 6.8% of GDP compared to 6% of GDP in 2012.*
- √ ***Budget deficit*** *is also forecasted to expand, increasing from 2.1% of GDP in 2012 to 2.5% of GDP in 2013.*
- √ ***Inflation*** *is estimated to ease down to 7.4%; still above the central bank 3-7% target range, yet declining from 8.9% in 2012.*
- √ *Turkey might need to defend the Turkish lira, given the expected* ***capital outflows*** *on signs that the US Federal Reserves will taper its loose monetary policy.*
- √ ***Fiscal and monetary policy*** *measures need to support growth without fuelling another boom in domestic demand, exerting additional pressures on the current account.*

I. A 2012/2013 economic snapshot

I.1. Real Sector and Inflation Developments

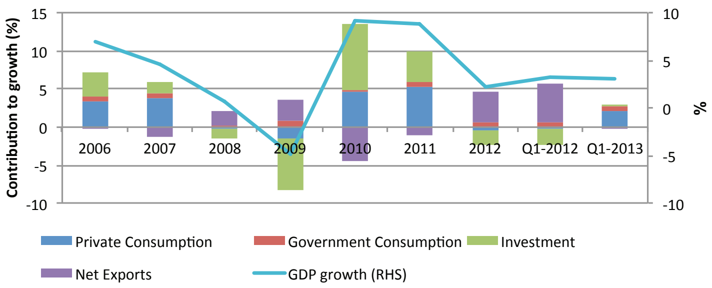
a.Growth loses momentum in 2012

Real growth in Turkey witnessed a sharp deceleration in 2012, going down to 2.3% as opposed to 8.8% in 2011. This deceleration can be explained by subsiding base effect and tighter monetary policy. As opposed to recent years, domestic demand did not drive growth in 2012 on the back of the tighter monetary policy stance. The decline in both private consumption (by -0.7% compared to 7.7%) and the investments (by -7.4% compared to a growth of 16.7% in 2011) accounted for a total contribution to GDP of -2.4 percentage points from overall growth, the first time since 2009.

The contraction in investments occurred despite the introduction of new investment incentives scheme in 2012, comprising of tax breaks, interest rate subsidies, research and development (R&D) support, as well as special support for investments in strategic sectors, large scale schemes, and in specific geographic regions. Alternatively, the main growth driver in 2012 was net exports, as exports rose by 17%, contributing to growth by 4.1 percentage points, while imports remained unchanged.

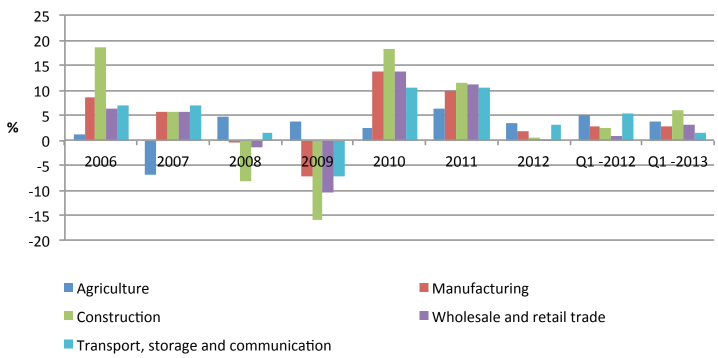
In Q1-2013, GDP expanded slightly by 3.3%, compared to 3% in Q1-2012 but there was a change in

Figure 1.
Contribution to GDP growth, FY03 to 6M-FY13



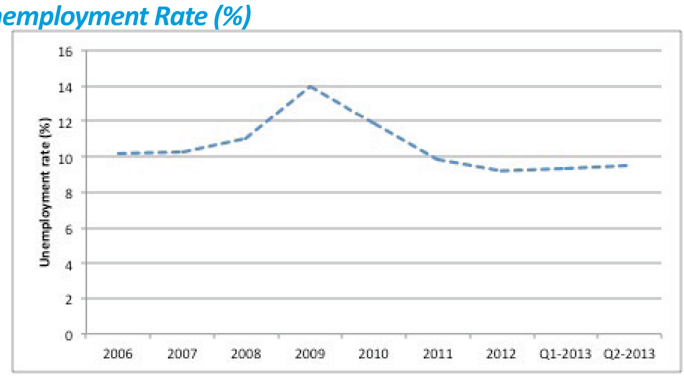
Source : TurkStat

Figure 2.
Sectoral Growth (%)



Source : Central Bank of the Republic of Turkey (CBRT)

Figure 3.
Unemployment Rate (%)



Source : TurkStat

the drivers of growth. On the one hand, domestic demand became once again the primary contributor to growth (101.6%) on the back of a surge in public consumption by 7.2%. Private consumption and investment also grew by 3% and 1.1%, respectively in Q1-2013. On the other hand, growth of net exports was 1.4%, contributing to growth by -1.6%. Analyzing growth from the sectoral perspective shows that the largest sectors in the economy decelerated in 2012, compared to 2011. For instance, growth in the manufacturing sector, which accounts for slightly less than quarter of the economy, declined from 10% in 2011 to 2% in 2012. In addition, transport, storage and communication, the second largest sector in the economy (about 15%) decelerated from 10.5% in 2011 to 3.2% in 2012. Meanwhile, agriculture which makes about 9% of the GDP grew by 3.5% in 2012, as opposed to 6.2% in 2011. During Q1-2013, growth in the manufacturing sector remained almost unchanged at 3%. Meanwhile, transport, storage and communication as well as agriculture decelerated, as growth in the former declined to 1.5% in 1Q-2013 from 5.9% in 1Q-2012, while agricultural growth fell to 3.6% from 5.2% in 1Q-2012.

b.Unemployment declines despite growth deceleration

With the sharp drop in GDP growth in 2012, employment growth declined from 6.7% in 2011 to 2.9% in 2012. Surprisingly, unemployment eased from 9.8% in 2011 to 9.2% in 2012. Yet, the first two quarters of 2013 show that unemployment inched up again, to 9.3% in 1Q-2013 and 9.5% in 2Q-2013.

The decline in unemployment reflects a similar trend in both male and female unemployment which respectively decreased from 9.2% and 11.3% in 2011 to 8.5% and 10.8% in 2012. Even though employment growth is higher among females (at 4.8% in 2012, compared to 2.2% for males), employment rates are still very low among women in Turkey. Employment rate among females in Turkey is the lowest in the OECD, as the OECD average was 57% in 2010 while it was 26% in Turkey .

Unemployment also declined both in urban and rural areas in 2012. Urban unemployment declined to 11.1% in 2012, from 11.9% in 2011. Meanwhile, rural unemployment came slightly down to 5.5%, from 5.8% in 2011.

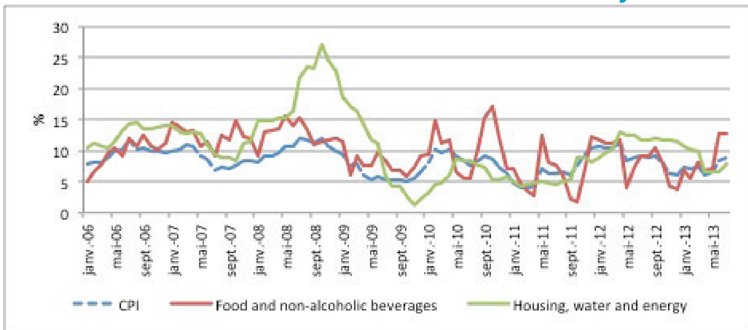
Compared to other countries, the softened impact of recent economic crisis on the Turkish labor market could be attributed to several reasons. The first is a labor market reform program that was implemented in 2008, prior to the crisis that aimed at reducing non-wage labor costs and helped set the basis for expanding active labor market programs. Second, the government introduced a crisis response package in 2009 that focused, among other objectives, on employment. In addition, at the beginning of 2011, legislative reforms were introduced to extend the scope of the incentives introduced in the 2008 scheme, especially with regards to incentives to hire women and youth, and social security contributions for self-employed women.

Finally, a "National Youth Employment Action Plan" (NYEAP) was announced at the end of 2011, with the aim of increasing the employment of disadvantaged groups in the labor market, namely, youth and women. The Action Plan, prepared by the Turkish Employment Organization (İŞKUR), consists of concrete measures to be implemented by İŞKUR until 2015 to increase youth employment, and strengthen the link between education and employment.

c.Inflation

After easing down to 6.5% in 2011, inflation jumped to 8.9% in 2012 which is well above the Central Bank of the Republic of Turkey's target of 5% with a 2 percentage points target band. Inflation increased for most CPI components, as food and non-alcoholic beverages, the largest component of the CPI (24.1%) increased from 6.3% in 2011 to 8.5% in 2012. In addition, inflation of housing, water and energy (the third largest component of the CPI, 16.7%) rose from 5.8% in 2011 to 11.4% in 2012. On the other hand, transport for instance, which accounts for 18% of the CPI, declined from 10% also in 2011 to reach 7.7% in 2012.

Figure 4.
Inflation rate



Source: TurkStat

In the first seven months of 2013, inflation eased again to 7.4%, down from 9.8% in the same period last year. The decline reflects lower food price inflation which declined from 9.5% in 7M-2012 to 8.6% in 7M-2013. Inflation fell in all CPI components, except health services, communications, and hotels, cafes and restaurants. The largest decline was witnessed in furnishing and household equipment, which fell from 10.7% in 7M-2012 to 4.6% in 7M-2013, as well as recreation and culture which fell from 7.1% to 1.6%, in the same respective periods.

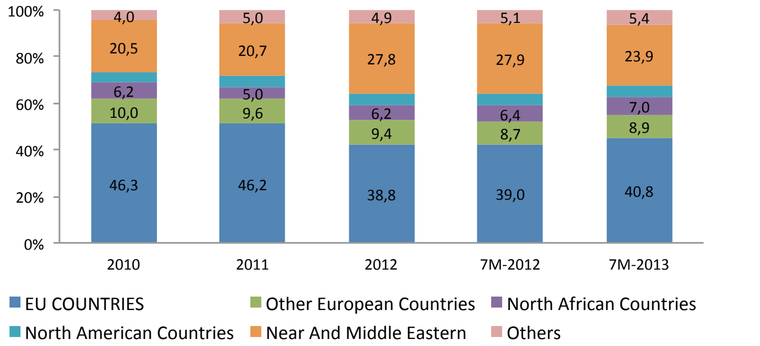
Inflation is likely to remain within the Central Bank's 3-7 percent target range this year unless there is a significant further depreciation in the Lira and/or administrative prices hikes in the remainder of the year.

I.2. External Sector

a.Trade deficit improves following waning domestic demand

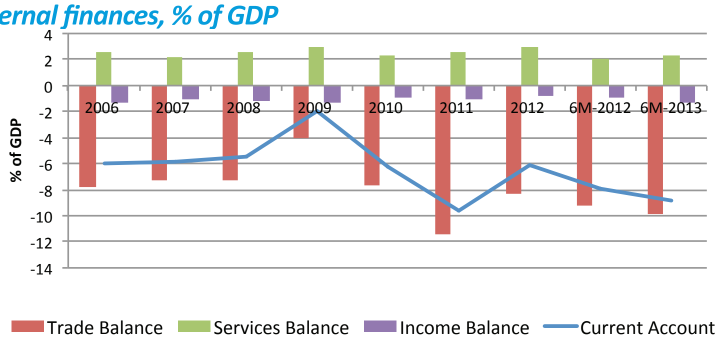
The current account deficit narrowed in 2012, going down to 6% of GDP from 9.7% in 2011. This decline mainly reflects an improvement in the merchandise balance. The merchandise trade deficit has declined to reach 8.3% of GDP in 2012, from 11.5% in 2011, on the back of soaring exports (from 18.5% of GDP in 2011 to 20.7% in 2012),

Figure 5.
Geographical Composition of Exports (% of Total)



Source : TurkStat

Figure 6.
External finances, % of GDP



Source : CBRT

while imports were cut by one percentage point of GDP (from 29.9% in 2011 to 28.9% in 2012).

It is worthwhile to note that Turkey succeeded in diversifying its export market destinations in 2012. Reduced European demand for Turkish exports (from more than 55% in 2011 to 48% in 2011 for all European countries) was compensated by a higher export share to countries in the Middle East and North Africa (from 25.7% of exports to 34%). This makes Turkey less susceptible to downturns in the Euro region.

In the meantime, the services surplus marginally expanded to 2.9% of GDP in 2012, from 2.6% a year earlier, and income balance deficit declined from 1% of GDP to 0.8%.

This trend was not maintained in 2013, as current account deficit slightly widened from 8% of GDP in 6M-2012 to 8.8% of GDP in 6M-2013. The increase in the current account deficit came on the back of an increase in the trade deficit, which rose from 9.2% of GDP in 6M-2012 to 9.9% of GDP in 6M-2013. On the other hand, the effect of the rising trade deficit was slightly offset by an expansion in the services surplus, which rose from 2% of GDP in 6M-2012 to 2.3% in 6M-2013.

Suppressed demand lead to a short term improvement in the CA picture, yet this is not expected to be maintained as domestic demand accelerates. According to the IMF, current account deficit in Turkey is mainly driven by industrial production in the long run and to a lesser extent by domestic consumption . So the recent adjustments in CA probably respond to short run factors, rather than long-run improvements in CA dynamics.

b. Capital Account

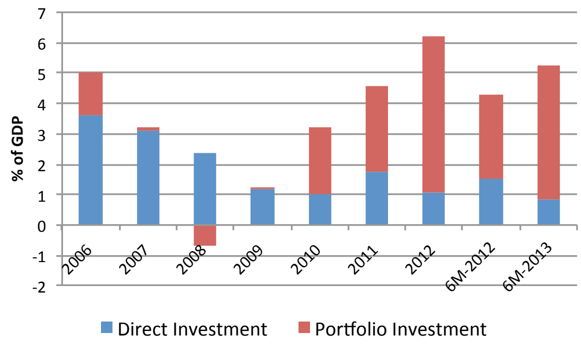
Portfolio investments, which are the main financing item of the current account, have increased from 2.8% of GDP in 2011 to 5.2% in 2012 and further in the first six month of 2013, to 4.4% of GDP (up from 2.8% in 6M-2012). In addition, foreign direct investments have declined in 2012 and the beginning of 2013. In 2011, FDI accounted for 1.8% of GDP, falling to 1.1% in 2012, while it was 1.5% of GDP in 6M-2012 but decline also to 0.9% of GDP in 6M-2013.

Due to the low national savings rate; which has fallen from 25% of GDP in the late 1990s to less than 15% of GDP in 2011 ; Turkey has been highly dependent on foreign financing for its investments. This makes it vulnerable to sharp global pro-cyclical movements, resulting not only in high volatility in investments, but also in output and economic growth. Any worsening in the economic situation in the Euro zone or a decline in investors' appetite for emerging markets would lead to economic fluctuations in Turkey. Turkey's gross external financing needs are projected to reach USD221.1 billion in 2013 (up from USD182.4 billion in 2012), exceeding 25% of GDP. High external needs are projected to persist during the medium term.

The government has been trying to introduce private pension reforms to encourage private savings, replacing tax incentives for private pensions with direct government contributions. Reforms were a positive step towards increasing private pension participation, as participants in the system increased by 14% in the first 6 months of 201 . Yet, according to the IMF (2012a), the savings gap is too wide to be bridged by these measures alone.

Throughout 2012, the main three international credit rating firms adjusted the credit rating for Turkey several times. In May 2012, Standard & Poor's cut the outlook for Turkey's 'BB' sovereign credit rating from positive to stable, citing risks about external demand and terms of trade, as well as the country's high debt as the reasons for the change in outlook. On the other hand, in June 2012, international rating firm Moody's upgraded Turkey's government bond ratings by one notch, from Ba2 to Ba1, while maintaining a positive outlook. The investment upgrade was on the back of improvement in Turkey's public finances, and policy actions taken addressing external imbalances. In addition, in November, Fitch upgraded Turkey's long-term foreign currency issuer default rating (IDR) from BB+ to BBB-, and its long-term local currency IDR from BB+ to BBB, putting Turkey at investment grade for the first time since 1994. Further upgrades were also witnessed in 2013, when Standards & Poor's raised Turkey's sovereign credit rating to 'BB+', up from 'BB', one notch below the investment grade in March 2013. Moody's also upgraded the country's government bond ratings by one notch in May 2013, from Ba1 to Baa3, assigning a stable outlook on improvements in key economic and public finance metrics, as well as progress on structural and institutional reforms that are expected to reduce existing vulnerabilities to shocks in international capital flows .

Figure 7.
Capital Flows (% of GDP)



Source: CBRT

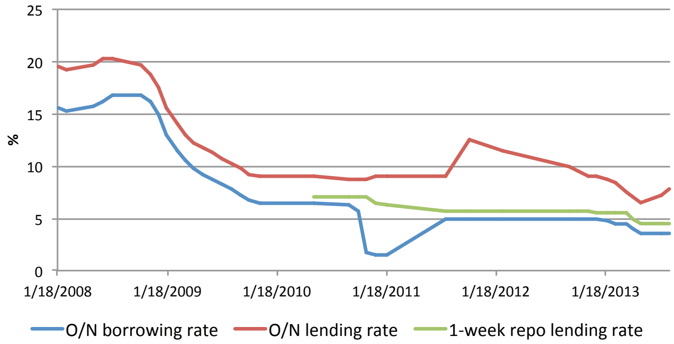
I.3.Macroeconomic Management

a. A tighter monetary policy stance is adopted in late 2013

In light of creeping inflation and downside risks to the lira, the Central Bank continued to pursue its unorthodox policy mix introduced in late 2010 which aims at managing excess liquidity in a context of volatile capital flows and a large interest rate spread. This mix relies on the policy instrument together with new measures which have the aim of better managing excess liquidity through the reserve requirements ratio a set of repo facilities and the width of interest rate corridor. According to the CBRT, this policy mix should help achieve two goals: price and financial stability.

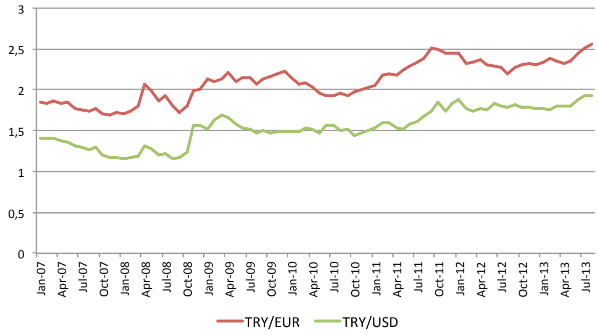
In this context, the CBRT had embarked on a loosening cycle since February 2012 in order to prompt weak economic activity, decreasing the overnight lending rate (the upper limit of the so-called interest rate corridor) from 12.5% to 11.5%. In support to this stance, the overnight lending rate was reduced once again in September 2012 from 11.5% to 10%. It was also reduced again twice in the following two months, by 50bps each time, going down to 9%. In December 2012, the cor-

Figure 8.
Policy Rates (%)



Source : CBRT

Figure 9.
Exchange Rate



Source : CBRT

ridor between the overnight and lending rate was reduced and moved downwards in several gradual steps during the first two quarters of 2013, from 5%-9% to 6.5%-3.5%. The one-week repo rate was also cut in December 2012 for the first time in 16 months by 25 bps to 5.5% and twice consecutively by 50 bps each in April and May 2013 and is now left at 4.5%.

Between July and August 2013, the overnight lending rate was raised by a total of 125 bp, up from 6.5% to 7.75%. Meanwhile, the overnight borrowing rate was kept at 3.5% since May 2013.

The CBRT has been inflation-targeting since 2006. Yet, with this new framework, it has also been adjusting its monetary stance according to capital inflows, in order to maintain a stable exchange rate. The CBRT tightens its monetary policy whenever the exchange rate comes under pressure , which might feed into inflation. In addition, its unorthodox mix has made it difficult for market participants to form inflationary expectations. The CBRT conducts a survey twice a month on people's inflationary expectations, and data shows that with the implementation of the new framework, the link between inflationary expectations and inflation targeting has been broken down, as expectations have remained flat.

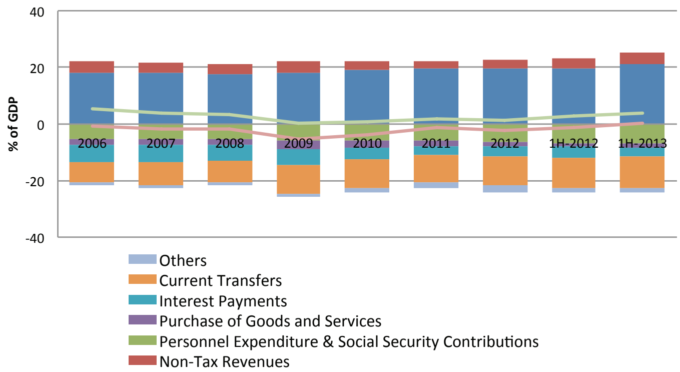
In 2011, the Turkish Lira has depreciated by 14.1% against the Euro and 9.8% against the USD. The Turkish Lira continued to weaken against the USD in 2012 (depreciating by 7.3%), owing to Turkey's large current account deficit and falling interest rates. Meanwhile, it fluctuated against the Euro, slightly appreciating on average (by 0.4% in 2012).

Between January 2013 and August 2013, The Turkish lira depreciated by around 10% against both the USD and the Euro. This reflects some uncertainty in the foreign exchange markets following anti-government protests in late May. Starting on 11 June, the central bank has intervened in the foreign exchange market to support the lira.

b. Fiscal Policy

The budget deficit widened to reach 2.1% of GDP in 2012, up from 1.4% in 2011 and compared to an original target of 1.5% of GDP. This comes on the back of rising public expenditure, from 23.6% of GDP in 2011 to about 25% of GDP in 2012. all expenditure items rose expect for purchases of goods and services); with the largest increase in current transfers (increasing by 0.8 percentage points from 9.5% of GDP in 2011 to 10.3% of GDP in 2012). This reflects a rise in personnel expenditures – an increase in both the number of permanent staff and wage indexation – and in transfer to state-owned enterprises as a results of delayed price adjustments in the energy sector. In the meantime, revenues grew slightly from 22.2% of GDP in 2011 to 22.8% in 2012, despite the adoption of an additional revenue-creating package of about TRK (10 billion or x% of GDP) that was adopted in October 2012 which included tax hikes in automotive, tobacco products, fuel as well as energy price increases. Tax revenues remained almost unchanged, while non-tax revenues increased by 0.5 percentage points (from 2.6% of GDP in 2011 to 3.1% in 2012).

Figure 10.
Public Finances (% of GDP)



Source: CBRT

On the other hand, the first half of the year 2013 witnessed an improvement in fiscal performance, turning a budget deficit of 1.1% of GDP into a budget surplus of 0.5% of GDP in the first half of 2013. The main reason behind this increase is a sharp rise in tax revenues, as tax revenues edged up by 2 percentage points, from 19.4% of GDP in 1H-2012 to 21.4% in 1H-2013. This lead to an increase in revenues from 23.5% of GDP in the first half of 2012 to 25.1% of GDP in 1H-2013. Meanwhile, expenditures remained constant at 24.6% of GDP in both years.

The budget deficit is expected to range between 2-3% in the medium term. The government is expected to keep a tight stance on fiscal policy, in order to maintain a low level of public debt, and to avoid fuelling inflation or a larger current account deficit through higher domestic demand.

II. Long-term challenges

II.1. The process of democratization is not a done deal

For the last 60 years Turkey has been formally governed "by a multi-party parliamentary system with competitive elections". The democratic process was regularly interrupted during the 1960s-1980s era, with a military coup in 1960, pressures in 1971 that led to parliament dissolution and a second coup in 1980. A common parameter after each of these incidents is that basic political freedoms were suspended. In more recent decades however, despite witnessing two economic crises (in 1994 and 2001), the path towards democratization was ongoing (FEMISE 2005).

As noted by Önis (2013), the new Turkey is in some respects more democratic than the old Kemalist Turkey. Perhaps most importantly, one notes an important decline in the influence the military exerts in internal politics. Meanwhile, the country is now more democratic "in terms of its ability to accommodate difference or diversity based on claims for recognition of different religious and ethnic identities".

Yet, in key areas the impetus of the desire for democratization has deteriorated during the later years. Some note that a "civilian tutelage" replaced the old "military tutelage", meaning the country has not necessarily become more democratic in total, with the introduction of new elements of exclusion. Controls over the press, lack of tolerance for opposition, the failing of the judicial, the overly long imprisonment of military officers and journalists are there to show the limitations of the democratization process in Turkey (also see Table 1).

Unfortunately, the year 2013 was a step-back for Turkey. The oppressive treatment of demonstrators in Istanbul in May triggered three weeks of mass protests that escalated into violence and led

Table 1.
Turkey's Democratization Process (1999-2010): Major Achievements vs. Limitations

Achievements	Limitations
Death penalty abolished	*The reformist spirit of the AKP in its first two terms waned*
National Security Council reformed	*The dominance of the ruling party limits the space available for political completion and genuine pluralism in the political and social spheres.*
A New Civil Code adopted	*The weakness of the opposition parties creates a loop-sided political contest*
Broadcasting in other languages other than Turkish	*Unfavorable external conditions weakens the hands of pro-democratization groups*
Rights of community foundations extended	*The democratic opening plunged into deadlock*
Anti-terror law revised. A civilian appointed as the secretary general of the National Security Council	*Significant concerns over restrictions over the freedom of expression and the autonomy and fairness of the judicial process. The pressure over judiciary and media tended to increase*
State Security Courts abolished	*Concerns about creeping authoritarianism of the government are exacerbated*
State television started broadcasting in different languages including Kurdish	*Domestic politics turned into a more conflict-driven and antagonized sphere; elements of continued polarization across the political spectrum*
Democratic opening initiated in 2007	*The maximalist demands of pro-Kurdish party turn into a stumbling block in solving the Kurdish problem*
A more pluralistic approach adopted toward Kurds, Alleviates, and non-Muslim groups	*PKK terrorism renders difficult the normalization of the domestic political agenda*
Substantial reforms introduced on judiciary, civil-military relations, privacy of individual life by a referendum in 2010	*Attempts to side-track the on-going constitutional process towards the institutionalization of a presidential system with weak checks and balances, with the explicit objective of increasing the power of the executive over the legislature and the judiciary*
Attempts to deal with memories of the authoritarian past through the trials of the key generals involved in the coup of September 12, 1980 and the " post-modern coup" of February 28, 1997	
The recent "peace process" introduced by the government created a significant element of hope that the Kurdish problem can be resolved in Turkey, although the successful completion of the process is confronted with serious hurdles. A peace process which does not go hand in hand with the democratic process is unlikely to have a lasting impact and is likely to be reversible	

Source: Önis, Ziya (2013)

to polarization of the Turkish society. There are genuine fears that the Turkish society could be moving towards a more conservative direction. Relations with Western allies have worsened and so have relations with portfolio investors after recent criticisms towards them (EIU, 2013). A likely future possibility in the Turkish political scene would be for Prime Minister Erdogan to stand down from his duties in order to run for president in August 2014. This will strongly depend on "whether Turkey adopts a new constitution, as promised, and whether this will enhance the powers of the president, as Mr Erdogan and his supporters hope" (EIU, 2013). Whatever the case, the process of democratization, that took a hit in recent years, needs to be put back on track. The country needs to avoid a deepening of social and political polarisation and not throw away past efforts for more inclusiveness.

II.2. Low savings remain a major risk

Among the key structural challenges of the Turkish economy one finds the low savings rate, which contributes to the existence of the large current account deficit. Following weakening private sector savings, total savings have been declining. As a result dependence on external sources has been on the rise, the savings-investment gap has been increasing and so has the current account deficit. While the latter seems to have been partially lessened, it still represents a risk and "substantial dependence on external financing leaves the economy vulnerable to any slowdown in capital inflows" (IDBG, 2013).

What the authorities need to understand is that low domestic saving endangers the sustainability of high growth rates. If Turkey wishes to recapture the growth momentum of yesteryear it needs to realize that increasing the share of domestic financing of growth can be an important means of mitigating external vulnerability. There are three potential transmission channels from low domestic savings and high external financing to lower growth (World Bank, 2011) :

√ For credit-constrained SMEs with very limited means of external financing, lack of domestic saving lowers investment and consequently growth of the economy.
√ For larger firms investor sentiment may also decline, in case of a sudden financing stop, further discouraging investment and growth.
√ Inflows of foreign capital impact the local currency; the latter appreciates adding pressure on profitability and competitiveness of tradable sectors.

A study by the World Bank (2011) has shown the existence of a robust positive association between capital inflows and economic growth in Turkey. More precisely, a shock to capital flows (sudden stop) would produce "large fluctuations in output through both direct and indirect channels". The reduction in capital inflows would reduce investment resources. Meanwhile, currency depreciation would worsen the balance sheets of firms that have high foreign exchange exposure. As a result, both investment and output would be hardly hit. A capital inflows slowdown is thus always likely and the recent criticism against portfolio investors could prove harmful. As noted by EIU it has coincided "with a shift in expectations regarding global liquidity, which has put severe pressure on the Turkish lira, pushing up domestic market interest rates and hitting share prices" (EIU, 2013).

II.3. Financial inclusiveness improving

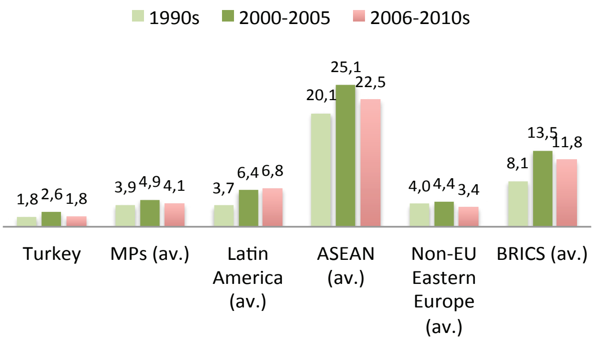
The integration and labour dynamic of Turkey has been progressively improving (though the situation for the youth did not considerably change according to the FEMISE 2012 report) and remains above what one observes in other MPs. Likewise, the social dynamic has improved though the mean years of schooling and expected years of schooling remain below the MPs average (see box with selected structural indicators).
Meanwhile, the level of financial inclusion in Turkey is considerably higher than the average regional level for most of the indicators used. But, due to Turkeys' size and level of development we should also compare with indicators of financial inclusion in European economies; in this case Turkey still has some road to travel.

The percentage of people with an account at a financial institution is roughly double the MPs average (57.6% versus 30.8%) though still below the Euro average (90.5%). Compared to MPs the percentage of women in Turkey with access to an account is higher (32.7% versus 20.5%) though considerably lower than the Euro average (88.8%). There also appears to be no exclusion vis-à-vis the Turkish youth with 43.8% of them having an account (on average only 21.2% of MPs youth have an account) while the less wealthy (bottom 40%) are surprisingly well included (50.8% of them have an account versus only 19.1% for MPs on average).

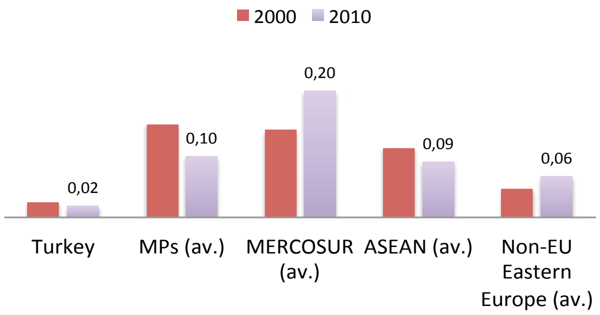
TURKEY VERSUS THE WORLD: A GLIMPSE AT SELECTED STRUCTURAL INDICATORS

Figure 11.
Integration dynamic (selected indicators)

a. High-tech. exports (% of manuf. exports)



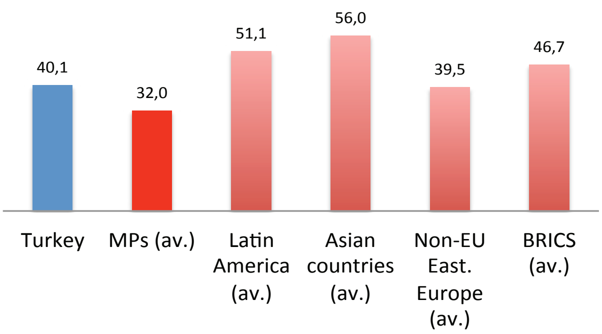
b. Trade Concentration Index



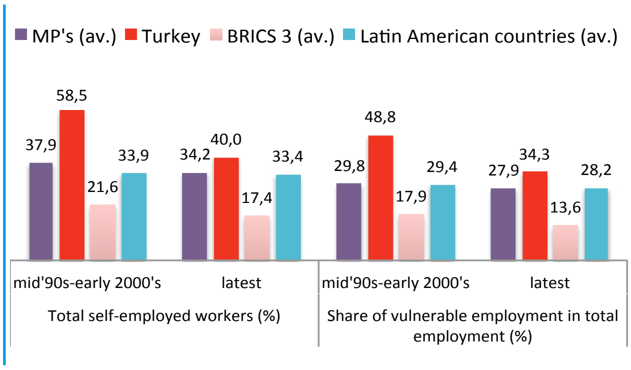
Source: WDI, FEMISE calculations using Tradesift and Comtrade data, based on SITC rev3 3-digit data.

Figure 12.
Domestic labour market dynamic

a. Labour force participation rates, 15-24 (%)

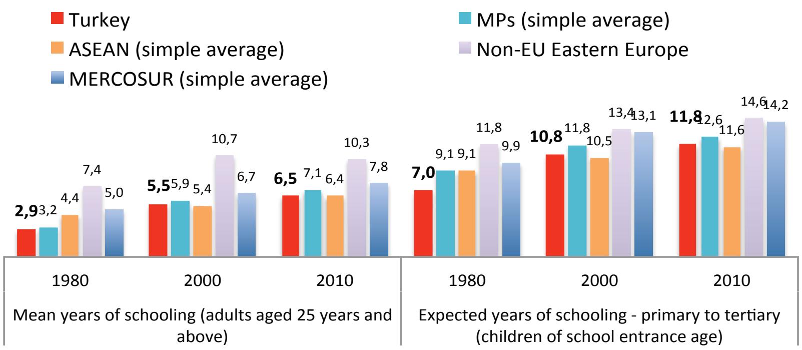


b. Informality and quality of employment



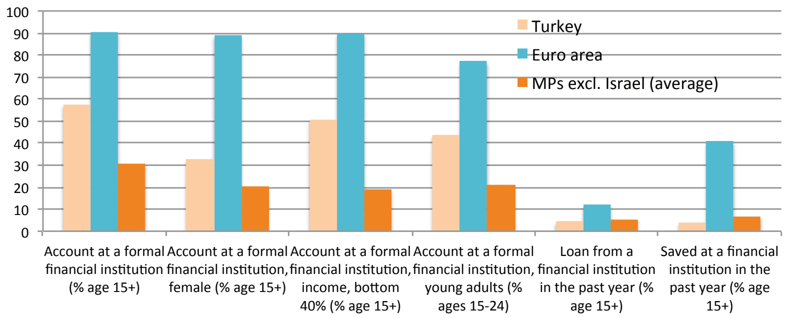
Source : IMF, World Economic Outlook database and EIU

Figure 13.
Social dynamic that improved
(selected indicators)HDI components related to schooling



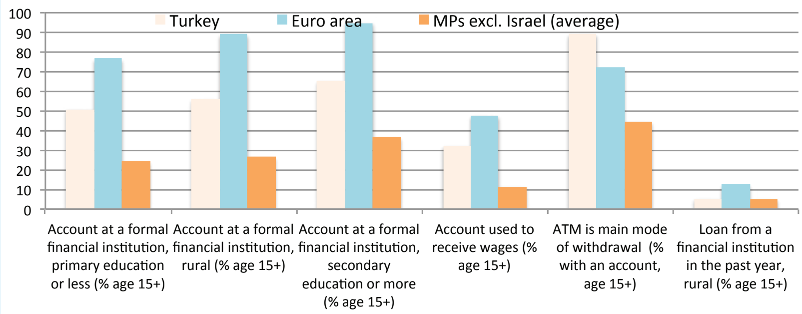
Source : IMF, World Economic Outlook database and EIU

Figure 14.
Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

Figure 15.
Seconde set of Indicators of Financial Inclusion, latest year (2011)



Source: Global Findex (Global Financial Inclusion Database), World Bank

However, it is interesting to note that there is a relatively low percentage of people that took a loan (4.6% versus 5.6% for MPs and 11.8% in Euro countries). Moreover, we should note that the share of the population that saved at a financial institution is relatively low as well compared to both MPs and Euro countries (only 4.2% versus 6.9% for MPs and 40.9% for the Euro area).

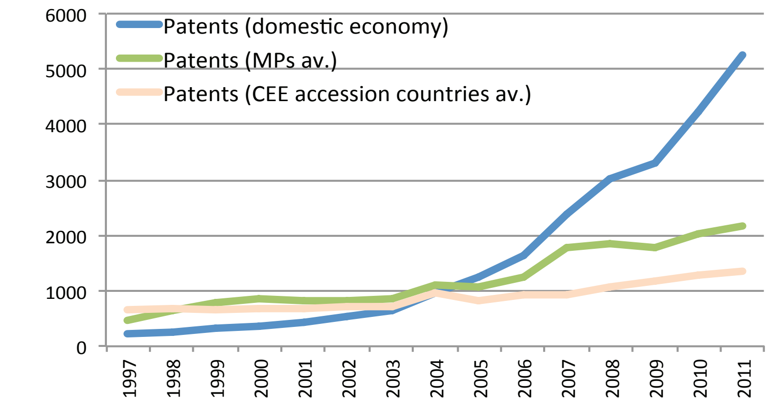
An additional set of indicators shows that for 89.1% of the population ATMs are the main mode of withdrawing money. This figure is not only well above the MPs average level, it is also higher than the Euro average of 71.9%, suggesting that in this respect the population is better integrated and used to a more "modern" means of withdrawing (taking also into account that 56.6% are in possession of a debit card versus 19.1% for the Mediterranean on average, though only 1 out of 3 women in Turkey have a debit card) while it also suggests effective banking sector outreach. Second, the more educated are more used to having an account, though there is still one third with a secondary level of education without an account. Lastly, exclusion in rural areas is not as marked as in other MPs though compared to the Euro area the share of the rural population with a recent loan is quite low (5.4% versus 12.5%).

II.4 Widespread culture of innovation but mixed results on innovation output

Turkey has been implementing innovation policies before many other Mediterranean neighbours, for at least two decades. Generous public support has been provided with a recent focus on technological entrepreneurship in Turkish SMEs and the commercialization of their research output. Aiming to expedite the process of converting technology into profit, the Technology and Innovation Support Programs Directorate (TEYDEB) was established to fund the technology development and innovation activities of firms. Over 1995-2009, 4752 firms applied to the programme and submitted more than 10000 R&D projects, of which, roughly 60% were supported. The applicants to the TEYDEB program, which are SMEs but also some larger firms, select one of the following technology groups according to their projects' focus: (i) machinery and manufacturing technologies, (ii) electrical and electronics, (iii) information technologies, (iv) materials, metallurgical and chemical technologies, or (v) biotechnology, agriculture, environmental and food technologies. The qualified projects are supported by means of non-reimbursable grants covering 50-60% of their eligible expenses in a matching fund scheme.

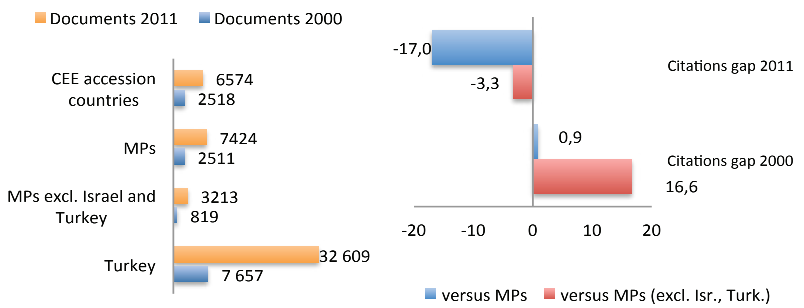
With such important initiatives, since 2004 there have been considerable policy shifts in Turkey. One notes (FEMISE FEM35-18, 2013) : (i) significant in-

Figure 16.
Intellectual property indicator: number of patents



Source: World Intellectual Property Organization

Figure 17.
Journals and country scientific indicator:
a) No of documents (2000 VS 2011) ***b) Citations per Document gap* (%)***



Source: SCImago Journal & Country Rank (SJR)
** FEMISE calculations based on SJR, the index measures in percentage terms how many more/less citations per document the country receives when compared to the regional average. Ex. a value of -10 means that the country receives 10% less citations per document compared to the MPs average.*

creases in public support to business R&D, (ii) a diversification of direct support programmes for private R&D and innovation tailored to the needs of potential innovators, (iii) a widening of the scope of existing fiscal incentives for private R&D activities and the implementation of new ones, and (iv) the implementation of new call-based grant programmes targeted at technology areas and industries based on national priorities.

In terms of results obtained on innovation-output one notes that:

√ When looking at the share of high-technology exports in manufacturing exports (an indicator of the presence or lack of innovation), Turkey's performance is limited; the country has achieved a lower share (1.8%) compared to the rest of MPs.

√ The number of patents was initially very low, but after the mid 2000s it marked a considerable increase and is now above the average regional level as well as above the CEE countries level.

√ Likewise, the number of trademarks has seen a tremendous expansion and the number of industrial designs has also skyrocketed since the start of the decade.

√ The number of articles published by Turkey is high. But, the number of citations received per document is now slightly below the MPs average.

Results on the output of innovation appear mixed. A recent FEMISE study tries to shed more light on the impact of government support for the development of private sector innovation. Its findings in the case of Turkey indicate that government support does contribute to higher firm-level innovation expenditure, which in turn improves chances of introducing product innovations. In the case of Turkey, innovation support from the EU (less than 2% of the total public support in Turkey) has also been a significant incentive for the innovation activities of Turkish firms. The study also notes that "while the EU-supported R&D projects are all based on international collaboration, only 1.5 % of R&D and innovation projects supported by national programmes are of a collaborative nature". Existing mechanisms should be strengthened and new policy instruments should be developed to ensure better efficiency of the current innovation support (see also recommendations).

III. Conclusion and recommendations

Turkey's economy rests on strong economic foundations as it has reacted well in face of the global economic crisis. Yet, it has some structural issues that it needs to address in order to decrease its vulnerability to the external economic environment, and to maintain strong economic performance. Turkey needs to adopt policies to increase its domestic savings rate, in order to decrease its dependence on external financing. External financing needs are expected to exceed 25% of GDP in the medium term, which poses significant risks on the economy, especially under the current global uncertainties. Any changes in the external economic environment will lead to high variations in capital flows and thus domestic demand, output and economic activity in general. Fluctuations in capital flows also put the Turkish lira under risks, posing risks on international reserves, since the CBRT resorts to its international reserves to defend the TRY whenever pressures on exchange rate grow.

Turkey has been successful in diversifying its export markets, as exporting to the Middle East and North Africa has allowed it to increase its exports despite the current crisis in Europe. This decreases the risks stemming from reduced demand of European consumers, as well as the weakening of the Euro, which amounts for a large share of Turkish exports' profits. Nonetheless, Turkish exporters still need to improve their competitiveness to reach more emerging markets. The government needs to focus its investment incentive scheme on strengthening its competitiveness, especially in the production of imported intermediate goods, in order to loosen the pressure on the current account deficit. Improving competitiveness would also attract FDI to the country. In 2007-2011, EU countries accounted for 72% of FDI in Turkey. Even though FDI are more stable than other types of flows and less vulnerable to external economic downturns, the Turkish government should target FDI inflows from more markets to diversify its sources of capital flow.

Also, higher-quality education at all levels will be needed with particular emphasis also on lifelong learning. The development of lifelong education programmes is a priority to upgrade labour market skills for the existent workforce. Meanwhile, vocational schools should co-operate with the business sector in developing generic skills. Developing the teaching of English should also be prioritized. Labour market reform should also be continued. One notes i) the need for a new and more flexible labour contract to be negotiated with social partners, ii) the severance payment regime should be re-designed for more flexibility in labour contracts and iii) employment prospects of vulnerable groups can be reinforced with social security contribution cuts. Lastly, among the priorities on competition and product market reforms we should stress that i) in network industries with a monopolistic tendency (energy, telecommunications) competitive segments should be fully opened to competition, ii) energy liberalisation plans should be fully implemented and iii) competition conditions across all main sectors of the economy should be monitored. Such reforms could boost domestic output and incomes by as much as 25% relative to a baseline scenario by 2030 (Gönenç et al, 2012).

> ***Any changes in the external economic environment will lead to high variations in capital flows and thus domestic demand, output and economic activity in general...***

Meanwhile, government support to firm innovation needs to be improved, this means (FEMISE FEM35-18, 2013):

- √ existing mechanisms should be strengthened and new policy instruments should be developed both for universities and the private sector in order to increase the number of collaborative R&D and innovation projects and to encourage the participation of EU support programmes.
- √ local support for innovation seems to be less efficient and this needs to be further assessed.

Local governments may lack the necessary know-how to carry on the central policy. In this case their infrastructure could need strengthening and their monitoring needs to be more efficient.

√ the effectiveness of the recent increase in fiscal incentives for private R&D and innovation should also be investigated. Funding agencies and local authorities need to collect more details in order to observe the individual effects of various national programs.

Lastly, the current democratization challenge is also an opportunity. Provided political consensus is achieved, a new Constitution could help strengthen liberal democracy in Turkey. For the time being the resolution of two issues is key:

√ consensus needs to be reached regarding the implementation of secularism. If achieved, it would facilitate genuine pluralism in Turkey.

√ a compromise is needed on “the meaning of the territorial unity of the Turkish state, especially with regards to the rights of the Kurdish citizens”. The Constitution can recognize the political rights of the Kurdish citizens, which should allow for some “devolution or de-centralization of political authority, in the direction of regional authority” (Onis, 2013).

All this could help Turkey recapture its recently lost “Mediterranean role model” position in the current volatile post-Arab Spring regional context.

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