

ECONOMIC MANAGEMENT UNDER FIRE

Ahmed Galal

Ishac Diwan
Hoda Selim

Ibrahim Elbadawi
Zafiris Tzannatos

Jala Youssef



FEMISE Euromed Report 2017



FEMISE Euromed Report 2017

ECONOMIC MANAGEMENT UNDER FIRE

Ahmed Galal

Ishac Diwan
Hoda Selim

Ibrahim Elbadawi
Zafiris Tzannatos

Jala Youssef

ECONOMIC
RESEARCH
FORUM



منتدى
البحوث
الاقتصادية



Funded by the
European Union



First published in 2017
FEMISE and ERF

Copyright © FEMISE Association

This report received financial support from the European Union through the FEMISE project on “Support to Economic Research, studies and dialogues of the Euro-Mediterranean Partnership”. Any views expressed in this report are the sole responsibility of the authors.

Contents

Preface	iv
Introduction	1
Chapter One: Economic Consequences of the Transition	7
1.1 Introduction	7
1.2 Macroeconomic Balances	10
1.3 Economic Growth: Actual	17
1.4 Economic Growth: Potential	21
1.5 Conclusions	24
Chapter Two: Macroeconomic Policy Response	31
2.1 Introduction	31
2.2 Understanding the Austerity versus Stimulus Debate	32
2.3 Fiscal Policy Response	36
2.4 Monetary Policy Response	44
2.5 Fiscal and Monetary Policy Consistency	56
2.6 Conclusions	58
Chapter Three: Social Policy Response	65
3.1 Introduction	65
3.2 Social Development	67
3.3 Response to Social Demands	72
3.4 Assessment of the Social Response to Date	83
3.5 Conclusions	87
Chapter Four: The Political Transition and Economic Development	91
4.1 Introduction	91
4.2 Transition Challenges, Politics and Institutions	93
4.3 Regime Evolution in the Arab Countries	96
4.4 The Evolution of the State and Fiscal Policy	100
4.5 The Growth Process and the Evolution of State-Business Relations	105
4.6 Macro-Management During and After Regime Changes	111
4.7 Conclusions	114
Chapter Five: Changing Course	121
5.1 Introduction	121
5.2 Restoring and Sustaining Macro-Balances and Economic Growth	122
5.3 Towards More Effective Social Protection and Social Mobility	126
5.4 Twinning Economic Reform and Politics	128
5.5 A Possible Role for External Actors	130
5.6 Conclusions	132

Preface

In selecting the topic of this year's Euro-Med report, it was difficult not to focus on macroeconomic management in South-Med countries. The uprisings that stormed Tunisia in December 2010 and spread thereafter to other countries in the region were associated with serious economic downturns, worrying macro imbalances and rising poverty. At the same time, aspirations for a better quality of life were intensely high among the populations. Policymakers in transition countries have had to strike a balance between meeting these aspirations and ensuring that their economies fare well in the future. This report is about assessing their efforts in navigating the transition and making suggestions for a better future.

The report focuses on five countries: Algeria, Egypt, Jordan, Morocco and Tunisia. It deals with economic management of the transition from different perspectives: macroeconomic management, economic growth and employment, social concerns, and political developments. While the analysis is mostly positive in nature, the report concludes with a normative chapter, prescribing a better way forward.

The key findings of the report are summarized in the introduction, and will not be reiterated here. Instead, I would like to take this opportunity to thank the contributors to the report. Without their hard work and insights, it would not have been possible to put this report together. I also want to thank the European Commission for the continued financial support to FEMISE over the years. This support enabled FEMISE to create a community of researchers and policymakers with deep interest in sustainable development across the two shores of the Mediterranean. Finally yet importantly, I want to thank Anita Saxena for her excellent editing of the report, Namees Nabeel for ably handling the copy editing, and Maryse Louis for managing the process.

This report received financial support from the European Union through the FEMISE project on "Support to Economic Research, studies and dialogues of the Euro-Mediterranean Partnership". Any views expressed in this report are the sole responsibility of the authors.

Ahmed Galal
Former President, FEMISE
January 2017

Introduction

After a long period of political stagnation, the South-Med region is finally seeing the beginnings of political and economic transformation. The uprisings began in Tunisia, at the end of 2010, and spread soon thereafter to Egypt, leading to the ousting of Bin Ali and Mubarak who had ruled their countries for decades. Other neighboring countries have seen a gradual political opening (Morocco and Jordan), or have fallen into mired conflict (Syria, Libya). Algeria has retained its previous regime, although the 19 year-long state of emergency has been lifted. Lebanon has suffered the spillover effects of the Syrian conflict, but its political system has remained essentially the same.

More than six years later, progress on the political front has been partial and uneven. In Tunisia and Egypt, the uprisings have led to the downfall of their autocratic rulers, giving way to the election of new presidents, the adoption of new constitutions and the election of new parliaments. Social and political tension still reigns in both countries, however, and frequent changes in government are common. A new political settlement is yet to be reached.

In Morocco and Jordan, the rulers have retained their hold on power, but have been compelled to adopt certain reforms. Morocco has amended its constitution to grant more power to the parliament and has called new parliamentary elections. In Jordan, the King has dismissed several cabinets and has promised economic and social reform. In Algeria, as noted above, no major changes in leadership or the political system have occurred. And while Lebanon has managed to maintain a tricky balance between different sectarian groups, Syria and Libya are still struggling to find a political settlement. Today, the overall picture of the region is far from settled, and political instability is manifest in the form of protests and sometimes violent clashes.

Beyond the boundaries of transition countries, the regional context is dominated by geopolitical tension and conflict. In Syria, the transition is turbulent and has been tragic in terms of loss of life, the displacement of people and the destruction of the country's institutions and physical infrastructure, not to mention the damage wrought to the social fabric of society. The conflict in Syria has had

significant negative spillover effects on Jordan and Lebanon, and even on some EU member countries. To a lesser extent, the violence in Libya has had an adverse impact on Tunisia. And since 2014, the decline in oil prices has begun to cast a shadow over the economies of oil exporters (such as Algeria) and, to a lesser extent, oil importers (such as Jordan and Egypt) with important ties to the GCC. Beyond the turbulent domestic and regional contexts, the global environment remains subdued, as advanced economies are only slowly recovering from the global financial crisis of 2008.

Expectedly, the political transition, coupled with regional and global adversities, has taken a toll on the economies of the South-Med countries. Macroeconomic conditions have deteriorated, most visibly in terms of growing macroeconomic imbalances, sluggish economic growth and rising poverty. South-Med economies, which had gradually been recovering from the global financial crisis of 2008, experienced an immediate drop in their GDP per capita growth to 0.4% in 2011, after having reached around 2 percent during the years of the global financial crisis and even higher levels of close to 4 percent during 2003-2008. Unemployment rose sharply in Egypt and Tunisia (to above 12 percent), and more alarmingly among the youth, to above 35 percent.

Concerning macroeconomic balances, pressures have intensified as governments have had to succumb to popular demands in an attempt to calm rising social unrest. Due to the erosion of fiscal space prior to the onset of the

political transition, budget deficits and public debts have crept up to averages of 9 and 50 percent of GDP respectively. Also, current accounts have come under significant pressure, rising to 9 percent of GDP on average, as a result of declining tourism receipts and, in some cases, growing trade deficits. Meanwhile, political instability has triggered capital outflow, which in many countries has led central banks to drain foreign reserves in order to maintain fixed exchange rate regimes; subsequently, financial buffers have dried-up. During the early years, weak macroeconomic imbalances were reflected in repeated downgrades of sovereign ratings and in higher sovereign borrowing costs. GDP per capita in South-Med economies began to pick up modestly as from 2012, with an average of 1 percent between 2012 and 2014. Yet, despite the passing years since the uprising, growth has yet to recover to pre-crisis levels, amid claims that the political crisis may have damaged long-term/potential growth. Moreover, in some South-Med countries, such as Egypt and Tunisia, macroeconomic imbalances have persisted. As these have been left unaddressed since 2011, they have considerably eroded financial buffers and have most likely undermined macroeconomic resilience. If they persist further, they may threaten fiscal and external sustainability. In addition to these short-term problems, the long-term challenges for the region remain as pressing as ever, including insufficient job creation, high unemployment (especially among the youth), low private sector development and rising

levels of poverty and inequality. Throughout the transition, policymakers in the South-Med economies have faced enormous challenges, with the need to reignite economic growth while restoring macroeconomic balances. They have been under pressure to respond to urgent social demands and yet have limited resources due to declining tourism receipts and remittances and to increasing capital flight. They are required to build stable political institutions, while their term in office is too short. It was also hoped that they would begin to establish a solid foundation for a modern, prosperous and politically open state, and yet they have faced strong demands from rebels for immediate gratification.

The trade-offs involved in pursuing different priorities, and the policies required to tackle them, make the task even more problematic. For example, a priority on resolving macroeconomic imbalances would require austerity measures, yet these would likely give rise to contractionary effects on output. Alternatively, adopting expansionary policies (through increased government expenditure or tax reductions) to reignite growth might seem reasonable, but fiscal expansion would put pressure on the government budget and would increase public debt, which might hinder long-term growth. Focusing on reducing poverty and inequality would appear to be consistent with rebel aspirations, but resources during transition are typically in short supply. Post-transition governments have also faced the additional problem of very short terms in office, not to

speak of questioned legitimacy.

In an attempt to evaluate the transition experiences to date, this report takes stock of the economic and social consequences of the political transition/shock in South-Med countries, assesses the policy responses to ameliorate their effects and offers some recommendations for the future. It focuses on the short term and on how different countries navigated the transition during the Arab Spring. In this sense, it complements a number of recent works on the economics and politics of the Arab Spring (e.g., Diwan and Galal, 2016, Amin, et al, 2012, and Muasher, 2014), which tended to focus on long-term development issues. The report specifically attempts to answer the following questions:

- What were the immediate economic consequences of the political transition in South-Med countries?
- How well did policymakers respond to the economic and social adversities associated with the political transition?
- Based on the analysis and the likely political evolution of these countries, what can be done to promote healthier macroeconomic balances, job creation and greater social inclusion?

Coverage of the Report

The report focuses on five South-Med transition countries: Algeria, Egypt, Jordan, Morocco and Tunisia. Libya and Syria were left out because the first order of business for these countries is to reach a political settlement. Lebanon is a special case among the South-

Med countries in that it has not experienced the kind of transition discussed in the report; it also has a specific political set up that deserves special treatment in its own right.

Nevertheless, the five countries analyzed in this report are quite diverse regarding the size of their economy and population, as well as in their level of economic development. Egypt has by far the largest population, around half of the total population of the five countries, and more than 13 times the size of the Jordanian population. All five economies belong to the middle-income group, but income disparities are apparent. As an oil exporter, Algeria has the highest GNI per capita, while the per capita income of Jordan and Tunisia (above USD 4,000) surpasses that of Egypt and Morocco.

In addition, while the countries covered in the report share certain cultural and historical characteristics, they differ in the nature of their political regimes, national histories and ethnic groups. For example, Jordan and Morocco are monarchies, while Egypt, Tunisia and Algeria are

republics. The Maghreb countries were occupied by France, while Egypt and Jordan were occupied by Britain. Morocco, Algeria and Jordan have some ethnic diversities, whereas Egypt and Tunisia have more homogenous populations.

The economic and political diversity of these countries has two effects on the analysis. On the one hand, this diversity enriches the discussion and brings out more insights than would have been possible had the countries been very similar. On the other hand, the diversity of the countries' initial conditions suggests that generalisations across countries and beyond are not admissible, and that special attention should be given to country-specific circumstances.

Report Main Findings

The main findings of the report are as follows.

- Firstly, just as in other transition countries, South-Med economies have suffered a deterioration in economic outcomes in the wake of the political upheavals that began

Key Economic Indicators of 5 South-Med Transition Countries, 2014

	Population, total	GNI per capita, Atlas method (current US \$)	GNI per capita, PPP (current international \$)	Exports of goods and services (% of GDP)
Algeria	38,934,334	5490	13880	30.53
Egypt	89,579,670	3210	10280	14.43
Jordan	6,607,000	5160	11910	43.28
Morocco	33,921,203	3070	7290	34.26
Tunisia	10,996,600	4230	11020	44.62

Source: World Development Indicators data, World Bank.

in December 2010. The magnitude of the deterioration in economic performance, relative to the experience of other transition countries, has not always been worse. With respect to growth, South-Med transition countries have not suffered the same output losses endured by other countries in transition. By contrast, other indicators (unemployment, fiscal balances, current account balances) have deteriorated in South-Med transition countries more significantly than elsewhere. So far, these imbalances have not threatened macroeconomic stability. However, it is not clear whether finances would be sustainable if macroeconomic imbalances were to persist and if foreign capital should fail to come through.

- Secondly, the impact of the political transition on economic performance has varied between countries. Egypt and Tunisia have been more directly exposed to the disruptive effects of political unrest than Jordan, Morocco and Algeria. However, the key factors in explaining the severity of the economic situation are related to initial country-specific conditions. For example, large pre-existing fiscal imbalances in Egypt have increased its fiscal vulnerability to pressure, however small this may be. By contrast, in Tunisia, where fiscal deficits were initially very low, the six-fold deterioration has taken the deficit to only 6 percent of GDP.
- Thirdly, the initial response to

the deteriorating macroeconomic conditions was expansionary in most South-Med countries, in accommodation of popular demands. However, all countries, except Algeria, eventually turned to the IMF for support. In the interim period, the conduct of fiscal and monetary policies was neither consistent, nor well-coordinated.

- Fourthly, South-Med countries have responded differently to the social consequences of the political transition, but their responses have generally been inadequate and may not have been consistent with long-term stability and dynamic growth. They have all moved to enhance social protection, but have failed to address the risks of serious illness, old age or loss of jobs. More importantly, they have not made significant progress in the delivery of better and more equitable social services. Finally, other than Tunisia, and to a lesser extent Morocco, they have not delivered on greater freedom for citizens.
- Fifthly, from a political standpoint, the analysis reveals that the five South-Med countries are far from attaining a competitive political environment, although Tunisia is striving to move in this direction. It is true that Tunisia and Egypt have adopted new constitutions and have conducted free Presidential and Parliamentary elections, while Morocco and Jordan have adjusted their constitutions. However, the emerg-

ing political regimes have yet to reflect these changes. The importance of political development is that it defines the contours of possible economic reform.

- Sixthly, looking ahead, the reform agenda of South-Med transition countries is extensive, especially if the objectives are to bring about shared prosperity, on one hand, and political inclusion, on the other. Chapter 5 elaborates the elements of this agenda, and suggests that external partners could play a positive role in facilitating the process.

Structure of the Report

The report is structured as follows. Chapter 1 reviews the impact of the political transition on the macroeconomic performance of Algeria, Egypt, Jordan, Morocco and Tunisia. Chapter 2 takes stock of the macro-policy response to the political shock and assesses the effectiveness of adopted policies. Chapter 3 focuses on the social response to popular demands in the aftermath of the uprisings. Chapter 4 traces the evolution of political regimes in the Arab countries, focusing on the interaction between politics and different facets of economic development. Finally, chapter 5 outlines a potential reform agenda for South-Med countries and identifies a possible role for external actors.

References

- Amin, M., R. Assaad, N. Al-Baharna, K. Dervis, RM. Desai, NS. Dhillon, A. Galal, H. Ghanem, C. Graham and D. Kaufmann (2012) "After the Spring: Economic Transitions in the Arab World", *Oxford University Press*.
- Diwan, I. and A. Galal eds. (2016) "The Middle East Economies in Times of Transition" *International Economic Association Series*, vol. 155-V, Palgrave.
- Muasher, M. (2014) "The Second Arab Awakening: And the Battle for Pluralism", *Yale University Press*.

CHAPTER 1

Economic Consequences of the Political Transition

1.1 Introduction

Before the uprisings began at the end of 2010, South-Med countries were hailed for their economic growth, especially between 2003 and 2008. Since then, they have been hit by two crises. Firstly, the global financial crisis, which began in late 2007 and led to a global slowdown in economic activity and trade, causing a temporary dip in their economic growth. Secondly, the eruption of political and social uprisings, bringing an abrupt end to the first signs of recovery from the former crisis.

Similar to the effects incurred by political transition elsewhere, the immediate impact on South-Med countries was a deterioration in macroeconomic conditions. Already weakened by the global financial crisis, macro-balances worsened further, especially during the first few years of unrest, while fiscal pressure intensified as most South-Med governments succumbed to popular demands in an attempt to quench the rising unrest. Due to the erosion of fiscal space prior to the onset of the political transition, budget deficits and public debts increased significantly. Current accounts came

under significant pressure as a result of declining tourism and, in some cases, growing trade deficits. Meanwhile, political instability triggered significant capital outflows, causing central banks in many countries to drain foreign reserves in order to maintain fixed exchange rate regimes. During those early years, weakening macroeconomic balances were reflected in repeated sovereign rating downgrades and higher sovereign borrowing costs.

Simultaneously, South-Med economies experienced an immediate drop in their GDP per capita growth to 0.4 percent in 2011, down from around 2 percent during the years of the global financial crisis and from close to 4 percent during the period 2003-2008. Unemployment also rose sharply in Egypt and Tunisia, to above 12 percent and to alarming levels among the youth (30 and 40 percent, respectively).

Since then, economic activity in the South-Med economies has gained momentum. Between 2012 and 2015, GDP per capita growth rates reached 3 percent on average. However, these growth rates remain below pre-uprising growth levels, raising concerns as

to whether the political transition has permanently damaged long-term growth potential.

Against this backdrop, the present chapter traces the macroeconomic effects of political transition in the South-Med countries, benchmarking their results against those of other transition economies. The chapter also assesses whether the political transition has damaged long-term growth potential and whether there is room for stimulating these economies. The chapter seeks to answer three specific questions:

- What has been the impact of transition on macroeconomic balances?
- What has been its impact on actual short-term economic growth?
- Finally, has political transition in South-Med countries permanently damaged long-term growth potential, or not?

The literature covering the impact of political transition on macroeconomic performance is substantial. It shows that political instability generates macroeconomic uncertainty, leading to reduced investment, lower rates of physical and human capital accumulation and, eventually, reduced productivity growth (Alesina and Perotti, 1996). Political instability tends to shorten policymakers' horizons, leading to sub-optimal, short-term, macroeconomic policies; it may also lead to more frequent shifts in policies, creating volatility and thus a negative impact on macroeconomic performance (Aisen and Veiga, 2011).

The empirical literature also shows that past political transi-

tions have been associated with deteriorating macroeconomic balances (higher deficits, weakened external balances), large output losses in the short-term and sluggish growth that generally persists for a few years after the unrest. Moreover, according to Elbadawi, Makdisi and Milante (2011) countries that have attempted to institute democratization experienced lower than average growth rates in the first few years. Where democratization has been successful, growth rates have been higher over longer periods than in countries that failed the transition, and higher than the average growth rates of countries that have made no attempt at democratization. Khandelwal and Roitman (2013) also show that actual output declines below potential for five years after the transition.

While the above findings suggest that political transition leads to output losses in the short-run, the evidence is inconclusive regarding its effect on medium-term growth. On the one hand, substantial cross-country literature finds no evidence of a significant correlation between democratic institutions and higher income growth (Barro 1996 and 1997 and Przeworski et al. 2000). On the other hand, Credit Suisse (2011) finds that growth tends to pick up eight years after a political shock. Focusing on within country effects, several studies find that only successful transitions to democracy lead to a growth dividend (Rodrik and Wacziarg, 2005; Persson and Tabellini, 2006; and Papaioannou and Siourounis, 2008). With greater nuance, Freund and Jaud (2014) identify and examine 100 successful, failed, and

gradual transitions that occurred in 158 countries over 1960–2011 and provide empirical evidence that it is regime change (and not successful democratization *per se*) that boosts long-term growth (by about 1 percentage point).¹ In other words, political transitions to democracy yield no growth dividends compared to other types of regime change. Moreover, they also show that countries undergoing a rapid regime change (taking 3 years or less), regardless of whether democracy is achieved or not, yielded an annual growth dividend of 0.5 to 1 percentage point over 7 to 14 years. Alternatively, countries which undergo long transitions tend to suffer from slower long-term growth. In other words, the short-term cost is rapidly offset by higher longer-term growth when the regime change is rapid, whether successful, failed or even reversed.

In recent years, further literature has shown renewed interest in the evolution of potential output in the aftermath of a financial crisis (European commission, 2009; Furceri and Mourougane, 2012; IMF, 2009 and 2015a). Understanding the dynamics of potential growth in South-Med economies, as we seek to do in this chapter, is important for two reasons. Firstly, because a permanent decline in potential growth means lower actual growth, lower job creation in a region where unemployment has been persistently high for decades, lower incomes, and fewer resources for the government to spend on education, healthcare, and social services. Overall, it will also mean slower income convergence

and catching-up with advanced economies. Secondly, because determining how the growth of actual and potential output behaves following a political shock is crucial in determining appropriate macroeconomic policies. A cyclical economic downturn would call for expansionary macroeconomic policies (if policy space is available) to pick up the slack in aggregate demand. In contrast, lower potential output growth from a more permanent shock would mean less scope for stimulus macroeconomic policies and would require structural policies.

The findings of the present analysis would suggest that the experience of South-Med transitions is consistent with that of other transitions, including those of Eastern Europe in the 80s and 90s, albeit less radical. The first main finding is that the political uprisings in the South-Med region have caused a deterioration in economic performance. The *direct* impact, in terms of lower growth and a deterioration in macroeconomic balances, has been extensive in Egypt and Tunisia. With respect to other transition countries, both economies have outperformed in the area of output losses, while underperforming with respect to macroeconomic balances. In Jordan, Morocco and Algeria, the political transition did not have the same disruptive effects on economic growth and macroeconomic balances as in Egypt and Tunisia. The most pronounced adverse effects have been in growing budget deficits and public debt, as governments have had to appease their citizens through subsidies and government jobs. These adverse effects

have been exacerbated by other exogenous factors. In Jordan, the conflicts in Syria and Iraq have led to a massive influx of refugees, putting enormous pressure on Jordan's limited resources, to disruptions in trade routes and a decline in tourism. The drought in Morocco has significantly shrunk agricultural production and therefore economic activity since 2012. In Algeria, declining oil prices have diminished the financial surpluses of the economy.

The second main finding of this chapter is that the decline in actual economic growth in South-Med economies is found to reflect a cyclical downturn and not a permanent decline in output. Given that output growth in these countries remains below potential, this means that there is scope in South-Med economies for macroeconomic stimulus (mainly fiscal policy) to raise aggregate demand and to boost short-term growth.

Third, despite the importance of working to revive growth potential, South-Med countries should not necessarily aim at restoring growth to pre-crisis levels (2003-2008), as growth during this period was accompanied by symptoms of economic overheating in some cases. Aiming at higher growth rates to progress towards economic convergence and greater levels of job creation would require the adoption of structural reforms to raise long-term growth.

The chapter is, hereafter, structured as follows: the next section takes stock of the evolution of macroeconomic balances, both external and internal, in the aftermath of the political shock; section 3 reviews the short-term

impact of the transition on actual economic growth, and section 4 on potential growth. Section 5 draws some conclusions.

1.2 Macroeconomic Balances

This section examines the evolution of macroeconomic balances in the aftermath of the uprisings in 2011. The analysis shows that macroeconomic imbalances have deteriorated with acute pressures on external and fiscal accounts, although macroeconomic stability has broadly been maintained.

Fiscal deficits

According to Khandelwal and Roitman (2013), political transition tends to be accompanied by subdued fiscal revenue and increased public expenditure, giving rise to a deterioration in overall fiscal balances by about 1 percent of GDP during the event year, and by a cumulative 1.75 percent of GDP for the subsequent two years. Fiscal deficits can be expected to return to pre-crisis levels only four years after the event. So far, this predication does not seem to hold in the case of the South-Med countries. There has certainly been a deterioration in macro-balances in these countries, but the magnitude of the deterioration has been more significant than elsewhere.

In 2009-2010, most South-Med economies had weak fiscal positions due to the fiscal stimulus packages adopted in *the aftermath of the global financial crisis*. Because of increased public spending, fiscal deficits had increased to around 5 percent of GDP in 2009-

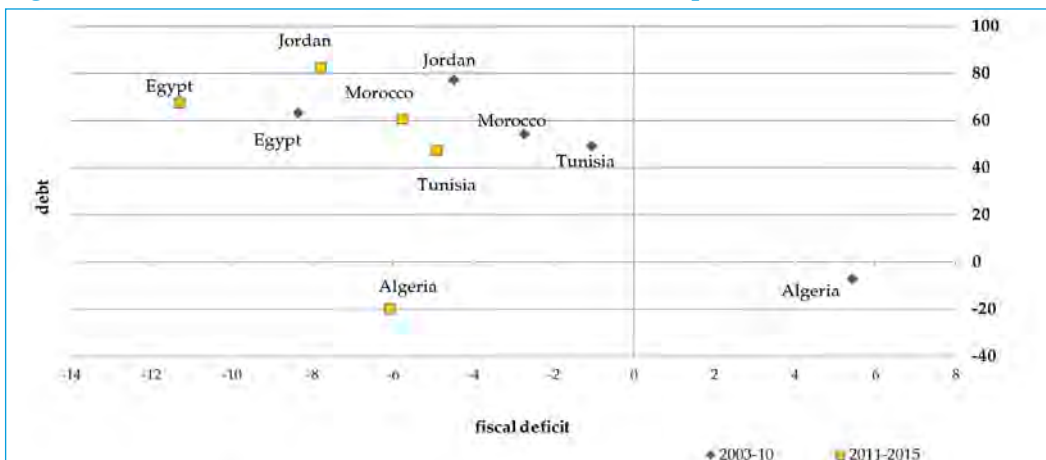
2010, up from around 1 percent in the period 2003-2008. After the uprisings, fiscal deficits and debt to GDP ratios shot up, particularly in Egypt and Tunisia, and to a lesser extent in Morocco (figure 1.1). During the same period, the fiscal deficit in Jordan went down, but net domestic debt increased. Algeria experienced the most dramatic increase in fiscal deficit, but the debt to GDP ratio remains very modest (and even negative).

The above developments are the product of what happened to government expenditures and revenues in the wake of the uprisings. On the expenditure side, most South-Med governments were compelled to increase public expenditure in an attempt to appease popular demands in turbulent social and economic environments (figure 1.2). The highest increases in public spending occurred in Tunisia, by more than 4 percentage points of GDP between 2010 and 2011. In countries that did not witness an uprising, spending was also increased by

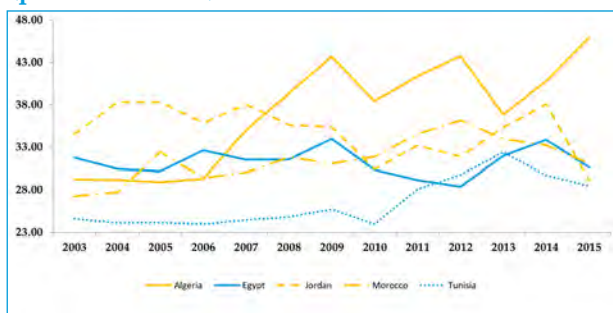
2.5-3 percentage point of GDP in an attempt to preemptively prevent potential unrest. Most of the increases in expenditure took the form of higher subsidies for food and energy, higher public-sector wages and pensions, and expanding unemployment benefits (for more details, see chapters 2 and 3). Egypt is the only South-Med country that did not increase spending (as a share to GDP) until 2013. As will be discussed later, the subsequent increase was partially in the form of public investment to stimulate aggregate demand and economic growth.

On the revenue side, during the first two years of the transition, fiscal revenues declined in Egypt relative to 2010, because of a drop in both tax and non-tax revenues, but picked up in 2014 as a result of exceptional grants (5 percent of GDP) (figure 1.3). To a lesser extent, Jordan experienced similar trends. In Morocco and Tunisia, revenues increased during the early years of the transition but declined afterwards. In Morocco, this occurred on the

Figure 1.1: Net domestic debt and overall fiscal balance (percent of GDP)



Source: IMF Article IV Consultation data.

Figure 1.2: Government expenditure, 2003-2015 (percent of GDP)

Source: IMF Article IV Consultation data.

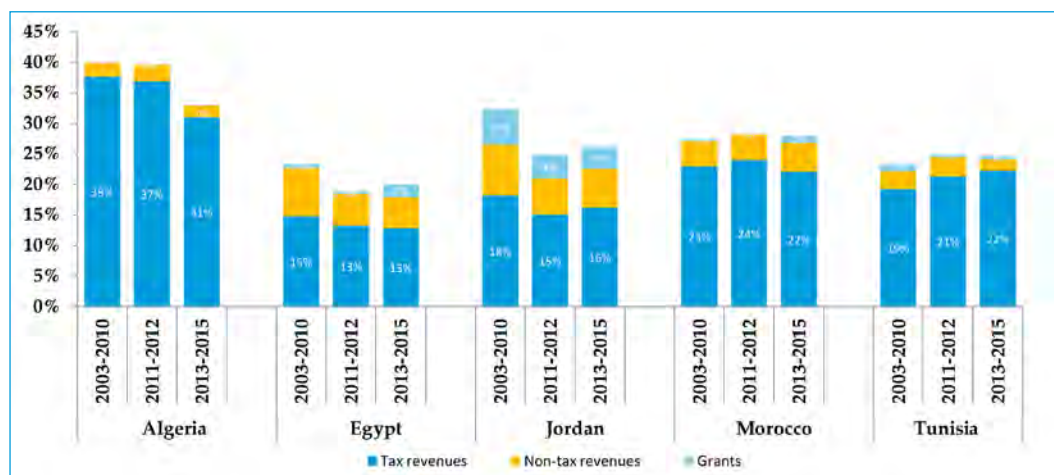
back of lower tax receipts, while in Tunisia it was a result of lower non-tax revenue.

These developments exerted further strain on the fiscal deficits. Relative to 2010, all South-Med countries (save Algeria) witnessed a deterioration in their budget deficits in the range of 0.2 (Jordan) to 2.7 (Tunisia) percentage point of GDP, in 2011. This trend continued until 2013 in most South-Med countries (and 2012 for Morocco). The cumulative deterioration in the deficits between 2010 and 2013 ranged

between 3 (Morocco) to 7 (Tunisia) percentage points of GDP. Fiscal balances improved by 2015 in Jordan and Morocco, on the back of low oil prices and fiscal consolidation efforts. In Egypt and Tunisia, fiscal deficits remain far from their pre-crisis levels by 3 and 5 percentage points of GDP, respectively. The deterioration in fiscal deficits in all South-Med countries surpassed predictions according to the literature.

Fiscal outcomes were worse for countries that suffered from high initial deficits prior to the uprising (figure 1.4). Egypt's fiscal deficit, which was already quite sizeable at 8 percent of GDP in 2010, deteriorated to above 10 percent of GDP in 2011, and peaked at 13 percent of GDP in 2013. Although the deficit has been reduced since 2014, reflecting a one-off considerable increase in grants in 2014 followed by fiscal consolidation in 2015 (resulting from lower subsidies), it still amounts to around 12 percent of GDP.

By contrast, in countries where

Figure 1.3: Revenue components, 2003-2015 (percent of GDP)

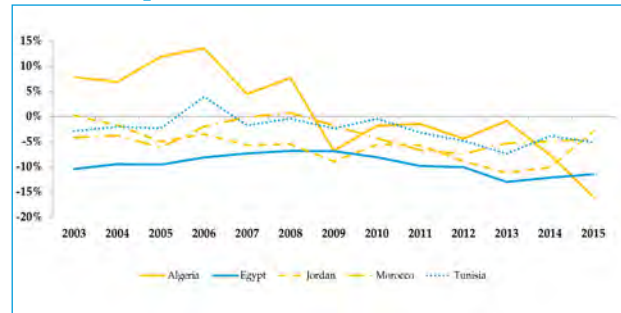
Source: IMF Article IV Consultation data.

initial fiscal conditions were relatively stronger, deficits remain below 10 percent of GDP. Tunisia's low fiscal deficit experienced a six-fold deterioration, reaching 6 percent of GDP, although this remains half the level of the deficit in Egypt. Fiscal deficits in Jordan and Morocco, which deteriorated to 11 and 5 percent of GDP after the uprising, have improved since 2013 and are currently below 5 percent of GDP.

Algeria's public finances are overly dependent on hydrocarbon revenues. Revenues increased in 2011-2012 on the back of high oil prices, but have been declining since 2013. Like other South-Med economies, public spending also surged in Algeria in 2011 and 2012, amid regional upheavals. As a result, Algeria's fiscal balance jumped to above 4 percent of GDP in 2012, up from less than 2 percent of GDP in 2010, despite solid oil revenues during that year. Although there was a significant improvement in 2013 (thanks to fiscal consolidation), the deficit soared to 15 percent of GDP in 2015 on the back of lower fiscal hydrocarbon revenues.

Overall, the deterioration in fiscal balances and the decline in GDP during the political transition led to the build-up of government domestic debt, which has risen considerably for all South-Med governments, except for Algeria (figure 1.5). The greatest concern lies with countries that entered the transition with a high debt, such as Egypt, where the debt to GDP ratio was around 55 percent of GDP in 2010. In Jordan, the debt to GDP ratio was also high in 2010 (71 percent), as a result of the fiscal stimulus

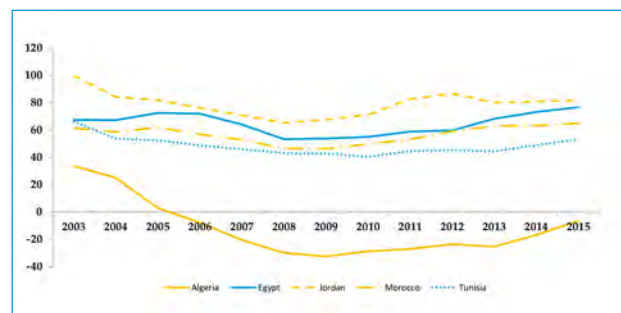
Figure 1.4: Fiscal deficits, central governments, 2003-2015 (percent of GDP)



Source: IMF Article IV Consultation data.

in the aftermath of the global financial crisis, and soared even higher, to more than 82 percent in 2011 (figure 1.5). It is claimed that the near complete halt of gas flows from Egypt required imports of more expensive fuel for electricity generation, which has also added to the debt stock of the national electricity company (IMF, 2015b). However, the debt to GDP ratio stabilized at 80 percent of GDP since 2013. In Tunisia and Morocco, debt levels were initially lower, hovering around 40 percent of GDP, but increased sharply to 64 percent of GDP and 55 percent of GDP, respectively, in 2015. In Algeria, thanks to oil wealth, the level of debt remains

Figure 1.5: Net domestic debt, central governments, 2003-2015 (% of GDP)



Source: IMF Article IV Consultation data.

in single digits as a share of GDP.

External balances

According to Khandelwal and Roitman (2013), most transition countries witnessed a deterioration in their current accounts during the year of political instability, with the external current account balances improving in 60 percent of the countries only five years after the event.

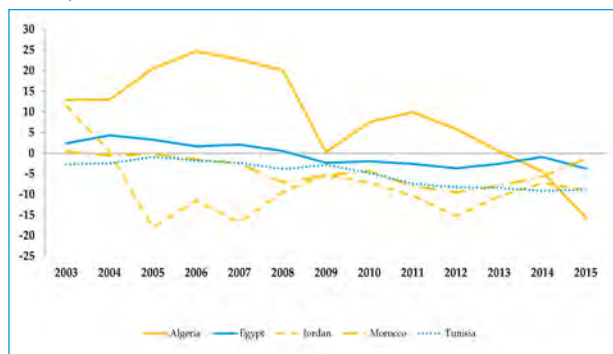
Before both the global financial crisis and the political transition, most South-Med countries were already running current account deficits between 2003 and 2008 (figure 1.6). The pre-crisis deficits were highest in Jordan (7 percent of GDP) on the back of buoyant energy imports (with Jordan importing 96 percent of its energy needs) but significantly lower (2 percent of GDP) in Morocco and Tunisia. Egypt was actually enjoying a small surplus of around 2 percent of GDP. In the aftermath of the financial crisis and the ensuing global slowdown in economic and trade activity - which meant lower export proceeds, lower investment

income as world interest rates plummeted and lower remittances - surpluses have disappeared and deficits have worsened (figure 1.6).

During the first few years after the uprising, current accounts in South-Med economies (except Algeria) have come under pressure, as a result of *declining tourism receipts* and in some cases growing trade deficits. Just like fiscal deficits, the deterioration in current accounts was more pronounced during the early years of the unrest. Seven years after the uprising, current accounts have stabilized only in Morocco, where they have returned to pre-crisis levels. This suggests that the performance of South-Med external balances is worse than endured by other transition countries.

In both Egypt and Tunisia, the current account deterioration is primarily the result of a drop in tourism revenues following ongoing security threats (see box on tourism). Additionally, in the case of Egypt, the fall in Suez Canal receipts (to less than 2 percent of GDP in 2015, from above 3 percent of GDP before the financial crisis), due to the depressed global economic environment and trade, has also contributed to the current account dynamics. But certain factors have partially offset some of the pressure on the current account in Egypt, the most significant being the bounce-back in remittances to 6 percent of GDP (which did not occur in Tunisia), proving to be more resilient than other types of inflows during the whole period of the political transition (figure 1.7). In addition, the trade balance has been narrowing on the back of subdued import

Figure 1.6: Current accounts, 2003-2015 (percent of GDP)

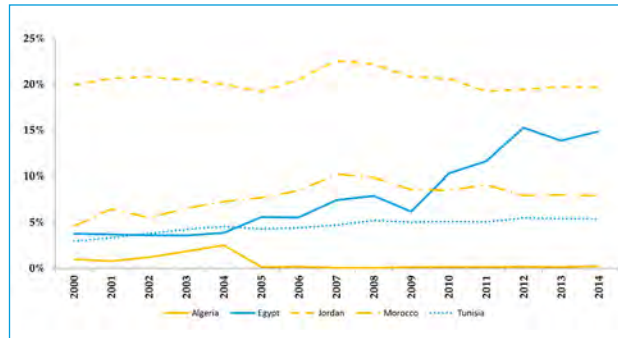


Source: IMF Article IV Consultation data.

growth due to sluggish economic activity, and also lower export revenue as a result of subdued global demand. Finally, in 2014, Egypt received substantial official grants from the GCC (around 4 percent of GDP), a historical high since 1993, which contributed to easing the pressure off external balances for that single year. However, in the case of Tunisia, a growing trade balance (from buoyant energy and capital goods imports and declining oil and phosphate exports) continues to act as a drag on the current account. As a result of these developments, Egypt's small deficit (2 percent of GDP in 2010) worsened gradually to 4 percent of GDP by 2015. However, Tunisia's large pre-crisis current account deficit (5 percent of GDP) deteriorated to an alarming 9 percent of GDP in 2015, its highest level since the 1980s. Consequently, external imbalances remain higher in Tunisia than in Egypt.

Jordan's pre-crisis current account significantly deteriorated to 10 percent of GDP in 2011 and then to 15 percent in 2012, following more expensive energy imports (for electricity generation) and declining remittances. Naturally, Jordan's external finances have stabilized with lower global oil prices. Morocco's current account deficit, which has been in continuous deterioration since 2002, doubled from 4 to 8 percent of GDP between 2010 and 2011 and widened even further in 2012 mainly as a result of higher fuel and food imports (the latter because of the drought), and lower tourism receipts and remittances from Europe. However, Morocco's current account position has

Figure 1.7: Remittances, 2000-2014 (percent of GDP)



Source: World Development Indicators, World Bank.

improved since 2013 because of lower oil prices, lower food imports thanks to a good agricultural season and high domestic food production, in addition to rising exports in newly developed sectors (IMF, 2015c).

Finally, Algeria's current account surpluses, which persisted for over 15 years, started to disappear. Lower hydrocarbon exports (following lower oil prices) and growing imports (mainly investment goods) led to the emergence of a current account deficit of 4 percent of GDP in 2015.

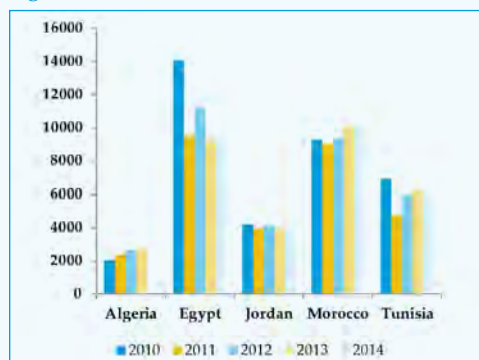
In terms of *Capital Flows*, South-Med economies, particularly Egypt and Jordan, attracted strong capital inflows during the period 2003 and 2008, benefiting mainly from oil petrodollars. Having already taken a hit during the financial crisis, FDI inflows have declined further over the past seven years, as a result of political uncertainty, which has undermined investor confidence. FDI inflows, which are usually considered as longer term, less reversible and largely non-debt creating flows, came down from 6 percent of GDP in 2008 (and even

Box: Tourism in South-Med Countries after the uprising

One of the immediate effects of the political uprising and related violent clashes was a sharp decline in tourist arrivals and receipts (figures 1.8 and 1.9). The number of tourist arrivals fell in all countries in 2011, but the decline was most severe in Egypt and Tunisia where arrivals dropped by 30 percent in 2011 and have not yet recovered.

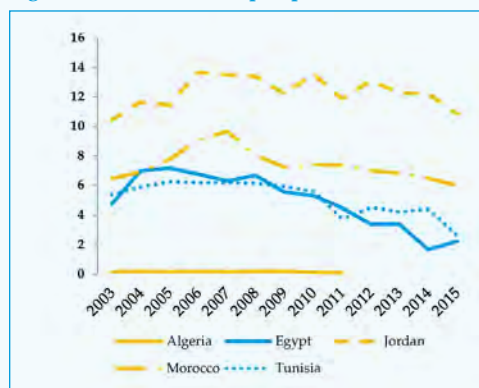
Tourism is an important source of foreign exchange earnings in South-Med economies where it ranged from 6 percent of GDP in Egypt and Tunisia and 12 percent of GDP in Jordan. Tourism receipts were generally resilient during the financial crisis, with only Egypt experiencing a decline to 5 percent of GDP. After the political uprising, tourism receipts dropped in both Egypt and Tunisia to less than 2 percent of GDP in 2015 (from above 6 percent in 2008), following security incidents and terrorist attacks. Given the contribution of this sector to value-added and foreign exchange earnings, its decline has had a significant effect on external balances and on economic growth.

Figure 1.8: Tourist arrivals, 2010-2014



Source: World Tourism Authority data.

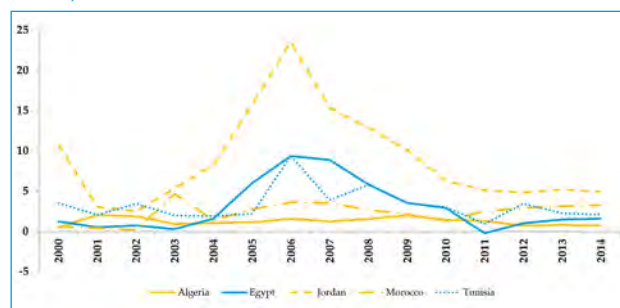
Figure 1.9: Tourism receipts (percent of GDP)



Source: Data from national central banks.

higher ratios of 6 and 13 percent for Egypt and Jordan, respectively) to 3 percent of GDP after the financial crisis and to less than

Figure 1.10: FDI inflows, 2000-2014 (percent of GDP)



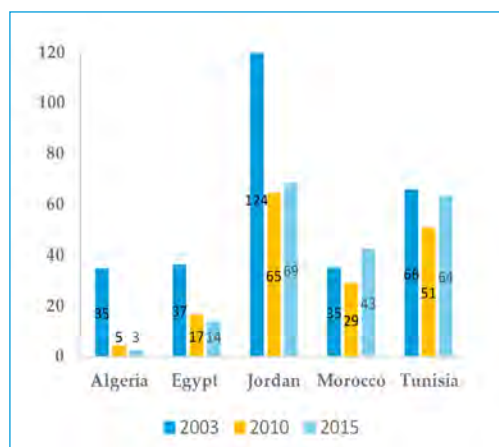
Source: World Development Indicators, World Bank.

2 percent of GDP in 2011 (figure 1.10). Seven years after the uprisings, they remain weak in all South-Med countries. Short-term portfolio investment outflows have also seen a sharp decrease, especially those in the form of T-bills in Egypt.

Finally, looking at external debt between 2008 and 2015, the ratios for most countries relative to GDP remained relatively modest. The highest ratios were seen in Jordan (83 percent in 2003) and Tunisia (51 percent in 2003). During the post-transition period, external debt essentially went down in all countries. Average gross

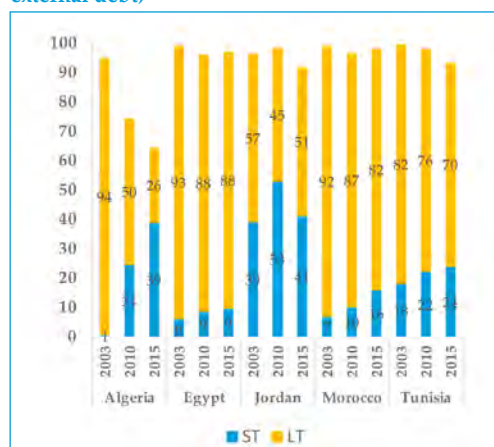
Figure 1.11: External debt

Total external debt (% of GDP)



Source: World Development Indicators, World Bank.

external debt for Morocco, Jordan and Tunisia increased from 45 to 55 percent of GDP (figure 1.11). The strongest increases were in 2012 and 2013, when the debt to GDP ratio cumulatively rose by almost 7 percentage points. Moreover, short-term debt has been rising in Tunisia since 2012, and in Morocco since 2013, though it remains at benign levels of 18 and 26 percent of GDP respectively. In Egypt, short-term debt remains below 10 percent of GDP. In Jordan, while short-term debt has been declining since 2011, it accounts for almost half of the total external debt. Standard debt indicators paint a good picture of the external vulnerability of the South-Med economies and generally do not suggest any debt-servicing problem in the near future. Liquidity indicators, such as debt service-to-exports ratios, have remained relatively benign over the last few years (below 15 percent in all 5 economies) and raise no immediate concerns.

Short and long term external debt (as % of total external debt)

1.3 Economic Growth: Actual

This section examines the evolution of actual growth in the South-Med countries between 2003 and 2015. This period covers different business cycles: a boom period that lasted between 2003 and 2008, followed by a mild economic slowdown after the global financial crisis (2009-10), ending with a steeper downturn associated with the political transition (2011-2014). The performance in the post-2011 period has partly been the product of prevailing social and political tensions, but this period has also coincided with adverse global economic conditions and regional geopolitical conflicts.

Prior to the uprisings, the South-Med transition economies fared relatively well in terms of growth performance. Egypt and Tunisia were praised by international financial institutions for their leading economic performance in the

Arab region. The 2008 financial crisis was associated with a short-lived growth dip from close to 5.5 percent between 2003 and 2008 to less than 4 percent, but by 2010 they were on the road to economic recovery. In terms of per capita growth, the performance was more modest, due to high population growth rates (table 1.1).

In the post-uprisings period, average real GDP growth in the South-Med economies fell from 3.7 percent in 2010 to less than 2.2 percent in 2011, its lowest level in over a decade. Per capita growth rate also dropped to 0.4 percent in 2011 but picked-up as from 2012 to an average of 1 percent between 2012 and 2014. Notwithstanding some improvement, seven years

after the uprising, in no South-Med economy (but Algeria) has per capita growth recovered to its pre-crisis level of 2008, amid claims that the political crisis may have damaged long-term/potential growth.

The growth depression has affected all countries, but its magnitude varies from country to country. Egypt and Tunisia, at the centre of the uprisings (toppling the rulers), have been the hardest hit. Both Egypt and Tunisia have experienced a decline in GDP per capita levels and growth rates. During 2011, GDP per capita contracted by 0.4 and 3 percent respectively and output growth losses were in the order of 3 and 5.5 percentage points. Since 2011, output growth has recovered more quickly in Tunisia (to close to 2 percent) than in Egypt, where the growth-population dynamics continue to cause contractions in per capita GDP. Six years later, both countries are still facing increasing security threats and social tension, preventing a sustainable growth upturn.

Meanwhile, growth has been more resilient in other South-Med economies, remaining positive, albeit at a lower level, in the aftermath of the uprisings. More importantly, the growth performance may not be solely reflecting the same disruptive effects related to the uprising as in Egypt and Tunisia. In Jordan, GDP growth rates fell in 2011 (including in per capita terms) following disruptions of natural gas supplies from Egypt and adverse regional spillovers, particularly from the conflict in Syria and Iraq with repercussions on security. The Jordanian authorities estimate that they have

Table 1.1: Real GDP Growth in the South-Med Transition Economies, (percent)

	GDP growth				
	2003-2014	2003-2008	2009-2010	2011	2012-2014
Algeria	3.6	4.1	2.6	2.8	3.3
Egypt	4.2	5.5	4.9	1.8	2.2
Jordan	5.3	7.4	3.9	2.6	2.9
Morocco	4.5	5.0	4.2	5.2	3.4
Tunisia	3.7	5.3	2.9	-1.9	2.8
Average	4.2	5.5	3.7	2.1	2.9
Egypt and Tunisia	4.0	5.4	3.9	-0.1	2.5
	GDP per capita growth				
	2003-2014	2003-2008	2009-2010	2011	2012-2014
Algeria	1.7	2.5	0.6	0.8	1.1
Egypt	2.0	3.3	2.6	-0.4	-0.4
Jordan	2.9	5.0	1.6	0.4	0.6
Morocco	3.4	4.0	2.9	4.1	2.3
Tunisia	2.7	4.1	2.2	-3.1	2.2
Average	2.5	3.8	2.0	0.4	1.2
Egypt and Tunisia	2.3	3.7	2.4	-1.7	0.9

Source: World Economic Outlook Database, IMF and Tunisia per capita GDP from World Development Indicators, World Bank.

received more than one million refugees, or about 20 percent of Jordan's population, putting pressure on economic infrastructures and labour markets (IMF, 2013). Moreover, the emergence of the Islamic State in Iraq and the Levant (ISIS) in Iraq, which is Jordan's largest trading partner and the destination of some 20 percent of its exports, have caused disruptions to exports as well as to tourism in Jordan.

Morocco is the only economy in the region where GDP per capita growth strengthened in 2011 but then declined afterwards, mostly as a result of the drought that led to a poor harvest and a decline in agriculture production. As for Algeria, growth remained resilient after the regional unrest and continued to grow until 2014. Indeed, between 2003 and 2014 the economy grew on average at around 3.5 percent. This is because Algeria did not witness the same kind of political unrest as other countries and in part, because GDP growth is primarily driven by the hydrocarbon sector.

Benchmarking the performance of South-Med countries, Khandelwal and Roitman (2013) estimate that declines in real GDP ranged between 1 and 7 percent during the first year of political instability. South-Med countries have not only escaped a recession (including Egypt and Tunisia), but also their GDP growth dip induced by the political transition was relatively lower than that seen in other transitions.

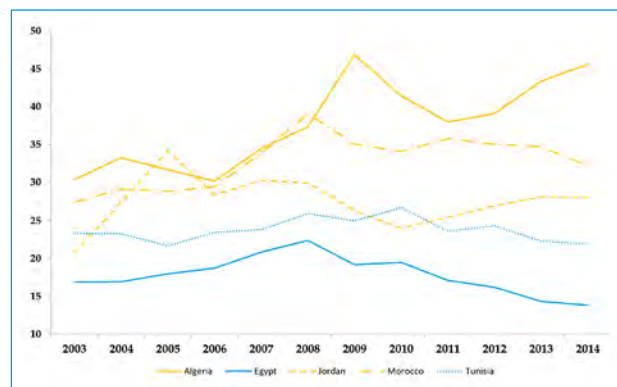
Turning to investment, it is known that the first year of political instability tends to be associated with a large decline in public and private investment.

The decline is estimated to be in the range of 10 and 40 percent, respectively (Khandelwal and Roitman, 2013). Moreover, as growth rates tend to remain modest in subsequent years, both public and private investment take at least 5 years to return to pre-crisis levels.

A similar pattern occurred in South-Med countries. In 2011, investment declined sharply in Egypt and Tunisia by 2 and 3 percentage points, respectively, standing at 17 and 24 percent of GDP (figure 1.12). By 2014, these figures had deteriorated to 14 and 22 percent of GDP in Egypt and Tunisia, also respectively. The situation was worse in Egypt as the investment to GDP ratio had fallen in 2009-10, following a sharp decline in private investment in the aftermath of the financial crisis. By 2011, low private investment had not recovered to pre-crisis levels.

The disaggregation of investment data in Egypt further reveals that public investment declined by close to 20 percent

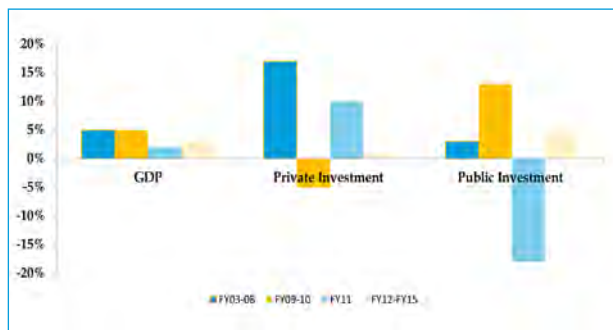
Figure 1.12: Gross capital formation, 2003-2014 (percent to GDP)



Source: World Development Indicators, World Bank.

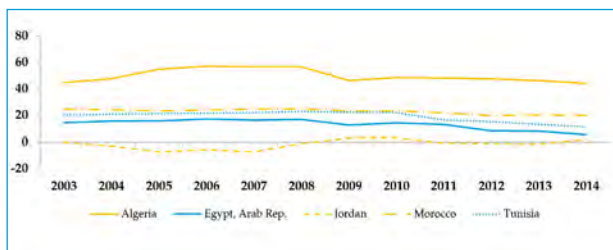
in 2011, down to 6 percent of GDP compared with a pre-crisis level of 8 percent of GDP (figure 1.13). Private investment growth remained positive but also declined to less than 10 percent in 2011, down from 11.5 percent during pre-crisis years. Prior to the uprising, private investment had declined (by more than 30 percent) in 2009 following the global financial crisis, a reaction that was much more severe than that which is currently witnessed during the political transition. Because investor confidence has not been restored, the current share of private investment to GDP of 8 percent is way below the 10 percent of the 2003-2008 pre-crisis period.

Figure 1.13: GDP by expenditure in Egypt (average annual growth rates)



Source: Calculated by the authors based on Egypt's national accounts, Ministry of Planning.

Figure 1.14: Gross domestic savings (percent of GDP)



Source: World Development Indicators, World Bank.

Savings have been particularly low in South-Med economies. Except for Algeria, savings accounted for around 15 percent of GDP, with ratios above 20 percent in Morocco and Tunisia. Savings have declined significantly since the political uprising with a ratio to GDP falling as low as 8 percent in Egypt (figure 1.14).

At the sectoral level, manufacturing and tourism were among the most impacted sectors in Egypt and Tunisia (figure 1.15). Non-oil manufacturing growth in the two countries declined by around 6 and 10 percentage points in 2011, respectively. Non-oil manufacturing has grown by less than 3 percent in Egypt since 2011 (compared to 5 percent during 2003-2010), largely due to the severe shortage of foreign currency to pay for raw materials and equipment, as will be seen in chapter 2. Non-manufacturing growth has virtually stagnated in Tunisia (compared to 3 percent during 2003-2010). Growth in tourism dropped by close to 18 and 25 percentages in both countries in 2011, and the sector has continued to contract due to sporadic security incidents in both countries.

In short, the *uprisings* caused a slowdown in economic activity, but other factors may have contributed to the prolonged growth slump. The economic slowdown in the US, Europe and China meant subdued external demand for South-Med exports. The escalation in geopolitical violence and civil wars (Syria and Libya) have had negative spillovers on neighboring economies that have further disrupted trade and undermined consumer and investor

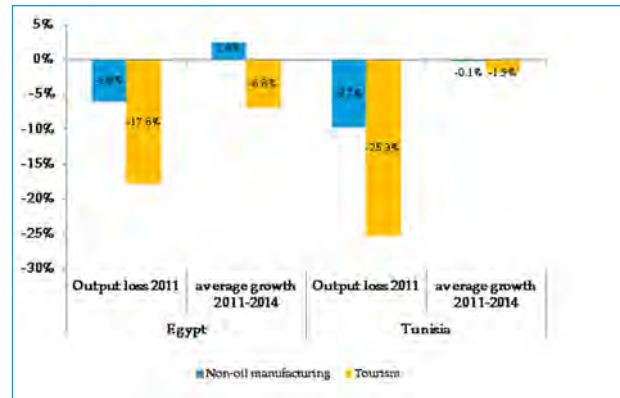
confidence in countries like Jordan and, to a lesser extent, Tunisia. The recent plunge in oil prices may have reduced the pressure on external finances and aided recovery for oil importers, but Mo-haddes and Raissi (2015) show that such gains have been offset by a decline in external demand and financing by oil exporters (through lower trade, remittances, and investment).

1.4 Economic Growth: Potential

Given the modest growth performance in the wake of the uprisings, one question is whether South-Med economies will be able to attain the pre-uprising growth rate of 5.5 percent achieved between 2003 and 2008 (even higher for Jordan and Egypt). A similar question can be raised about the GDP per capita growth of 4 percent during the 2003-2008 period. This section describes what happened to both potential output and the output gap over the period 2003-2015. The question is whether the political uprisings have caused permanent damage to growth potential and whether the decline will persist once the cyclical recovery is complete.

Potential output is defined as the level of output consistent with stable inflation (Okun, 1962). In the short term, actual output can deviate temporarily from potential output as shocks hit the economy, reflecting the slow adjustment in wages and prices to shocks (IMF, 2015a). The short-term divergence of actual from potential output is referred to as the output gap, or economic

Figure 1.15: Sectoral performance in Egypt and Tunisia after the uprising



Source: Calculated by the authors based on data from national authorities.

slack. Output below potential (a negative output gap) implies that there is underemployment (excess supply) of capital and labour. This section describes what happened to both potential output and the output gap over the period 2003-2015. It does not look at the medium-term trajectory of potential output.

Understanding the dynamics of potential growth in South-Med economies is important for two reasons. The first is that a permanent decline in potential growth means lower actual growth, lower job creation in a region where unemployment has been persistently high for decades, lower incomes, and fewer resources for the government to spend on education, healthcare, and social services. Overall, it will also mean slower income convergence and catching-up with advanced economies. Second, the diagnosis of how the growth of actual and potential output behaves, following the political shock, is crucial in establishing appropriate macroeco-

nomic policies. A cyclical growth slowdown would call for expansionary macroeconomic policies (if policy space is available) to pick up the slack in aggregate demand. In contrast, lower growth in potential output would tend to imply a more permanent shock with long-lasting losses, which may prevent potential growth from returning to pre-crisis rates in the long run. In this case, there would be less scope for stimulating the economy through macroeconomic policies and structural policies would be required.

The literature addressing the impact of (financial) crisis on potential growth has thrived in the context of advanced economies. Furceri and Mourougane (2012) find that the crisis lowered potential output by around 1.5–2.4 percent on average in OECD countries. Barrera and others (2009) find that potential output in the United States is expected to be about 5.75 percent below the counterfactual level produced by average growth rates before the global financial crisis. In the case of the MENA region, Khandelwal and Roitman (2013) estimate that actual growth rates dipped below trend during the year of the event and in subsequent years. As a result, output gaps turned negative the year of the event, and continued to widen for some time. On average, output remained below potential for 4 years after the initial drop, taking around 5 years for the recovery. Mitra and others (2015) estimate that MENA's (excluding the GCC) per capita GDP will drop from one-half to one-third of the average of emerging markets and developing coun-

tries (EMDC) over the next five years.

Complementing this work, this section decomposes actual growth into cyclical and structural components to assess whether the current decline in the rate of output growth reflects a cyclical or structural downturn, and more broadly to understand the dynamics of potential growth. The methodology used is explained in Annex 1.1 at the end of this chapter.

The results can be summarized as follows. Actual growth is below potential in Egypt, Jordan and Tunisia, suggesting that they are operating well below potential. However, the growth rate dip below trend does not coincide with the start of the political transition in all 3 countries (figure 1.16). In Jordan and Tunisia, it was the financial crisis rather than the political uprising that brought actual growth below its trend. In Egypt, the output gap turned negative in 2011 and has been widening over time. By 2014, output growth remained 90 percent below potential. Jordan's output gap has been negative since 2010 and has been widening ever since, with an actual of around 40 percent below potential. Just like Egypt, Tunisia's actual output took a hard hit in 2011, thus widening Tunisia's negative output gap. However, the output gap has significantly narrowed over time and output is around 40 percent below trend.

This suggests that Egypt until the political transition, as well as Jordan and Tunisia until the global financial crisis, experienced exceptionally high growth rates and grew above potential growth, as

shown by their positive output gap. This further suggests that while there is a case for reigniting growth in the short-term, pre-crisis growth (2003-2008) is not an appropriate target, as this level may be accompanied by symptoms of economic overheating such as high inflation, excessive liquidity and credit growth and investment. The short-term target should be to reignite short-term growth to trend rather than to pre-crisis levels.

In figure 1.17, per capita growth rates are decomposed into cyclical and trend components for the 5 South-Med countries over the period 1991-2014. The figure clearly shows a significant cyclical downturn in per capita growth in 2011, the year of the political uprisings. Being cyclical in nature, this drop is a temporary phenomenon that should not last or prevent growth from recovering again. And as it turned out, the cyclical component of per capita income growth all but subsided in 2014. The other period that experienced a cyclical change in per capita growth is 2003-2008, reflecting perhaps a boom that was not sustainable.

In terms of potential growth, figure 1.18 shows the trend for all 5 South-Med countries over the period 2002-2014. The most notable observation is that there was a mild decline in potential growth in all South-Med economies, except Morocco. The decline in potential per capita growth in Egypt and Tunisia was more pronounced and started as far back as the mid-2000s. In Egypt, potential growth declined from about 2.3 percent in 2003 to about

Figure 1.16a: Egypt actual and potential growth

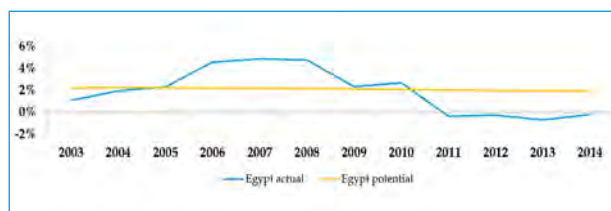


Figure 1.16b: Tunisia actual and potential growth

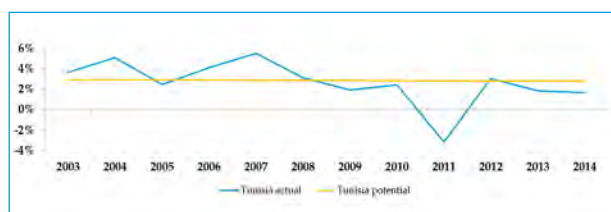
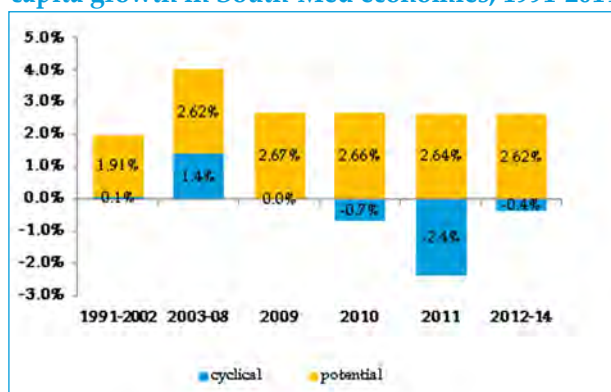


Figure 1.16c: Jordan actual and potential growth



Source: Calculated by the authors based on World Economic Outlook Database, IMF.

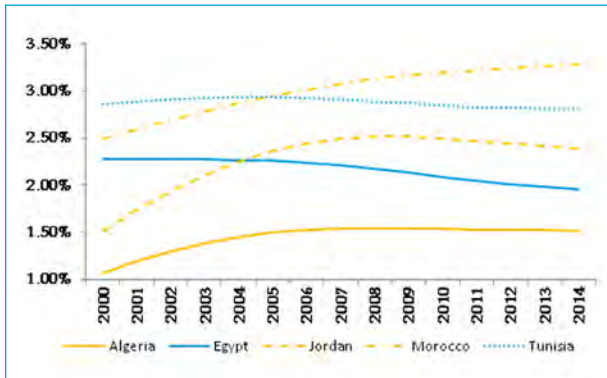
Figure 1.17: Cyclical and trend components of per capita growth in South-Med economies, 1991-2014



Source: Calculated by the authors based on World Economic Outlook Database, IMF.

1.9 percent in 2014, and in Tunisia it declined from 3 to 2.8 percent during the same period. Owing

Figure 1.18: Potential GDP per capita growth in South-Med economies



Source: Calculated by the authors based on World Economic Outlook Database, IMF.

to a large population drag on growth, Egypt experienced larger drops in potential growth (by 1/3 percentage point over the period 2003-2014) than Tunisia (a drop only by 0.1 percentage point).

The potential GDP per capita growth rates in Algeria and Jordan grew at 1.5 and 2.4 percent, respectively, in the pre-crisis period (2003-2008). These rates remained fairly constant during the global financial crisis in 2009-2010. In Jordan, the political transition has been associated with a decline in potential growth in the same order of magnitude as Egypt (0.1 percentage point). In Morocco, there has been an upward trend since the 1980s, with potential per capita growth rising from about 2.8 percent in 2003 to 3.2 percent in 2014. It is the only South-Med country to have not experienced any decline in potential growth since 2003.²

Based on these results, one would expect that growth in South-Med countries would start picking up as political stability is restored, particularly in Egypt

and Tunisia. However, even if South-Med economies recover to their potential, past performance has not been high enough to enable them to make progress on the convergence with the living standards prevailing in advanced economies, or to create sufficient jobs for new entrants into the labour market. To do so, it would be necessary to carry out deeper and more extensive institutional reforms that would require time to implement and to reap benefits. Reigniting short-term growth would require the most immediate constraints and opportunities facing these economies to be directly targeted. Longer term growth would take much more substantial reforms.

1.5 Conclusions

After having barely recovered from the effects of the global financial crisis, the political uprising took the South-Med countries by surprise at the end of 2010. The political transition has been accompanied by deteriorating macroeconomic conditions, as has happened in political transitions elsewhere. The years following the uprisings have been accompanied by a global slowdown and the emergence of geopolitical tension and conflict.

Pressing social demands, declining tourism receipts, capital outflows and sluggish economic growth have imposed mounting pressures on fiscal and external balances. Seven years after the uprisings, growth remains subdued and macroeconomic imbalances remain persistent, for some countries more than others.

The review, in this chapter, of the economic consequences of the uprisings on the economies of Algeria, Egypt, Jordan, Morocco and Tunisia relative to the findings of the literature can be summarized as follows:

First, in line with what happened in transitions elsewhere, the first few years (2011 and 2012) were the worst in terms of economic performance with the sharpest increases in fiscal deficits, current account deficits and growth and/or output declines. Some countries have been able to reverse these trends, starting 2013, or at least arrest further deterioration. The magnitude of the economic impact of the political transition has varied from one country to another. Egypt and Tunisia have been more directly exposed to the disruptive effects of the political unrest than Jordan and Morocco.

Second, if one were to benchmark the performance of the South-Med economies against the literature on the economics of political transition, the conclusion is that their performance is mixed. The output loss (in per capita terms) in the aftermath of the uprisings has been smaller than that ensured by other transition countries. Moreover, the recovery time (from negative growth) has also been shorter. This is more apparent in the case of Tunisia, which experienced negative growth of 3 percent in 2011 but positive growth afterwards. Notwithstanding some recovery, growth has remained below potential and below pre-crisis levels.

In terms of macroeconomic aggregates, the deterioration in some South-Med economies has

been worse than in other transitions. In Egypt, fiscal imbalances are worrying, as are external imbalances in Tunisia. In all countries, the persistence of fiscal imbalances has led to the build-up of government debt, which is a source of vulnerability in Jordan and Egypt. These developments have markedly heightened concerns about the sustainability of public finances. External imbalances are quite apparent in Tunisia with the persistent decline in tourism receipts. So far, these imbalances have not threatened macroeconomic stability in the sense that South-Med economies have not encountered any balance of payments or external financing crises. However, should macroeconomic imbalances persist, these countries could become more vulnerable.

Third, the severity of the economic situation in a country depends on initial conditions. For example, pre-existing large fiscal imbalances in Egypt have increased its fiscal vulnerability to further pressure, no matter how slight. In contrast, because Tunisia's fiscal deficits were initially very low before the uprising (only 1 percent of GDP), a six-fold deterioration was not disastrous. The contrast between Egypt and Tunisia with respect to external balances is also telling, where Tunisia's external balances were eroded in the aftermath of the financial crisis while Egypt enjoyed some financial surpluses.

Fourth, most South-Med economies are currently operating below capacity given that their actual growth is below potential. This suggests that there is scope for active macroeconomic policy

(mainly fiscal policy) to raise aggregate demand and, in turn, short-term growth. This is consistent with the finding that the weakness in economic activity is primarily due to cyclical factors; these are temporary effects that should not prevent a recovery of growth. However, achieving sufficient growth to make progress on convergence with countries that have higher standards of living would require an enhancement of growth potential through major structural and institutional reforms.

Fifth, and finally, the political transition is not the sole culprit behind weakened economic fundamentals in South-Med economies. The latter have had to face two challenging back-to-back crises (the global financial crisis followed by the political transition). They have also had to deal with other exogenous shocks, including the rise (decline) in commodity prices in 2008 and, in 2014 and beyond, a global economic slowdown in the US, Europe and China. Also, many South-Med countries are very close to conflict zones and have had to bear negative spillover effects from regional conflicts. Nevertheless, the political uprisings have had their toll on economic performance, most notably in Egypt and Tunisia.

Notes

1. The authors identify democratic transitions as rapid—occurring within 3 years—and large increases in the score on Polity scale. Failed transitions are rapid transitions to democracy that succeed in changing the regime temporarily or par-

tially but do not result in sustained democracy, defined by a high polity score. Gradual ones achieve democracy, but the increase in polity score occurs over a longer period, more than 3 years and up to 15 years.

2. The sensitivity of the results is tested through several robustness checks, by applying different smoothing parameters (the baseline of 6.25 is varied to 100 and 200). The main findings do not change significantly in the robustness tests performed (table A1.3 in Annex 1.1).

References

- Alesina, A. and R. Perotti (1996) “Income distribution, political instability and investment”, *European Economic Review*, vol. 40, issue 6, pages 1203-1228, April.
- Aisen, A. and FJ. Veiga, (2011) “How Does Political Instability Affects Economic Growth?”, *IMF Working Paper* No. 11/12, January.
- Barrera, N., O. Celasun, M. Esteveao, G. Keim, A. Maechler, P. Mills, and A. Bhatia (2009) “United States: Selected Issues”, *International Monetary Fund*.
- Barro, RJ. (1997) “Determinants of Economic Growth: A Cross-Country Empirical study”, *NBER Working Paper* No. 5698, August.
- Barro, RJ. (1996) “Democracy and Growth”, *NBER Working Paper* No. 4909, October.
- Credit Suisse (2011) “From Spring to Revival – Regime change and economic transformation”
- Elbadawi, I., S. Makdisi, and G. Milante (2011) “Explaining the Arab Democracy Deficit: the Role of Oil and Conflicts” in “Democracy in the Arab

- World: Explaining the Deficit" edited by Elbadawi, I. and S. Makdisi, *Routledge and International Development Centre*.
- European commission (2009) "Impact of the current economic and financial crisis on potential output", *Occasional Papers* No.49, June.
- Freund, C. and M. Jaud (2014) "Regime Change, Democracy and Growth", *Peterson Institute for International Economics Working Paper* No. 14 – 1, April.
- Furceri, D. and A. Mourougane (2012) "The effect of financial crises on potential output: New empirical evidence from OECD countries", *Journal of Macroeconomics*, vol. 34, issue 3, September, pages 822-832.
- Hodrick, R. and EC. Prescott (1997) "Postwar US Business Cycles: An Empirical Investigation", *Journal of Money, Credit and Banking*, vol. 29, no. 1, February, pages 1-16.
- International Monetary Fund (IMF) (2015a) "Chapter 3: Where are we headed: Perspectives on Potential Output" in "World Economic Outlook: Uneven Growth – Short and Long Term Factors"
- ____ (2015b) "Jordan: Seventh and Final Review Under the Stand By-Arrangement and Proposal for Post-Program Monitoring – Press Release; Staff Report; and Statement by the Executive Director for Jordan"
- ____ (2015c) "Morocco: 2015 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for Morocco"
- ____ (2013) "Jordan: First Review Under the Stand-By Arrangement, Request for Waivers of Nonobservance of Performance Criteria, Modification of Performance Criteria, and Rephrasing of Access – Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Jordan"
- ____ (2009) "World Economic Outlook October 2009: Sustaining the Recovery"
- Khandelwal, P. and A. Roitman (2013) "The Economics of Political Transitions: Implications for the Arab Spring", *IMF Working Paper* No. 13/69, March.
- Mitra, P., A. Hosny, G. Abajyan and M. Fischer (2015) "Estimating Potential Growth in the Middle East and Central Asia", *IMF Working Paper* No. 15/62, March.
- Mohaddes, K. and M. Raissi (2015) "The U.S. Oil Supply Revolution and the Global Economy", *IMF Working Paper* No.15/259, December.
- Okun, AM. (1962) "Potential GNP: Its Measurement and Significance" in: "Proceedings of the Business and Economic Statistics Section of the American Statistical Association", *American Statistical Association*, pages 89-104.
- Papaioannou, E. and G. Siourourinis (2008) "Democratization and Growth", *The Economic Journal*, vol. 118, issue 532, October, pages 1520-1551.
- Persson, T. and G. Tabellini (2006) "Democracy and development: the devil in details", *NBER Working Paper* No. 11993, February.
- Przeworski, A., ME. Alvarez,

- JA. Cheibub and F. Limongi (2000) "Democracy and Development: Political Institutions and Well-Being in the World, 1950-1990", *Cambridge University Press*.
- Ravn, M. and H. Uhlig (2002) "Notes on Adjusting the Hodrick-Prescott Filter for the Frequency of Observations", *The Review of Economics and Statistics*, vol. 84, issue 2, May, pages 371-380.
- Rodrik, D. and R. Wacziarg (2005) "Do Democratic Transition Produce Bad Economic Outcomes", *American Economic Review*, vol. 95, issue 2, May, pages 50-55.

Annex 1.1: Estimating Potential Output

To estimate potential output which is unobservable, this paper applies the widely known and common technique of the Hodrick Prescott (HP) linear filter (1997). This univariate filter estimates the series that minimizes the deviation between actual and potential output while constraining the rate of change in potential output for the whole sample of T observations. Alternatively, it decomposes or filters raw GDP data into cyclical and trend or structural components. Hence, the HP filter minimizes the following:

$$\text{Min} \sum_{t=1}^T (y_t - y_t^*)^2 + \lambda \sum_{t=2}^{T-1} [(y_{t+1}^* - y_t^*) - (y_t^* - y_{t-1}^*)]^2,$$

where y is the logarithm of real GDP and y^* is the logarithm of potential real GDP. λ , is a weighting factor that determines the degree of smoothness of the trend. A low value of λ will produce potential output that follows actual output more closely. The standard procedure is to set λ equal to 1600 for quarterly data, and 6.25 for annual data, following the Ravn-Uhlig (2002) rule which sets λ to $1600 \cdot p^4$, where p is the number of periods per quarter. T is the length of the time series.

The appeal of this approach is that it is simple, transparent, and can be applied to any country where GDP data exist. However, it also has apparent drawbacks, derived from its limitation as a purely statistical technique. First, the HP filter estimate trends in growth without regard to other macroeconomic variables and therefore is unable to capture

structural changes. Second, the HP filter suffers from the “end-point problem”: the instability of estimates near the end of the sample period, whereby the end-point-data tend to drive estimates of the trend at the end of the sample. This problem may result in revisions to potential output estimates at or near the end of the sample as new data is released. A common approach to deal with the problem is to extend the sample by using the forecast data, as we do in this chapter.

Finally, it is difficult to identify the appropriate value of the restriction parameter (λ) which captures the importance of cyclical shocks to output relative to trend output shocks, and thereby controls the smoothness of the series of potential output: a smaller value of λ indicates a smaller importance of cyclical shocks and yields a more volatile series of potential output. To resolve this problem, we test the sensitivity of the results by estimating potential output for several values of λ . For this chapter, the restriction parameter λ is set at 6.25, as suggested by the literature for annual time series. STATA is used to apply all the filters on real GDP in local currency. The data ranges over 1980-2019 and are from the WEO database.

The sensitivity of the results is tested through several robustness checks, by applying different smoothing parameters (the baseline of 6.25 is varied to 100 and 200). The main findings do not change significantly in the robustness tests performed (table A1.3).

Table A1.3: Robustness Check of Potential Growth Estimates (in percent) - Variations of Smoothing Parameters (lambda) in HP filter (Averages)

	2003-2010	2009	2011	2012-2014
South-Med Economies				
HP filter baseline, lambda=6.25	2.4	2.4	2.4	2.4
HP filter, lambda=100	2.8	2.4	2.0	1.8
HP filter, lambda=200	2.7	2.5	2.2	2.0
Algeria				
HP filter baseline, lambda=6.25	1.5	1.5	1.5	1.5
HP filter, lambda=100	2.1	1.4	1.1	1.1
HP filter, lambda=200	2.0	1.5	1.3	1.2
Egypt				
HP filter baseline, lambda=6.25	2.21	2.13	2.05	1.98
HP filter, lambda=100	2.6	2.2	1.7	1.5
HP filter, lambda=200	2.5	2.2	1.9	1.7
Jordan				
HP filter baseline, lambda=6.25	2.4	2.5	2.5	2.4
HP filter, lambda=100	3.4	2.9	2.1	1.6
HP filter, lambda=200	3.2	2.9	2.3	1.9
Morocco				
HP filter baseline, lambda=6.25	3.0	3.2	3.2	3.3
HP filter, lambda=100	3.4	3.4	3.3	3.2
HP filter, lambda=200	3.3	3.4	3.3	3.3
Tunisia				
HP filter baseline, lambda=6.25	2.9	2.9	2.8	2.8
HP filter, lambda=100	2.9	2.3	1.8	1.6
HP filter, lambda=200	2.9	2.4	2.0	2.0

Source: Calculated by the authors based on World Economic Outlook Database, IMF.

CHAPTER 2

Macroeconomic Policy Response¹

2.1 Introduction

As noted in the previous chapter, the political transition in South-Med economies has been accompanied by two main economic challenges: deteriorating macroeconomic imbalances and a cyclical economic downturn. In principle, addressing these challenges involves making one of two macroeconomic management choices. The first is to give priority to correcting macroeconomic imbalances by adopting austerity measures to limit their damaging impact on the economy, but that would be at the expense of contractionary effects on output. The other is giving priority to restoring economic growth to its potential through expansionary policies, but that would be at the risk of further deteriorations in fiscal deficits and public debt, which may harm long-term growth.

This chapter identifies and assesses the fiscal and monetary measures adopted by South-Med countries in response to macroeconomic challenges in the wake of the political uprisings. To this end, it will attempt to answer the following questions:

- What are the trade-offs as-

sociated with different approaches in dealing with macroeconomic imbalances and sluggish economic growth?

- In the South-Med countries, which approach did policymakers choose?
- Finally, how effective were the adopted policies in achieving their intended objectives?

The findings of this chapter suggest that South-Med governments have not implemented coordinated macroeconomic policies to stimulate aggregate demand and economic growth. On the contrary, these have oscillated over time. At an earlier stage, fiscal management was expansionary but had the aim of calming social discontent at the expense of exacerbating fiscal imbalances. At a later stage, fiscal adjustment became inevitable and consolidation measures were adopted often with the support of the IMF.

Meanwhile, the exchange rate stabilization policy, led by the South-Med central banks, was too costly and ineffective in Egypt and Tunisia. The attempt by the Central Bank of Egypt (CBE) to ease the persistent squeeze on

foreign exchange liquidity succeeded neither in stabilizing the exchange rate nor in eliminating the black market until the floatation of the pound in 2016. In both countries, monetary policy has been accommodating, which has sustained inflationary pressures and impeded the effectiveness of monetary policy. In Jordan and Morocco, monetary policy has been restrictive, which has stifled credit and economic growth. In Algeria, the price of oil has proved to be the dominant factor in determining macroeconomic outcomes.

Two other factors have played an important role in navigating the transition in South-Med countries. The first is access to external finance, which provided temporary relief to plug financing gaps. However, this support was not accompanied, in Egypt, by the adoption of the necessary reforms to correct short-term and structural imbalances. The other factor resides in the country's initial conditions at the time of the uprisings. Tunisia and Egypt provide opposite examples. In 2010, Tunisia had a low fiscal deficit and debt, safe foreign exchange buffers and low inflation, all of which accorded the authorities more space to provide monetary and fiscal stimulus. By contrast, Egypt was not in such an enviable position, hence a rapid deterioration in macroeconomic conditions.

As of today, all South-Med countries are still in the process of restoring macro balances and igniting economic growth. Despite consolidation efforts, fiscal vulnerabilities remain, leading South-Med economies to renew

IMF support. In addition, growth remains below potential and there is evidence of a crowding out of private sector credit. Currently, not only are these countries working towards improving economic performance, but they are also struggling to configure new and more inclusive political institutions.

The rest of the chapter is structured as follows. The next section reviews the literature on the debate of austerity versus expansion. Section 3 describes and assesses fiscal management during the transition, regarding its objective, composition and impact. Section 4 provides the same analysis for monetary policy. Section 5 addresses the issue of monetary and fiscal policy consistency. Section 6 draws some conclusions.

2.2 Understanding the austerity versus stimulus debate

The austerity versus stimulus debate has gained renewed interest since the onset of the Great Recession in late 2007 and, later, in the context of the Greek crisis. This debate is at the heart of economic policymaking in South-Med economies given that they face similar policy dilemmas. Policymakers are confronted with strikingly different choices. Like other countries in this position, policymakers in South-Med countries could follow expansionary fiscal policy to stimulate economic growth, or act prudently by giving priority to fiscal consolidation and debt reduction. But which approach is likely to be more beneficial to the

economy, both now and later? Under what conditions would one approach be superior to the other? And what role could/should monetary policy play in both cases? Unfortunately, the literature is inconclusive with respect to these questions.

Generally speaking, fiscal policy can be used to stabilise output through automatic stabilizers and/or discretionary actions. Automatic stabilizers are the cyclical component of the revenues and expenditures that automatically respond to cyclical changes in output and make fiscal policy automatically countercyclical. For instance, during a downturn, taxes decline because profits and incomes fall while unemployment benefits and other social spending rise. However, the effectiveness of automatic stabilizers depends on the existence of a large tax base with progressive taxation and/or a good coverage of unemployment benefits. Therefore, their impact may be hampered by the absence of proper taxation and unemployment benefits and/or may not be sufficient to restore growth. In this case, discretionary or active countercyclical fiscal action may be necessary. But not all economists advocate this view for countries in recession that are seeking to restore economic growth.

Let's start with the Keynesian view, which argues for stimulus policies during downturns to restore growth over fiscal consolidation by increasing public spending (borrowing) or easing taxes. According to this view, fiscal consolidation to reduce debt would deprive the economy of its key growth drivers and could

even increase debt further. It would, as firmly supported by Krugman (2010), reduce short-term growth and raise unemployment. These findings are empirically supported in a study by the IMF (2010). Furthermore, Frankel et al. (2012) argues that regardless of the economic cycle, fiscal policy should be countercyclical, meaning spending hikes and/or tax cuts in response to downturns and reduced spending and/or taxes hikes during economic booms. Countercyclical policy can dampen the severity of business cycle fluctuations, reduce the risks of overheating (inflation and asset bubbles) during booms and mitigate the losses in output and employment during recessions. It would also ensure that an unexpected decline in revenue would not lead to abrupt changes in government spending with adverse macroeconomic effects. More importantly, it could also prevent overspending during upturns and therefore help to create and maintain the necessary fiscal space that would be used during recessions.

The effectiveness of stimulus depends on the existence of a slack in the economy and on the size of the fiscal multiplier, which is defined as the short-term change in real GDP caused by one unit increase in government discretionary spending. If fiscal multipliers are large, then additional spending or tax reductions could lead to significant output expansion. The size of the fiscal multiplier itself depends on the country's initial conditions.² Multipliers tend to be large (leading to a large output loss in the case of a fiscal consolidation, and vice

versa) if there is less leakage and, for example, only a small part of the stimulus is saved or spent on imports. They are also larger if there are no automatic stabilizers to partly offset the impact of the initial fiscal shock on GDP. Moreover, the impact of fiscal expansion on output would be limited if it is associated with concerns about sustainability, leading the private sector to increase savings rather than investing or consuming and therefore offsetting the impact of fiscal intervention on GDP.

Empirically, fiscal multipliers are found to be larger in downturns than in expansions (IMF, 2010). In a prominent article, Blanchard and Leigh (2013) show that some economic conditions in advanced countries (interest rates near the zero lower bound (ZLB), poorly functioning financial systems and the existence of significant slack in the economy) were associated with fiscal multipliers that were substantially higher than those usually assumed.

At the other end of the spectrum, advocates of austerity policies urge governments to resolve fiscal imbalances (through fiscal contractions) because the accumulation of the stock of public debt associated with fiscal stimulus, particularly if the recession is persistent or if the initial levels of deficits and debt are high, would hamper long-term growth. Empirical support suggests that a debt-to-GDP ratio of 85-90 percent or more may constrain growth (Kumar and Woo, 2010 and Reinhart and Rogoff, 2010 and Cecchetti, Mohanty, and Zampolli, 2011). Other evidence shows that negative long-term

effects of public debt build-up on output growth would disappear if public debt is on a downward trajectory (Chudik et al., 2015). Alternatively, IMF (2010) shows that reducing government debt would raise long-term output, as the lighter burden of interest payments would create fiscal room for cutting distortionary taxes.

Another part of the literature, initiated by a paper by Giavazzi and Pagano (1990), has uncovered “non-Keynesian” effects of fiscal adjustments. It shows that reducing deficits can stimulate short-term growth, a notion often referred to as the “expansionary fiscal contractions”. The expansion would occur as an improvement in household and business confidence, and therefore private demand, removing the fear of future harsher fiscal adjustments and future taxes.

In terms of how contraction ought to happen, it has been shown that spending-based fiscal contractions may have lower costs in terms of lost output (alternatively a smaller multiplier) than tax increases (IMF, 2010). Alesina and Perotti (1995) and Alesina and Ardagna (2010) had already shown that spending-based consolidations are associated with above average increases in output and private consumption, while revenue-based consolidations are associated with recessions. Perotti (2012) explains that this occurs due to monetary policy accommodation (interest rate cuts, low interest rates and currency depreciation/devaluation to promote exports) to help cushion the impact of fiscal contraction on demand, as well as reduced inflation expectations to make wage

moderation possible. Alternatively, fixed exchange rates would not provide any adjustment to (partly) offset the contractionary effect of fiscal consolidation and can thus be associated with larger output contractions (relative to flexible regimes). Another possible reason is that tax-based adjustments (through indirect tax hikes for example) often result in price increases that would require a restrictive monetary policy stance to curb inflation but would hurt growth (IMF, 2010). Because not all countries can increase net exports at the same time, this finding implies that fiscal contraction is likely to be more painful when many countries adjust at the same time (IMF, 2012a).

This is essentially what the literature says about fiscal policy; what does it say about monetary policy? The commonly accepted view, derived from Friedman's (1968) quantity theory of money, is that in the long-run, changes in the money supply only cause changes in prices but not in output. In the short-run, however, there is a trade-off between changes in the money supply (inflation) and output because prices and wages are sticky, as illustrated by the Phillips curve (Friedman, 1968 and Phelps, 1968). In practice, this means that monetary policy can moderate short-term real fluctuations, if it is autonomous. To the extent that fixed exchange rates are managed with an independent tool (foreign exchange interventions), there would be some scope for *autonomous monetary policy using interest rates* to influence domestic objectives such as inflation and short-term output (Ostry et. Al, 2012).

The exchange rate can also play an active role in adjusting to current account imbalances which, if large and persistent, could lead to a build-up of excessive foreign debt and increase an economy's vulnerability to a sudden stop in capital flows, which might force an abrupt and disruptive adjustment. Gervais et al. (2016) provide empirical evidence that flexible real exchange rates (through nominal flexibility) can promote current account rebalancing, through expenditure-switching between domestic and foreign goods, which can promote exports (Friedman, 1953). Moreover, they find the adjustment to be more costly in terms of output loss for countries that have a fixed exchange rate regime, since they tend to delay exchange rate devaluations until the occurrence of a currency crisis.

In short, there are compelling arguments in favour of each of the two approaches: expansionary and contractionary policies. The course of action most suited to each country depends on its initial and specific conditions that determine the size of the fiscal multiplier or, alternatively, the foregone loss in output. Expansionary fiscal policy is easier to adopt when the country has fiscal space, when it can access additional financing at a reasonable cost and when it has the capacity to reorder its existing expenditures and undertake structural and institutional reforms. Austerity policies may be advisable when these conditions are not met and when there is room for monetary policy accommodation to soften the impact of such policies. Finally, each policy choice

involves trade-offs and there is no free lunch.

Against this brief review of the literature, we turn next to the macroeconomic responses of 5 South-Med countries in the aftermath of the political uprisings in 2010. The five countries, in alphabetical order, are: Algeria, Egypt, Jordan, Morocco and Tunisia.

2.3 Fiscal policy response

The 2011 uprisings triggered immediate discretionary fiscal expansions by most South-Med governments, which were rolled back a few years later. This section aims to characterise their fiscal responses in terms of objectives, stance and composition. It also aims to assess the effectiveness of fiscal policy in terms of sustainability and impact on growth.

Fiscal policy objectives, stance and composition

Starting with fiscal policy *objectives*, it seems that South-Med countries have attempted, in the past seven years, to strike a balance between easing social tension, requiring an expansionary policy, and containing the deterioration of fiscal imbalances, requiring fiscal consolidation and austerity measures.

During the early years of the uprising (2011-2012), priority was given to the political objective in most countries. Fiscal expansions were used either to ease rising social discontent (Tunisia and Egypt) or, preemptively, to maintain social peace in countries that did not experience significant unrest (Algeria, Jordan and Morocco). At a later stage, it

became evident that South-Med countries had to consolidate their fiscal positions. Thus, by 2016, all South-Med countries, except Algeria, concluded agreements with the IMF (See Table 2.1 for details). The timing and pace of the adjustment in each country were determined primarily by three inter-related factors: (i) the severity of social/political unrest, (ii) initial conditions, and (iii) access to external finance.

At one end of the spectrum, Jordan and Morocco initiated fiscal consolidation as early as 2012. The consolidation effort came sooner than in other South-Med countries because the political tension was less severe. It was promoted by the relatively weak (pre-crisis) initial fiscal conditions, which quickly deteriorated in both countries to 9 and 8 percent of GDP, respectively. Also, these countries were not the recipient of major financial support from abroad. In both cases, the consolidation programs were accompanied by measures to protect the poor. In Morocco, for example, there was a budget reallocation in favour of measures to strengthen social safety nets through increases in education allowances, medical insurance and public transportation (IMF, 2015a).

At the other end of the spectrum, Egypt delayed fiscal consolidation the most, even though it had the worst initial fiscal condition (an overall deficit of 8 percent and a primary deficit of 2.5 percent of GDP) of all South-Med countries. This was not for lack of trying. On the contrary, Egypt negotiated a program with the IMF as early as mid-2011 for a USD

3 billion loan, which met with public resistance and cancellation (Hanieh, 2015). A second attempt was made in mid-2012 for a loan of USD 4.8 billion, but this attempt suffered the same fate as the previous one. Another factor that may have delayed consolidation was having access to external financing from the GCC. With these resources, it was possible to embark on a fiscal stimulus package (of around 1.2 percent of GDP in 2013) with the dual objectives of activating the economy and achieving social justice (MOF, 2014), making Egypt the only South-Med country to have made an explicit attempt at stimulating aggregate demand. By mid-2014, however, the deterioration in public finance (averaging 13 and 7 percent of GDP for the overall and primary deficits, respectively), the easing of social pressure and the curtailment of GCC funds, prompted the government to unilaterally reduce energy subsidies. By 2016, four years later than Jordan and Morocco, the government concluded an agreement with the IMF.

Tunisia falls in the middle. Like Egypt, prolonged social unrest made it difficult to reverse spending expansions. A healthy initial (pre-crisis) condition made it possible to sustain expansionary policies for a year longer than Jordan and Morocco. By 2013, however, worsening fiscal balances (overall and primary deficits of 7 and 6 percent of GDP, respectively) triggered consolidation plans with IMF support. This program involved partial redirection of resources from subsidy savings towards such social programs as education, health,

Table 2.1: IMF programs in South-Med countries in the post-uprising period

Country	Date	Program	Size	Duration
Jordan	August 2012	Stand-By-Arrangement (SBA)	SDR 1.364 billion (about US\$2 billion)	3 years
	August 2016	Extended Fund Facility (EFF)	SDR 514.65 million (about US\$723 million)	3 years
Morocco	August 2012	Precautionary and Liquidity Line (PLL)	SDR 4,117.4 million (about US\$6.21 billion)	2 years
	July 2014	Precautionary and Liquidity Line (PLL)	SDR 3.2351 billion (about US\$5 billion)	2 years
	July 2016	Precautionary and Liquidity Line (PLL)	SDR 2.504 billion (about US\$3.47 billion)	2 years
Tunisia	June 2013	Stand-By-Arrangement (SBA)	SDR 1.146 billion (about US\$1.74 billion)	2 years, 7 months extension
	April 2016	Extended Arrangement under Extended Facility Fund	SDR 2.04 billion (about US\$2.9 billion)	4 years
Egypt	November 2016	Extended Fund Facility (EFF)	SDR 8.5966 billion (about US\$12 billion)	3 years

Source: IMF.

employment promotion and cash transfers (IMF, 2013a). The implementation of the program in 2013 triggered social protest (Hanieh, 2015), which caused some delay.

As for Algeria, fiscal management was driven primarily by oil prices. And, like other South-Med economies, fiscal policy was used initially to quieten discontent. The recent sharp drop in hydrocarbon revenues on the back of falling oil prices led to cuts in spending and an overall deterioration in public finance.

To formalise the above narrative, the fiscal impulse (FI) was computed for South-Med countries to capture the stance of fiscal policy during the period 2011-2015. The methodology used is

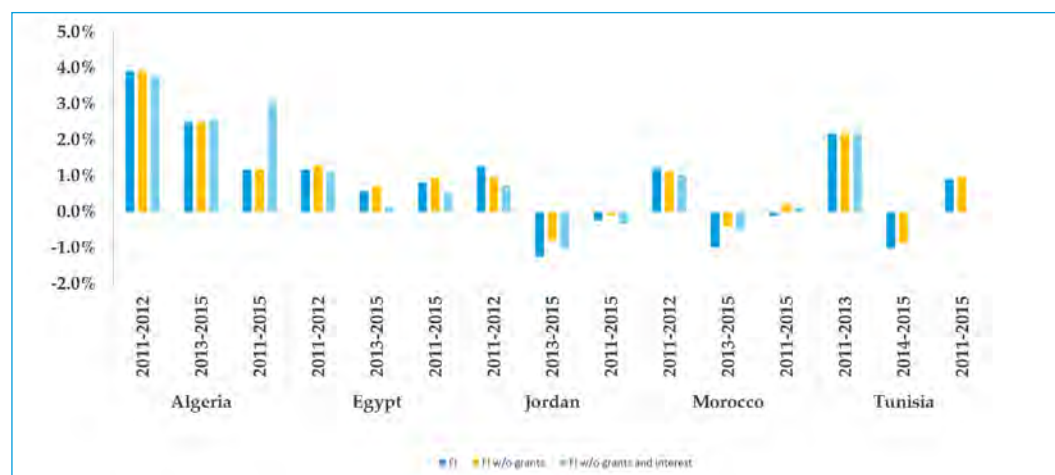
explained in Annex 2.1 at the end of this chapter and the results are shown in figure 2.1 in 3 different ways. The figure shows that, over the period 2011-2015, fiscal policy was contractionary in Morocco and Jordan, where consolidation was implemented less than two years after the uprising, but expansionary in Egypt and Tunisia, where fiscal consolidation was undertaken at a later date. In Algeria, fiscal policy was expansionary throughout.

Breaking down the 2011-2015 period into sub-periods, figure 2.1 shows that, during the early years of the uprising, the fiscal impulse was positive in all South-Med economies, suggesting an expansionary fiscal policy. The FI reached close to 4 percentage points of GDP in Algeria, 2.2 percentage points in Tunisia and around 1 percentage point in other South-Med countries. Fiscal consolidation in Jordan and Morocco led to an overall contrac-

tionary stance between 2013 and 2015. Meanwhile, higher spending maintained the expansionary stance in Tunisia until 2013. Spending-based contractions took place in 2014 though the fiscal stance slightly eased again in 2015. Finally, unlike other South-Med economies, Egypt's fiscal expansionary stance continued in 2013-2014 because of large spending expansions. However, the fiscal impulse slowed down in 2014 on the back of partial fiscal consolidation.

Turning to the *composition* of the fiscal response, figure 2.2 shows that the spending hikes during the first two years of the political uprising were mostly in the form of current spending. The size of fiscal expansions averaged slightly less than 3 percent of GDP in South-Med countries, but there were considerable variations across countries. Tunisia experienced the most significant increase in current spending (by

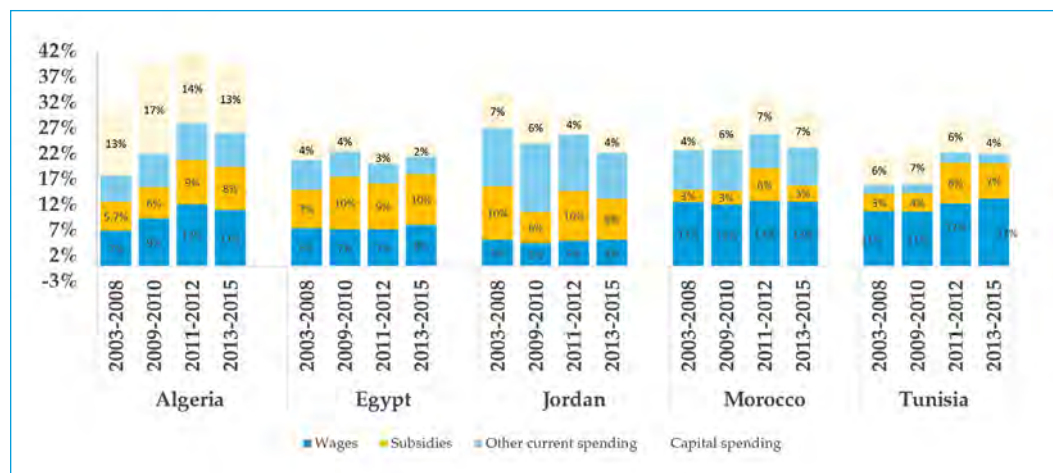
Figure 2.1: Fiscal impulse (FI) in South-Med countries after the uprisings (percent)



Note: The fiscal impulse measure was calculated once based on overall deficit, once on deficit excluding grants and once on primary deficit excluding grants.

Source: Calculated by the authors based on fiscal data extracted from IMF Article IV Consultation central government budget tables, and potential output was calculated using the HP filter, $\lambda = 6.25$.

Figure 2.2: Primary expenditure components (percent of GDP)



Note: Current spending excludes interest.

Source: Calculated by the authors based on fiscal data extracted from IMF Article IV Consultation central government budget tables.

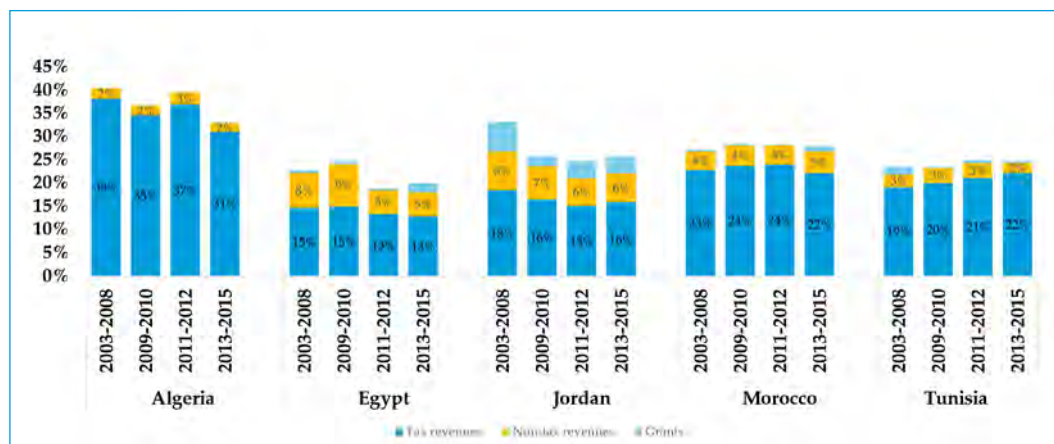
around 10 percentage points of GDP between 2010 and 2013). Meanwhile, current spending in Jordan and Morocco was increased by 2 and 3 percentage points of GDP. Algeria and Tunisia increased public sector wages and subsidies, while Jordan and Morocco increased subsidies.

To finance spending expansions, Jordan cut capital spending, especially as revenues decreased (figure 2.3). In fact, Jordan's substantial subsidy increase was entirely offset by an equal reduction in capital spending. Morocco could increase domestic revenues, which also allowed it to increase capital expenditure (by 1 percent of GDP), making it the only South-Med country to have done so. Algeria and Tunisia, with the largest fiscal expansions, resorted to both capital spending cuts and higher revenues (including grants of 1 percent of GDP, in 2012, for Tunisia).

The austerity measures in Jordan and Morocco that began in

2012 curtailed current spending by 4 and 5 percentage points of GDP, respectively. In Morocco, the removal of subsidies (on both petroleum products and basic foodstuffs) and the partial indexation of domestic retail energy prices to world prices, brought subsidies from 6 percent of GDP in 2012 to less than 4 percent of GDP in 2014. Despite the inflow of some grants to Morocco, fiscal consolidation was associated with reduced capital spending. In Jordan, fuel pump subsidies were also eliminated in late 2012 and an automatic pricing adjustment was re-established and accompanied by introducing cash transfers to about 70 percent of the population. Fiscal consolidation was financed by higher revenues (including grants in 2014) so that the government could redirect resources from current spending to capital spending, which increased by 1 percent of GDP between 2012 and 2014.

Figure 2.3: Revenues Components (percent of GDP)



Source: IMF Article IV Consultation fiscal data.

In Tunisia, the consolidation plans curtailed public spending in 2014 (from 26 to 21 percent of GDP) by reducing subsidies, which went down from 10 to 6 percent of GDP. However, on the back of unceasing tension, Tunisia was unable to fully implement the revenue-enhancing measures (higher stamp duties and excises on alcoholic beverages).

In Egypt, declining fiscal revenues in 2011-2012 led to a combination of cuts in capital spending, which was already low, and a freeze of (primary) current spending as a ratio to GDP. Starting in 2013, current spending expansions (up from 20 percent of GDP in 2011-2012 to 22 percent in 2013) occurred on the back of higher subsidies, social benefits and wages. The 2014 fiscal stimulus included current spending hikes (up by 0.8 percentage point of GDP) in the form of salary increases (minimum wage for civil servants) pensions and other social benefits. Moreover, it also included an increase in capital spending on infrastructure projects (0.4 percentage point

of GDP). These fiscal expansions were partly financed by substantial grants and a dormant government deposit at the CBE (MOF, 2014). In 2015, the deterioration in public finances forced the government to curtail current spending with substantial fuel subsidy reductions (down to 6 percent of GDP from 9 percent in 2013) and to impose a freeze on investment spending.

During the period 2011-2015, the composition of public spending in all South-Med economies was biased in favour of wages and subsidies, at the expense of public investment. In fact, capital spending was brought down from an average (excluding Algeria) of 5.5 percent, in 2010, to 4.4 percent of GDP, in 2015, while wages and subsidies rose to 15.5 percent of GDP (from less than 14 percent of GDP). In Egypt and Tunisia, these trends were more pronounced. As such, fiscal management was driven by social concerns at the expense of fiscal sustainability. Only in Egypt was there a short-lived attempt to use fiscal policy to stimulate aggregate demand.

Sooner or later, consolidation was inevitable in all South-Med countries.

Fiscal sustainability and growth

Starting with fiscal sustainability, figure 2.4 and table 2.2 show that the fiscal expansions and/or revenue drops in 2011-2012 were accompanied by a substantial increase in primary deficits and debt to GDP ratios. Fiscal consolidation helped contain fiscal vulnerabilities and maintain overall macroeconomic stability, but concerns remained regarding public debt.

The fiscal consolidations in Jordan and Morocco, in 2012, improved the situation, so that by the end of 2015 primary balances were close to pre-crisis ratios. However, public debt in both countries rose beyond pre-crisis levels. Per the IMF, the debt to GDP ratios should be reduced further to 77 percent in Jordan and 60 percent in Morocco by 2021 and 2020, respectively (IMF, 2016a and 2015b). To achieve these targets, both countries embarked on successor IMF arrangements in 2016.

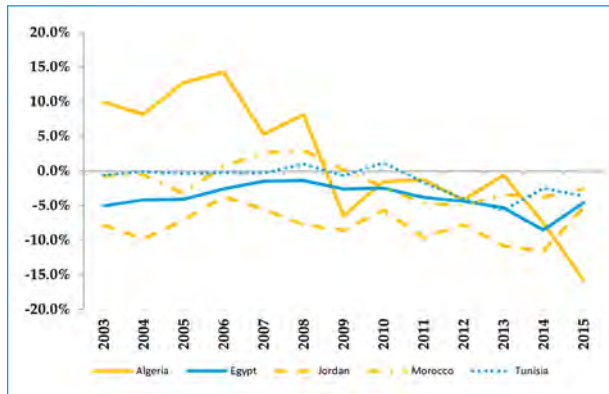
Given that Tunisia's fiscal consolidation program was mindful of social discontent, it was implemented at a slow pace and thus the primary deficit only marginally improved in 2014-2015, relative to the stimulus years of 2011-2012. However, thanks to the country's favorable initial conditions, the debt levels remain slightly below pre-crisis levels and primary deficits are only around 4 percent of GDP. The target for the debt-to-GDP ratio in 2020 is under 50 percent (IMF, 2016b).

Table 2.2: Fiscal vulnerability in South-Med economies

	2003-2008	2009-2010	2011-2012	2013-2015
Algeria				
Fiscal impulse	-0.7	2.1	3.8	2.6
Primary balance	9.8	-4.0	-2.7	-7.9
Primary balance (without grants)	9.8	-4.0	-2.7	-7.9
Debt-to-GDP ratios	61.4	-30.6	-25.3	-16.2
Egypt				
Fiscal impulse	-0.9	0.4	1.1	1.8
Primary balance	-2.5	-2.0	-3.7	-4.5
Primary balance (without grants)	-3.1	-2.5	-4.1	-6.9
Debt-to-GDP ratios	66.2	54.5	59.4	70.8
Jordan				
Fiscal impulse	-0.2	-1.6	0.7	-1.0
Primary balance	-0.6	-5.0	-4.9	-5.6
Primary balance (without grants)	-6.9	-7.1	-8.7	-9.2
Debt-to-GDP ratios	79.8	69.6	84.8	81.3
Morocco				
Fiscal impulse	0.1	2.5	1.0	-0.5
Primary balance	0.6	-0.7	-4.7	-2.1
Primary balance (without grants)	0.3	-1.1	-4.8	-3.2
Debt-to-GDP ratios	56.4	48.1	56.2	63.8
Tunisia				
Fiscal impulse	-0.2	-0.1	2.2	-0.9
Primary balance	1.5	0.5	-3.3	-2.6
Primary balance (without grants)	-0.1	0.3	-3.8	-3.0
Debt-to-GDP ratios	51.8	41.7	44.9	51.1

Note: The reported fiscal impulse measure excludes both grants and interest.

Source: Calculated by the authors based on fiscal data extracted from IMF Article IV Consultation central government budget tables, and potential output data for the FI measure using the HP filter, $\lambda = 6.25$.

Figure 2.4: Primary deficits, excluding grants (percent of GDP)

Source: Calculated by the authors based on fiscal data extracted from IMF Article IV Consultation central government budget tables.

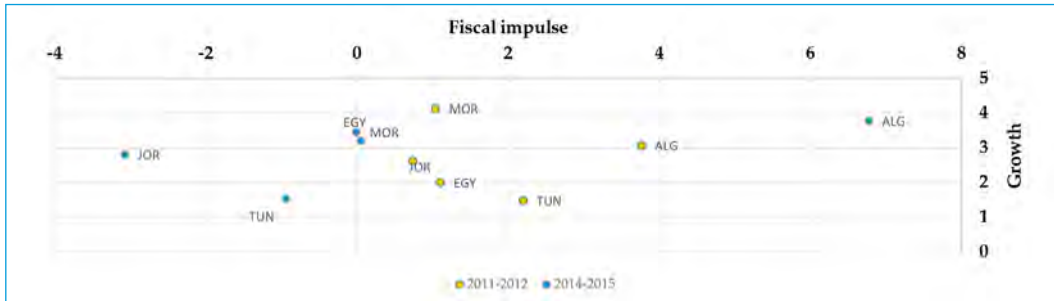
Despite the spending freeze in the early years of the uprising, Egypt's primary deficits (excluding grants) deteriorated from 2.5 percent in 2010 to almost 4.4 percent of GDP in 2012, on the back of lower revenues and heavy government borrowing. The latter resulted in an increase in the cost of government borrowing, signalling an elevated risk premium. The 91-day T-bill rate jumped from an average of 10 percent in 2010 to above 18 percent in early 2012, the highest rate since 2008. The Egyptian government also encountered difficulties on several occasions in raising the required amounts for its T-bill auctions during the early years of the uprising, as investors demanded higher yields. With the acceleration of expansion in 2013-2014, and despite access to external finance, fiscal imbalances deteriorated further. The partial consolidation of 2015 offset some of this deterioration but sustainability concerns remain.

In Algeria, oil revenues could

finance the expansions without significant harm to fiscal vulnerability. However, with the drop in oil prices starting 2014, the IMF (2014a) estimates that fiscal policy is currently on an unsustainable path. Algeria's fiscal breakeven oil price increased from \$20/barrel in 2003 to \$125/barrel in 2012 and was projected to reach \$136/barrel in 2014, keeping in mind that the fiscal breakeven oil price is the theoretical price of oil that would yield a balanced budget in a given year.

What about economic growth? Although early expansionary policy in South-Med countries was not explicitly motivated by stimulating aggregate demand, it would still be expected to have some impact on economic growth. To assess the macroeconomic effects of fiscal management in South-Med economies, we attempt to determine the counter-cyclicity of different budget components (revenues and spending) to find out how fiscal policy may have combated business cycle fluctuations. The methodology we use is explained, along with the detailed results, in Annex 2.2 at the end of this chapter. Here we plot the FI and economic growth between two points: 2010-2011 and 2014-2015 in figure 2.5 and make a few broad remarks below.

Overall fiscal management has not been very effective in stimulating economic growth in South-Med countries, which remained below potential. Early fiscal expansions took the form of politically motivated current spending, which could have at best have contributed to temporary boosts of consumption and investment. But, as shown in figure 2.5, fiscal

Figure 2.5: Fiscal impulse and growth rates between 2010-11 and 2014-2015 (percent)

Source: Calculated by the authors based on computed fiscal impulse and World Economic Outlook database, IMF.

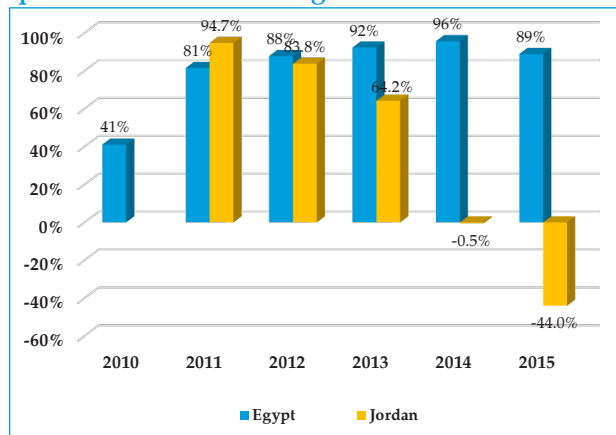
expansions were associated with slightly higher growth in Egypt. In other countries, growth essentially stagnated between 2011-2012 and 2013-2015.

One reason for this result is that expansionary policies were reversed in a relatively short period of time. And indeed, in the case of Tunisia, the IMF (2012b) shows that the 2011 fiscal impulse may have contributed to GDP growth by 0.5 to 0.7 percent in 2011. The other explanation is that current spending stimulus tends to have lower multiplier effects than capital spending. Preliminary estimates for Tunisia find a multiplier on capital spending of about 0.3, while that on current spending is about half of that (IMF, 2012b). Most of the expansion in South-Med countries took the form of current spending due to the prevailing socio-political difficulties, which were costly but perhaps unavoidable. In other words, the fiscal expansions were not designed to permanently boost investment and job-creating growth, but rather to accommodate social grievances. The only exception to this was one short-lived stimulus plan in Egypt, in the second half of 2013.

In addition, the expansionary policy was financed through extensive borrowing, which resulted in higher overall costs of borrowing and a crowding out of private investment. As budget deficits soared in the absence of an effective secondary market for T-bills, governments in Egypt and Jordan have increasingly relied on commercial banks to finance their deficits (figure 2.6). Credit to the government outpaced private credit growth in most South-Med countries, which more than doubled in Egypt, tripled in Tunisia and exponentially increased in Morocco. Jordan temporarily suffered from crowding out, but that trend was reversed with fiscal consolidation efforts in 2014 and 2015.

Eventually, fiscal management in South-Med countries prioritized the preservation of macroeconomic stability over growth, for some countries sooner than others. The decision to consolidate was inevitable for all countries, including most recently in Egypt. The lax fiscal policy pursued during the uprisings limited fiscal space to counteract the deterioration of economic activity, suggesting that the countercyclical

Figure 2.6: Bank financing of the deficit, 2010-2015 (percent of total financing)



Source: Calculated by the authors based on data from the monthly financial bulletin from Egypt's ministry of finance website and Jordan's IMF Article IV Consultation data.

cal capacity of policies was severely constrained. For most, the only way to adjust their fiscal balances was to borrow externally (through IMF support). Nevertheless, despite consolidation efforts, fiscal vulnerabilities remain, leading many South-Med economies to renew IMF support. In all South-Med economies, growth has remained below potential and there is evidence of a crowding out of private sector credit.

2.4 Monetary policy response

Among other effects, the 2011 uprisings were associated with a drop in foreign exchange earnings and short-term capital outflows, both of which put significant pressure on current accounts and, in turn, on nominal exchange rates. This section explores how the central banks in South-Med countries responded to foreign exchange scarcity, given their

mandate, or actually pursued monetary policy goals. It also assesses the impact of monetary policy on domestic goals such as inflation and economic growth.

Objectives and exchange rate management

Notwithstanding announced objectives, all South-Med central banks are exchange rate targeters, at least in de facto terms. Observing their actions, central banks seem to have strived to maintain an official parity between an anchor currency (or basket) and their domestic currency (Table 2.5). Algeria, Jordan and Morocco have had formal peg arrangements, with explicit exchange rate targets. Egypt and Tunisia have de jure more flexible arrangements, but they implicitly attempt to maintain exchange rate stability or, at a minimum, to reduce exchange rate volatility.

Because foreign exchange interventions were used as an independent tool to manage the exchange rate, there was some scope for monetary policy in certain countries, through interest rates, to pursue domestic objectives, such as price stability, short-term output stabilization and financial stability. And some countries have done so. For example, the central banks in Egypt and Tunisia have attempted to alleviate liquidity shortages in the banking sectors. The central bank of Egypt (CBE) has supplied foreign exchange liquidity to banks through regular and exceptional auctions. The Central Bank of Tunisia (CBT) has provided the *direct refinancing of banks* through liquidity injections to alleviate structural liquidity shortages due

Table 2.5: Exchange rate regimes in South-Med economies, 2010-2014

Country	2010	2011	2012	2013	2014
Algeria	Composite exchange rate anchor (managed arrangement)	No change	No change	No change	No change
Egypt	Crawl-like arrangement against a composite basket	Other stabilized arrangement	Other crawl-like stabilized arrangement without an explicit exchange rate anchor (de facto peg to US\$)	Stabilized arrangement without an explicit exchange rate anchor (de facto peg to the US\$)	No change
Jordan	Conventional Peg to USD	No change	No change	No change	No change
Morocco	Conventional Peg to a composite basket (Euro-USD with 80/20 weights)	No change	No change	No change	No change
Tunisia	Other conventional fixed peg arrangement with a composite anchor	n/a	Crawl-like arrangement without an explicit exchange rate anchor (de facto peg to a composite basket)	No change	No change

Source: IMF.

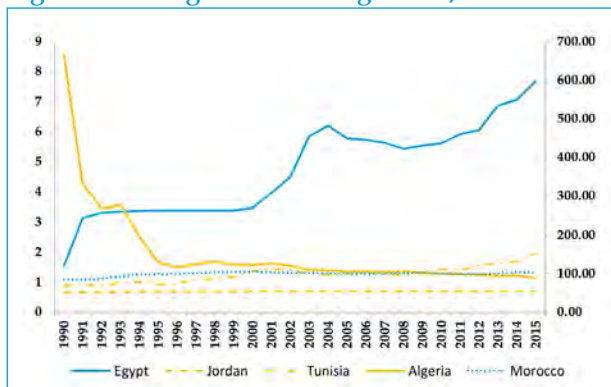
to increased demand for cash and sizeable deposit withdrawals. These measures aim at preserving financial stability.

The pursuit of monetary policy has been constrained, however, by fiscal dominance in all South-Med economies because of high fiscal deficits and large public debt. Under a fiscally dominant regime, as in Sargent and Wallace (1981), central banks may not be able to effectively counter inflationary pressure. They also tend to succumb to government pressure to finance the deficit or do away with a tighter monetary policy stance to avoid increasing the cost of public debt service. In this context, monetary policy objectives are subservient to fiscal objectives.

At any rate, because the exchange rate has been a central component in the conduct of monetary policy and an important anchor for expectations in

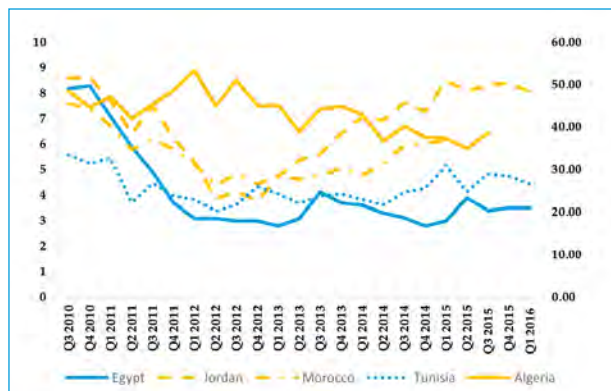
South-Med countries, central banks have shown notable reluctance to let the exchange rate adjust to ever-deteriorating current accounts in the aftermath of the political shock. As shown in figure 2.7, there has been very little movement in the nominal exchange rate versus the US\$ or the basket of currencies in almost all South-Med countries, except for Egypt. Central banks have used foreign exchange interventions to stabilise the currency, international reserves permitting.

At the same time, following the reversal of capital inflows, the response of South-Med central banks focused on eroding reserve buffers accumulated during previous years. Figure 2.8 shows that depletion was significant during the early years of the uprising, which stood then at healthy levels of 9 (Jordan) and 5 (Tunisia) months of imports before the political shock. The safe benchmark

Figure 2.7: Long-term exchange rates, 1990-2015

Note: Bilateral exchange rates (local currency per USD) is plotted for Egypt, Jordan and Tunisia. An increase indicates a depreciation of the domestic currency against the USD and vice versa. The nominal effective exchange rate is plotted for Algeria and Morocco because their currencies are pegged to a composite basket. An increase indicates an appreciation of the domestic currency against the anchor basket and vice versa.

Source: World Development Indicators, World Bank.

Figure 2.8: Reserves in months of imports, 2010-2016

Source: data from national central banks

for reserve adequacy is about 3 months of imports, which is a proxy for current account vulnerability when the balance of payments is dominated by trade and when the country has limited access to capital markets.

Once safe reserve buffers were depleted, persistence of the current account imbalances and

scarcity of capital inflows forced South-Med countries to either initiate an exchange rate adjustment, or to borrow to finance the current account. The choices they made depended on (i) the persistence of current account imbalances, (ii) their willingness to adopt a policy mix of reserve depletion and exchange rate flexibility, and (iii) access to external finance.

At one end of the spectrum, reserve depletion reached its limits in Jordan and Morocco sooner than in Egypt and Tunisia. In the former countries, where exchange rate regimes are strictly managed, extensive foreign exchange interventions were successful in maintaining exchange rate stability. However, the pace of reserve depletion worsened in 2012, relative to 2011, leading to a fall in reserves below 4 months of imports. The IMF support in 2012 subsequently facilitated access to capital markets. Reserve accumulation was resumed in Jordan by sizeable grants from the GCC countries in 2013 (US\$1.25 billion in grants), the World Bank (US\$150 million emergency loan to cover the cost of hosting the Syrian refugees), as well as a successful US dollar-denominated domestic bond issuances (IMF, 2014b and World Bank, 2014). Similarly, reserves in Morocco improved on the back of a narrowing current account deficit and a significant increase in foreign direct investment. By 2014 and 2015, both countries had recovered their pre-crisis levels of reserve holdings.

At the other end of the spectrum, the central banks of Egypt and Tunisia combined limited exchange rate flexibility and reserve depletion. By the end of 2012, the

exchange rates had depreciated respectively by 6 and 9 percent in Egypt and Tunisia, respectively, accompanied by a depletion of around 60 and 25 percent of pre-crisis foreign exchange holdings. Among all South-Med economies, Egypt is the country where official reserves have come down the most. In 2011 alone, it had lost more than USD 20 billion (or more than 40 percent of 2010 reserve holdings).

As current account pressures persisted and reserve buffers reached a critical minimum, central banks were compelled to relax exchange rate management, starting late 2012. In Egypt, the central bank introduced small devaluations paced out over a long period (12 percent in Q1-2013, 6 percent in Q1-2015 and 14 percent in March and May 2016). Since the uprisings, the Egyptian currency has lost 50 percent of its value. By comparison, the CBT was more flexible and more mindful of reserve erosion. By September 2011, it abandoned the euro-dollar basket as the primary monetary anchor and added a monetary aggregate along with the exchange rate anchor. Moreover, it started in late 2012 to base its reference exchange rate on the average interbank exchange rate, instead of the fixed currency basket. These measures led to several exchange rate adjustments that helped limit CBT interventions to cases when quotations deviated significantly from the daily interbank rate and overall offset some reserve losses (IMF, 2012b). In February 2016, the CBT introduced a weekly foreign-exchange auction system to help promote competitive bidding for foreign exchange. It has

also set a ceiling for net foreign exchange interventions so that it could only intervene to smooth “excessively large” fluctuations. Despite these measures, the Tunisian currency has also lost half of its value.

Both Egypt and Tunisia have benefited from access to foreign grants, which provided temporary boosts to reserves. In Egypt, starting 2013, reserve accumulation largely reflected sporadic deposits made by Turkey, Libya and several GCC states. It is estimated that the total amount of these deposits between May 2012 and November 2014 amounted to USD 20 billion. Moreover, the government could access capital markets through the issuance of foreign currency denominated bonds. In Tunisia, stronger FDI inflows, sustained multilateral and bilateral loans (World Bank (US\$500 million) and the African Development Bank (US\$200 million)), and access to capital markets (with US Treasury and Japan Bank for International Cooperation (JBIC) guarantees) boosted central bank reserves (IMF, 2013a).

Under increasing pressure, the CBE and the CBT introduced price and capital controls. In 2013, the CBE imposed restrictions on bid-ask spreads quoted by authorised foreign exchange dealers, thus prohibiting them from quoting their own rates. These restrictions became tighter over time. Other capital control measures were extended to the repatriation of export proceeds of certain products and limits on transfers abroad and, in February 2015 on foreign exchange cash withdrawals (and deposits). Later on, limits were imposed on foreign

exchange currency transactions using debit and credit cards. The CBE has also issued an import priority list for the allocation of foreign exchange by banks. The CBT imposed similar restrictions. For instance, it required surplus funds in foreign currency accounts to be converted to dinars. However, as of 2016, ex-ante controls on capital account transactions were replaced with ex-post controls and ceilings for foreigners' holdings of government securities were eliminated. Also, greater powers were granted to banks for FX transfers (IMF, 2016b). The imposition of partial capital controls did not preserve the stability of the exchange in both countries.

In a category of its own, the exchange rate and reserves in Algeria remained at the mercy of oil revenues, which only came under pressure with the decline in oil prices in 2014 and 2015.

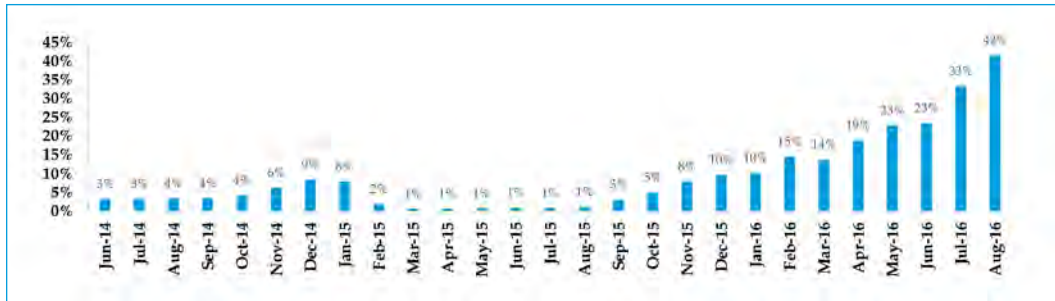
What does all this mean? Firstly, the reliance on foreign exchange intervention for exchange rate stabilization, which was used in Jordan and Morocco, was effective in preserving exchange rate stability with IMF support. In Egypt and Tunisia, where a protracted political transition led to a more permanent drop in foreign exchange earnings, the combination of exchange rate and reserve mix proved largely ineffective. This could be traced to several factors. First, the policy mix was tighter-than necessary and therefore costly in terms of reserve depletion. By mid-2016, almost 6 years after the uprising, the currencies of Egypt and Tunisia had lost half of their 2010 values and around half and a third of the

stock of reserves, respectively. As exchange rate devaluations were not sufficient for the current account to self-correct, interventions compromised reserve adequacy. In Egypt, reserves had reached a record low of around US\$ 13 billion in 2013. Currently, the reserve levels in Egypt and Tunisia can only finance 3 and 4 months of imports, respectively, and have fallen from triple and double these figures in 2006.

Secondly, repeated currency devaluations never brought the exchange rate to a value consistent with long-run fundamentals and therefore never provided effective stabilization. Short-term management (arbitrary and sizeable reserve depletion and unsustainable access to external finance) in the face of a prolonged shock (owing to political instability and/or security incidents) proved ineffective, ill perceived and costly. Access to foreign grants may have only delayed much needed exchange rate devaluations. At the end, Egypt had to let the exchange rate go in 2016.

Thirdly, exchange management in Egypt resulted in severe market distortions. As the official exchange rate was far from its long-term equilibrium value, an acute foreign exchange liquidity squeeze ensued, and eventually led to the emergence of a black exchange rate market in June 2014. The black-market rate has been depreciating at a faster rate than the official rate and the black-market premium has been widening over time, reaching more than 40 percent in August 2016 (figure 2.9). With the floatation of the pound in 2016, the black market has almost vanished.

Figure 2.9: Black market premium in Egypt forex market, 2014-2016



Source: Calculated by authors based on market data from HC securities.

Fourthly, ad hoc interventions by the central bank and the lack of a clear nominal target for monetary policy may have fed market expectations with negative sentiments and exacerbated credibility concerns. In March 2016, for example, the CBE issued a press release to justify an exchange rate devaluation, indicating that the policy would become more flexible, thus shaping market expectations towards less intervention and future devaluations. This step was followed the next day, however, by a sizeable (exceptional) foreign exchange intervention that stabilized the exchange rate for the following 6 months.

Monetary policy stance and macroeconomic effects

Prior to the uprisings, South-Med economies had strengthened their monetary policy frameworks by introducing policy rates that set the target for overnight interbank rates and other interest rates. In addition, they had at their disposal other tools to influence market liquidity, including reserve requirements and shorter term maturity instruments that could ease banking sector liquidity and spur credit growth. Unfortunately,

these tools were not always deployed in a consistent fashion, which makes it difficult to draw conclusive observations about the stance of monetary policy. Nevertheless, an attempt is made here to disentangle this issue.

Starting with reserve requirements, most central banks in South-Med countries in the post uprising period eventually opted for monetary easing through reductions in reserve requirements (Table 2.6). The CBE cut the reserve requirement ratio twice, in March and May 2011. It introduced a short-term instrument (7-day repurchase agreements in March 2011 and 28-day repurchase agreements in June 2012) to relieve liquidity pressures in the banking system. The CBT also cut the required reserve rate on demand deposits 3 consecutive times in 2011, by a total of 10.5 percentage points to 2 percent. Reserve requirements were further lowered in 2013 to 1 percent. In addition, in 2015, the CBT introduced foreign exchange swaps to support liquidity. The CBM eased reserve requirements starting 2013 before reverting to some tightening in 2016. And while the CBJ did not adjust reserve

Table 2.6: Reserve requirements, 2010-2016 (percent)

Year	Algeria	Egypt	Jordan	Morocco	Tunisia
2010	8.0	14	7.00	6.00	12.50
2011	9.0	14	7.00	6.00	2.00
2012	11.0	10	7.00	6.00	2.00
2013	12.0	10	7.00	4.00	1.00
2014	12.0	10	7.00	2.00	1.00
2015	12.0	10	7.00	2.00	1.00
2016	12.0	10	7.00	4.00	1.00

Source: IMF.

requirements, it introduced a weekly repurchase agreements facility in 2012 to provide liquidity to banks and minimise volatility in interest rates in the inter-bank market. In addition, forward forex operations with banks were also introduced. Algeria is the only country that increased reserve requirements over time.

With respect to interest rates, Central Banks in South-Med countries oscillated between accommodative and restrictive stances. As shown in Table 2.7, Egypt adopted a restrictive stance in the early years of the uprisings (with interest rate hikes of 100 bps

in September 2011 and another 50 bps in March 2013) to curb inflation. But this position was reversed into a more relaxed stance between August and December 2013 (with three cuts in policy rates, cumulatively adding up to 150 bps), with the aim of supporting economic growth. The subsidy reduction in July 2014 prompted policy tightening and the official stance has reverted to being restrictive since December 2015 (three nominal policy rate increases until June 2016), bringing policy rates to historically high levels (of 11.75 and 12.75 percent for overnight deposit and lending rates, respectively).

In Tunisia, monetary policy has focused on maintaining the liquidity of the banking sector, which had been facing structural shortages since the beginning of the political uprising, caused by weak economic activity and a deposit drawdown by cash-strapped mining companies impacted by work stoppage (IMF, 2013a). It was relatively accommodative in 2011 (interest rates

Table 2.7: Changes in policy rates, 2010-2016 (percent)

	2010	2011	2012	2013	2014	2015	2016
Change in nominal policy rates							
Algeria	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Egypt	0.00	1.00	0.00	-1.00	1.00	0.00	2.50
Jordan	-0.50	0.25	1.75	-0.50	-0.75	-1.25	0.00
Morocco	0.00	0.00	-0.25	0.00	-0.50	0.00	-0.25
Tunisia	0.00	-1.00	0.25	0.25	0.75	-0.50	0.00
Change in real policy rates							
Algeria	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Egypt	0.00	1.00	0.00	-1.00	1.00	0.00	2.50
Jordan	-0.50	0.25	1.75	-0.50	-0.75	-1.25	0.00
Morocco	0.00	0.00	-0.25	0.00	-0.50	0.00	-0.25
Tunisia	0.00	-1.00	0.25	0.25	0.75	-0.50	0.00

Source: data from national central banks.

were cut twice consecutively in June and September 2011 by 100 bps to their lowest level since 2009), with the aim of easing credit conditions, but switched to tightening between 2012 and 2015 (interest rate hikes in August 2012 by 25 bps and in March 2013, January and July 2014, cumulatively adding up to 100 bps), in an attempt to reverse excessive credit growth. The CBT's attempt to relax the monetary stance once more in November 2015 did not trigger a decline in real rates, suggesting a restrictive stance.

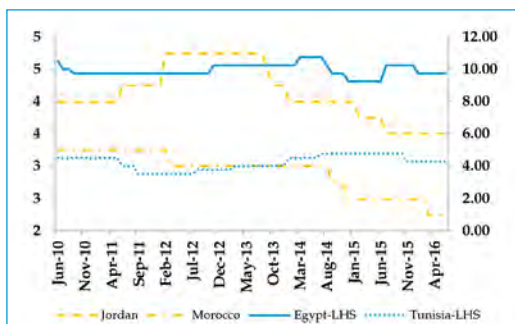
Monetary policy in Egypt and Tunisia has kept real interest rates in negative territories most of the time (figure 2.10). The situation is more worrying in Egypt because negative interest rates have persisted over a long period while nominal interest rates are high. Real negative rates suggest that monetary policy is ineffective in affecting liquidity since agents would prefer to hold cash balances rather than hold bank deposits and to spend rather than save. Of course, negative interest rates could support a modest expansion in credit, but they also tend to impede the transmission mechanisms of monetary decisions to

the real sector, and, if they persist, could also compromise financial stability.

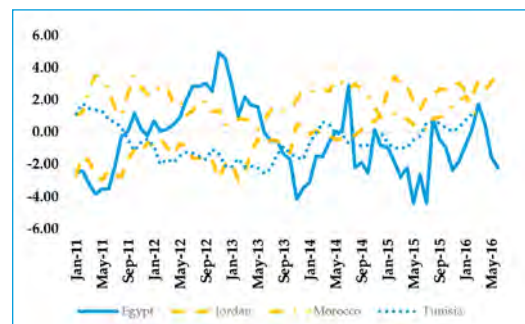
In Jordan and Morocco, on the back of low-inflation, monetary policy has been mostly accommodative in support of growth. In Jordan, apart from a short period of nominal policy tightening between June 2011 and November 2012 (with the June hikes aimed at ensuring a competitive yield on local currency-denominated assets and the November hikes aiming to curb the second-round effects of inflation arising from subsidy reform), the CBJ reduced interest rates between 2012 and 2015. Morocco's central bank has also attempted to implement monetary policy expansion in nominal terms. Interest rate cuts in 2012, 2014 and 2016, brought policy rates to historically low levels of 2.25 percent. However, in contrast to Egypt and Tunisia, the real policy stance in Jordan and Morocco has been rather restrictive (except for 2012 in Jordan) as real interest rates have increased on the back of decelerating inflation and even deflation since 2015 in Jordan. In December 2013, the CBM also established a new refinancing mechanism to

Figure 2.10: Nominal and real interest rates (percent)

(a) Nominal



(b) Real



Source: data from national central banks.

support credit to small enterprises, particularly in the industrial or export-oriented sectors.

In Algeria, monetary policy has been completely inactive through interest rates but policy tightening was implemented to some extent in 2011 and 2012, with an increase in the banks' minimum reserve requirement to control liquidity and inflation. The CBA introduced, in January 2013, a six-month liquidity management instrument.

Beyond conventional measures, the CBE and the CBT have adopted a number of unconventional measures to deal with liquidity shortages in the aftermath of the uprisings. In Egypt, the CBE has focused on the provision of foreign exchange liquidity to the banking sector to ease the severe liquidity squeeze that was caused by the depletion of reserve and overly tight exchange rate policy. This has been exacerbated by the implementation of major infrastructure projects with sizeable import requirements. Starting December 2012, the CBE has held regular foreign exchange auctions for banks and, since April 2013, exceptional auctions. Between December 2012 and June 2016, the CBE intervened through regular auctions, with a total amount of US\$ 19 billion. In addition, it intervened 9 times through exceptional auctions between April 2013 and March 2016, with a total value of US\$ 7.4 billion. Commercial banks were required to apply with the amount of their clients' outstanding import needs for specific goods (like staple commodities, capital goods spare parts; intermediate production components and raw materials; and

pharmaceuticals and vaccines). In addition, it intervened in the US dollar interbank market in 2015, with a total amount of USD 1.2 billion (CBE, 2015).

In addition, in 2016 the CBE launched an initiative to increase access to finance by SMEs (at lower interest rates) through commercial banks. In return, participating banks have been permitted to reduce their level of required reserves by the CBE with an amount equivalent to their SME lending. This program aims to finance 350,000 SMEs and create 4 million new job opportunities over a period of four years. It gives priority to exporting firms and those working in innovation.

In Tunisia, the banking sector's structural liquidity shortages triggered several responses. In 2011, the BCT extended the maturity of its auctions, which are its principal instrument for intervention on the money market, from seven days to one month, and then to three months (IMF, 2013b). Through this measure, the CBT has injected liquidity to refinance commercial banks (mainly through auctions and later through foreign exchange swaps), with the aim of maintaining overall financial stability and addressing failures in the market for interbank liquidity. Unlike unconventional measures in advanced economies, these operations cannot be considered as quantitative easing because they did not involve large-scale asset purchases financed by the issuance of central bank money. Nor did they attempt to directly affect asset prices.

Bank refinancing operations were quite significant in 2011 and

2012, leading the CBT to impose an additional 50 percent reserve requirement on increases in consumer credit in 2012, though this was reduced to 30 percent in March 2013 and removed in 2015. Nevertheless, banks continue to rely on central bank refinancing. By mid-2016, an amount of around TND 25 billion was extended to banks through refinancing of banks (excluding OMOs in the amount of about TND 2.3 billion).

What was the effect of monetary policy on inflation, credit and growth? In principle, an accommodative stance (interest rate cuts) would support growth but could spur inflationary pressures. Meanwhile, a restrictive stance (interest rate hikes) would curb inflation at the expense of harming credit, investment and therefore growth.

A formal approach to evaluate the monetary policy stance is to estimate the central bank reaction function that relates the interest rate response to inflation and output (Taylor, 1993). However, we use a less quantitative measure to get an indication of the cyclicity of monetary policy. More specifically, we measure the correlation between the cyclical component of inflation and the cyclical component of the policy rates. To get an indication of the response to output, we also compute the average correlation between the cyclical component of the policy rate and real GDP. The results are reported in Table 2.8 and elaborated below.

Starting with inflation, the nominal response of the central banks in Jordan and Tunisia after the uprising has been counter-

cyclical (as indicated by a positive correlation between policy rates and inflation), suggesting that central banks have reduced policy rates when inflation was declining and vice versa. However, their attempts at nominal tightening have not been sufficiently transmitted to real interest movements (which matter more), which have remained pro-cyclical. In Egypt and Morocco, monetary policy has been pro-cyclical in both nominal and real terms, which reflects CBM's monetary stimulus to ease growth in a context of decelerating inflation. In the case of Egypt, interest rates were increased while inflation was declining (November 2011), and decreased despite mounting inflationary pressures (second half of 2013).

The pro-cyclical response to inflation (in real terms) in Jordan and Morocco could also reflect the fixed peg arrangements and thus the inability to raise interest rates while international interest rates are kept near the ZLB. This would also mean their central banks will soon have almost no room to further reduce short-term interest rates, with the rates standing respectively at 1.5 and 2.25 percent, respectively.

South-Med countries did not witness exceptional inflationary pressures during the political transition, a conclusion that echoes with Khandelwal and Roitman (2013). In fact, inflation generally eased from previous years (resulting from high commodity prices) to lower levels after the uprising (except in Tunisia) on the backdrop of subdued economic activity among other factors.

Table 2.8: Monetary policy management and macroeconomic outcomes

	Egypt		Jordan		Morocco		Tunisia	
	2005-2010	2011-2015	2005-2010	2011-2015	2005-2010	2011-2015	2005-2010	2011-2015
Counter-cyclical (inflation)								
Cyclical with nominal rates	64.3	-38.9	38.8	81.8	31.5	-36.7	44.6	9.3
Cyclical with real rates	-89.8	-96.3	-91.8	-84.2	-91.6	-69.3	-86.6	-73.4
Counter-cyclical (output)								
Cyclical with nominal rates	11.6	-32.6	1.0	8.4	17.4	-55.8	41.6	80.3
Cyclical with real rates	-43.9	-32.0	-5.9	-8.6	34.5	-10.5	25.2	8.8
Monetary policy outcomes								
CPI inflation	11.1	9.5	5.4	3.1	2.0	1.2	3.3	4.9
Deposit growth	12.9	15.6	11.7	7.7				
Credit growth	8.7	22.7	17.4	8.6	15.3	5.8	11.3	10.3
Loan to deposit ratio	54.2	47.6	66.4	66.7				

Note: The cyclical component is derived from the average of the estimated trend using a HP filter with lambda 100 and 6.25. For inflation, a positive correlation is indicative of countercyclical monetary policy, suggesting that policy rates were raised when inflation was high (or vice versa), while a negative correlation indicates procyclical monetary policy, suggesting that policy rates were not used to pre-emptively curb inflation. For growth, a positive correlation is indicative a countercyclical stance while a negative correlation indicates a pro-cyclical one. Source: Calculated by the authors based on data from national central banks and World Development Indicators, World Bank.

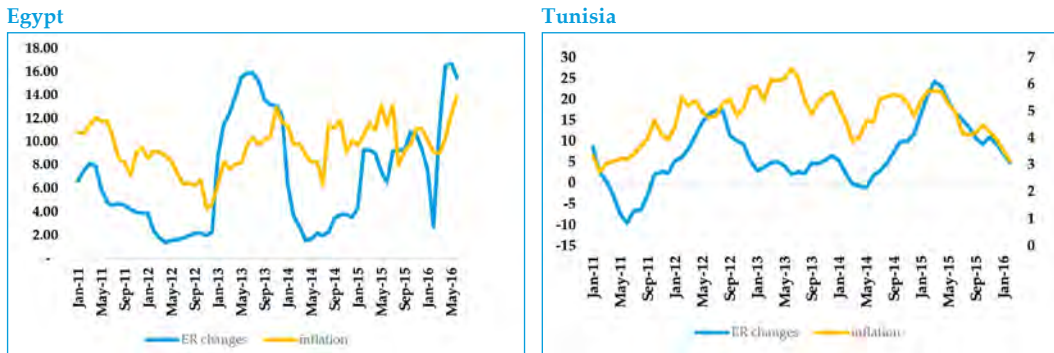
In Egypt, where inflation has been in double-digits over the past decade, monetary policy has maintained negative real interest rates. The CBE's restrictive stance in late 2011 subdued inflationary pressures, though it remained at 7 percent in the following year. Subsequently, the interest rate hikes following the elimination of energy subsidies in July 2014 did not prevent inflation from increasing to 11 percent thereafter. In Tunisia, inflation has remained mostly in the low single digits, temporarily edging up to close to 7 percent in 2013. Inflation spiked once more following the subsidy reform in May 2014. Furthermore, exchange rate devaluations in both countries have contributed

to rising inflation, reflecting the pass-through from devaluation to domestic prices (figure 2.11).

In Jordan and Morocco, inflation has been below 5 percent, despite expansionary spending and energy subsidy phase-outs (in November 2012 for Jordan, and September 2013 for Morocco). Jordan and Morocco's monetary accommodating stance, yet restrictive in real terms, has been associated with declining inflation.

As for liquidity, credit growth significantly slowed down in Morocco and Jordan to well below 10 percent in the period 2011-2015, compared with pre-crisis periods (Table 2.8). By contrast, credit growth in the same two periods declined very little in Tunisia

Figure 2.11: Exchange rate change and inflation in Egypt and Tunisia, 2011-2016 (percent)



Source: data from national central banks.

(from 11.3 percent in 2005-2010 to 10.3 percent in 2011-2015), while going up significantly in Egypt (from 8.7 percent in 2005-2010 to 22.7 in the period 2011-2015). The significant increase in credit growth in Egypt in the latter period was due to a buoyant credit to the government, which continued to creep up since 2011 to reach 55 percent of GDP in 2014.

Turning to *output* stabilization, the monetary policy response was relatively weak after the uprising, except in Tunisia where the monetary policy was counter-cyclical as indicated by the positive correlation between the policy rate and growth. This confirms Tunisia's monetary easing that associated the cyclical downturn in 2011, followed by policy tightening to ease credit conditions while economic activity picked-up. In contrast, Egypt's pro-cyclical response, in both nominal and real terms, suggests that monetary policy has not accommodated growth. This could be due to policy tightening taking place several times during the cyclical downturn after the uprising. Moreover, the prevailing high inflation environment

suggests that policy cuts to favour growth have often led to even higher inflation. In fact, inflation crept up again to 13 percent as the real monetary stance loosened in 2013. In both countries, any potential positive effects from interest cuts to favour investment and growth would be significantly limited by policy uncertainty, security concerns (as well as foreign currency shortages in Egypt).

Morocco's monetary policy response appears to be pro-cyclical despite monetary easing. Moreover, a low inflation environment has led to real rate increases. As for Jordan, nominal attempts at monetary expansion have been supportive of growth, although as real rates have been increasing, they may not have supported investment and growth.

The exchange rate could have played a major role in demand stimulation in Egypt and Tunisia, on the back of their currency devaluations. The latter could have helped restore competitiveness and exports and eventually led to a self-correcting current account mechanism. However, devaluations could have contractionary

effects to the extent that imported intermediate goods are extensively used in the production of exports, leading to high inflation that would reduce real income and consumption.

Moreover, because the CBT did not have a formal lender of last resort (LOLR) facility (law approved in early 2016), these facilities were provided through CBT normal liquidity functions without a formal LOLR framework. This suggests that such funds were not appropriately secured by acceptable collateral and were not limited to solvent but illiquid banks. These measures may also have increased the exposure of the CBT's balance sheet to the banking system.³ A central bank law to this effect was approved in early 2016.

In summary, monetary policy management was complicated by the pursuit of domestic objectives moving in different directions. Meanwhile, the monetary policy response depended on country-specific circumstances. On the one hand, the response of the central banks in Morocco and Jordan focused on conventional measures (interest rates and reserve requirements). In the absence of overt inflationary pressures, their central banks have been able to put more emphasis on output stabilization. Yet, on the back of decelerating inflation, nominal attempts at loosening monetary policy did not lead to declining real rates and therefore have not boosted credit conditions, which remain significantly below pre-crisis levels.

On the other hand, Egypt and Tunisia resorted to conventional and unconventional measures.

Nominal tightening maintained negative interest rates, which suggest a *de facto* accommodative monetary policy stance. As a result, inflation has remained high in Egypt (in double-digits) and has increased in Tunisia. The CBE and CBT also adopted liquidity-enhancing measures to boost banking sector liquidity. As these measures were not effective, they engaged in direct liquidity injections to the banking sector. The CBE did so in the hope of easing a persistent foreign exchange liquidity squeeze, while the CBT provided direct refinancing to banks in the hope of maintaining financial stability. Negative rates have also fuelled credit growth in both countries. In Egypt, the government has been the main actor to benefit from cheap credit at negative rates, a situation that has contributed to the crowding out of the private sector. In Tunisia, direct liquidity injections have underpinned credit growth in a fragile banking sector. Tunisia's monetary policy response to output stabilization has been more effective than Egypt's as Egypt's high inflation environment suggests that the policy cuts have often led to a deterioration in the inflation outlook. In both countries, an effective impact of monetary expansions on output have been constrained by the political and social unrest and security threats.

2.5 Fiscal-monetary policy consistency

Having taken stock of fiscal and monetary policy responses, we now question the extent to which the monetary policy stance has

been influenced by fiscal policy considerations and the extent to which there has been consistency in the policy mix.

The first step is to characterise the policy mix. Table 2.9 reports the fiscal impulse measure and the stance of monetary policy in South-Med economies after the uprisings. As may be seen, the policy mix has varied significantly across economies and across time. South-Med authorities have not taken coordinated measures to stimulate aggregate demand. For example, some fiscal expansions in Egypt (2012), Jordan (2011) and Tunisia (2012) were accompanied by a contractionary monetary policy. Others were accompanied with monetary stimulus: Egypt in 2014, Jordan in 2013 and 2014, Morocco in 2014, and Tunisia in 2011 and 2015.

More importantly, with the exception of Jordan in 2015 and Morocco in 2012, fiscal adjustment has not been accompanied by monetary policy accommoda-

tion in order to cushion its contractionary effects. In Egypt 2015 and Tunisia in 2014, fiscal contraction was compounded by a restrictive monetary stance. In the case of Morocco, fiscal contractions in 2013 and 2015 have been accompanied by a neutral monetary policy.

Moreover, in Egypt, fiscal dominance could have constrained monetary policy's decisions to raise interest rates, which was necessary to curb inflation. With lending policy rates of close to 12.75 and T-bill rates of close to 13 percent, monetary policy has almost had no scope for further tightening without this leading to a significant ballooning in interest payments and, in turn, a deterioration in fiscal sustainability. (See figure 2.12 for the trend in overnight CBE's overnight lending rates and the cost of T-bills).

In short, there is no evidence of coordination between fiscal and monetary policy. Monetary policy has not provided the re-

Table 2.9: Fiscal policy response and changes in policy rates

Year	Egypt		Jordan		Morocco		Tunisia	
	Fiscal impulse	Change in policy rates	Fiscal impulse	Change in policy rates	Fiscal impulse	Change in policy rates	Fiscal impulse	Change in policy rates
2008	0.39	1.75	4.94	-0.75	0.63	0.25	-0.82	0.00
2009	1.08	-1.50	-0.44	-1.50	2.77	-0.25	1.58	-0.75
2010	-0.34	-0.75	-2.72	-0.50	2.15	0.00	-1.88	0.00
2011	0.70	0.00	4.48	0.25	2.26	0.00	2.03	-1.00
2012	1.51	1.00	-3.01	1.75	-0.18	-0.25	2.83	0.25
2013	0.35	0.50	3.09	-0.50	-1.45	0.00	1.73	0.25
2014	3.25	-1.50	0.39	-0.75	0.34	-0.50	-2.88	0.75
2015	-3.15	0.50	-6.53	-1.25	-0.36	0.00	1.00	-0.50

Note: Fiscal impulse: positive means fiscal policy is expansionary and negative means contractionary. Change in policy rates: increase in rates means restrictive monetary policy and a decrease means accommodative monetary policy.

Source: Fiscal impulse calculated by the authors based on fiscal data extracted from IMF Article IV Consultation central government budget tables and policy rates data from national central banks.

Figure 2.12: T-bill rate and overnight CBE lending rate in Egypt (percent)



Source: Central Bank of Egypt

quired easing during fiscal adjustment in Jordan and Morocco. In Egypt, it has been subservient to fiscal objectives.

2.6 Conclusion

South-Med economies have managed to preserve macroeconomic stability despite a turbulent sociopolitical context, spillovers from regional conflict, and numerous exogenous shocks, including terror attacks. However, critical economic challenges remain, mainly a cyclical economic downturn and deteriorating macroeconomic imbalances. In this context, macroeconomic management could only address one of the following challenges: resolving macroeconomic imbalances or accommodating the effects of the shock by restoring economic growth. The choice was complicated by intense and turbulent sociopolitical conditions in the wake of the uprisings that began in 2010.

The objective of this chapter was twofold. First, it intended to identify how governments used monetary and fiscal policies to address macroeconomic challenges. Second, it intended to assess the effectiveness of their response against the targeted objectives.

In terms of their fiscal policy response, the shock translated into pressing popular demands on the government for jobs, higher wages and other social benefits. In response, governments offered politically-motivated current spending expansions to appease social discontent, thus deterring fiscal management from the objective of consolidation. The cost of delaying consolidation was high though perhaps unavoidable. It can be argued that fiscal management was successful in maintaining social peace in some countries more than others. Once this goal was achieved, fiscal sustainability concerns rose to the forefront and consolidation measures were implemented. In this context, *fiscal management prioritized the preservation of macroeconomic stability over growth.*

At the same time, the uprisings resulted in a sudden drying up of foreign exchange earnings, which had an impact on the primary monetary policy target, the nominal exchange rate. In response, South-Med central banks relied on foreign exchange interventions to stabilise the exchange rate. This policy could only be pursued as long as there were safe reserve buffers to finance these interventions. In addition, monetary policy paid attention to other domestic objectives. Egypt attempted to control persistent inflationary pressures, while Tuni-

sia targeted banking sector liquidity. In Jordan and Morocco, where inflation was in low single digits, central banks could ease monetary policy to stimulate aggregate demand. Most central banks used conventional measures (interest rates and reserve requirements) to boost credit conditions. In addition, the central banks in Egypt and Tunisia used unconventional liquidity-enhancing measures to boost banking sector liquidity.

The problem is that South-Med authorities have not adopted a coordinated effort to stimulate aggregate demand. Moreover, their fiscal and monetary policy has not always been consistent.

In terms of the macroeconomic effects, fiscal management (whether consolidation or stimulus) has not been very effective either in stimulating growth, which has remained below potential, or in encouraging private investment. This is because crisis-driven stimulus packages have not been designed to boost aggregate demand, but to contain social discontent. Despite consolidation efforts, fiscal vulnerabilities remain, leading many South-Med economies to renew IMF support.

The response by the central banks in Egypt and Tunisia to preserve exchange rate stability has been too costly and ineffective. It has focused too much on reserve depletion and too little on exchange rate flexibility in the face of a prolonged and lasting shock. Otherwise, the effectiveness of monetary policy with respect to other objectives varies from one country to another. On the one hand, on the back of decelerating inflation, monetary policy in Jordan and Morocco has been eased,

though insufficiently, thus credit growth remains significantly below pre-crisis levels. The prevalence of negative interest rates in Egypt and Tunisia has maintained a de facto accommodative monetary policy stance, which may have fuelled credit growth, sustained inflationary pressures and generally impeded the effectiveness of monetary policy. In Egypt, the government has been the main actor to benefit from bank credit at negative real rates, a situation that has contributed to the crowding out of the private sector. In Tunisia, the CBT's continuous refinancing to banks has underpinned credit growth in a fragile banking sector. Finally, the CBE's attempt to ease the persistent foreign exchange liquidity squeeze has not been effective.

Apart from the above issues, it is worthwhile to note that access to external finance has provided a temporary solution to plug financing gaps, whether internal or external. However, the support has not been accompanied by the necessary reforms to correct structural imbalances, and has not proved effective. The situation was more favorable for economies such as in Tunisia, which enjoyed relatively better initial conditions (low fiscal deficits and debt as well as safe foreign exchange buffers and low inflation).

The concepts and issues discussed in this chapter are indicative of the complexities involved in macroeconomic policymaking. The analysis clearly shows that there can be a variety of policy packages to achieve different economic policy objectives. Each choice will entail policy dilemmas, trade-offs and costs. The

real choice, though, is between making tough political decisions that address the root causes of the crisis once and for all, without postponing—once more—the necessary measures with the false hope that these problems will self-resolve.

Notes

1. The authors of this chapter would like to thank Diaa Noureldin for insightful discussions and HC Research for sharing market data on the Egyptian black market exchange rate.
2. This section draws on Batini, Eyraud, Forni, and Weber (2014).
3. This facility should be reserved: (i) for solvent but illiquid banks; (ii) be structured so that there is incentive for banks to first seek funding from all other sources; and (iii) be more expensive than other central bank operations (IMF, 2012).

References

- Abdih, Y., P. Lopez-Murphy, A. Roitman and R. Sahay (2010) "The Cyclicalities of Fiscal Policy in the Middle East and Central Asia: Is the Current Crisis Different?", *IMF Working Paper* No. 10/68, March.
- Alesina, A. and R. Perotti (1995) "Fiscal Expansions and Adjustments in OECD Countries", *NBER Working Paper Series* No. 5730, August.
- Alesina, A. and S. Ardagna (2010) "Large Changes in Fiscal Policy: Taxes versus Spending" in "Tax Policy and the Economy" edited by Brown, JR., *University of Chicago Press*, Vol. 24, pages 35-68.
- Arab Republic of Egypt Ministry of Finance (MOF) (2014) "Mid-Year Economic and Fiscal Review H1-FY14"
- Batini, N., L. Eyraud, L. Forni and A. Weber (2014) "Fiscal Multipliers: Size, Determinants and Use in Macroeconomic Projections", *International Monetary Fund Technical Notes and Manuals*.
- Blanchard, O. and D. Leigh (2013) "Growth Forecast Errors and Fiscal Multipliers", *IMF Working Paper* No. 13/1, January.
- Cecchetti, SG., MS. Mohanty, and F. Zampolli (2011) "The real effects of debt", *BIS Working Papers* No. 352, September.
- Chudik, A., K. Mohaddes, MH. Pesaran, and M. Raissi (2015) "Is There a Debt-threshold Effect on Output Growth?", *IMF Working Paper* No. 15/197, September.
- Frankel, J., C. Vegh and G. Vuletin (2012) "On graduation from fiscal procyclicality", *Journal of Development Economics*, vol. 100, Issue 1, January, pages 32-47.
- Friedman, M. (1953) "The methodology of positive economics" in "Essays in positive economics" edited by Friedman, M., *University of Chicago Press*.
- Friedman, M. (1968) "The role of Monetary Policy", *The American Economic Review*, Vol. LVIII, No.1, March.
- Giavazzi, F. and M. Pagano (1990) "Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries" in *NBER Macroeconomics Annual* edited by Blanchard, O. and S. Fischer, MIT Press.
- Gervais, O., L. Schembri and L. Suchanek (2016) "Current account dynamics, real exchange rate adjustment, and the exchange rate regime in

- emerging-market economies", *Journal of Development Economics*, Vol. 119, March, pages 86-99.
- Hanieh, A (2015) "Shifting Priorities or Business as Usual? Continuity and Change in the post-2011 IMF and World Bank Engagement with Tunisia, Morocco and Egypt", *British Journal of Middle Eastern Studies*, Vol. 42, Issue 1, December, pages. 119-134.
- Heller, PS., RD. Haas and AS. Mansur (1986) "A Review of the Fiscal Impulse Measure", *Occasional Papers of the International Monetary Fund* No. 44, May.
- International Monetary Fund (IMF) (2016a) "Morocco Request for an Arrangement Under the Precautionary and Liquidity Line and Cancellation of the Current Arrangement – Press Release; Staff Report; and Statement by the Executive Director for Morocco"
- _____ (2016b) "Tunisia Request for an Extended Arrangement Under the Extended Fund Facility – Press Release; Staff Report; and Statement by the Executive Director for Tunisia"
- _____ (2015a) "Morocco Ex Post Evaluation of Exceptional Access Under the 2012 Precautionary and Liquidity Line Arrangement – Press Release; Staff Report and Statement by the Executive Director for Morocco"
- _____ (2015b) "Jordan Seventh and Final Review Under the Stand-By Arrangement and Proposal for Post-Program Monitoring- Press Release; Staff Report; and Statement by the Executive Director for Jordan"
- _____ (2014a) "Algeria 2014 Article IV Consultation – Staff Report; Press Release; and Statement by the Executive Director for Algeria"
- _____ (2014b) "Jordan 2014 Article IV Consultation, Third and Fourth Reviews Under the Stand-By Arrangement, Request for Waivers of Non-observance of Performance Criterion – Staff Report; Press Releases; and Statement by the Executive Director for Jordan"
- _____ (2013a) "Tunisia: Request for a Stand-By Arrangement – Staff Report, Press Release on the Executive Board Discussion; and Statement by the Executive Director for Tunisia"
- _____ (2013b) "Monetary Issues in the Middle East and North Africa Region: A Policy Implementation Handbook for Central Bankers"
- _____ (2012a) "Chapter 3: The Good, the Bad and the Ugly: 100 Years of Dealing with Public Debt Overhangs" in "World Economic Outlook: Coping With High Debt and Sluggish Growth"
- _____ (2012b) "Tunisia: 2012 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Tunisia"
- _____ (2010) "Chapter 3: Will it hurt? Macroeconomic Effects of Fiscal Consolidation" in "World Economic Outlook: Recovery, Risk, and Rebalancing"
- Khandelwal, P. and A. Roitman (2013) "The Economics of Political Transitions: Implica-

- tions for the Arab Spring", *IMF Working Paper* No. 13/69, March.
- Krugman, P. (2010) "Myths on Austerity", *The New York Times*, July 1.
- Kumar, MS. and J. Woo (2010) "Public Debt and Growth", *IMF Working Paper* No. 10/174, July.
- Ostry, JD, AR. Ghosh, and M. Chamon (2012) "Two Targets, Two Instruments: Monetary and Exchange Rate Policies in Emerging Market Economies", *IMF Staff Discussion Note* No. 12/01, February.
- Perotti, R. (2012) "The "Austerity Myth" Gain Without Pain" in "Fiscal Policy After the Financial Crisis" edited by Alesina, A. and F. Giavazzi, *University of Chicago Press*, pages 307-354.
- Phelps, ES. (1968) "Money-wage dynamics and labor-market equilibrium", *Journal of Political Economy*, vol. 76, part 2, August, pages 678-711.
- Reinhart, CM. and KS. Rogoff (2010) "Growth in a Time of Debt", *American Economic Review*, vol. 100, no. 2, May, pages 573-578.
- Sargent, T. and N. Wallace (1981) "Some Unpleasant Monetarist Arithmetic", *Federal Reserve Bank of Minneapolis*.
- Taylor, JB. (1993) "Discretion versus policy rules in practice", *Carnegie-Rochester Conference Series on Public Policy* 39, pages: 195-214.
- World Bank (2014) "Jordan Economic Monitor - Resilience and Turmoil"

Annex 1.2:

Fiscal impulse measure

Assessing the fiscal policy stance is a challenging task because there is a two-way relationship between fiscal variables and output. Changes in the former can be either the cause or the result of changes in economic activity. On the one hand, automatic stabilizers respond to the business cycle. On the other, discretionary spending hikes or tax cuts may be implemented by governments in order to stimulate economic activity. In this context, the "cyclically neutral balance" is the budget balance when output is close to potential. Any excess of the actual balance from the cyclically neutral balance is considered expansionary. This budget is derived from the actual budget by assuming that nominal tax revenues are unit elastic to actual nominal GDP and government expenditures are unit elastic with respect to nominal potential output. Government expenditure is cyclically contractionary (expansionary) if it increases less than (more than) proportionately with potential output. It can be neutral if it increases proportionately with potential output. Similarly, with respect to revenues, a more than proportionate change in revenue relative to output is considered contractionary and vice versa.

Along the lines explained above, we compute a fiscal impulse (FI) indicator that measures the excess between the actual budget and the cyclically neutral. This methodology is described in Heller et al (1986) and computes the FI as follows:

$$FI = -\delta B + t\delta Y - g_0\delta Y_p$$

FI is the absolute measure of the fiscal impulse (FI)

T = Government revenues

G = Government expenditures

δB = first difference in the actual budget balance (T-G)

$t_0 = T_0 / Y_0$ is the base year revenue ratio

$g_0 = G_0 / Y_0$ is the base year expenditure ratio

δY_p = Potential output in nominal prices (first difference)

δY = Actual output in nominal prices (first difference)

The subscript “0” refers to the base year values of any variable. For the purposes of this study, we have adopted a “rolling” base year whereby the figures at time t are sequentially taken as base year figures for the FI at time $t+1$. An actual deficit in excess of the cyclically neutral deficit (defined as $t\delta Y - g_0\delta Y_p$) is considered as expansionary, relative to the base year fiscal stance, and the FI is positive. Hence, a positive (negative) measure of MFI will imply a more expansionary (contractionary) fiscal stance compared to the previous year. This measure of fiscal stance does not distinguish whether the stance stems from revenue or spending. It also does not distinguish whether the change in results from the impact of discretionary actions or automatic stabilizers in the budget.

Annex 2.2: Measuring counter-cyclical- ity of fiscal policy

To assess the macroeconomic effects of fiscal management in South-Med economies, we at-

tempt to determine the counter-cyclical-ity of different budget components (revenues and spending), which relates the ability of fiscal policy to combat business cycle fluctuations. According to Abdih et al. (2010), fiscal policy is:

- Pro-cyclical if and only if government spending increases (decreases) in good (bad) times.
- Counter-cyclical if and only if government spending decreases (increases) in good (bad) times.
- Acyclical if and only if government spending remains constant across time.

A similar logic applies to the changes in revenues in the opposite direction. The typical approaches to estimating the cyclical-ity of fiscal policy involve the regression of fiscal variables (fiscal balance or spending) on an indicator of the economic cycle (output gap or growth). We use a simpler method following Frankel et al. (2012), according to which we compute the correlations between the cyclical components of real government expenditure and real GDP. A positive (negative) correlation indicates pro-cyclical (countercyclical) fiscal policy. The results are shown in the table below for each of the five South-Med countries. Beside showing the average correlation between the cyclical components of real government revenue and spending and real GDP before and after 2010, the table below also reports several other macroeconomic variables.

Table 2.10: Fiscal management and macroeconomic outcomes

	Algeria		Egypt		Jordan		Morocco		Tunisia	
	2002-2010	2011-2015	2002-2010	2011-2015	2002-2010	2011-2015	2002-2010	2011-2015	2002-2010	2011-2015
Fiscal cyclicity										
Cyclicity of revenues	0.36	-0.53	0.62	-0.46	-0.31	0.93	0.17	-0.64	-0.26	0.46
Cyclicity of revenues excluding grants	0.36	-0.53	0.64	0.28	0.53	0.42	0.18	-0.57	0.64	0.48
Counter-cyclicity of current primary spending	-0.61	0.19	0.24	-0.84	0.07	-0.08	-0.61	-0.36	-0.32	0.37
Counter-cyclicity of capital spending	-0.45	0.89	0.57	0.35	0.01	0.76	-0.19	-0.29	0.26	-0.76
Cyclicity of total spending	-0.65	0.77	0.39	-0.70	0.15	0.71	-0.57	-0.40	-0.16	0.13
Real Economy										
Real GDP growth	3.96	3.29	5.09	2.50	6.44	2.73	4.70	3.97	4.36	1.50
Potential growth	3.49	3.14	5.13	2.74	6.43	2.83	4.78	3.72	4.37	1.84
Unemployment rate	15.56	10.53	10.08	12.40	13.84	12.39	10.20	9.36	13.39	16.25
Gross fixed capital formation (% change)	10.24	6.27	7.21	0.53	8.87	1.78	7.27	2.18	6.19	1.86
Gross fixed capital formation, private sector (% change)	n/a	n/a	17.95	8.93	17.91	8.24	n/a	n/a	n/a	n/a
Claims on central government (% change)	37.40	-18.43	15.85	35.56	45.81	16.90	0.15	13.36	7.80	23.53
Domestic credit to private sector (% change)	21.50	14.81	8.28	10.10	12.73	6.42	12.22	3.85	9.42	9.06

Note: All fiscal variables are in real terms. They were deflated by the GDP deflator. Cyclical components were calculated based on the gap between actual and potential measures, the latter calculated using the Hodrick-Prescott filter (lambda=6.25).

Source: Calculated by the authors based on World Economic Outlook, IMF and World Development Indicators, World Bank databases.

CHAPTER 3

Social Policy Response

3.1 Introduction

In addition to their impact on macroeconomic performance, the uprisings have also had adverse social effects. Poverty, inequality and unemployment appear to have persisted or deteriorated in the wake of the uprisings. Ironically, social justice was one of the rebels' main slogans. This chapter seeks to ascertain whether responses to social demands in the wake of the uprisings were appropriate and sustainable. More specifically, the chapter will attempt to answer the following questions:

- What happened to social development in South-Med countries in the wake of the uprisings?
- How did different governments attempt to improve social conditions?
- Was the response appropriate and sustainable?

This investigation is hampered by four factors. First, data on social outcomes is not readily available in South-Med countries. Second, the results based on available data are not always easy to interpret; for example, data on inequality using household

consumption tells us little about income distribution, let alone wealth distribution. Third, no single indicator captures the complexity of social conditions, which makes any assessment of social development difficult, especially if individual indicators move in opposite directions. Finally, there is a time lag between the timing of reforms and the time within which their effects are felt by the population, for example in such reform areas as education. Notwithstanding these limitations, some insights may still be gained from pulling together as many pieces of the puzzle as possible.

To place the analysis in a historical perspective, South-Med countries experienced a shift in their social contract in the late 1980s and early 1990s; from a "statist" to a "pro-market" social contract. At the expense of oversimplification, under the old contract the state provided citizens with various economic benefits, but denied them political participation. Under the new contract, the state gave way to market forces and allowed a greater role for the private sector, but only conceded a limited degree of political participation. Across the two

contracts, however, the relationship between the rulers and their citizens retained the main features of the so-called authoritarian bargain (see Desai et al, 2007). Protests were suppressed and despite some political liberalization, the region continued, until 2010, to score poorly on such governance indicators as voice and accountability. The spark of mass uprisings in Tunisia, in December 2010, ignited massive uprisings in several neighboring countries.

Pro-market reforms produced decent economic growth rates, which were associated with a reduction in absolute poverty. The 5 South-Med countries in our sample grew on average by 3.7 percent between 1990 and 2000, surging to close to 5 percent (4.8 percent) during the decade of 2000-2010. The problem lies in the frequently made claim that benefits were not shared widely. This era saw a significant rollback of the State from the provision of social services and the rise of preferential treatment in favour of politically connected firms. Both phenomena led to rising dissatisfaction among increasingly young and educated populations and the rise of crony capitalists (Diwan et al, 2016 and Reijkers et al, 2014). The share of wages in some national incomes shrank; equal opportunities diminished (e.g., Assaad et al, 2016) and perceptions of inequality worsened. Hence the uprisings and the fall of Ben Ali and Mubarak in Tunisia and Egypt, respectively.

In the years following the uprisings (2010-2015), economic growth dropped to 2.9 percent and macroeconomic balances deteriorated. To improve social

conditions, interim governments adopted a variety of measures. Most notably:

- They increased commodity subsidies and began to phase out energy subsidies, along with the introduction of cash transfer programs.
- They increased pensions, minimum wages and in some cases government employment.
- However, they made modest progress on initiatives to empower citizens through reforms, for example, of more progressive taxation and the provision of quality health, education and infrastructure (such as energy, water, and transport) to deprived groups.

While these measures must have been beneficial to those who received them, they were partial, myopic and unsustainable. Partial because they did not build on a coherent view of the world that connects economic growth with poverty reduction and a more egalitarian society. They were myopic because they were selected to produce immediate results, often at the expense of public investment and reforms of health, education or the tax regime. And they were unsustainable because they pushed budget deficits and public debts beyond safe boundaries. As a result, several governments, including Jordan, Tunisia and more recently Egypt, have had to seek IMF support to cover growing financing gaps, earn investors' confidence and carry out short term corrective measures.

More broadly, it is not clear

whether the rulers in South-Med countries have changed their bargain with citizens after the uprisings. Egypt and Tunisia have certainly adopted new constitutions and conducted multiple elections of presidents and parliaments in the span of a few years. Morocco and Jordan have modified their constitutions to allow more participation. Although the new constitutions contain many features of liberal democracy, they are yet to be tested in the day-to-day practice of politics, let alone be fully integrated in the body politics. It is likely that the transition process will take a few rounds of elections, and even longer for a new bargain to materialise.

The rest of the chapter is organized as follows. The next section traces the evolution of a number of social development indicators in South-Med countries. Section 3 reviews the responses of different governments to social demands. Section 4 evaluates the actions taken thus far. Section 5 draws some conclusions.

3.2 Social development

The impact of the uprisings on social development is hard to predict *a priori*. Two forces seem to operate in opposite directions. On the one hand, the deterioration in economic performance associated with political instability leaves governments with fewer resources to spend on social development. On the other hand, the uprisings have been driven in part by dissatisfaction with economic disparities, which means that interim governments face pressure to respond to these demands. In

addition to these opposing forces, social policies cannot be predicted while abstracting from the nature of the prevailing political regime and the distribution of power among different interest groups in society.

In this section, an attempt is made to draw a picture of what has happened to social development before and after the uprisings in the 5 South-Med countries, data permitting. The focus will be on three particular dimensions: (1) the nexus of growth, poverty and employment, (2) human development and inequality, and (3) voice and accountability.

The nexus of growth, employment and poverty

In principle, higher economic growth is necessary for job creation and poverty reduction. Given that economic growth is a function of factor accumulation and productivity improvements, an increase in growth means that more labour is being deployed. The intensity of job creation depends, however, on the technology used, the pool of available skills and the characteristics of the sectors experiencing expansion. All three dimensions can be influenced by policies through incentive structures that may or may not promote labour-intensive technology, acquiring the skills most in demand in the market place, and the nature and speed of structural transformation toward higher productivity sectors.

With respect to poverty, even moderate increases in average incomes per capita can lead to proportionate reductions in poverty as long as inequality does

not increase and, even more so, if inequality decreases. The main channel here is employment. In addition, pro-poor policies can play a role in ameliorating poverty in two ways. The first is by establishing effective safety nets through such programs as cash transfers (conditional or not), health and unemployment insurances and pension reforms. The second involves the empowerment of citizens, for example, through more progressive taxation and the provision of quality health care, education and infrastructures (such as energy, water, and transport) to deprived groups.

The above generalizations take on distinct characteristics during transitions. As noted earlier, political instability leads to a slowdown in economic activity and, by association, a rise in unemployment and poverty. According to Khandelwal and Roitman (2013), unemployment rates tend to rise during political instability, by about 1–1.5 percentage points on average during the first two years after the start of political unrest, and it takes between 4 to 5 years for unemployment to return to pre-crisis levels. With the rise of unemployment, poverty can be expected to rise as well.

To explore what happened to employment and poverty in the post-uprising period in the South-Med countries, we first looked at the evolution of economic growth before and after the uprisings. Comparing the growth rates in the 2000s with those during the 5 years after the uprisings, figure 3.1 shows that all South-Med countries experienced a loss in economic growth relative to the

earlier period, albeit to varying degrees. The biggest losses, in order, were in Jordan, Tunisia and Egypt. Morocco and Algeria also experienced a loss in output, but amounting to less than one percentage point.

Taking population growth into account, figure 3.2 shows the average per capita growth rates of South-Med countries between 2002-10 and 2010-14. On average, per capita growth rates declined from 3.1 percent during the earlier period to 1.0 percent in the post-uprising period. The decline occurred in all countries, but most alarmingly in Egypt, Tunisia and Jordan. In Egypt, the drop was so significant that Egyptians saw their per capita income decline, although very modestly.

Correspondingly, the capacity of these economies to create new jobs diminished. Unemployment rates shot up in 2011, in Egypt and Tunisia, by more than 3 and 5 percentage points, respectively (figure 3.3). Although unemployment among women was much higher than for men in both countries, it was male unemployment that bore the brunt of the crisis in Egypt. In Tunisia, both male and female unemployment increased significantly. On a more positive note, the unemployment figures appear to have stopped rising since 2013 in Egypt and Tunisia, although they remain well above pre-crisis levels. In Algeria, Jordan and Morocco, unemployment went down after 2010, though it remains close to 10 percent. In particular, the fall in Algerian unemployment has been outstanding over the past decade, down from 24 percent to 10 percent.

Focusing on youth unemployment, the problem is more acute in Egypt and Tunisia than in the other countries (figure 3.4). In 2011, youth unemployment increased in these two countries by 7 and 13 percentage points. Subsequently, youth unemployment in Egypt crept up to 33 percent in 2013. In Tunisia, it attained 31 percent in 2013. Jordan showed no great differences with the first two countries. In Algeria and Morocco, youth unemployment actually went down after 2010, albeit remaining in the vicinity of 10 percent.

Given that economic growth declined in the post-uprising period, it is to be expected that poverty would also have risen. Unfortunately, detailed information on the evolution of poverty in South-Med countries after the uprisings is scarce, if not inexistent. One exception is Egypt, where the percent of poor people rose from 19.6 percent in 2005 to 26.3 percent in 2013. No similar information is available for the other countries. However, if the trend in Egypt were to be used as a guide, poverty might have risen in recent years in Tunisia and Jordan, given their high loss of growth in the latter period. Before the uprisings, the information provided in table 3.1 suggests that Tunisia managed to reduce the percent of poor people by more than one half in a single decade (2000s). Morocco also made significant progress, reducing the percent of the poor from 15.3 percent in 2001 to 9.0 percent in 2007.

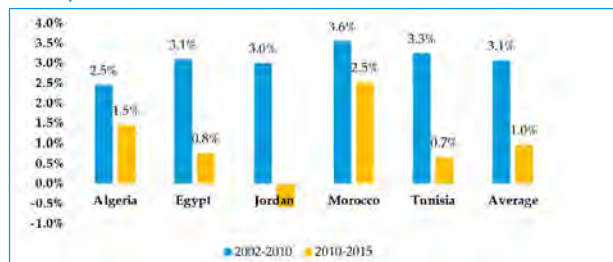
While the discussion of poverty focuses on the least privileged groups in society, inequality focuses on the relative distribution

Figure 3.1: Differences in average GDP growth rates between 2010-15 and 2000-10



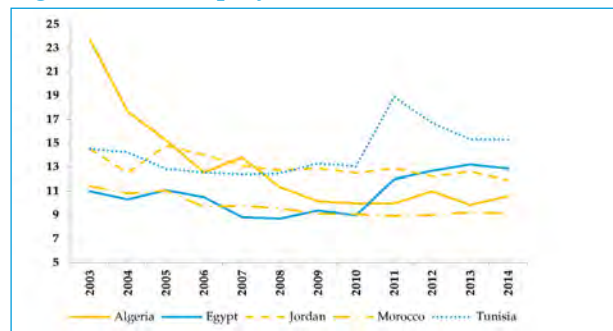
Source: World Economic Outlook Database, IMF.

Figure 3.2: Average annual growth in per capita GDP, 2002-10 and 2010-15



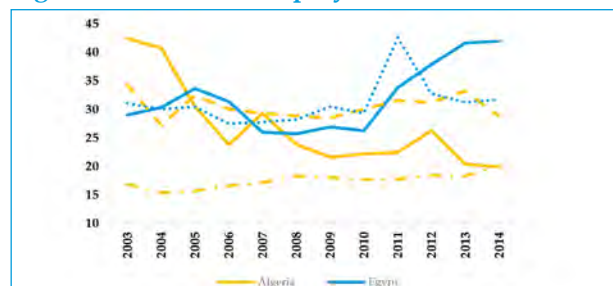
Source: World Development Indicators, World Bank.

Figure 3.3: Unemployment rates, 2003-2014



Source: World Development Indicators, World Bank.

Figure 3.4: Youth unemployment rates, 2003-2014



Source: World Development Indicators, World Bank

of economic outcomes within or across countries. Beside inequality in outcomes, the concept of inequality of opportunity has been gaining grounds in recent times. The basic idea is that differences in economic outcomes can be attributed to effort or circumstances. Variations due to effort are ethically justified; those attributable to circumstances are not. Accordingly, policymakers ought to take measures to equalise circumstances if they are to bring about a more egalitarian society (for elaboration, see, for example, Rawls, 1971 and Roemer, 1998).

In South-Med countries, one crude measure of the evolution of inequality is the share of wages in national incomes. A declining share of wages in GDP implies that capitalists are capturing a larger fraction of national income. Figure 3.5 shows the share of

wages relative to GDP over the period 2000-2014. The most striking observation is the notable difference in the shares of wages across countries. Workers in Jordan, Tunisia and Morocco enjoy a much larger share of GDP than their counterparts in Egypt and Algeria. The second observation concerns the trend. Here, the big decline in the share of wages relative to GDP occurred in Egypt and Morocco. The biggest improvements occurred in Algeria, followed modestly by Tunisia. The data for Jordan is not available beyond 2009.

The most commonly used measures of inequality are Gini coefficients and the income shares by different deciles of the population. These two indicators are reported in Table 3.1 for different years. The Gini coefficients suggest that Morocco and Tunisia

Table 3.1: Poverty headcount, Gini coefficients, and decile income shares in South-Med countries, selected years

Country	Year	Poverty headcount ratio at national poverty lines (% of population)	Gini index	Share of income/ consumption by deciles	
				Lowest 10%	Highest 10%
Algeria	1995	-	35.3	2.9	26.9
Egypt	2005	19.6	32.1	-	-
	2011	25.2	31.4	3.4	26
	2013	26.3	30.2	3.4	24.7
	2015	27.8	-	4.2	25.0
Jordan	2006	13	37.7	3.3	27.5
	2010	14.4	35.4	3.5	27.5
	2013	12	34.8	2.8	26.7
Morocco	2001	15.3	40.6	2.6	32.2
	2007	9	40.9	2.6	33.1
Tunisia	2000	32.4	40.8	2.4	31.6
	2010	15.5	36.1	2.6	27

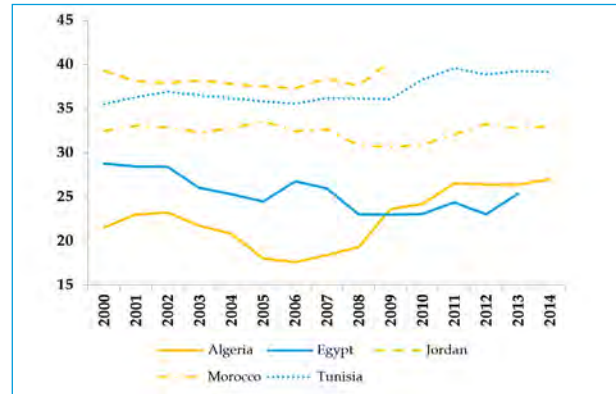
Sources: World Development Indicators, World Bank, ILO KILM database, CAPMAS Egypt and Economic Research Forum (ERF) data portal for household surveys for 2011 and 2013 for Egypt and 2013 for Jordan.

are more unequal than Egypt and Algeria. The trend over time is generally positive, although the changes are relatively modest. As for the income shares of the richest and lowest income deciles, the picture is consistent across countries. In all cases and over time, the income share of the richest 10 percent of the population ranges between one quarter and one third of national incomes, while the poorest 10 percent only receive between 2 and 3 percent of national incomes.

The above conclusions must be taken with a grain of salt, however. They draw on household surveys, which tend to miss top income data. They also underestimate the extent of income inequality because they often measure expenditure rather than income. More seriously, these are flows of income/expenditure, not wealth, as a more appropriate measure according to Piketty (2014).

With respect to inequality of opportunity, the evidence from South-Med countries is scarce but growing. For example, El Enbaby and Galal (2015) and Hassine (2012) estimated the extent to which circumstances beyond the control of individuals accounted for variations in earnings in Egypt. Salehi-Isfahani et al. (2014) explored how much circumstances accounted for inequality of opportunity in education in a number of MENA countries. Assaad et al. (2012) explored inequality of opportunity in health outcomes in the Arab world, including Egypt, Morocco and Jordan. While the data did not allow researchers to take into account a sufficient number of circumstances to account for variations in opportuni-

Figure 3.5: Labor income share in GDP, 2000-2014



Source: ILO - Global Wages Report data and National Accounts data from: Algeria National Office of Statistics, Egypt Ministry of Planning, Morocco Haut Commissariat au Plan, and Tunisia National Institute of Statistics.

ties, all studies find that circumstance variables such as parents' education and their occupation, area of birth and gender made a difference in the fortune of their children. Hence, even if Gini coefficients are not high in the region, citizens of these countries do not enjoy equal opportunities in earnings, educational attainment or health outcomes.

Voice and accountability

Voice and accountability, being key features of the political system, can be viewed as the other side of the coin of social development. Where societies enjoy inclusive political and economic institutions, the likelihood is high that they will enjoy high and shared prosperity (Acemoglu and Robinson, 2012, North, 1990). In South-Med countries, the demand for freedom was one of the main slogans of the rebels in Tahrir square and other squares. Accordingly, it is important to find out whether progress has been made on this

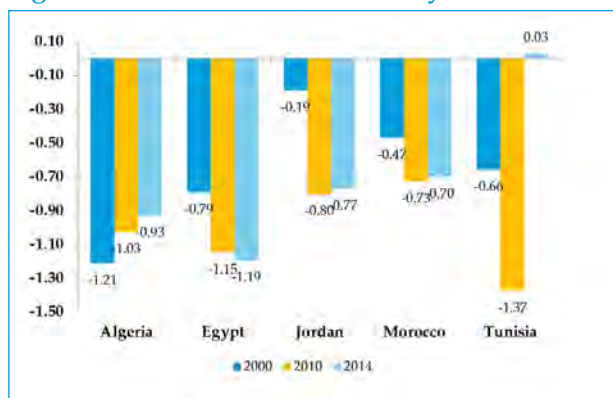
front in the post-uprising periods, or not.

Figure 3.6 shows the evolution of voice and accountability for the 5 South-Med countries for the years 2000, 2010 and 2014. The indicator reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and freedom of the media. It ranges from approximately -2.5 (weak) to 2.5 (strong) performance.¹ The results give cause for concern. To

begin with, all 5 countries, except Tunisia in 2014, enjoyed lower than average levels of voice and accountability. Comparatively, Algeria and Egypt scored less well than Jordan, Morocco, and Tunisia (except in 2010). Over time, only Tunisia and Algeria have done better, while Egypt, Jordan and Morocco have done worse.

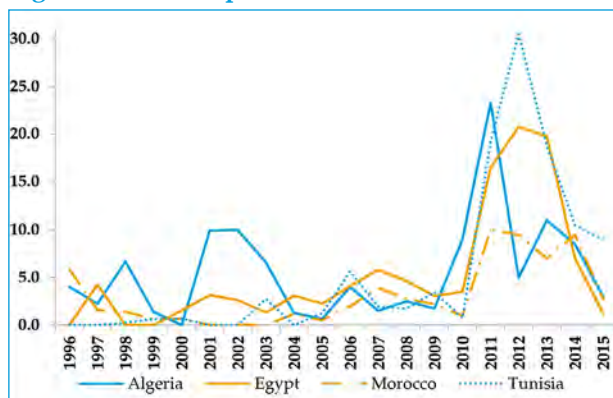
If citizens are not satisfied with their political systems or economic and social conditions, they have the option of protesting. To get a sense of the evolution of this mechanism over time, figure 3.7 shows the trend in all 5 countries over the period 1996 to 2015. The figure captures strikes and demonstrations, with each event weighted by its intensity (number of protesters) and duration (number of weeks). What the figure shows, unsurprisingly, is that protests peaked in all countries around 2010-2011 during the Arab Spring. By 2015, the level of protests subsided to the levels of the early 2000s. This trend does not necessarily mean that citizens are happier with their conditions. It might very well be the result of demonstration fatigue, suppression by the state or a position of "wait and see".

Figure 3.6: Voice and accountability indicator



Source: World Governance Indicators, World Bank.

Figure 3.7: Public protests indicator, 1996-2015



Source: African Economic Outlook calculations based on news verified by the press agencies (Marchés Tropicaux et Méditerranéens for 1996-2005, AFP and Reuters for 2006 onwards).

3.2 Response to social demands

Interim governments in South-Med countries responded to the social demands of the rebels to varying degrees. Across countries, whether directly witnessing a dramatic political uprising or simply feeling the heat coming from their neighbors, govern-

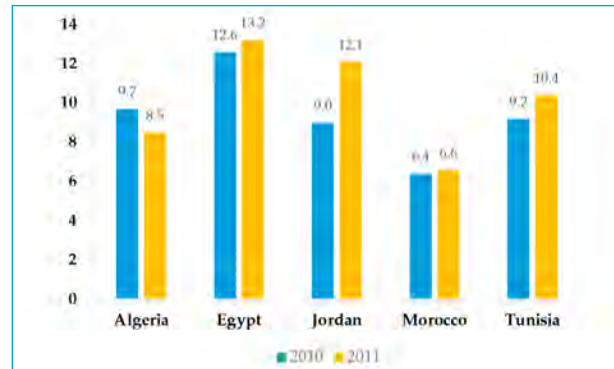
ments attempted to ameliorate the adverse effects of the transition and in some cases to appease the public or certain interest groups. This section attempts to capture these responses by documenting the main actions taken by different governments under the headings of social protection and empowerment through social services.

Social protection

Figure 3.8 shows the total expenditures on social protection in South-Med countries per the ILO definition, which comprises 11 functions or policies: health, disability, old age, survivors, maternity, family/children, unemployment, employment injury, housing, active labour market programs and general protection against poverty and social exclusion. The data compares 2010 and 2011, or one year before the uprisings and one year into the uprisings.

Figure 3.8 shows that overall expenditure on social protection was the highest in Egypt, although Jordan, Tunisia and Algeria, to some extent, were not far from Egypt. Morocco stands out as having spent only about half of the amount spent by Egypt. Over time, between 2010 and 2011, all countries increased their expenditures on social protection, except Algeria. The most notable increases were in Tunisia and Jordan, followed by Egypt, perhaps reflecting the intensity of political movements. Public spending on social protection as a share of GDP hardly changed in Morocco, while the level of expenditures declined in Algeria.

Figure 3.8: Total public social protection expenditure (percent to GDP)



Note: The data for Algeria and Morocco were not available for 2010 and the last available date were for 2009.

Source: ILO Social Security Inquiry Database.

In terms of initiatives to respond to social concerns in the post-uprising period, a review of the evidence suggests that most countries took actions. Most notably:

- They initiated energy subsidy reforms as part of their fiscal consolidation effort, while simultaneously adopting cash transfer programs to reduce the burden on the poor.
- They also increased expenditure on certain social programs, including food subsidies and housing. For example, the food subsidy in Tunisia was increased by 11 percent in the wake of the uprising (Achy, 2011; Chemingui and Sanchez, 2011).
- Finally, most countries increased pensions, public sector salaries and government employment. They also revised the minimum wage upwardly, although this revision was only applied to government employees in Egypt.

With respect to energy subsidies and cash transfers, all South-Med countries were active in the post-uprising period. They initiated cash transfer programs and moved gradually towards removing energy subsidies. This reform initiative was consistent with the broadly supported empirical finding that universal commodity subsidies tend to accrue disproportionately to the non-poor, encourage arbitrage and distort consumption and production. In contrast, a targeted program involving cash transfers tends to benefit the poor in a more cost effective manner.

In Egypt, the government initiated energy subsidy reforms as early as 2012. Between 2011 and mid-2012, the price of gas was increased by 30 percent for non-energy intensive industries and slightly more (33 percent) for energy intensive industries. In January 2013, household electricity prices were increased by 16 percent, while the prices of natural gas and fuel oil for electricity generation rose by one-third. In February 2013, the Government increased fuel prices for various industries from LE1,000 to LE1,500 per ton, and raised the price of gas for industrial use (with some exceptions, such as bakeries and electricity). The increase in electricity prices was not applied to households consuming less than 50 kilowatts/month (about one quarter of all consumers). In July 2014, there were further increases in energy prices, both for households and commercial users. The increase varied between 40 percent and 80 percent. Further reforms were planned to reach close to cost recovery

levels in fuel and electricity production by 2018/19. In parallel, the government introduced two cash transfer programs. One for the elderly and disabled, which is called Karama. The other is a cash transfer program in support of the poor (called Takafol). The latter program is conditional upon child enrolment in school and meeting health requirements. The two programs were piloted on 600,000 families in Upper Egypt, with a plan to cover 1.5 million households once fully rolled out (IMF, 2015a). These two programs supplement an existing social solidarity pension system, which covers 1.5 million households.

Similarly, Tunisia increased petrol and diesel prices and electricity tariffs on average by 7 percent in 2012. This was followed by further increases of around 8 percent the year after. In January 2014, energy subsidies to cement companies were reduced by 50 percent, with a view to eliminating them fully by 2015. At the same time, electricity tariffs and natural gas prices were increased for medium and low-voltage consumers by 10 percent, and by a further 10 percent in May 2014, along with the adoption of an automatic petrol price formula. To mitigate the negative effects of these measures, electricity tariffs for households consuming less than 100 kwh/month were kept under control. The government also introduced a new housing program for needy families and increased the tax deduction for the poorest households (IMF, 2014a). Early in December 2011, the government increased the monthly benefits for poor families and added 50,000 families

to those already receiving them, thus reaching a total of 235,000 families (World Bank, 2014a).

In Jordan, the government introduced a cash transfer program, in mid-November 2012, to households with annual earnings below JD10,000. The amount of the transfer was a sizeable JD70 per household member/per month for up to six members. This measure reached almost 70 percent of the population in 2013 (World Bank, 2014b). The fiscal savings from the removal of fuel subsidies and their replacement with cash transfers was around 1 percentage point of GDP (World Bank, 2013). With respect to electricity subsidies, Jordan introduced three sequential increases in tariffs for richer households, large domestic corporations and selected economic sectors, including banks, telecommunications, hotels and mining (IMF, 2014a and 2014b). Prices at fuel pumps were liberalized. Subsidies for petrol, diesel, kerosene and Liquefied Petroleum Gas (LPG) were reduced. As a result, subsidies came down from JD884 million (4 percent of GDP) in 2012 to JD250 million by 2013 (Atamanov et al, 2015; IMF, 2014a and World Bank, 2014b). In January 2014, electricity tariffs were further increased by up to 15 percent for selected consumers (IMF, 2014a). Further increases followed for selected businesses and households that consume over 600 kilowatt-hours/month (World Bank, 2014b).

In Morocco, attempts to alleviate the burden of reform on the poor included the expansion of benefits of existing social programs (such as support for school-age children and for the

poor facing medical expenses), as well as the introduction of new programs to support low income widows and physically disabled individuals. Limits were imposed on fare increases against rising costs of fuel (IMF, 2015b). In parallel, the Moroccan Government increased the retail price of diesel, petrol and industrial fuel oil by 14-27 percent, thus saving 0.7 percent of GDP by the end of 2012. This was followed in 2013, first, by partial indexation of the prices for diesel, petrol and industrial fuel to world prices and, second, by hedging provisions to reduce the volatility arising from fluctuations in the international price of oil. The prices for diesel were increased further by 9 percent, for petrol by 5 percent, and for fuel by 14 percent. Starting February 2014, the subsidies on the domestic prices of petrol, diesel and industrial fuel oil were gradually removed. Transfers to the public electricity company (ONEE) were gradually eliminated by 2017. The government also considered ways to gradually reduce subsidies on wheat, sugar, and butane. These efforts reduced the subsidy bill from 6.6 percent of GDP in 2012 to 3.6 percent in 2014 and to an estimated 2.3 percent of GDP in 2015 (IMF, 2015b and 2014a).

Turning to wages, pensions and government employment, Egypt and Tunisia increased their public-sector employment in response to rising unemployment. In Egypt, one million persons were recruited by the public sector in the wake of the uprisings. In Tunisia, forty thousand public jobs were created (Subrahmanyan and Castel, 2014). In the same direction, all South-Med coun-

tries increased public sector wages. Egypt raised civil service salaries by 15 percent in the waning days of the Mubarak regime (and further increases were brought by the Muslim Brotherhood government). Morocco increased civil service salaries by around \$75 per month. Jordan granted a one-off cash transfer to civil servants at a cost of more than \$110 million.

By 2012, all five countries had also increased minimum wages. In 2011, the Egyptian government granted public servants on permanent contracts a minimum monthly wage of LE700 (US\$ 120), effective in July 2012. A similar minimum wage increase for private sector workers was discussed by the National Wages Council, but no agreement was reached. In January 2014, the minimum wage for public sector employees was raised again to LE1,200 (US\$ 170) (Bank Audi, 2014). A new law on workers' rights was approved at the cabinet level after the Uprisings but has yet to be ratified, amid complaints about restrictions on trade

union freedom and activities (See Kienle, 2015).

In Algeria, the minimum salary was increased by 20 percent, effective in January 2012 (IMF, 2012 and European Training Foundation, 2014). In July 2012, the Tunisian government, after consultation with the unions and employers' organizations, raised the minimum salary in the industrial and agricultural sectors (Kienle, 2015). Jordan also saw significant hikes in minimum wages in the private sector, most notably in 2012 (see figure 3.9).

Finally, the Moroccan government increased the minimum wage of workers in the private sector by 10 percent in 2014. In the public sector, the monthly minimum wage was increased by nearly 30 percent, although it was made effective as of 2015 to reduce its impact on the public wage bill in 2014 to only 0.02 percent of GDP (IMF, 2014c).

Social services

The swift response by South-Med governments to enhance social protection was not matched by a similar response to improve the provision of social services, mainly health and education. Understandably, improving the provision of health and education services is not a short-term project, nor can it be achieved merely by increasing government expenditure. The reform process is much more complex, and involves building schools and hospitals, hiring more teachers and doctors, changing the curriculum and adopting modern teaching techniques. In addition, it requires a change in the incentive

Figure 3.9: Minimum Wages and GDP Per Capita in Jordan (Index = 100 in 1999)



Source: Tzannatos, Z. (2015).

structures for teachers/doctors and students/patients, increasing the autonomy of service providers in return for accountability, and greater transparency and participation in policy making (see World Bank, 2008). The question remains, however, as to how much attention governments in South-Med countries have paid to health and education in the post-uprising period.

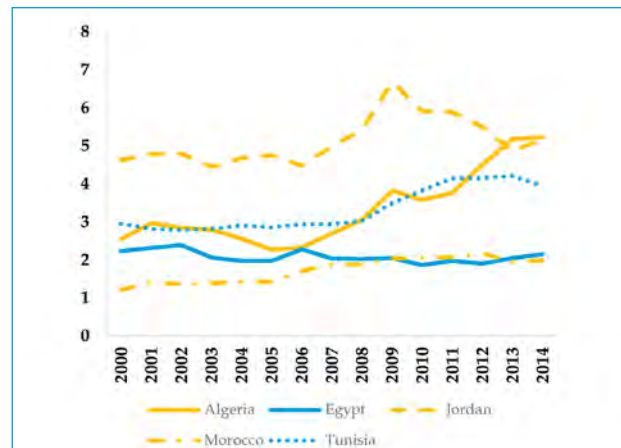
Starting with health, it is evident that the health sector has received more attention in national debates since the uprisings than before. The newly adopted constitution in Egypt in 2014 guarantees each citizen the right to have access health care, and sets a floor for public spending on health at 3 percent of GDP. The new Tunisian Constitution of 2014 also asserts that access to health services is a human right. It further states that the government will guarantee preventive health care and treatment for every citizen, while ensuring free health care for those without adequate means. In Morocco, in response to protests in 2012, the government implemented a Medical Assistance Plan to ensure the provision of healthcare to the poor (African Development Bank, 2013).

How far was this attention translated into action? Figure 3.10 shows government expenditures on health in South-Med countries over the period 2000-2014. The picture conveys mixed signals. Public spending on health as percentage of GDP declined in Jordan between 2010 and 2013, although Jordan has consistently spent more on this sector than all other South-Med countries. Morocco and Egypt essentially

maintained the same low levels of expenditures on health over the entire period. However, the Egyptian government initiated two socially relevant programs: one in March 2015 to cover the poor in Upper Egypt; the other in 2012 to combat the Hepatitis C Virus (HCV). Only Tunisia and Algeria increased their public expenditure on health over time, especially after the uprisings.

Notwithstanding the above declarations and the increase in public expenditure on health in some countries, the system continues to suffer from several shortcomings. Table 3.2 shows the hospital beds per 1,000 people in 2007 and 2012. It clearly indicates that Tunisia is the only country that has witnessed an improvement in the number of hospital beds per 1,000 people. The latest available data for the percent of the population covered (as members of health insurance or free access to health care services provided by the State) predates the uprisings. However, the percent was as low as 51 percent for Egypt (2008) and

Figure 3.10: Public Expenditure on Health, 2000-2013 (as % of GDP)



Source: World Development Indicators, World Bank.

42 percent for Morocco (2007). In the other countries, the coverage was better, 85 percent for Algeria (2005), 75 percent for Jordan (2006) and 80 percent for Tunisia (2005). (See ILO (2014) for further details).

Another indicator of accessibility is out-of-pocket health expenses (OOP), which tend, in the presence of universal healthcare systems, to account for less than 20 percent of total health expenditures (Alami, 2014). In the case of our five countries, figure 3.11 indicates that the ratio is much higher. The problem is particularly acute in Egypt and Morocco,

with patients paying more than 50 percent out of pocket. Over time, the trend of OOP health expenditures has remained relatively stable in all 5 countries, with the exception of Jordan where the ratio has decreased since 2008. Beside issues of access to health services, high OOP expenditures have implications for poverty. In Egypt, Rashad and Sharaf (2015) estimated that high OOP expenditures have driven 7.4 percent of the households below the poverty lines. For Tunisia, Elgazzar et al. (2010) estimates show that 17.8 percent of households will fall into poverty after accounting for the effect of OOP payments.

Ultimately, health sector reforms, along with concurrent socio-economic developments, ought to be reflected in health outcomes. By this yardstick, table 3.3 indicates that all five countries have witnessed an improvement over the past decade. Life expectancy has increased and maternal mortality and mortality rates under the age of 5 have decreased. However, these positive results are national averages and could conceal significant variations within society. Therefore, even if health outcomes are improving in general, more benefits may be accruing to certain groups than others.

To find out, table 3.4 compares two health outcomes by wealth quintile for Egypt, Jordan and Morocco. The health outcomes are mortality rates under the age of 5 per 1,000 births and the percentage of women delivering in a health facility. The data shows that health outcomes have improved for all groups, irrespective of their wealth over time.

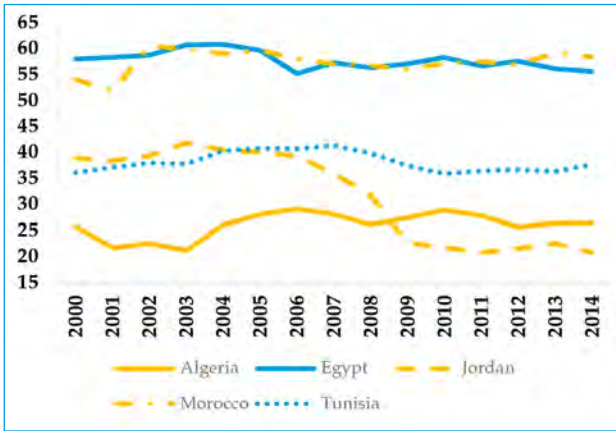
Table 3.2: Health facilities

	Hospital beds (per 1,000 people)	
	2007	2012
Algeria*	1.7	-
Egypt	2.1	0.5
Jordan	1.8	1.8
Morocco*	1.1	0.9
Tunisia	1.8	2.1

Note: *2004.

Source: World Development Indicators, World Bank.

Figure 3.11: Out-of-pocket health expenditures, 2000-2014 (% of total expenditure on health)



Source: World Development Indicators, World Bank.

However, a gap persists between the highest and lowest quintiles, especially in Egypt and Morocco. By comparison, Jordan has done much better over time.

Turning to education, the response by South-Med governments after the uprisings was not much better than in the health sector. In fact, in the four countries for which data is available for the period 2002-2013, the share of public expenditure on education relative to GDP was lower in 2013 than it was on average during the period 2002-2008 (Table 3.5). During this period, the role of the private sector in the provision of education was encouraged, most notably, in Jordan and Egypt (Galal and Kanaan, 2010). Although

most countries continue to declare their commitments to free education, families are reportedly enduring an increasing burden of the cost in the form of higher tuition fees and private tutoring.

Regarding the quality of education, the TIMSS scores (Trends in International Mathematics and Science Study) are shown in Table 3.6. The results consistently show that all five South-Med countries performed less well than the international average in math and science at all levels of education (4th and 8th grades) in 2007 and 2011. Within the South-Med countries, students scored better in Tunisia and Jordan than in Egypt and Morocco.

Table 3.3: Health outcomes, 2000-2014

	Life expectancy at birth, total (years)			Maternal mortality ratio (modelled estimate, per 100,000 live births)			Mortality rate, under-5 (per 1,000 live births)		
	2000	2010	2014	2000	2010	2014	2000	2010	2014
Algeria	70.2	73.8	74.8	170.0	147.0	141.0	39.7	27.3	25.6
Egypt	68.6	70.3	71.1	63.0	40.0	34.0	46.5	29.0	24.8
Jordan	71.8	73.4	74.1	77.0	59.0	59.0	27.7	20.8	18.5
Morocco	68.5	72.6	74.0	221.0	153.0	126.0	50.0	33.1	28.6
Tunisia	72.6	74.6	74.1	84.0	67.0	63.0	31.7	17.4	14.6

Source: World Development Indicators, World Bank.

Table 3.4: Health outcomes by wealth quintiles

		Under-five mortality rates (per 1000 births)			percentage of women delivering in a health facility		
		lowest 20%	highest 20%	total	lowest 20%	highest 20%	total
Egypt	2005	74.6	25.1	41	40.9	92.0	64.6
	2008	49.0	18.9	33	45.4	94.6	71.7
	2014	42.0	19.0	27	75.1	97.7	86.7
Jordan	2007	30.0	27.0	22	97.3	99.9	98.7
	2012	29.0	11.0	21	96.9	100	98.8
Morocco	2004	78.0	26.0	47	28.3	94	60.8

Source: Demographic and Health Surveys, several years.

The TIMMS scores are consistent with the populations' perception of the population level of their education systems. According to the Global Competitiveness Reports Database, the following questions were asked:

- "In your country, how would you assess the quality of primary schools? [1 = extremely poor; 7 = excellent]"
- "How well does the education system in your country meet the needs of a competitive economy? [1 = not well at all; 7 = extremely well]"
- In your country, how would you assess the quality of maths and science education? [1 = extremely poor; 7 = excellent]"

The responses are shown in Table 3.7. They indicate that the quality of the education systems were considered above average in Tunisia and Jordan, but average or below average in Algeria, Egypt and Morocco. Comparing the scores for 2015 to those for 2010, there was a modest improvement in Algeria, but a stagnation or even a deterioration everywhere else.

Certainly, South-Med countries have improved adult literacy and net enrolment over time (Table 3.8). The improvements in adult literacy have been most significant in Morocco and in net enrolment in Egypt and Morocco. Nevertheless, adult literacy rates remain at around 70 percent in Morocco and Egypt. Moreover, net enrolment rates came down from 89.7 percent in 2010 to 87.5

Table 3.5: Public expenditure on education, 2008-2013 (% of GDP)

	2002-2008 (average)	2008	2009	2010	2011	2012	2013
Algeria	-	4.3	-	-	-	-	-
Egypt	4.8	3.7	4.2	4.1	3.9	3.7	3.6
Jordan	5.0	3.8	3.7	3.4	3.7	3.8	4.0
Morocco	5.8	5.4	5.9	5.8	5.1	4.9	4.7
Tunisia	6.4	6.3	6.5	6.3	-	6.2	-

Source: National Statistics Offices and World Development Indicators, World Bank.

Table 3.6: TIMSS average scores for 4th and 8th grades, 2007 and 2011

	Overall Mathematics				Overall Science			
	2007		2011		2007		2011	
	4th grade	8th grade	4th grade	8th grade	4th grade	8th grade	4th grade	8th grade
Algeria	378	387	-	-	354	408	-	-
Egypt	-	391	-	-	-	408	-	-
Jordan	-	427	-	406	-	482	-	449
Morocco	341	-	335	371	297	-	264	376
Tunisia	327	420	359	425	318	445	346	439
International average	-	-	468	478	-	-	461	485

Source: TIMSS Results Reports, International Association for the Evaluation of Educational Achievement.

percent in 2012 in Jordan.

One problem that has persisted over time is a mismatch between education outcomes and labour market demand, especially for graduates with tertiary education. Across countries, unemployment has continued to be high among this group. As per Table 3.9, unemployment rates among graduates with tertiary education increased between 2001 and 2011, and there are no good reasons to suggest that this trend has vanished. On the contrary, with

rising overall unemployment, the situation may have become worse. It is worth pointing out that the sharpest deterioration in unemployment among college graduates was in Tunisia.

Non-economic concerns

Beyond economic concerns, the uprisings were also an expression of dissatisfaction with the prevailing political systems. Perhaps this is so because the two are linked; bad political systems fail to meet

Table 3.7: Perceptions of the quality of education, 2007-2015

	Algeria		Egypt		Jordan		Morocco		Tunisia	
	2010	2015	2010	2015	2010	2015	2010	2015	2010	2015
Primary	3.1	2.9	2.5	2.1	4.0	4.0	3.1	3.0	5.0	3.6
Education system	2.9	3.3	2.5	2.1	3.9	4.4	3.1	2.8	5.0	3.3
Math and science	3.6	3.3	2.7	2.6	4.4	4.2	4.0	4.0	5.6	4.4

Source: Global Competitiveness Reports Database, World Economic Forum.

Table 3.8: Education outcomes

	Adult literacy rate, both sexes (%)		Net enrolment rate, primary, both sexes (%)		
	Mid 2000s*	2015	2000	2010	2012
Algeria	72.6	79.6	89.2	97.0	
Egypt	71.4	75.8	86.3	97.3	98.3
Jordan	91.1	98.0	95.1	89.7	87.5
Morocco	52.3	71.7	75.8	94.4	97.3
Tunisia	74.3	81.1	95.4	98.9	98.8

Note: *Algeria in 2006, Egypt and Jordan in 2005, Morocco and Tunisia in 2004.

Source: World Development Indicators, World Bank

Table 3.9: Unemployment among graduates with tertiary education (% of total unemployment)

	2001	2008	2011
Algeria	9.2	19.8	23.1
Egypt	-	31.7	32.1
Jordan	14.7	30.3	34.4
Morocco	18.7	16.9	18.3
Tunisia	6.7	25.9	30.9

Source: World Development Indicators, World Bank.

the aspirations of citizens for social mobility and greater equality, and vice versa. Not surprisingly, one of the common slogans of the rebels was freedom. The question is this: a few years later, have these countries become more democratic and less corrupt? Have their political systems become more inclusive, or have they merely replaced one extractive elite by another?

On the positive side, both Egypt and Tunisia have adopted new and more liberal constitutions in the post-uprising period. They have run more transparent elections of presidents and parliaments than before. In Morocco and Jordan, partial political reforms have also been adopted. Across all countries, the leaders have announced their commitment to democracy, good governance and less corruption.

The problem is that people do not seem to have felt that a real change has taken place in their political and social lives. Table 3.10 shows the Freedom House index for all five countries at two different points in time (2010 and 2015). The countries are classified as Free (F), Partially Free (PF) and

not free (NF). The results are revealing. By 2015, Algeria, Egypt, Jordan were considered not free. Only Tunisia was considered free, while Morocco partially free. Over time, the changes, if any, have been very modest.

Looking at the corruption index, the scores for the five South-Med countries in 2003, 2010 and 2015 are shown in figure 3.12. Overall, Tunisia and Jordan are perceived to be less corrupt than Algeria, Egypt and Morocco. The good news is that people believe that corruption has declined over time in all countries, except in Tunisia. The most notable improvement has been in Jordan.

In summary, South-Med countries have responded to the social consequences of the uprisings primarily by adopting better targeting mechanisms for the poor and by saving resources through energy subsidy reforms. They have also attended to labour demands, mostly in the form of government employment and higher wages. Progress in social protection has not been matched by similar progress in empowering citizens through the better provision of health and education

Table 3.10: Freedom House index, 2000-2015

	2010			2016		
	Political Rights	Civil Liberties	Status	Political Rights	Civil Liberties	Status
Algeria	6	5	NF	6	5	NF
Egypt	6	5	NF	6	5	NF
Jordan	6	5	NF	6	5	NF
Morocco	5	4	PF	5	4	PF
Tunisia	7	5	NF	1	3	F

Note: “F” “PF” and “NF” stand for “Free” “Partly Free” and “Not Free”, respectively. Starting 2003, countries whose combined average ratings fall between 3.0 and 5.0 are “Partly Free” and those between 5.5 and 7.0 are “Not Free.”

Source: Several “Freedom in the World” annual reports, Freedom House.

services. And despite some progress in building de jure political institutions, citizens are not convinced that many de facto changes in political institutions have taken place, except in Tunisia and partially in Morocco.

3.4 Assessment of the social response to date

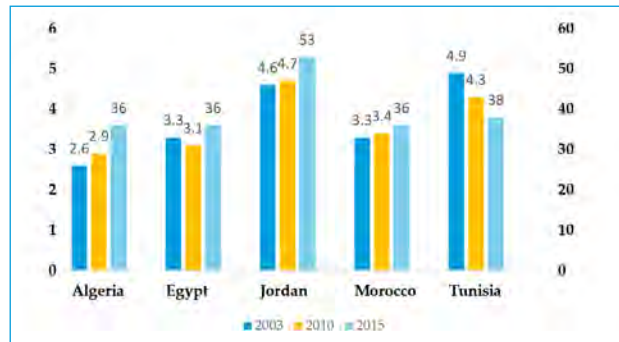
It is difficult to assess the impact of social policies on citizens because of the time lag between reforms and their effect and because it is not easy to establish a reliable counterfactual. It is possible nevertheless to comment on the reforms in terms of their appropriateness and effectiveness in achieving intended objectives.

The broad conclusion of this section is that the responses thus far seem to have eased the burden of transition and reduced its hardship for the groups that have received benefits. Those who have found a job or are receiving higher wages or cash transfers are doubtless better off than if no reforms had been implemented. On the other hand, the reforms seem to suffer from several shortcomings. First, they have been driven primarily by short-term political gains. Second, they have lacked sustainability. Third, they do not represent a major departure from the old social contract.

Short-termism and political expediency

The responses to social demands surveyed in the previous section suggest that interim governments opted for policies that focus on

Figure 3.12: Corruption perceptions index (CPI), 2003-2015



Note: The Corruption Perceptions Index aggregates data from different sources of perceptions of business people and country experts of the level of corruption in the public sector. For 2015, the data are standardized to a scale of 0-100, where a 0 equals the highest level of perceived corruption and 100 equals the lowest level of perceived corruption. As for 2010 and 2003, the CPI measures are standardized to a scale from 10 (very clean) to 0 (highly corrupt).

Source: Transparency International data.

the short-run, under the influence of the politics of the hour. They opted for reforms that have immediate rather than delayed payoffs. As shown in table 3.11, all five South-Med countries increased government expenditures during the period 2010 to 2014. The increase in expenditures as a percent of GDP between 2010 and 2014 was high in hard-hit Egypt and Tunisia. But the same was true in Jordan, Algeria and Morocco. At the same time, the opposite trend was held with respect to public investment. In all five countries, public investment, as a percent of GDP, was reduced between 2010 and 2015. Tunisia, Egypt and Jordan went the farthest, with a reduction of 1-2 percentage points of GDP. Algeria followed likewise. Only Morocco modestly increased the level of investment relative to GDP during this period.

The above pattern of fiscal

Table 3.11: Public investment and general government expenditure, 2010-2014 (% of GDP)

	Public investment expenditure			General government expenditure		
	2010	2014	change	2010	2014	change
Algeria	15.1	14.5	-0.60	37.0	40.7	3.6
Egypt	3.8	2.5	-1.30	31.8	36.7	4.9
Jordan	5.1	4.5	-0.60	30.4	30.9	0.4
Morocco	6.2	7.0	0.80	31.1	33.0	1.9
Tunisia	6.6	4.3	-2.30	25.6	29.2	3.5

Source: IMF Article IV consultations and World Economic Outlook Database.

response suggests that governments attempted to appease organized groups with political influence rather than the public at large. Many of the reforms addressed organized workers, either because they have strong trade unions (Tunisia), or because they work for a large bureaucracy (Egypt) whose support is important for the regime. Ironically, when Egypt raised the minimum wage, it was only applied to government employees, as business associations were opposed to its application in the private sector. Workers in the informal sector saw none of the benefits in Egypt, or elsewhere, partly because of enforcement difficulties and partly because they lack the channels to make their voices heard. At the same time, no major actions were taken to extract taxes from the rich to meet the growing expenditures. The justification was that this would discourage investment at a time when the economy was sluggish. Perhaps, also, the regimes did not want to antagonize powerful interest groups.

Sustainability

The above pattern of behavior may be understandable in light

of the political instability experienced during the transition, but it has proved to be costly. It is true that aspirations for instant gratifications at the time were intense, so was the willingness on the part of many groups to participate in riots. At the same time, governments were preoccupied with laying the foundations for more inclusive political institutions, let alone restoring security. However, the fact remains that the responses to social demands were myopic and tilted in favour of certain groups. With some exceptions, those who needed help the most were left out. Equally important, the responses have eroded economic sustainability.

Obviously, the adverse economic conditions associated with political instability made sustainability difficult, but so did the unwillingness of interim governments to raise taxes or engage in a major restructuring of expenditures during the early years of the transition. At the end, South-Med countries have had to face the challenge of escalating public debt to risky levels and eventually to resort to the IMF for a bailout.

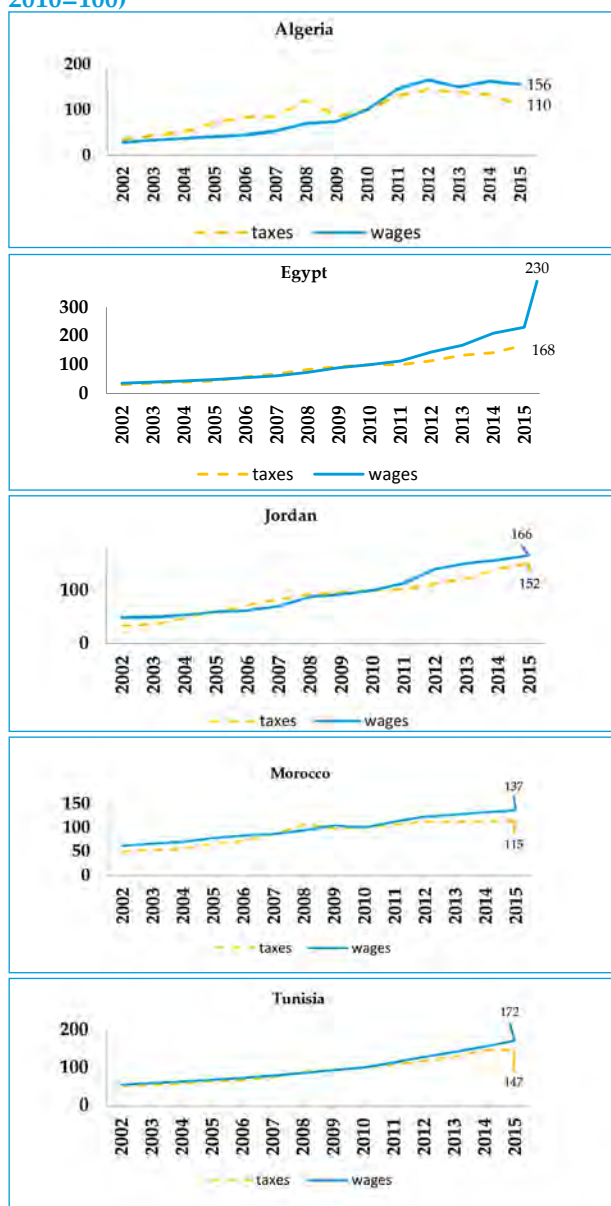
To explain what happened further, we may consider the

trends in taxation and the government wage bill over the period 2002 to 2014 (figure 3.13). The remarkable observation from this figure is that the index for tax revenues in all South-Med countries has not kept pace with the increase in public sector wages. The divergence between both trends began around 2010/11. The sharpest divergence occurred in Egypt, Jordan and Algeria. Tunisia was more disciplined than other countries.

From a social development point of view, it would also have been useful for interim governments to begin a process of restructuring public expenditure in favour of education, health, and infrastructure. Several studies have pointed out that publicly provided education and health services have become increasingly ineffective at delivering quality services (World Bank, 2008). Teacher and doctor absenteeism in schools and clinics are common. A private sector has emerged that makes people pay for the same services to which they were entitled. As an Egyptian woman put it, 'you can go to the private clinic and lose all your money, or go to the public clinic and lose your life' (Devarajan, 2015). But not much has been done on this front. Delaying reforms of the social sector can also be destabilizing in the long-run.

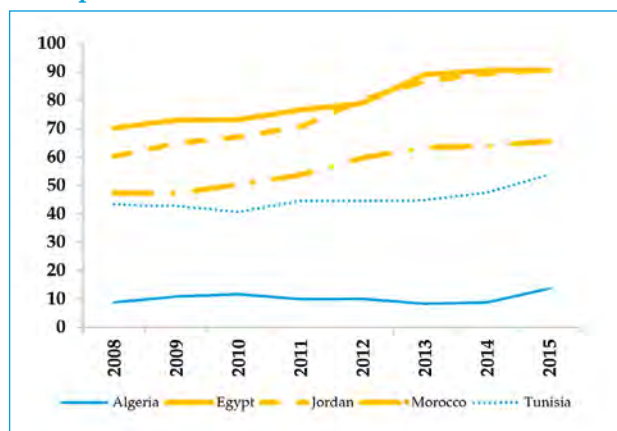
Exacerbating the problem further is that South-Med countries have increased public spending essentially through debt financing. As a result, public debt positions have deteriorated relative to GDP in all countries but Algeria (figure 3.14). The problem has become worse over time since 2011,

Figure 3.13: Limited economic base and taxes against rising wage bills, 2002-2014 (Index 2010=100)



Source: IMF Article IV Consultation data

and has reached alarming levels of about 90 percent of GDP in Egypt and Jordan in recent years. Debt is also high in Morocco and Tunisia, but less so than in Egypt and Jordan.

Figure 3.14: General government gross debt, 2008–2015 (percent of GDP)

Source: World Economic Outlook Database, IMF.

A new social contract?

To place the discussion of social contracts in a broader context, Hickley (2011) has put forward a way of differentiating between two types of social contracts. As shown in Table 3.12, each of these contracts has a key feature pertaining to its overarching goal, the position of individuals in society, the foundation of society and the political arrangements agreed

upon. Broadly speaking, social contracts are liberal and interest-based, or rights-based. There is a further distinction under the rights-based contract, depending on the commitment made by different societies to upholding certain rights and the responsibility of the state in these societies.

From the perspective of economic and social development, Neoliberalism gives prominence to individual choice, markets as a mechanism for resource allocation and the fortune of individuals, and opportunity and safety nets as society's way of dealing with social concerns. At the other end of the spectrum, social democracy is built on the premise of citizen empowerment, the central role of the state in aiding indivisibles and the prominence of universal rights as the foundation of inclusion.

Against this typology, what can be said about the South-Med countries? Unfortunately, the picture is still unclear, to say the least. Before the uprisings, a ruling elite

Table 3.12: Approaches to social contracts

	Liberal/Interest-based		Social/Right-based	
			(Negative)	(Positive)
Key proponents	Hobbes, Hayek, Nozick Gauthier, Buchanan	Locke	Rousseau, Kant, Rawls, Scanlon	
Overarching goal of the social contract	Protection; maintenance of order	Protecting existing property rights	Promoting justice	
Vision of individual	Rational actor; motivated by subjective ends. Individual as isolated from others	Rights bearing citizen	Impartial actor; motivated by impersonal aims Individual in relation to others	
Vision of society	Individualistic Merit-based notion of justice	Individualistic	Commonwealth Equality-based social justice	
Basis for social relations	Utilitarian	Mutual respect	Mutual respect	
View of political arrangements	Political arrangements for mutual advantage (although on ethical/moral grounds under a right based approach)			

Source: Hickley, S. (2011) "The politics of social protection: what do we get from a 'social contract' approach?", Chronic Poverty Research Centre Working Paper No. 216, July.

captured most of the political and economic power. Democracy and liberties were thin. The liberalization of the 1980s and 1990s led to rolling back of the role of the state in favour of markets as a mechanism for resource allocation and even the provision of social services. Corruption was also widespread.

In the post-uprising period, the changes in the political landscape have been modest, or merely in relation to formal institutions. The room for reversal is not out of the question. And it will take time for formal institutions to find their place in reality. The next chapter elaborates the evolution of the political systems in South-Med countries thus far, as well as their likely trajectories.

3.5 Concluding remarks

This chapter intends to document the social consequences of the uprisings, analyze the way different governments in South-Med countries have responded to social demands, and to provide an assessment of the reforms they have carried out. The analysis is not limited to the economic dimensions of the consequences, but is extended to include political concerns. The following are the main conclusions.

First, the uprisings have led to a deterioration in social conditions, especially in Egypt and Tunisia, where the political upheavals were most intense. The consequences have been seen in rising unemployment, poverty and inequality of opportunity. The uncertainty associated with political instability has led to

slower investment and economic growth, which has meant that governments have had fewer resources to meet social demands.

Second, in response to worsening social conditions, interim governments opted for short-term measures to appease the streets. They implemented initiatives to increase social protection, through programs such as cash transfers. They also increased employment and wages in government and allocated more resources to commodity subsidies such as food. Under pressure, they acted on energy subsidies to save resources for their social protection programs. In the process of doing all this, they have tended to appease organized groups at the expense of unorganized ones.

Progress in social protection has not been matched by reforms to improve the provision of social services, such as health and education. The two sectors have not seen a greater allocation of resources, nor have they undergone reforms to improve quality and access to these services. Similarly, although governments have carried out some reforms of formal political institutions and conducted free elections, the political landscape remains highly imperfect. Only Tunisia is considered “free” and Morocco “partially free”, with the other countries remaining “not free” (Table 3.10). Corruption may have subsided marginally, but it remains relatively high. As such, the political bargain that prevailed before the uprisings would seem to perdure to date.

Finally, the assessment of the response to social concerns has been myopic, unsustainable and

modest. Myopic because it has focused on improving the current situation, even if the action is to be costly in the future. This is most visible in the increase in current government expenditures, while cutting public investments. Unsustainable because the deteriorating fiscal deficits have led to an escalation in public debt and ultimately to resorting to the IMF for a bail out. Modest in terms of observed changes in the political bargain between citizens and their new rulers. Without notable progress on building inclusive political institutions, the prospects for sustainable prosperity among all citizens remain distant (Acemoglu and Robinson, 2012, Galal and Selim, 2013).

Notes

1. WGI rely on perceptions from various data sources, including surveys of firms and households, as well as the subjective assessments of a variety of commercial business information providers, non-governmental organizations, and a number of multi-lateral organizations and other public-sector bodies.

References

- Acemoglu, D. and J.A. Robinson (2012) "Why nations fail: the origins of power, prosperity and poverty", vol. 4, *Crown Business*.
- Achy, L. (2011) "Tunisia's Economic Challenges", *Carnegie Papers*, December.
- African Development Bank (2013) "Medical Coverage Reform Support Program – Phase 3, Kingdom of Morocco, Appraisal Report"
- Alami, R. (2014) "Health, Social Policy and inclusive growth in MENA", *SOAS Department of Economics Working Paper Series* No. 188, the School of Oriental and African Studies, April.
- Assaad, R., C. Kraft, J. Roemer and D. Salehi-Isfahani (2016) "Inequality of Opportunity in Income and Consumption: the Middle East and North Africa Region in Comparative Perspective", *ERF Working Paper* No. 1003, May.
- Assaad, R., C. Kraft, N. Hassine and D. Salehi-Isfahani (2012) "Inequality of Opportunity in Child Health in the Arab World and Turkey", *ERF Working Paper* No. 665, April.
- Atamanov, A., J. Jellena and U. Serajuddin (2015) "Energy Subsidies Reform in Jordan – Welfare Implications of Different Scenarios", *World Bank Policy Research Working Paper* No. 7313, June.
- Bank Audi (2014) "Egypt Economic Report – Growing Hopes for Macro Recovery Following Transitional Years of Economic Sluggishness".
- Chemingui, M. and M. Sanchez (2011) "Assessing Development Strategies to Achieve the MDGs in the Republic of Tunisia", *United Nations Department for Social and Economic Affairs*, October.
- Desai, R., A. Olofsgard and T. Yousef (2007) "The Logic of Authoritarian Bargain: A Test of Structural Model", *Brookings Global Economy and Development Working Paper* No. 3, January.
- Devarajan, S. (2015) "What is the

- social contract and why does the Arab world need a new one?", *World Bank Blog Voices and Views: Middle East and North Africa*, December.
- Diwan, I., P. Keefer and M. Schiffbauer (2016) "Pyramid Capitalism: Cronyism, Regulation and Firm Productivity in Egypt", *IDB Working Papers Series* No. IDB-WP-739, October.
- El Enbaby, H. and R. Galal, (2015) "Inequality of Opportunity in Individuals' Wages and Households' Assets in Egypt", *ERF Working Paper* No. 942, September.
- Elgazzar, H., F. Raad, C. Arfa, A. Mataria, N. Salti, J. Chaaban, D. Salehi-Isfahani, S. Fesharaki, and M. Majbouri (2010) "Who Pays: Out-of-Pocket health spending and equity implications in the Middle East and North Africa", *World Bank Health, Nutrition and Population Discussion Paper*.
- European Training Foundation (2014) "Employment Policies and Active Labour Market Programmes in Algeria"
- Galal, A. and H. Selim (2013) "The Elusive Quest for Arab Economic Development", *Middle East Development Journal*, Vol. 05, No. 01, March.
- Galal, A. and T. Kanaan (2010) "Financing Higher Education in Arab Countries", *ERF Policy Research Report* No. 34, July.
- Hassine, N. (2012) "Inequality of Opportunity in Egypt", *World Bank Economic Review*, vol. 26, issue 2, June, pages: 265 – 295.
- Hickley, S. (2011) "The politics of social protection: what do we get from a 'social contract' approach?", *Chronic Poverty Research Centre Working Paper* No. 216, July.
- International Labor Organization (ILO) (2014) "World Social Protection Report 2014-2015: Building economic recovery, inclusive development and social justice"
- International Monetary Fund (IMF) (2015a) "Arab Republic of Egypt 2014 article IV Consultation – Staff Report; Press Release and Statement by the Executive Director for the Arab Republic of Egypt"
- ____ (2015b) "Morocco 2014 Article IV Consultation – Staff Report; Press Release and Statement by the Executive Director for Morocco"
- ____ (2014a) "Subsidy Reform in the Middle East and North Africa – Recent Progress and Challenges Ahead"
- ____ (2014b) Jordan 2014 Article IV Consultation, Third and Fourth Reviews Under the Stand-By Arrangement, Request for Waivers of Non-observance of Performance Criterion – Staff Report; Press Releases; and Statement by the Executive Director for Jordan"
- ____ (2014c) "Morocco: Request for an Arrangement Under the Precautionary and Liquidity Line and Cancellation of the Current Arrangement – Staff Report; Press Release and Statement by the Executive Director for Morocco"
- ____ (2012) "Algeria 2011 Article IV Consultation – Staff Report; Public Information Notice"
- Khandelwal, P. and A. Roitman (2013) "The Economics of Political Transitions: Implications for the Arab Spring", *IMF Working Paper* No. 13/69,

- March.
- Kienle, E. (2015) "Changed Regimes, Changed Priorities? Economic and Social Policies After the 2011 Elections in Tunisia and Egypt", *ERF Working Paper* No. 928, July.
- North, DC. (1990) "Institutions, Institutional Change, and Economic Performance", Cambridge University Press.
- Piketty, T. (2014) "Capital in the Twenty-First Century", *Harvard University Press*.
- Rashad, A. and M. Sharaf (2015) "Catastrophic and Impoverishing Effects of Out-of-Pocket Health Expenditure: New Evidence from Egypt", *ERF Working Paper* No. 974
- Rawls, J. (1971) "A Theory of Justice", Rev. Ed. Belknap Press of Harvard University Press.
- Reijkers, B., C. Freund and A. Nucifora (2014) "All in the Family – State Capture in Tunisia", *World Bank Policy Research Working Paper* No. 6810, March.
- Roemer, JE. (1998) "Equality of Opportunity", *Harvard University Press*.
- Salehi-Isfahani, D., N. Hassine and R. Assaad (2014). "Equality of opportunity in educational achievement in the Middle East and North Africa", *The Journal of Economic Inequality*, vol. 12, issue 4, November, pages 489-515
- Subrahmanyam, G. and V. Castel (2014) "Labor market reforms in post-transition North Africa", *African Development Bank Group Economic Brief*
- Tzannatos, Z. (2015). "Jordan's National Employment Strategy, 2011-2020, an update and future directions". *International Labor Organization*.
- World Bank (2014a) "The Unfinished Revolution Bringing Opportunity, Good Jobs and Greater Wealth to All Tunisians"
- World Bank (2014b) "Jordan Economic Monitor - Resilience and Turmoil"
- World Bank (2013) "Jordan Economic Monitor - Maintaining Stability and Fostering Shared Prosperity Amid Regional Turmoil"
- World Bank (2008) "The Road Not Traveled – Education Reform in the Middle East and North Africa", *MENA Development Report*.

CHAPTER 4

Political Transition and Economic Development

4.1 Introduction

This report has so far analyzed the economic consequences of the political transitions in South-Med countries and how successive governments have attempted to restore macroeconomic balances, reignite economic growth and achieve greater social justice. The unfolding political realities in the wake of the uprisings were taken as given, at least regarding how they would constrain and shape the choices available to policy-makers, as well as the feedback from economic performance to politics. In this chapter, an attempt is made to rectify this omission.

Broadening the scope of the analysis beyond pure economic management, it is important to point out that six years after the spark of the Arab uprisings, South-Med countries continue to face enormous challenges in the spheres of security and political development. Iraq, Libya, Syria and Yemen are at risk of becoming failed states. Rebuilding national coalitions that can preserve a modicum of stability is now a priority. Other countries – Jordan, Morocco, and Algeria – have

managed to largely diffuse the political shock. In these countries, the regimes have survived either by increasing patronage (esp. in Algeria), or by promising a gradual change in politics and economics (Jordan, Morocco).

The countries for which transition is more complex are Egypt and Tunisia (and to some extent Lebanon which is attempting to salvage its core political settlement), where the political shock resulted in regime change. In these two cases, the macro and growth performance have deteriorated markedly, as discussed in the previous chapters, as have state services. In these “transitioning” countries, the economic reform agenda has centred on three concerns: the first and most immediate is that of economic stabilization in order to avoid an economic and financial meltdown, which would further complicate the political process; the second is related to the modernisation of the state and the rehabilitation of public services; and the third concerns the business environment and job creation.

That much is well known. What is less clear is the extent to which the new political circum-

stances allow the new governments to shape and carry out economic reform. Also unclear is how one can build reform packages that command a minimum level of political support - a tricky endeavour in the best of circumstances and challenging in the current hyper-politicized environment. A further complicating factor relates to the quality of the institutions inherited from the past, which were already in a state of partial decay before the uprisings of 2011.

Additionally, the rulers in the region now have to reckon with a new reality. In all countries in the Middle East – both where millions have protested and managed to oust long-standing dictators and where opposition is muted – politics have changed significantly in the last seven years. New political actors have taken the reins of state power. Islamists have won free and fair elections in Tunisia, Egypt and Morocco, even if their time in office was relatively short-lived and their actual strength in society is less extensive than many had long assumed. New political movements and parties have been formed and others are in formation. Above all, the public engages more overtly in politics, making the “street” a force to reckon with.

The central claim of this chapter is that in order to develop a positive grammar of policies during transitions, it is essential to understand two things: first, the nature of the political transition in different countries (the starting points and destinations of each country); second, the likely types of interaction

between the changes in political circumstances and the institutions responsible for delivering economic outcomes, especially if political transitions are bringing about new political settlements.

To this end, the chapter attempts to answer the following questions:

- Is there a typology of alternative political/institutional paths in the wake of transition?
- Based on this framework, what is the likely evolution of political regimes in the Arab Countries in transition?
- In comparing Egypt and Tunisia, what can be said about the relationship between the evolution of political regimes, on the one hand, and the state-business relationship and the state’s capacity to deliver social services and macro-manage the economy, on the other?

The analysis takes politics as given, but it describes the feedback on politics from economic performance. It pays special attention to Tunisia, a polity that seems to be moving towards more competitive forms, and Egypt, which by contrast seems to be moving toward a more dominant path. It explores the implications of these two divergent paths for economic growth, social services and macroeconomic management. The analysis reveals that while the macro-situation is likely to remain unstable in the future in both countries, the pressure points will be different and will come mostly from the state sector in

Tunisia, and from low private sector growth in Egypt.

The rest of the chapter is organized as follows. Section 2 offers a stylized framework that helps in understanding the dynamic political economy path followed by the post-revolt countries, and discusses the implication for institutions - inherited and future. Section 3 applies this framework in a speculation on the likely evolution of political regimes in the Arab region. Sections 4-6 look in more detail at Tunisia and Egypt, focusing on state capacity (section 4), economic growth (section 5) and macro-management (section 6). Section 7 concludes.

4.2 Transition challenges, politics, and institutions

“Transitology”, taken to include both political and economic transformations, can be confusing. Much about transitions is specific to countries, including starting points and destinations, but analysts usually look for general rules. Initially, the emphasis is on the political side, which tends to be the leading concern. But if the economy deteriorates, this makes political change harder, and calls intensify for economic improvements to support political change. This creates a risk of being caught in a transition trap (EBRD, 2013). In previous transitions, especially in Eastern Europe and the Former Soviet Union (FSU), growth dipped for 4 years on average after the political transition before it recovered and reverted to normal rates (Freund and Mottaghi, 2011).

While useful, the above ac-

counts do not provide an explanation of the political changes occurring through the transition, or provide a precise account of how economic performance relates to changes in the political regime. The alternative of considering each case to be highly specific is not very useful either. What is needed is a framework that allows us to go beyond the every-case-is-unique level of complexity, but does not fall into the one-size-fits-all pitfall while recommending the same best practice as a cure for all ills. We need a simple typology of political regimes and how they may evolve over time in order to speak of a transition from one regime to another, as well as one that allows for some logical mapping between regime types and the institutions that matter from a socioeconomic development perspective. Such a typology is offered below.

A typology of political paths

A useful political-economy framework, which integrates governance and growth, is provided by the work of Khan (2010) and Levy (2014). It is summarized in Table 4.1. In this view of the world, once countries manage to ensure a basic level of security, they evolve into a political space characterized by either a dominant party, or a competitive political regime (the vertical axis). Horizontal movements along the map represent instances where the quality of governance improves or slides back, and vertical movements represent passages from autocratic to competitive systems.

The “founding” political settlement is a bargain among elites

Table 4.1: A typology of political regimes and regime dynamics

		Quality of governance	
		Myopic/personalized	Institutionalized
From conflict to a political settlement that binds elites in a rent/ power sharing coalition, and society with a workable social contract	Dominant	Dominant discretionary Arab oil importers after economic liberalization (II)	Rule by law dominant - developmental state Arab states before regimes narrowed (I)
	competitive	Personalized/fragmented competitive Arab "transition" countries after 2011 (III)	Rule of law competitive Goal post-Arab Spring for democratising countries (IV)
			Sustainable democracy (VI)

Source: Inspired by Levy (2014), Khan (2010).

that ends violent conflict – and forms a base for a country to begin its development history. The analysis of “political settlements” is a vast subject (see in particular the work of Mushtaq Khan and Douglas North). Settlements can be viewed as deals among elites to create a ruling coalition that can ensure peace (through violence and threats), and that governs by restricting organizations through both formal and informal rules (Khan, 2010). The quality of a settlement can be judged by how costly it is for the economy to allow the coalition sufficient finance to sustain peace (North et al, 2009).

The character of a “founding” settlement sets a country along one of two broad trajectories (Levy and Fukuyama, 2010). The resulting political order could be organised around a dominant political party or leader and top-down nationalistic movements, as happened in much of the decolonized world in the 1950s and 60s and in the Arab region. Alternatively, it could be more competitive, as in India and Bangladesh after their independence, and in much of Latin America, East

Europe, and Africa after they moved to a new, more competitive settlement in the 1980s and 90s. Within each trajectory the main developmental challenges are very different for countries in an early-stage than in the later stages – making for four idealized categories.

Democratic/competitive and autocratic/dominant party regimes develop different types of institutions, with different strengths and weaknesses. But their economies do not fare differently on average - the accepted wisdom these days being that economic growth under autocratic and democratic systems has similar means but larger variance under autocracy (Besley and Kudamatsu, 2007). In this classification, all Arab regimes (save Lebanon) are characterized by a dominant ruler or party over the past 50 years or so, and belong to the upper part of the graph. Their growth rates over time have been at least comparable to other developing countries.

The second dimension of the table relates to the quality of governance in each of these distinct political paths, from basic

settlements that deliver security, to higher quality regimes. Various analysts have characterized low/high “quality” differently. The duality between “myopic” vs. “long horizon” rule dates back to Olson (1993). Khan focuses more on the degree of centralisation, with territorial and within-elite fragmentation weakening power (Khan, 2010). Levy and Fukuyama, Khan, and North, also emphasise a distinction between formal/informal and personalized/institutionalized relations. In these various meanings then, the “good” governance regime would be associated with a development state that is more institutionalized, long-lived and centralised, while a “good” competitive system would be close to a rule-based sustainable democracy.

We thus obtain, besides the initial settlement, four idealized types of regimes, which fall short of a sustainable democracy. Let us next characterise the character of each regime type and the institutions associated with them.

Regimes and institutions

How do institutions evolve within this political map? Political scientists, in their discussions, have differentiated between the evolution of autocratic and competitive paths. In the autocratic regimes, authority very much emanates from the state, and improvements tend to be top-down, coming from central initiatives that roll down the bureaucracy, in an attempt to affect society and the economy. In the early phase of Arab development this took the form, for example, of SOEs, central planning and management, mass education campaigns, iconic infrastructure projects and, in some cases, deeply transformational nationalizations of private interests and land reforms. More broadly, Levy (2014) analyzed 51 dominant systems, 39 intermediate, and 29 competitive systems, and found several key distinctions between the character of those two types of regimes (Table 4.2).

According to Levy, typical autocratic states do not trust the

Table 4.2: Two development trajectories

	Dominant party Trajectory	Democratic Trajectory
Elite bargain organisation	Dominant leader/party	Competitive among at least two long lived parties/groups
Mode of decision-making	Centrally coordinated, top-down, possibility of a development state	Decentralised, the result of coalitions. Success on the “edge of chaos”. Islands of quality can arise if they get protected from state predation
Governance risks	All actions emanate from the state – state capacity is central. No trust of the private sector - Cronyism tends to be narrow. Succession risks are high	Institutional decay and clientelism. Political corruption in business. Electoral fiscal cycles are initially deep
Frontier challenges	As economy becomes more complex, ability to open up for more markets and competition. As incomes rise, ability to respond to new aspirations of middle class	Stronger capacity of state institutions. Coordination among actors to beat the tragedy of the commons

Source: Adapted from Levy (2014)

private sector as the latter tends to oppose central planning and may support the opposition. On the other hand, competitive systems are more open to a competitive private sector, but they make it difficult to control state machinery, which remains undermined by political clientelism and rent-seeking, and they tend to be dominated by uncooperative behavior and predatory risk. The question that is discussed next is: where does the Arab region fit into this typology and how have their institutions evolved over time?

4.3 Regime evolution in the Arab countries

There are no precise methods for measuring where countries fit in the above political space, but various heuristic claims can be defended.¹ First, all Arab countries (except perhaps Lebanon) approached type I after the big state push post-independence. These regimes were in some cases led by a king (Jordan, Morocco, KSA), and in other cases by the military and/or unique parties, as in Iraq, Libya, Syria, Algeria. They were organized around charismatic individuals who became presidents for life after having successfully consolidated their grip on power (Owen, 2014). In this, they were similar to other state-dominant post-independence countries, such as Korea in the 1960s and early 1970s, or contemporary Ethiopia and Rwanda, countries where a flush of authority sets a country on the move after its leadership has embraced a coherent and mobilizing strategy for development.

Second, the failure of the state-led modernisation of the economy, and import substitution strategies, pushed all countries to implement economic, but not political liberalization starting in the 1980s. The roll back of the state was very large by international standards. Increasingly, rulers resorted to divide-and-rule strategies to stay in power, leading to a weakening of the quality of governance (and in particular in the rule of law and state capacity). So, after the liberalization reforms of the 1980s-90s, these countries tended to move to the left towards type II, as governance became more myopic and oriented to short-term survival in some countries, and more fragmented in others.

Third, popular frustration with low quality governance, rising repression and unmet social aspirations among an increasingly educated population, produced a political shock in 2011, when mass movements throughout the Middle East attempted to shift the course of politics towards more competitive systems. Such jumps from autocratic to more competitive systems have also occurred elsewhere in the past. Most political scientists seem to believe that as countries get richer, they will end up in a competitive polity with more space for “voice”. This case is powerfully developed in Acemoglu and Robinson (2012), who argue that without political and economic inclusion, societies are unlikely to be able to become prosperous. While the rise of China (or the GCC for that matter) questions such general statements, it is undeniable that countries that success-

fully traverse the earlier-stages of the 'dominant state' trajectory have, over time, increasingly confronted governance-related challenges that push them to either restore lost power, or to open up their polity. Such pressures can arise both from failure and from success. Failures have often been associated with leadership that ends-up using its authority for narrowly self-seeking ends, thus breaking the "autocratic bargain" and losing legitimacy. In much of the Arab world of the 2000s, there was no ideological foundation left to ruling regimes, in sharp contrast to the widely legitimate and mobilizing ideologies of the 1960s. But pressure arises equally from success. Success in accelerating economic growth, as happened in much of the Arab world in the 2000s as a result of the Structural Adjustment Programs (SAPs) of the 1980s and 90s, resulted in a more sophisticated private sector, a growing middle class, and an emerging network of civil society organizations – all of which seek institutions capable of both the impartial resolution of disputes and the provision of a platform for 'level-playing-field' competition. This enhanced social and economic complexity tends to come into increasing conflict with control-oriented political and state institutions.

Fourth, the reaction of political elites to these mass movements varied greatly among the countries of the region, setting them on widely different courses. The extent to which the sudden political opening, that followed decades of dominant state politics, has unleashed previously suppressed conflicts, makes the

governance challenges during the transition more complex and profound. The difficulty of consolidating a competitive system is that once the flush of electoral enthusiasm has worn off, institutions capable of supporting continuing competition are unlikely to be in place, given the autocratic past. The result, as in Bangladesh or Kenya, can be a polity in which the rules of the game are clientelistic – and which teeters, seemingly indefinitely, on what Levy and Fukuyama (2010) call the edge of chaos. Interestingly, it turns out that this 'edge of chaos' can be compatible with significant economic dynamism. But whether a country can sustain its high-wire act for a sufficiently long time for these gains to be consolidated – or whether the 'edge of chaos' is a prelude to backsliding, is uncertain.

The cases of Syria, Iraq, Yemen, and Libya illustrate extreme cases, where a move away from autocracy has led to the explosion of the past settlements. At the other extreme, the GCC countries have remained stable as they reacted to the uprisings by increased patronage. In part, their relative stability arises from their high per capita resource wealth, which enables rulers to maintain a modicum of support among their citizen populations. Except for Bahrain, where opposition mobilisation has been intense (largely in reaction to the fact that a Sunni royal family rules over a Shi'a majority population in an exclusionary fashion), the political situation has remained calm. But while oil wealth has cushioned these regimes from making major changes in their political

settlements for now, these settlements increasingly pit the interests of the local business class against those of national labour as the size of the oil rent (per capita) falls over time. With youth unemployment on the rise, opposition has also risen. The goal of moving back closer to regime I, to avoid backsliding into a type II regime, will thus be increasingly harder.

In Tunisia and Egypt, the post-revolutionary years have marked a slide towards more competitive, but also chaotic politics, which have deeply marked the way in which institutions inherited from the past have been able to function. In Tunisia, following Ben Ali's departure from the country, a state of emergency was declared. First, a caretaker coalition government was created, including members of Ben Ali's party. Following more protests, the cabinet was reshuffled to remove them. Following further public protests, Ghannouchi resigned, and Essebsi became Prime Minister. On 3 March 2011, the president announced the elections for the Constituent Assembly, which were held on 23 October 2011. The Islamist Ennahda Party won the plurality of seats and formed a new government, in a coalition with two junior partners. Tunisia's National Constituent Assembly approved a new Constitution for the country on January 25, 2014. Following the assassination of political leader Brahmi in July 2013, a political deadlock ended with a compromise reached, between the country's ruling and opposition parties, to form a non-political technocrat cabinet led by Jomaa to hold the fort until the parliamentary and

presidential elections in October and November 2014 – the quartet that brokered this important deal received the Nobel prize for peace in 2015. The secular Nidaa Tounis movement won both elections and formed a government of national coalition. In all, there were therefore 3 presidents and 4 cabinets between 2011 and 2015.

Egypt has also undergone a difficult and protracted period of political instability since 2011, marked by several major events: after the fall of Mubarak, the military took charge for several months, before parliamentary elections were held early in 2012 and presidential elections in June 2012, bringing the Muslim Brotherhood to power. A new constitution was passed and the Parliament was disbanded by the Supreme Court. Mass demonstrations in 2013 brought the army back to power, followed by the adoption of a new constitution in January 2014, the election of Sissi as president in May 2014; and parliamentary elections held from October to December 2015. In Egypt too, therefore, there were 3 presidents and 4 cabinets between 2011 and 2015. The political situation has seemingly stabilized around a young strong military ruler, with rising repression amidst worsening security conditions.

Fifth, as already apparent in the comparison, countries have reacted to the new situation in different ways, breaking the uniformity of politics that characterized the Middle East in the past (Owen, 2014). In the transition countries, the two polar cases are those of Egypt and Tunisia. Egypt is seeking to adapt to the new cir-

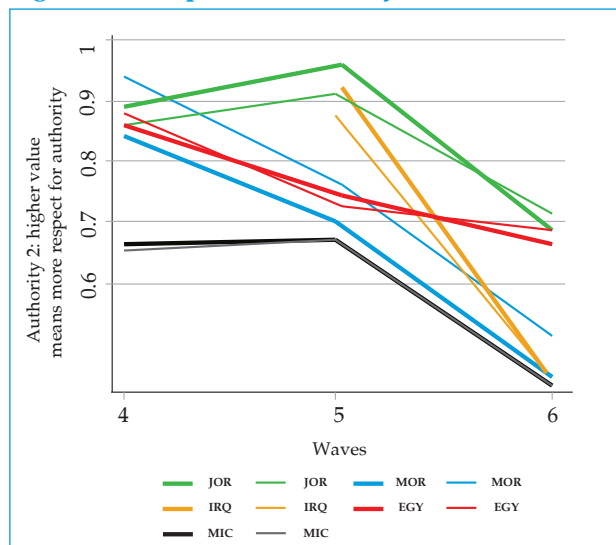
cumstances through a “reformation” of the old system -- moving back from III to II and possibly to I. Tunisia is seeking to find ways to adjust its politics and economics to a more competitive system, as in IV. Political scientists have examined the reasons for this political divergence – attributing it variably to the existence of a large army in Egypt, to the leadership of Tunisia’s main parties and the active role of civil society in mediating dispute, and to the moderate qualities of Tunisia’s Islamic opposition and its ability to find compromises (Cammett, 2016). Jordan, Morocco, and Algeria have chosen an intermediate path, with important political reforms initiated in order to preserve and gradually change the existing political settlement, but without major power loss in the short term. One can depict such a strategy as a gradual diagonal movement from regimes II to IV.

All these political strategies present challenges and risks. ‘Jumps’ from dominant to competitive trajectories could proceed relatively smoothly – as in South Korea, where ‘later stage state dominance’ evolved fairly seamlessly into a competitive polity. But it could also unfold more discontinuously – as in the Arab region. Other examples of such jumps include Eastern Europe color revolutions, and also Indonesia and Thailand. The peculiarities of the Arab region in these respects are several. Unlike Eastern Europe, the delegitimized institutions of the past could not be replaced by ready-made new rules. Unlike the transition in Latin America, there is little in terms of historical tradition to come back

to, since autocratic nationalism came right after independence and decolonization. Unlike the recent transition in South Korea, Indonesia, or Mexico, the autocratic rulers had not prepared the institutional ground for a more inclusive future. Newly formed competitive democracies face challenges related to the lack of adaptation to their new circumstances. There are no political parties to aggregate preferences at the outset of the “jump”, or institutions that can generate cooperative solutions.

Autocratic restorations also face challenges, albeit of a different type from those experienced by young and fragile democracies. Examples, from the Former Soviet Union’s failed reformation to Pakistan’s unstable equilibrium, point to the risks ahead in Egypt. The revolts have unleashed social activism to a level unseen in the past, and while the fear of chaos may have cooled these impulses in the short term, it has become much harder for regimes to stay in place if a minimum level of satisfaction is not ensured for important constituencies in a reformulated autocratic bargain. This new reality can be seen in the dramatic shift, over the past few years, of public opinion regarding popular values associated with respect for authority. In the four Arab countries for which the WVS has data, we observe a steep fall in “respect for authority” between 2008 and 2013 (see figure 4.1).²

In the Arab region, therefore, the risks are high. While newly competitive systems lack the institutions of checks and balances, the autocratic choice is constrained by heightened fears of

Figure 4.1: Respect for authority, 2008-2013

Source: World Value Survey.

the reaction from their “streets”. Both types of constraints can prevent determined efforts to restart economic recovery until political crises are resolved. A downward spiral may ensue, with polarized politics exacerbating economic difficulties, leading in turn to more fractious politics, thus causing countries to slide into a transition trap (EBRD, 2013).

To explore these issues in more detail, the analysis in the next 3 sections focuses on Tunisia and Egypt, two countries where the political path, as argued above, is likely to diverge. It will be argued, as a result of this divergence, that they are likely to face different constraints on development – in the case of Tunisia, the main challenges will come from the state sector, while in Egypt, they will come from the growth process. In both cases, however, macro-presures are likely to remain high, albeit for different reasons.

4.4 The evolution of the state and fiscal policy

State capacity is needed to create public goods – from the protection of property rights, to justice, education, or infrastructure and safety nets. The weaknesses of the state, in weak forms of authoritarianism, are quite different from its maladies under weak competitive regimes. This section first characterizes how institutions fared as Arab regimes moved from type I to II, and the sudden fall to regime III after 2011, before contrasting the future challenges of Egypt and Tunisia in their attempts to move to regimes II/I and IV respectively.

From type I to type II regimes

The last twenty years have seen a slow transition in much of the region, from very large to much smaller and impoverished states. After shooting up in the 1970s, government expenditures fell precipitously in the 1980s before stabilizing in the 1990s at much lower levels. Many countries had just started to increase expenditures again during the last oil boom of the 2000s. To get a sense of magnitude, one can calculate that from the highest levels (in the 1970s), by the early 1990s, state expenditures had been cut dramatically – by 36% of GDP in Egypt, and 16% of GDP in Tunisia, with the resultant state expenditures reduced to the range of 25-30% of GDP in both countries (Diwan and Akin 2015). Such a deep roll-back of state expenditures had, over time, a dramatic impact on some of the key services offered by the state, especially in Egypt

where the roll-back was larger, and as a result public institutions have declined steadily, and more so in Egypt.³

One of the most deeply affected items was public investment, which collapsed in both countries, going from a height of 20% of GDP in Egypt to about 10%, and in Tunisia, from 15% of GDP to about 5% (Diwan and Akin 2015). The reduction in public investment affected public services, infrastructure, and thus the competitiveness of the economy. The greatest cuts were typically for groups with little political voice – such as the poor – and in lagging regions with little political weight, and from where political tensions erupted after 2011, such as Sidi Bouzid in Tunisia's neglected interior, or the Sinai Peninsula in Egypt's neglected periphery.

The civil service wage bill was squeezed too, but less than public investment. The challenge of large and underpaid state sectors is great in many countries, and has negatively affected the ability of the state to deliver basic services to the population. The situation has become worse in Egypt compared to Tunisia – while in both countries, the civil service employs about 20-25% of the labour force, Egypt was spending, in 2010, only about 7% of GDP on the wage bill, while Tunisia was spending 10%. Reduced expenditure on health and education, which were the main levers that allowed the poor to escape their poverty trap in the past, has created a major source of inequality of opportunity that has slowed down social mobility [see Assaad and Kraft, 2016 for a good summary of this growing literature].

While education has expanded fast, it is higher education that has particularly expanded in the more recent period. This has especially been the case in Tunisia, where tertiary enrolment rates jumped from 8% of the age cohort in 1980, to 19% in 2000, to a whopping 36% by 2010. In Egypt and Algeria too, the rates of enrolment in tertiary education are nearly as high. The expansion of tertiary education may have kept the youth out of the street for a few years, but at enormous costs for the long term, producing people with high expectations that cannot be satisfied given the overall low demand for skills generated in the economy, a rise in the educated unemployed and thus high levels of frustrations among these young and their parents, and a decrease in the overall quality of the education system.

One of the consequences of state disengagement is that social grievances rose, and with them, a broad movement of opposition was unleashed in the 1980s. In this period, and unlike other regions such as Latin America and sub-Saharan Africa in the 1980s and 1990s, economic crises in the Arab region did not provoke regime change during the near synchronous “third wave” of democratization. Rulers in the Arab countries did not open up the political space in order to reduce social pressure stemming from dwindling economic resources. To the contrary, in 2010, the region was less politically open than it was in 1980, as the rise in grievances led governments to tighten their grip on the “street”. Mounting opposition was met with the rising repression of certain groups, and

the co-optation of others (see, for example, Henry and Springborg 2010; King 2009; Posusney and Angrist 2005; Schlumberger 2007, Cammett et al 2015).

Subsidies on consumer goods suffered the greatest slash during the adjustment episode. In Egypt, they fell from a staggering 23% GDP at their height, to less than 2% of GDP at the end of the adjustment period, while in Tunisia, they fell from 11% of GDP to close to zero. With the increase in energy prices in the 2000s, however, energy subsidies rose (Diwan and Akin 2015). Unlike the past goal of supporting the poor, however, the more recent rise in subsidies was an attempt by many governments to lure the rich and the middle class to continue supporting their weakened hold on power. These expenditures further shrank an already squeezed fiscal space. Energy subsidies grew over time, and by 2011 they were much higher in the Middle East than in any other region of the world. In 2010, these subsidies represented about 9% of expenditures in Egypt, and 5% in Tunisia.

Other politically meaningful constituencies, and particularly powerful labour unions, were also typically protected. Organized labour has long been a force in Tunisia and in Egypt (as well as in Morocco and Algeria). Although, trade unions did not represent the vast number of workers employed in the informal sector, they were strong in larger enterprises and in the public sector. Keeping the social peace requires at least their acquiescence. This helps explain why the civil service remained over-bloated, why privatization was

slow (as opposed by the unions) and the (formal) labour market structures remained rigid (thus slowing the development of export industries). The “labour aristocracy” of organized and public-sector workers was somewhat protected, while those forced into the informal sector, unemployment, or emigration have paid the price of the rising dualism in labour markets - few governments, faced with strikes, street protests, and rising opposition forces (mainly Islamist), would have risked alienating such a key urban constituency as organized labour (Beinin and Vairel 2013; Hibou, 2006).

Thus, by 2011, the inheritance of the past included an overstaffed and underpaid civil service, poor quality services - especially for the poor-, an oversized and poor quality university system, large subsidies to the middle and upper classes, low levels of public investment in infrastructure, impoverished lagging regions, and repression of the opposition. Twenty years of decay have deeply marked the institutions inherited by the regimes that came out of the Arab uprisings of 2011, whether in the education, security, or macro-control areas, thus severely restricting their ability to reform their systems in ways that are adapted to the ideologies that they embodied.

From regimes II to III after 2011

All of these problems have become exacerbated by the move to a more competitive political regime of type III, just after 2011. In the new competitive environ-

ment, with political parties that remain fragmented and weak governing coalitions, one would expect power to become myopic, and to easily fall prey to rent-seeking groups with a bit of voice, such as public sector unions, street movements, and middle class groups unwilling to give up “their” subsidies. In Egypt and Tunisia, these pressures accommodated the fault-lines created by their recent past. Underpaid public servants pushed for, and obtained, higher wages. Hiring in the public sector also rose. As a result, the civil servant wage bill rose fast – from 11% of GDP in Tunisia in 2011 to 13% of GDP in 2014; and from nearly 8% of GDP in Egypt in 2011 to nearly 9% of GDP in 2014. With the continuation of high energy prices worldwide, energy subsidies, which mainly benefit the middle class, also rose – from 5% of GDP in Tunisia in 2011 to nearly 8% of GDP in 2013; and from nearly 9.5% of GDP in Egypt in 2011 to 11.5% of GDP in 2014.

Although less apparent, both countries also experienced a sharp fall in state capacity due to the inadequacy of inherited methods for disciplining state bureaucracy, based on the increasingly unworkable top-down vertical accountability systems of the past, built around discretionary power, that were supposed to deter a lack of performance. While measures are lacking at this stage to document this deterioration, it was most visible, for example, in the disappearance of the police from the streets of Cairo during 2011-13, and the accumulation of rubbish in the streets of Tunis during the same period, a city

that was immaculately clean under dictatorship.

What to expect in the future?

State capacity is thought to be of several types: vertical, territorial, and horizontal (or “embedded” in the sense of Evans, 1995). Organizational/vertical accountability works best under dominant regimes, but its territorial reach can be low, particularly because of the low political weight attached to the political periphery. To confront the loss of discipline and the parallel deterioration of public services brought about by the political transition, two methods are possible. The first is what Egypt is attempting, which is a restoration of vertical accountability by tightening the internal controls in the bureaucracy. The second method is the development of horizontal mechanisms, which can complement vertical systems, or if these are weak, substitute them to a certain extent. The experience and pre-conditions for horizontal accountability mechanisms, involving civil society and beneficiary groups, do not exist early in transition, and there is no access to information to allow such processes to work. These can however be built over time as a result of efforts by civil society to increase public sector accountability (Levy and Walton, 2013).

What can be expected in the future for Egypt and Tunisia? In Tunisia, it is likely that increased political competition will lead to a situation where state capacity will decay further, in the short-to medium-terms, due to the increase in political clientelism and the loss of central control. This

is clearly demonstrated with the continued rise in the civil service salary bill – the recent decision to increase wages starting in 2016 by an equivalent 0.7% of GDP (bringing the wage bill in 2016 to over 14% of GDP) broke one of the central tenets of the IMF program, and put external financing and macro-stability in jeopardy. Moreover, in spite of policy pronouncements by all transitional governments, the pressure to keep up with subsidies did not relent until, luckily, energy prices went down in 2014-15.

On the service delivery front, while this loss of control has remained limited in Tunisia due to the more solid institutions it has inherited from the past, one can expect that the capacity of the state will continue to fall in the future, because of pressure to continue to increase staffing, which will in turn increase pressure to underpay public servants. At the same time, it is also likely that a more competitive and clientelistic political system will work to the advantage of more particular interest groups who will manage to benefit from the state, at the expense of programmatic policies that benefit the whole population. Therefore, improvements over time are unlikely to happen until horizontal systems by beneficiary groups become more developed. Given that there is little historical experience with such mechanisms, the process is likely to be long. Indeed, the introduction of a freedom of information law, which is proceeding, has been extremely slow. Moreover, while there are increasing discussions on decentralization, support for lagging regions, and reforms of

the education system, no quick changes can be expected on these fronts given the low starting point levels throughout. In Tunisia, therefore, the task of rebuilding institutions on a different base, including the development of new of horizontal checks and balances, is likely to be the main binding constraint to development in the near future.

In contrast, one would expect that Egypt would increasingly be able, as it moves (back) to a more dominant party system, to reign over its civil service and its state system. Yet, in contrast to Tunisia, the inheritance of the past will not help, as the state bureaucracy is already way over-staffed and way under-paid, and the state will have more political space to resist pressure from lobby groups. This is already visible with President Sissi's early success in controlling wages in the public sector (which fell to 8.3% of GDP in 2015) and in starting to reduce energy subsidies –energy subsidies were already cut in half in 2015. While vertical controls are being re-instated, Egypt has avoided any move to improve horizontal accountability, (refusing, for example, to even consider introducing a freedom of information law when prompted by the World Bank to make this a central condition in a large budget support operation in 2012-13), and recentralising controls as opposed to moving towards a more decentralised system. It remains to be seen if this attempt to reimpose top down systems will work in improving the quality of services over time. For Egypt, it is thus unlikely that control over bureaucracy will be the binding

constraint to development in the near term.

4.5 The growth process and the evolution of state-business relations

Arab States in transition have inherited hybrid economic systems of moderate performance - part crony and part informal - a reflection of a governance system based on political and economic exclusion. Regulations and institutions were tilted towards accommodating the interests of the politically connected rather than serving the purpose of productivity gains and job creation. As political regimes weakened, the patron-client relation became tilted towards the interest of the clients rather than put at the service of an effective industrial policy.

For private activity to grow and be productive, investors need to know that they can obtain commensurate returns for their efforts. In low quality governance systems, where rules and institutions are weak, this presupposes that they have deals with the state that protect their property rights and possibly give them advantages over competitors (Hallward-Driemeir et al, 2010). For investors to invest, therefore, two factors are determining. The first is the extent to which these deals are ordered/disordered, i.e., how far they are respected inter-temporally once they are made. The second is the extent to which they are allowed to enter into deals, which depends on their identity, and how open/closed the deal space is.

The four combinations of

these two factors describe the “deals space”, which can be mapped to the political space in the sense that each of its “ideal” cells is more likely to correspond to a particular political regime (see table 4.3). In particular:

- Type I. Ordered closed deals. Only those with political connections get to make deals, and they can be confident that officials will deliver. Such a situation is likely to accommodate medium levels of economic growth.
- Type II. Disordered close deals. As political risk rises, only those with political clout can make deals, but with the high probability that future regimes will not honour deals, deals become disordered. Such systems are likely to have low growth.
- Type III. Disordered open deals. Anyone can make a deal, but no certainty that officials will deliver. Firms feel the need to make deals, but the return is highly uncertain as they may face different officials in the future. Such systems are likely to have medium to low levels of growth, because they are more inclusive than, even though as corrupt as, type II situations.
- Type IV. Open ordered deals. Anyone can make a deal, and they can be certain it will be honoured. This is a world close to rules, the only distinction having to do with formal vs. informal rules. Such a

system is likely to support high levels of economic growth.

Below, we describe how Tunisia and Egypt moved from types I to II after the liberalization of the 1980s, and then after the Arab Spring of 2011 to zone III. We also show how the various institutions that support private sector growth fared during these transitions, as well as the challenges they face now, given the inherited institutions of the past.

A recent history of the private sector – from regime of type I in the 1970s and 80s to type II in the 2000s

Let us first recount how the move from I to II, which occurred in the context of the 1980s' liberalization, impacted the economy. Essentially, it will be argued that state-business relations moved to the left, from types I to II, as political risk rose and the capitalistic base of the private sector narrowed, due to two inter-related factors: first, politicians restricting entry into the private sector to reduce opposition risk, and second, politically supported firms demanding higher returns to offset political risk.

During the move from state-run to market economies in the mid-1980s, done under duress as the Arab state was in crisis, autocrats faced rising opposition while simultaneously losing the levers not just of ideology, but also of ownership of state-owned enterprises, large investment budgets, large civil services, large military and security spending. Political stability required that the emerging private sector be managed politically in order to ensure its political neutrality, and avoid the risk of its support to the opposition. Control over the private sector was achieved by erecting barriers to entry that excluded opponents and provided privileges to a small group of trusted allies. While close state-business relations are also prevalent in type I regimes, as with South Korea's General Park, the patron-client relation in type I are more easily managed towards performance, and are akin to successful industrial policy (Khan, 2010). The difference in type II is that the bargaining power shifts to the client, who demands higher returns, commensurate with higher political risk. Moreover, in type I, the exclusionary aspect is not as im-

Table 4.2: The deals space

	Disordered	Ordered
Closed (deals available only to specific individuals/organizations)	Only those with political clout can make deals, even when they cannot be certain that officials will deliver. Type II – Crony base narrows and demands higher returns in the face of rising political risk -> medium- low growth	Only those with political connections get to make deals, and they can be confident that officials will deliver. Type I – patron-client relation well managed, but economy not inclusive -> medium growth
Open (deals depend on actions of agents but not identities)	Anyone can make a deal, but no certainty that officials will deliver (petty corruption). Type III – generalized corruption -> low growth.	Anyone can make a deal, and they can be certain that officials will deliver. Type IV – near-rules world -> high growth

Source: Inspired by Khan (2010), Hallward-Driemeier, Khun-Jush, and Pritchett, 2010.

portant, leading to more inclusion and growth compared to regime II.

Mechanisms to bestow privileges on allies and to exclude potential opponents included practices such as protecting monopoly rights, preferential access to privatization, favoured access to government procurement (and land), and better treatment by regulators. Privatization tended to be modest and to advantage insiders. State monopolies were often replaced by private monopolies, which, unlike their predecessors, did not care about social welfare and took full advantage of their market dominance to reap monopoly profits.

The networks of privilege became narrower. While these networks existed in the pre-liberalization period, they were secondary to SOEs, and the private sector operated as a complement to the public sector.⁴ After the liberalization period however, these networks became both more important, in terms of their control of the economy, and also narrower, being concentrated around 20-30 families close to the ruler (Owen, 2014). In the case of Egypt, Diwan et al (2014) identify around five hundred firms controlled by thirty-two businessmen with high-level political connections, most of whom also occupied political posts in the mid-2000s.⁵ Between 2000 and 2010, these firms came to dominate the Egyptian corporate landscape and monopolized most profitable new economic opportunities among themselves. By 2010, these firms earned 60 percent of the overall corporate profit in that sector, even though they employed only 11 percent

of the labour force in the formal private sector. In Tunisia too, Ben Ali's cronies became extremely powerful and rich – with a wealth estimated at about one-quarter of Tunisia's GDP in 2011 (when their assets were expropriated). The confiscation affected 117 individuals and 400 enterprises who were accused of illegally profiting from political connections. These firms accounted for a whopping 21 percent of all net private-sector profits in 2010, although they produced only about 3 percent of private-sector output and employed 1 percent of the labor force (Rijkers et al, 2014).⁶

The banking sector has played an important role in supporting the political regulation of markets. State banks still dominate the financial landscape of Egypt and Tunisia. Egypt saw a partial liberalization of its banking sector, but even private banks engaged in "name lending" to connected interests. Partly because connected groups developed their own banks, and partly because truly private banks chose to lend to the connected firms because they were more profitable (Diwan and Schiffbauer, 2015). As a result, the banks' lending patterns became extremely concentrated, with more than 80% of credit going to connected firms in 2010 (Rocha, 2011). In Tunisia, financial liberalization was even less ambitious. Collusive behavior among bankers kept competition levels low and profits high (Henry and Springborg, 2010). Although there have been some regulatory changes as well as some privatization, the state has retained a dominant role. Indeed, after three years of stimulus fol-

lowing the Jasmine Revolution of 2011, one of the main threats to the Tunisian economy became the very high number of non-performing loans carried by the state banks, which required a costly bail-out, with little in the way of reforms to show for.

The main channel by which corruption can hurt growth is that it reduces the beneficial effect of competition – the dynamic forces that drive the private sector to innovate and to invest in processes and assets that can help improve efficiency and labour productivity. The seminal work of Philippe Aghion (2001) has shown how this dynamic process is attenuated when leading firms benefit from exogenous cost advantages that cannot be overcome, leading to market structures with a few large but inefficient firms, and an overly large number of inefficient small firms. In the case of Egypt, there is significant evidence that cronyism led to stagnant economic growth and poor job creation. While their advantages allowed connected firms to increase their profits, they were run less efficiently than their competitors, because they were more capital-intensive and were shielded from competition. This contributed to the misallocation of scarce national savings and low growth. Moreover, Diwan et al (2015) find that sectors that were dominated by a few crony firms were less dynamic— they saw lower firm entry, had a larger “missing middle” of medium-size enterprises, and overall did not create as many jobs compared to more competitive sectors. These effects add up to a sizeable aggregate impact of cronyism on growth. It can

be estimated that Egypt’s growth could have been 1 % larger per year, and labour demand 20% higher over the past decade, in the absence of privileges. Similar processes were at play in the other countries. In Tunisia, the system developed a sharp distinction between on-shore and off-shore businesses, with the first reserved for the politically connected, and the second allowed to operate with a system of low taxation in order to boost exports. In reality, however, the growth of export businesses was taxed by the low competitiveness of on-shore services, and was unable to upgrade over time (Cammatt et al, 2015, chapter 9).

The existence of large informal sectors is also directly connected to the regulatory environment. Politically, with all formal support going to the loyal formal private sector, the opposition was allowed to “hide” in the informal sector, but with no access to regulatory support. At the same time, the labour market was regulated to protect the interest of elite labour, deepening the chasm between the formal and informal sectors. The share of employment in micro-firms with less than five employees, dominated the private sector, ranging from about 40% in Tunisia to almost 60% in Egypt. Micro-start-ups – firms of less than 5 years old and with less than 5 employees – accounted for 92% of net job creation in Tunisia from 1996- 2010. Yet, the probability that micro-firms might grow beyond 10 employees, 7 years later, is only 3% in Tunisia. This limits the pool of young firms and thus the scope for net job creation, and results in a small

formal private sector. Small firms tend to stay small, and large firms stay large, resulting in a “missing middle”, the component of the private sector that tends to exhibit the greatest degree of innovation in other countries.

The social inheritance of concentrated capitalism has also been highly problematic. Cronyism made “capitalism” unpopular, led to the emergence of a very rich “1 percent,” and the slow growth of the formal private sector exacerbated labour market dualism, increasing the inequality of opportunities faced by young graduates; it also helped keep unpopular regimes in power in Tunisia and Egypt. For all these reasons, large swaths of the population increasingly came to see cronyism and corruption, both petty and grand, as the hallmark of economic liberalism and the source of many ills, including the job deficit and the rise in inequality, and it thus became a driving force of popular discontent. Many indicators point to the deep polar concerns with corruption – for example, Gallup data during 2009–2012 in eighteen Arab countries reveal that the perception of state corruption was high and highly correlated with perceptions of business corruption (Diwan and Nabli, 2013).

From regime II to regime III after 2011

Regime II did deliver some growth. In Tunisia and Egypt, economic growth averaged 4 to 5% a year after 2000, below the growth rates of successful MICs, but at about the average global growth. The move to III has re-

duced growth since 2011. In Tunisia, growth rates were negative in 2010, and below 1% in 2015. In Egypt, growth was 1.8% in 2011, and 2.2% in 2014, before making a comeback to 4% in 2015. The low growth is reflective of the inability of governments to further expand their spending (see next section on macro), but the root cause of the fall in aggregate demand and growth is the unwillingness of the private sector to invest. In Tunisia, private investment has fallen to about 18% GDP since 2011. In Egypt however, private investment has fallen more deeply, from the relatively low level of about 14% of GDP in 2011, to 10–11% in 2014–15. Part of the lower investment reflects heightened security risks. But equally, lower private investment must also reflect the breakdown in the “ordering” of deals. In the new regime III, investment is fully exposed to predatory practices, and political risk translates into heightened investment and property right risks.

Future challenges

The challenges are likely to be quite different in Egypt and Tunisia, given the different evolution of their political systems. In the case of Tunisia, the deals space, while disordered, is now more open. Compared to the previous situation, one can thus expect gains, as the capitalistic base widens, once the security situation improves. This is because unlike the situation under Ben-Ali, the new political regime is unlikely to be in a position to exclude firms based on their political leanings. Indeed, an economic reconcilia-

tion legislation, currently under debate, would pardon individuals who committed economic or financial offenses under the Ben Ali regime, if such individuals return a portion of their illicit gains. Improved regulations to ensure deals are more ordered will surely help in leading to even further increases in security, and thus in investments. Such reforms will not be easy, as reflected in the recent reforms of the state-owned banks, which were recapitalized, but not privatized, mainly because of pressures from the national labour union which was weary of losing financing for SOEs. On the other hand, the recent reform of the investment code, which offers major simplifications relative to the past, is starting to reduce the tax differential between on-shore and off-shore systems. These reforms, operated on the “edge of chaos”, are a testimony to how competitive political systems tend to be more attracted to competitive economics. Thus, Tunisia is likely to fare relatively well in private sector growth in the future, possibly better than in the recent past where it was stuck in regime II, with probable further improvement over time as the quality of its private sector management improves from III towards IV. This should also be the case in Morocco and Jordan, albeit to a lesser extent, as rulers in these countries remain wary of truly independent private entrepreneurs and thus, will want to retain some “closeness” in the deal space. In the near term, therefore, progress is likely to continue on the private sector front, which is thus not likely to be the main binding constraint to growth.

The situation in Egypt is quite different in this respect, given that the government of President Sissi has chosen the route of rebuilding state dominance, i.e., moving back from III to II (and hopefully over time, to I). In such a situation, the state is unlikely to trust the (unconnected) private sector. Indeed, the government is itself to implement a large-scale investment program, articulated around mega-projects mostly led by government and SOEs, such as the expansion of the capacity of the Suez Canal, the construction of a new mega-industrial zone, a major expansion of housing for 2 million public sector employees around a new economic city in greater Cairo and the attraction of GCC FDI for the construction of several refineries and power-plants. Recent offshore oil and gas discoveries will no doubt also attract large capital expenditures. At the same time, the new government has taken its distance from the old Mubarak cronies (Adly, 2014). This is unlikely to be sustainable, and is likely to be part of a disciplining strategy as Sissi develops his own group of cronies. But if political risk remains high, a risk inherent to this “restoration” strategy that so far lacks broad popular legitimacy (as reflected in very low participation rates in the recent 2015 parliamentary elections), it is likely that this new group will remain as narrow as in the recent past, and growth will remain low. Thus, low economic growth is likely to be the main constraint faced by Egypt in the near future. Progress can be achieved if the government manages to traverse the regime space back from II to I,

and to develop a larger class of investors, who can be managed for efficiency, including by fostering competition among them, so they are pushed to deliver growth.

4.6 Macro-management during and after regime change

In Egypt and Tunisia, the economic costs of the transition, which were described in chapters 2 and 3, while not as dramatic, have been high. In Egypt, GDP annual growth collapsed to around 2% between 2012-14, as political and social turmoil disrupted domestic production compounded by electricity blackouts and energy shortages. Growth rose to 4% in 2015 largely driven by rising consumption. Economic growth in Tunisia also slowed down considerably following the 2011 Revolution. A short-lived rebound in 2012 did not lead to a sustained economic recovery. In 2013 and 2014, real GDP growth stood at 2.3 percent. Expansion in services and administrative sectors were offset by a declining private sector and low external demand, reflecting stagnation in the Eurozone. The social tensions and terror attacks that marked the first half of 2015, further negatively affected activity, as growth dropped to less than 1% in 2015. Transitions tend to produce larger deficits for a variety of reasons. The slowdown in the economy reduces revenues, and spending tends to rise to reduce social tension. In many ways, therefore, the macro-picture is endogenous to the forces described above – low growth, as long as institutions

that support the private sector do not adapt, and pressure to spend more as long as the institutions supporting state expenditure are not overhauled. Initially, governments in transition countries reacted with expansionary policies to smooth out the downturn, especially in the face of rising social demands and the high expectations generated by the uprisings. Public sector wages, subsidies and government investment were increased in many countries around the region. In the Gulf countries, budgets expanded massively. Expenditure increased by over one-third in Saudi Arabia. In the oil importing countries, both external accounts and budget balances deteriorated. By 2013, fiscal deficits in Tunisia and Egypt (but also Morocco, Jordan, and Lebanon) had shot up.

In Egypt, the fiscal deficit ballooned at 13% of GDP in 2013, and international reserves plummeted, while in Tunisia, it rose to 6% of GDP with reserves down to 4 months of import. This was the result of a combination of increased spending and lower tax revenues. In Egypt, public expenditure rose rapidly after 2011, from 29% GDP in 2011, to 34% in 2013, and 36% in 2014. Right after the revolution, subsidies and the public sector wage bill rose. By 2013, wages consumed 25% of expenditures (up from 18% in 2011). Expenditures on subsidies reached 32% of total expenditures in 2014. Energy subsidies were the main contributor, accounting for nearly 25 per cent of public spending (7 per cent of GDP), equivalent to the combined spending on health, education and public investment. Tax rev-

venues fell to 13% of GDP (Tunisia 19%). Driven by increased spending on subsidies, wages and interest payments, combined with lower revenues, the fiscal deficit widened from 8.1% of GDP in 2010, to 10.6% in 2012, 13.7% in 2013, and 12.8 per cent in 2014.

In Tunisia too, fiscal policy has been biased towards recurrent spending, while public investment has suffered from both budget constraints and bottlenecks in project execution. The bulk of the adjustment was borne by lower capital spending, reaching a record low in 2013 (1% of GDP). The challenge of finding a balance between fiscal consolidation and maintaining social peace is illustrated in the continued increase of the wage bill and subsidies until 2014, despite the freezing of salaries, the hiring of public servants and the gradual increase of subsidized fuel prices. In 2014, the wage bill reached 13.8 percent of GDP (against 10.6 percent in 2010), and subsidies and transfers represented 7.2 percent of GDP (against 3.6 percent in 2010). The government's recent decision (September 2015) to increase wages starting in 2016, by an equivalent of 0.7 percent of GDP, undermines the efforts to slow down recurrent spending growth and progressively improve expenditure composition. Subsidies have become a growing fiscal burden, reaching approximately 24 percent of total spending. Fuel subsidies reached two-third of the total subsidy budget in 2013, against less than one third in 2009, equivalent to almost 90 percent of the combined expenditures for health and basic education.

Our discussion above suggests

that both Egypt and Tunisia will experience fiscal pressure in the years to come, but for different reasons: in Tunisia, it will be difficult to resist spending that benefits particular high voice groups, at least until institutions that aggregate demands, and face trade-offs, are developed (if ever); while in Egypt, it will be difficult to reduce macro-tensions due to low economic growth rates. In Egypt, repression can be used to improve macro-stability. In Tunisia, on the other hand, this is not possible. It will be necessary to build institutions that can support good budgets in the presence of electoral competition, as the building of checks and balances requires the existence of various meso-level institutions, that do not yet exist, to represent and aggregate preferences, to set the stage and rules for productive bargaining and to support parties to make credible commitments through time.

Indeed, by 2014-15, under General Sissi's stern watch, fiscal consolidation was starting to be pursued boldly to bring the deficit below 10% GDP (primary below 2%). Expenditure fell to 33% GDP, with further plans to reduce it to 30% in 2016, and to 26% in 2018 (IMF, 2015). Energy subsidy reforms have been introduced to bring energy prices closer to cost recovery levels. The prices of key hydrocarbons were raised by more than 50 per cent in July 2014, and electricity tariffs have been rising for both commercial and residential use under a plan to eliminate power subsidies by 2018. A number of tax increases have been promulgated, including wealth tax, a capital gains tax for companies listed on the stock

exchange, a new property tax, and an increase in VAT (to 14%).

In Tunisia, by contrast, the disappearance of the autocratic discipline of the past, means that balancing budgets has become a subject of bargaining between fragile governments afraid of street movements, and new-formed interest groups, or reorganized old groups. These groups include young political parties, workers' unions, regional interests, and corporatist interests, all of which lack long-term strategic horizons and are unable to properly access information, which favours short term strategies based on myopia and a lack of cooperation. Exacerbating the situation in early transition, is the lack of institutions that can commit to a particular sharing of the pie. Such a situation is most likely to lead to a "grabbing equilibrium" where short-term interest and a lack of trust predominate.

As a result, stabilization will involve a war of attrition, especially when important agents refuse to accept to pay for adjustment costs and try to pass them on to other agents. Such situations are especially prevalent under conditions of asymmetric information over the ability of agents to bear such costs, which prolongs the attrition war (Alesina and Drazen, 1989). A second type of phenomenon, which may occur later, is that of fiscal electoral cycles, with fiscal deficits rising before elections. This effect tends to be larger when democracies are young, and to weaken in mature democracies, as voters become more discriminating (Drazen, 2001). In messy democracies, this electoral budget cycle may be

expected for 3-4 elections at least. Over time, things improve as voters learn, and institutions for checks and balances adapt.

In such situations, it is not unusual for distributional flights to push governments to delay stabilization all the way to a financial crisis. There are many examples of descents into deep financial crisis before more responsible democracies take root, for example Turkey 2000-01. Thus, the speed at which deficits can be resolved depend very much on the existence of institutions that distribute losses among social groups fairly and effectively. However, and again, such institutions of social dialogue and bargaining were not needed under autocratic rule as such decisions were centralised around the ruler's top circle.

In both countries, the balance of payment has deteriorated, requiring increased external support to maintain sustainability. In Egypt, capital outflows, lower foreign direct investment and a worsening current account deficit, including a particularly affected tourism sector, have significantly eroded foreign reserves. These dropped from 6.8 months of imports end of 2010 to 2.5 months in June 2013. Tourist arrivals have yet to return to pre-revolution levels—9.9 million tourists visited in 2014 compared to 14.7 million in 2010, a 33 per cent decline. As a result, public debt has been rising rapidly, mainly through internal borrowings. It reached 96% GDP in 2015. Heavy support from the GCC, which is now at about \$20 billion a year, has made all the difference since 2014, but this is far from sustainable, especially given the recent collapse in oil

prices. And while FDI has picked up again since the 2011 lows, it remains small at 1.4 per cent of GDP and insufficient to pull growth. Egypt launched a \$1.5 billion international bond in June 2015, marking a return to the market that is likely to be overused in the coming period given the large BoP deficits and the low level of foreign exchange reserves, which remain only slightly above the critical threshold of three months of import-cover.

Tunisia's balance of payment has also deteriorated, but to a lesser extent. Current account imbalances have risen since 2011, as a widening trade deficit could not be offset by net service imports, notably tourism, due to the uncertain political and security situation. A more flexible stance in the exchange rate policy, together with heavy reliance on external financing from international financial institutions (IFIs), has helped preserve an acceptable level of international reserves. External debt has increased since the revolution, reflecting the fiscal expansion and the widening of the current account deficit. Public debt, mostly external, rose from 40.7% of GDP in 2010 to 44.8 percent in 2013 and 56% in 2015. In 2015, Tunisia launched a \$1 billion sovereign bond. A recent debt sustainability analysis shows that in the absence of reforms, public debt could reach around 75 percent of GDP by 2020. Already, the financing gap for 2016 is creating uncertainties, as the heavy reliance on IFIs confronts an inability by the government to enter into conditionality agreements that it can respect.

It is thus possible that both

Tunisia and Egypt will be unable to stabilise their macro-situation before a financial blow-up. Tunisia still has a bit more debt space than Egypt. Egypt, however, is increasingly obtaining its external support from the GCC at grant terms, while Tunisia is borrowing at more expensive terms from creditors that are more sensitive to issues of credit-worthiness.

Thus, in the short term, the most immediate challenge in all transition countries remains economic stabilization, in order to avoid an economic and financial meltdown, which would further complicate the political process. Building a package of measures that reduces expenditures and raises revenues, and that commands a minimum level of popular support is a tricky endeavour in the best of circumstances, and will be especially challenging in the current hyper-politicized environment of Tunisia. In the current circumstances, increased external assistance to Egypt can help smooth a return to lower fiscal deficit. In Tunisia, however, external support of the state budget is unlikely to be useful in the present conditions, as this would only reduce the internal pressure on the political settlement to become more efficient, and thus delay necessary political adjustments. Instead, support for the private sector is more likely to be useful.

4.7 Conclusions

The transitioning South-Med countries stand at a historical crossroad in their development history. In the past 50 years, they have been through two distinct

development phases and one long transition. State-led growth delivered fast development in the young states before reaching its limits in the 1980s. A long transition phase of low growth led to a second phase, which saw the maintenance of the old autocratic governance framework, the roll-back of the state, and a move towards an imbalanced form of capitalism. The second phase delivered some growth, but it also generated popular dissatisfaction leading to an increasingly vocal opposition to this system. The challenge of the third phase will be to find a development path that performs better both economically and politically.

To avoid getting stuck in a destructive political-economy trap, it is imperative that economic performance improves. The countries that will find a virtuous development path are those that can create sufficient political space to implement the kind of reforms that can improve social services and boost economic growth. Unfortunately, our analysis has revealed that such triumphalist scenarios are unlikely to arise immediately after transition.

As we have seen, after decades in which the politics of the various countries in the region converged towards high levels of authoritarianism, the contours of the emerging political settlement of the future are now diverging in important ways in the region. The cases of Tunisia and Egypt, which we have analyzed in some detail, represent two polar cases: one that is striving towards competitive politics, and the other that is attempting a reformation towards a strengthened authori-

tarian system. Each has structural strengths and weaknesses.

The first area we focused on is the rehabilitation of public services – such as the health, education and social protection systems. Ideally, new governments with broad popular support should be able to redirect expenditures towards social services and away from subsidies that benefit the better-off, and to make tax systems more progressive while enlarging the tax base. But improving service delivery and fighting petty corruption will require increased public sector wages, which will be complicated by the large size of the civil service. Here, we have argued that in the short- to medium-terms, this will be easier in Egypt than in Tunisia, even though, paradoxically, the political demands will be higher in the latter than in the more repressed case of the former. The use of social accountability mechanisms, involving more active participation in checks and balances by citizens group, municipalities, and NGOs, will have to play a central role to support this transformation, a development that is more likely over time in Tunisia than in Egypt.

The other set of concerns discussed, centres on the business environment and job creation. The ideal road to a more dynamic private sector is well known and involves moving from a system of political regulation of the market (by granting privileges to regime supporters) to a system of regulation based on efficiency and job creation. This, we have argued, is unlikely to happen in both Tunisia and Egypt. In Egypt, a return to a dominant political

regime will revive a mistrust for the independent private sector. In Tunisia, more clientelistic politics are unlikely to allow for the quick adoption of new rules to govern private activities, but there will be more space for competition, leading to gains in the expansion of private activities in the near future.

But while diverging in significant ways, both regimes face high risks and have certain common challenges. To gain popular appeal, they need to include fewer favours for elite capital - although the challenge will be to convince large capital-holders to invest in the future, rather than withdraw, as happened with the socialist revolutions of the 1960s. To stabilise the “street”, the interests of the poor will have to be better balanced with those of the middle class, which compared to the poor, benefited under authoritarian bargains, but only in the sense of receiving a larger share of a small pie. Importantly, in order to be able to find new “growth-pacts” that enlarge the economic pie, the main social actors will need to be in a position to represent their interests, make commitments and reach agreements, and have the capacity to ensure that commitments by all groups are adhered to over time. In this, the role of politics will be crucial to allow the main social forces to acquire a voice, and to find productive ways to negotiate cooperative and superior outcomes. In short, political transactions will have to play a more central role in shaping the future, compared to the earlier phases of development.

Notes

1. It should be possible to operationalize the typology by measuring the competition axis using measures such as Polity or Voice in the World Bank governance indicators, and the quality of governance using indicators such as Rule of Law and Government Capacity (again from the World Bank governance indicators) – but this task is not pursued here.
2. This is measured as an index based on two questions from the World Value Survey Poll taken in 2013: “is greater respect for authority a good thing? Is obeying rulers an essential characteristic of democracy?”
3. This is reflected in declines in the indicator of state capacity, which declined in both Egypt and Tunisia after 1995, in Tunisia from 0.5 to 0, and in Egypt from 0 to -0.5 (Kaufman et al 2003).
4. Pioneering studies in this field include, on Tunisia, Cammett 2007, Hibou 2006; on Egypt, Sfakianakis, 2004, Kienle 2001, 2004, Osman 2010, and Roll 2010.
5. See also Chekir and Diwan 2012, and Acemoglu et al 2014.
6. See also Chekir and Menard 2012.

References

- Acemoglu, D., T. Hassan and A. Tahoun (2014) “The Power of the Street Evidence from Egypt’s Arab Spring”, *NBER Working Paper* No. 20665, November.
- Acemoglu, D. and J.A. Robinson (2012) “Why nations fail: the origins of power, prosperity and poverty”, vol. 4, *Crown Business*.
- Adly, A. (2014) “The Future of Big Business in the New Egypt”, *Carnegie Middle East Center*, November.
- Aghion, P., C. Harris, P. Howitt, and J. Vickers (2001) “Competition, imitation and growth

- with step-by-step innovation", *Review of Economic Studies*, vol. 68, no.3, July, pages 467-492.
- Alesina, A. and A. Drazen (1989) "Why are stabilizations delayed?", *NBER Working Paper* No. 3053, August.
- Assaad, R., and C. Kraft (2016) "Inequality of Opportunity in Human Development" in "The Middle East Economies in Times of Transition" edited by Diwan, I. and A. Galal, *International Economic Association Series*, vol. 155-V, Palgrave.
- Beinin, J. and F. Vairel (2013) "Social Movements, Mobilization, and Contestation in the Middle East and North Africa", Second Edition, *Stanford University Press*.
- Besley, TJ. and M. Kudamatsu (2007) "Making Autocracy Work", Suntory and Toyota International Centers for Economics and Related Disciplines, London School of Economics and Political Science, May.
- Chekir, H. and I. Diwan (2012) "Crony Capitalism in Egypt", *Globalization and Development*.
- Chekir, H. and C. Menard (2012) "Barriers to Private Firm Dynamism in Tunisia: a Qualitative Approach", *World Bank* mimeo.
- Cammett, MC. (2016) "Transition Experiences and Relevant Lessons" in "The Middle East Economies in Times of Transition" edited by Diwan, I. and A. Galal, *International Economic Association Series*, vol. 155-V, Palgrave.
- Cammett, MC., I. Diwan, A. Richards, and J. Waterbury (2015) "A political economy of the Middle East", Fourth Edition, *Westview Press*.
- Cammett, MC. (2007) "Globalization and Business Politics in Arab North Africa: A Comparative Perspective", *Cambridge University Press*.
- Diwan, I. and T. Akin (2015) "Fifty Years of Fiscal Policy in the MENA region", *ERF Working Paper* No. 914, May.
- Diwan, I., P. Keefer, and M. Schiffbauer (2015) "Pyramid Capitalism: Political Connections, Regulation, and Firm Productivity in Egypt" *World Bank Policy Research Working Paper* No. 7354.
- Diwan, I., and M. Schiffbauer (2015) "Cronyism and Private Banks in Egypt", mimeo.
- Diwan, I., P. Keefer, and M. Schiffbauer (2014) "On top of the Pyramids: Cronyism and Private Sector Growth in Egypt", *World Bank*, mimeo.
- Diwan, I., and M. Nabli (2013) "How Does the Arab Street View the Private Sector? – An analysis of the Gallup Polls 2009-2012 in 18 Arab Countries", *World Economic Forum*.
- Drazen, A. (2001) "The political business cycle after 25 years" in "NBER Macroeconomics Annual 2000" edited by Bernanke, BS. and K. Rogoff, *MIT Press*, vol. 15., pages 75-138.
- European Bank for Reconstruction and Development (EBRD) (2013) "Transition report 2013: Stuck in Transition?"
- Evans, PB. (1995) "Embedded autonomy: states and industrial transformation", vol. 25, *Princeton University Press*.
- Freund, C. and L. Mottaghi (2011) "Transition to Democracy", *World Bank*, Mimeo.

- Hallward-Driemeier, M., G. Khun-Jush, and L. Pritchett (2010) "Deals versus Rules: Policy Implementation Uncertainty and Why Firms Hate It", *NBER Working Paper* No. 16001, May.
- Henry, CM. and R. Springborg (2010) "Globalization and the Politics of Development in the Middle East", Vol. 1, *Cambridge University Press*.
- Hibou, B. (2006) "La Force de L'Obeissance: Economic Politique de la Repression en Tunisie", *Editions de la Decouverte*.
- International Monetary Fund (IMF) (2015a) "Arab Republic of Egypt 2014 article IV Consultation – Staff Report; Press Release and Statement by the Executive Director for the Arab Republic of Egypt"
- Khan, MH. (2010) "Political Settlements and the Governance of Growth Enhancing Institutions." Unpublished manuscript, *School of Oriental and African Studies (SOAS)*.
- Kienle, E. (2001) "A Grand Delusion: Democracy and Economic Reform in Egypt", I.B. Tauris.
- King, SJ. (2009) "The new authoritarianism in the Middle East and North Africa", *Indiana University Press*.
- Levy, B. (2014) "Working with the Grain", *Oxford University Press*.
- Levy, B., and M. Walton (2013) "Institutions, incentives and service provision: bringing politics back in" *Effective States and Inclusive Development Working Paper* No. 18, February.
- Levy, B., and F. Fukuyama (2010) "Development strategies: integrating governance and growth", *World Bank Policy Research Working Paper Series* No. 5196, January.
- North, DC., JJ. Wallis, and BR. Weingast (2009) "Violence and social orders: a conceptual framework for interpreting recorded human history", *Cambridge University Press*.
- Olson, M. (1993) "Dictatorship, Democracy, and Development" *American Political Science Review*, vol. 87, issue 03, pages 567-576.
- Osman, T. (2010) "Egypt on the Brink: From Nasser to Mubarak.", *Yale University Press*.
- Owen, R. (2014) "The Rise and Fall of Arab Presidents for Life: With a New Afterword", *Harvard University Press*.
- Posusney, MP., and MP. Angrist (2005) "Authoritarianism in the Middle East: Regimes and Resistance", Lynne Rienner Publishers.
- Roll, S. (2010) "'Finance Matters!' The Influence of Financial Sector Reforms on the Development of the Entrepreneurial Elite in Egypt", *Mediterranean Politics*, vol. 15, issue 3, pages 349-370.
- Rijkers, B., C. Freund, and A. Nucifora (2014) "The Perils of Industrial Policy: Evidence from Tunisia" *World Bank, working paper*.
- Schlumberger, O. ed. (2007) "Debating Arab Authoritarianism: Dynamics and Durability in Nondemocratic Regimes", *Stanford University Press*.
- Sfakianakis, J. (2004) "The Whales of the Nile: Networks, Businessmen and Bureaucrats during the Era of Privatization in

Egypt" in "Networks of Privilege: Rethinking the Politics of Economic Reform in the Middle East" edited by S. Heydemann, *Palgrave Macmillan*.

CHAPTER 5

Changing Course

5.1 Introduction

In chapters 2, 3 and 4 of this report, the analysis was positive in nature. We attempted to identify the consequences of the 2010 uprisings, assess the responses by South-Med governments to the demands of the rebels, and analyze the nature and likely evolution of the political regimes. In this chapter, the analysis is of a normative nature. Its objective is to make recommendations that may be helpful in putting the South-Med countries on the path towards shared and sustainable prosperity.

To make the analysis tractable, the structure of the chapter will mirror the previous chapters. We will first deal with restoring and sustaining macroeconomic balances and economic growth, followed by a discussion of social concerns. In Section 5.4, we share some thoughts on the relationship between economic performance and the political regimes, followed by Section 5.5 on the role of external partners. Section 5.6 draws some conclusions.

Our starting point for considering the future of South-Med countries is that the previous

development model has failed to meet the population's aspirations for freedom and shared prosperity. Seven years on, the model does not seem to have changed much. To embark on a new course, the new strategy should aim at achieving the dual overarching objectives of consolidating the post-transition democratic polity, on the one hand, while making the transition to a dynamic and equitable economy, on the other. The two objectives are bound together in a symbiotic relationship; hence, for a successful outcome, both challenges must be addressed simultaneously.

In outlining the features of the new strategy, a few ideas guide our thinking. First, we take it as given that high economic growth is a necessary but not a sufficient condition for inclusive development. Core issues such as macro-stability, social protection, social mobility, decent employment and quality of life are all important objectives in their own right. Second, it is true that the future of South-Med countries partly depends on external factors, including regional conflicts, the state of global economic activity and shifts in political powers. However, success or

failure is primarily determined by the interaction between internal actors and the policies they collectively opt to adopt. Finally, short- and medium-term actions may not always be compatible. And given that short-term measures determine the contours of future economic performance, it is important that current policy actions do not jeopardise long-term objectives.

5.2 Restoring and sustaining macro-balances and economic growth

The most pressing transitional challenges facing South-Med countries include macroeconomic stabilization, activating the economy and addressing youth unemployment. In this section, we attempt to draw short- and medium-term agendas to deal with these challenges. Advocated solutions may not necessarily be the only viable options, but even then, we hope they will trigger a healthy debate about the best course of action in these countries.

Macroeconomic stabilization

The story told in chapters 2 and 3 is that the uprisings were associated with deteriorating macroeconomic balances, rising public debt, sluggish economic growth and rising unemployment. Initially, South-Med countries responded to social demands by following expansionary policies, but eventually they came to the conclusion that they needed to consolidate their macro-positions. The IMF came to the rescue, with its usual measures of reduc-

ing fiscal deficits and allowing the exchange rate to curb current account deficits. The programs also involved the phasing out of distortionary energy subsidies and the expansion of social protection programs. By now, all five South-Med countries, except Algeria, have a program with the Fund. The hope is that these programs will bring about greater macroeconomic stability, even if they entail sluggish economic growth and high unemployment in the short-run. Once macroeconomic stability has been restored, confidence will return and economic growth will pick up.

Considering the choices made, the best South-Med countries can do, going forward, is to capitalise on the lessons of the transition experiences to date. Among these lessons is that fiscal expansion, when such a decision is taken, should be mostly in the form of greater public investment, and not expansion of current expenditures. There is a vast literature on the positive impact of investment in infrastructure on growth and employment, which can be quite sizeable even in the short term. For example, the evidence from Latin America and the Caribbean suggests that every US\$1 billion spent on infrastructure project generates, directly and indirectly, about 40,000 new jobs annually. This literature also finds that income inequality tends to decline with higher infrastructure in both stock and quality (Calderon and Serven, 2004). Extrapolating the analysis to Egypt and Tunisia, the IMF (2011) estimates that a 1% of GDP spent on infrastructure could generate as many as

87,000 new jobs in Egypt and 18,000 jobs in Tunisia in the short-term.

Another lesson on the fiscal front is that South-Med countries would benefit from instituting counter-cyclical fiscal rules to stimulate the economy at times of slowdown and vice versa. In this vein, Elbadawi and Soto (2012) argue that progress on the political front will make it easier to adopt such rules. But even then, the learning curve might be long and painstaking. The Chilean fiscal rule was a culmination of a long history of fiscal prudence, reflected in the achievement of cash surpluses for twelve consecutive years and the creation, in 1987, of a fiscal revenue stabilization fund financed by proceeds from copper sales. Until the situation is ripe for adopting counter-cyclical fiscal rules, it would still be useful to consider adopting Keynesian policies at times of economic downturn.

On the monetary policy front, it was unfortunate that Egypt, and Tunisia to a lesser degree, defended exchange rate targets until international reserves were nearly exhausted. Imposing quantitative restrictions to control exchange rate markets reveals to be both ineffective and costly. A more flexible exchange rate at an earlier stage in the transition would have saved international reserves, motivated economic actors to adjust and eased the imports of much needed intermediate inputs. Subsequently, after the central bank of Egypt had decided to let the exchange rate go, it did not announce a new nominal anchor for monetary policy as commonly done

by central banks elsewhere. An absence of clarity on monetary policy objectives, means that economic agents have no basis to form their expectations about the future, thus raising potential adverse effects on investment and growth.

On the interaction between monetary and fiscal policies, there are two concerns. First, monetary policy in South-Med countries have tended to be accommodative of fiscal policy. Fiscal dominance is known to have such adverse effects as fuelling inflation and crowding out the private sector in the credit market. It is therefore important not only to establish rules about government borrowing from the central bank, but also to respect these rules. In Egypt, such a rule exists but it is not adhered to by the Central Bank.

The second concern relates to the lack of consistency between monetary and fiscal policies. As explained in chapter 2, South-Med authorities did not always adopt a coordinated fiscal and monetary policy stance. The two policies did not always stimulate aggregate demand or tighten economic activities. They often moved in opposite directions, possibly exacerbating rather than resolving the macroeconomic problems. Only when South-med countries signed agreements with the IMF did they seem to have followed consistent fiscal and monetary policies, albeit giving priority to macro-balances at the expense of growth.

Reigniting and Sustaining Job-Creating Growth

Prior to the uprisings, South-Med countries performed relatively well in terms of growth performance (averaging 5.4 percent during the period 2003-2008). In the post-uprising period, they grew only at half that level. However, even if we assume that the political transition is a temporary shock and that past growth levels will once again be achieved, that will still not be enough. Past growth suffered from two main shortcomings: (1) it was not based on the contribution of a dynamic, efficient and outward-oriented private sector, and (2) it was not sufficiently inclusive, at least in terms of job creation. Future growth strategies should avoid these shortcomings. In addition, the strategy should be based on a two-pronged effort: a short-term strategy aimed at stimulating growth and a medium- to long-term strategy aimed at sustaining economic growth.

In the short run, even in the presence of an IMF austerity program, expansionary policy could involve frontloaded viable labour-intensive infrastructure projects that are already in the pipeline. It could also target the elimination of binding bottlenecks, for example, electricity. Such policies will not only provide wage employment in the short run, but also enhance long-term growth prospects as well as sustained job creation. This policy contrasts the trend in South-Med countries with respect to public investment in the past few years, which declined from 6.6 percent of GDP, in 2012, to a record low of 4.2 percent of

GDP, in 2014.

In the medium-term, sustainable economic growth would require, among other things, a much more friendly and neutral business environment than South-Med countries have had so far (as evidenced by their low ranking on the World Bank's Doing Business Reports). Morocco has made progress in this regard in recent years, but no similar progress has taken place in the other South-Med countries. On the contrary, there is plenty of pre-uprising evidence suggesting that the private sector in the region flourished because of its cosy relationship with government (World Bank, 2009). Partial attempts to improve the business environments (e.g., adopting a new investment law in Egypt in 2016) may be inadequate to entice the private sector to make long-term investments. What South-Med countries need is a package of reforms that dramatically increases competition, ensures that the regulations are fair and transparent and provides credible commitments to protect property rights.

This is not to suggest that the role of the state should diminish. The role of the government as a regulator should be stronger. So should its role as the provider of social services, which the private sector is unwilling or unable to provide. Health and education are prime examples. The distributional role of the state through fiscal and other policies is critical. More generally, governments also provide the rules that ensure the efficient functioning of markets and the safeguarding against abuse of market power.

To play their role effectively, however, South-Med governments need to deal with their bloated and often inefficient bureaucracies.

In addition to the business environment and a realignment of the state's role, an important source of economic growth that remains untapped in South-Med countries is that of export and diversification, especially of tradeable goods and services. Here, the real exchange rate¹ can be an effective policy instrument. For small and medium size low- and middle-income developing countries, where there are somewhat limited opportunities for significantly increasing total factor productivity in the short-run, a real undervaluation of the actual exchange rate has been proposed, in the recent growth and development literature, as a viable option for an export-oriented development strategy. Engineering real currency undervaluation would promote exports and lead to sustained growth transitions (see for example, Aghion et al, 2006; Aguirre and Calderon, 2005; Elbadawi et al, 2008; and Rodrik, 2008).

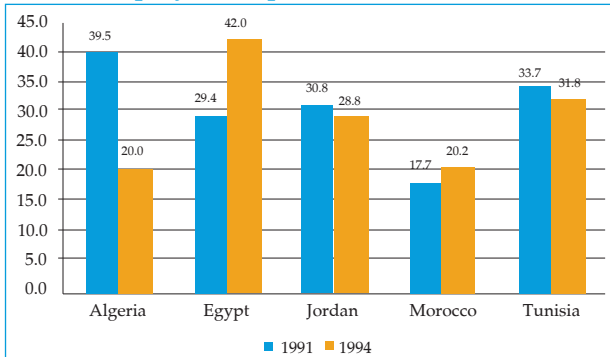
In addition to the exchange rate policy, South-Med countries also need to revise their industrial policies (selective intervention). Thus far, the evidence points out that this policy has essentially been successful in South-East Asia, but not elsewhere (World Bank, 1993). For South-Med countries, the evidence suggests that industrial policy has suffered from being fundamentally inward looking, promoting old rather than new products, with no time limits on

the duration of infant industries until they grow (Galal, 2008, Galal et al, 2015, Sekkat, 2010). This policy also seems to have encouraged rent-seeking behavior and cronyism, two symptoms of the pre-uprising regimes. In the post-uprising era, South-Med countries have an opportunity, at least in countries making inroads into political openness, to revise their industrial policy to truly promote output diversification and achieve sustainable growth.

Of course, sustained economic growth would also require well-educated human capital, higher savings and stable inflation. However, the broader question is how to make growth more inclusive in South-Med countries, especially in terms of creating jobs to absorb youth unemployment. The reason for singling out the youth (15-24 years old), is that their rates of unemployment are among the highest in the world. In Egypt, they accounted for close to 30% of total unemployment in 1991. By 2014, the figure jumped to 42 percent (figure 5.1). In Tunisia and Jordan, the ratios hovered around 30 percent. This phenomenon is largely a problem of youth insertion into the labour market.

To address the problem of youth unemployment in the short run, South-Med governments could launch Active Labour Market Programs (ALMPs). They could explore the possibility of supporting employment in small and medium enterprises by giving them benefits tied to greater employment, especially for new job seekers. These incentives could take the form of tax exemptions or reductions, credit

Figure 5.1: Youth unemployment as a share of total unemployment (percent)



Source: World Development Indicators, World Bank.

guarantees, or even contributions to social and health insurances. More broadly, governments could ease the burden of unemployment by introducing unemployment insurance schemes. Additionally, they could facilitate the negotiation process on productivity-based wage agreements between organized labour and the private sector.

In the medium to long run, growth will create jobs as long as the incentive structure for economic agents does not favour capital at the expense of labour. In addition, the recent literature makes a strong link between industrialization and job-creation in developing economies. For example, a recent report by the United Nations Industrial Development Organization (UNIDO, 2009) documents the experiences of countries adopting labour-intensive manufacturing-based development. It finds that growing manufacturing sectors can create jobs at a spectacular level and at higher wages. Moreover, manufacturing is usually gender neutral.

Similarly, exports tend to cap-

italise on the abundant factor of production in developing countries, which is labour. Accordingly, a combination of policies that do not favour capital at the expense of labour, an industrial policy that favours manufacturing and agriculture, and measures to promote exports, are likely to induce growth in job creations. Short of such policies, the informal sector becomes the option of last resort. In this sector, employment tends to be characterized by low productivity, low wages and certainly disagreeable working conditions (e.g. Assaad, 2002; Galal, 2002; Elbadawi and Loayza, 2008).

5.3 Towards more effective social protection and social mobility

In response to social demands, South-Med governments have taken measures to improve social protection and, to a lesser extent, the delivery of health and education services. They have started phasing out energy subsidized and have expanded programs that target the poor. Some countries have increased public expenditure on health and education, while others have allowed greater private sector provision of these services. On the face of it, these measures constitute a move in the right direction, especially as commodity subsidies tend to benefit the rich and middle class more than the poor. According to the IMF (2012), only 20% of commodity subsidies reach the poor.

Notwithstanding the merits of the above measures, they do suffer from several shortcom-

ings. The targeting programs leave out too many poor families. For example, the poor represented about 28 percent of the population in 2016, whereas the cash transfer program was to cover only one-fourth of that percent. Certain social protection measures, e.g., increasing employment in bloated bureaucracies, were politically motivated at the expense of efficient outcomes. The measures have also lacked the institutionalization or upgrading of the critical components of social protection, such as health insurance, social security coverage, and unemployment insurance (Razzaz, 2013). Equally important, the education and health services remain of poor quality and are not universally accessible. Accordingly, further and more systematic reforms are necessary to strengthen the safety nets and to enhance the opportunity for upward social mobility in South-Med countries.

For the next generation of social protection reforms, two issues stand out. The first relates to the need to rapidly expand the cash transfer programs to cover as many eligible families as possible. Although it is not easy to identify the poor and to continually update the records as conditions change, slow progress on this front can be costly to the poor themselves, as well as to the level of support for further economic reform. The second pillar of social protection concerns coverage for the elderly, for sickness and for job loss. Here, South-Med countries need to design or redesign their protection schemes in a manner consistent with their initial conditions, especially in

terms of the goodness of existing systems, if any, resource availability and implementation capacity.

With respect to health and education, significant reforms are necessary to enable citizens to participate in the fruits of economic growth and to enhance the possibility of upward social mobility. The challenge facing South-Med countries is to figure out the best way to provide equal access to good quality health care and education. Here the literature is very rich, but it does not offer a blueprint. For example, Finland is the world's best performer in education, although its education system is highly centralised and government driven. In contrast, the US system performs reasonably well with a system in which the government and the private sector operate side-by-side, at a decentralised level. In the health sector, both the US and Canada provide good quality services, albeit following two very different systems. In Canada, the government is a single buyer, while in the US the citizens are the buyers. What seems to matter most is that the system is internally consistent and that it responds to the needs of a given society. Given the diversity of options and the variations in the initial conditions in South-Med countries, each of them should develop its own strategy, while recognizing that increased expenditure may be a necessary, but not a sufficient, condition to bring about the required improvements.

Finally, because social protection and social service reforms affect all citizens as recipients and/

or providers, they cannot be carried out successfully without the wide participation of different groups in society. Besides able leadership, South-Med countries would benefit from a social dialogue to build informed consensus on society's objectives, the trade-offs associated with different options and the best instruments to achieve the objectives.

5.4 Twinning economic reform and politics

The analysis of the evolution of the transitioning South-Med countries in Chapter 4 points out that these countries stand at a historical crossroad in their development history. After decades of convergence towards high levels of authoritarianism, the contours of the emerging political settlement in these countries is now diverging. To avoid becoming stuck in a destructive political-economy trap, it is imperative that South-Med countries work towards improving economic performance to create sufficient political space to implement political reforms. At the same time, they need to build inclusive political and economic institutions to empower citizens and to make further economic reforms possible. Moving on both tracks would create a virtuous development path, which could eventually lead to shared prosperity.

Unfortunately, the analysis of chapter 4 was not optimistic about the prospects of South-Med countries moving directly into competitive political systems any time soon. The in-depth analysis of Tunisia and Egypt

reaches the conclusion that they represent two polar cases: Tunisia is striving towards competitive politics; while Egypt is attempting a reformation towards a dominant regime on account of terrorism. Morocco and Jordan were not analyzed in detail, but gradualism on both politics and economics has been the hallmark of their behavior so far. In Algeria, there has been no notable change in the political regime. Under these conditions, the normative question is what should be done to move towards a successful transition and a virtuous development path.

On economic reforms, a list of suggestions has been drawn up in the previous sections. Here, we attempt to explore how the governments in Egypt and Tunisia are likely to move forward. Next, we briefly discuss how the "street" or voice can support the move towards a successful transition.

Let us consider first the business environment and job creation. The ideal road to a more dynamic private sector is relatively well known and involves moving from a system of political regulation of the market (by granting privileges to regime supporters) to a system of regulation based on efficiency and job creation. It was argued in Chapter 4 that this kind of reform would be difficult in both Tunisia and Egypt. In Egypt, a return to a dominant political regime will bring back the mistrust of the independent private sector. It will be the responsibility of the political leaders to adopt confidence-building measures to persuade the private sector to

engage in large-scale investment and economic activity. In Tunisia, the clientelistic politics of the past are unlikely to support a quick adoption of new rules to govern private activities, but there will be more space for competition, leading to gains in the expansion of private activities in the near future.

Next, we may consider the rehabilitation of health, education and social protection systems. Ideally, new governments would enjoy broad popular support and therefore be in a position to redirect expenditures towards social services and away from commodity subsidies. They should also be able to make taxation more progressive, while enlarging the tax base. However, these reforms would be met with opposition from the rich elite and bureaucrats. Improving the delivery of social services would also require higher civil service wages and the end of petty corruption. The question is, which regime is likely to be able to achieve this? It was argued in chapter 4 that these types of reforms would be easier to implement in Egypt, in the short run, than in Tunisia, because of the divergence of the two political regimes. In the long-run, Tunisia is likely to fare better than Egypt thanks to the emerging social accountability mechanisms and the participation of different citizen groups, municipalities and NGOs.

In both countries, to have popular appeal, they need to include fewer favours for elite capital - although the challenge will be to convince large capital-holders to invest in the future, rather than

withdraw, as happened with the socialist revolutions of the 1960s. To stabilize the “street”, the interests of the poor will have to be better balanced with those of the middle class, which compared to the poor, benefited under authoritarian bargains, but only in the sense of getting a larger share of a small pie. Importantly, in order to be able to find new “growth-pacts” to enlarge the economic pie, the main social actors will need to be in a position to represent their interests, make commitments and reach agreements, and have the capacity to ensure that commitments by all groups are adhered to over time. In this, the role of politics will be crucial in allowing the main social forces to acquire a voice, and to find productive ways to negotiate cooperative and superior outcomes. In short, political transactions will have to play a more central role in shaping the future, compared to the earlier phases of development

Also, the future of political and economic development in transitioning South-Med countries cannot be divorced from the “voice” of the “street”. The new rulers now have to reckon with the emerging capacity of citizens to use their newly-earned freedom to voice their economic and political preferences, and to attempt to influence how and who should be governing them or managing their economies. This ‘voice’ can arguably shape the political economy debate, which will ultimately determine the future of both polity and the economy in South-Med countries.

Thus far, in the early stages of the transition, the deteriorating

conditions in terms of security of individuals and communities, social services, economic growth and unemployment have produced assertive but uncoordinated and, often times, contradictory popular demands. Largely, voice was manifest in terms of 'demands for more' subsidies and higher wages for the employed by the most organized social groups. Realizing the power of these groups, the authorities in the post-transition countries have been responsive at the expense of worsening fiscal deficits and spiralling public debts. Not only has this response complicated the prospects for future economic performance, but it might also have signalled a return to a new style of bargain, akin to the ill-fated 'authoritarian bargain'.

Looking ahead, the impact of voice on the future of polity and economics in these societies hinges on the strategies of the social groups involved and the responses they elicit from the newly elected transitional authorities. Notwithstanding, the underlying risks associated with voice, when it is used as a force for 'uninformed populism' or 'subnational allocation of rents', could be a potent driver for plural democratic participation. This could lead to a 'demand for different' and transformative new social contracts with radically different 'rules of the game': the constitutions, laws and regulations, and the underlying public discourse on political and economic freedoms, social and economic justice, and the future role of the state (Razzaz, 2013).

To reap the benefit from political transition in South-Med

countries, it is important to establish a system capable of delivering inclusive and sustainable development. To this end, South-Med countries would benefit from a trajectory of institutionalizing plural voices. Successful development strategies require the understanding and endorsement of the majority of the population. The participation of policy-oriented research, civil society organizations and informed public opinion makers is key. In turn, these individuals and organizations can play the role of informing various stakeholders, offering them a menu of choices that reflect their own interests and those pertaining to broader national interests. This process will not only help to identify the winners and losers of various policy options, as well as the trade-offs involved, but it will also make information available to the public so that they can hold governments accountable for their commitments.

5.5 A possible role for external actors

Abstracting from the role that external actors can play on the political front, they can help ease the transition process in South-Med countries through different channels: finance, technical advice and as anchors for reform. Thus far, South-Med countries have received some support in all of these areas. The question is whether the support came in time, at the levels required and whether it was associated with appropriate reform conditions. In discussing these issues below, we

take it for granted that it is in the interest of external partners to see South-Med transition countries move towards more open and prosperous societies.

On finance, the uprisings were associated with significant financing gaps because of growing fiscal deficits and diminishing foreign exchange receipts. A combination of social pressure, capital outflows and low tourism receipts gave rise to what seemed to be a temporary need for external borrowing or grants from abroad. The euphoric atmosphere at the time of the Arab Spring prompted the international community to put together what came to be known as the Deville Partnership. The GCC also came to the rescue, mostly in Egypt and to a lesser extent in Jordan and Tunisia. So did the IFIs. The IMF provided support at different times to four out of the five South-Med countries studied in this report. The World Bank intensified its engagement in South-Med countries, supporting safety-net programs, infrastructure projects, sectoral developments and occasionally structural reforms. So did regional development banks, including the African Development Bank and the Arab Fund for Economic and Social Development. There was also official support on a bilateral basis.

Whether the level of financial support came in time or at the level required is questionable. There was a discussion at the beginning of the Arab Spring of a Marshal plan for the region, which never materialized. The Deville Partnership promised more than US\$30 billion, but

these turned out to be resources that IFIs were committed to deliver on their own anyway. The fact remains, however, that external actors kept the South-Med countries afloat at a time when they needed support the most.

Of course, the provision of financial support was supposed to be a temporary measure, until the economies of South-Med countries recovered. To ensure that recovery was sustainable, support was sometimes accompanied by conditionality and sometimes not. For example, grants from the GCC to Egypt were not conditional on undertaking certain reforms. Rather, they were provided in support of the political transformation after the ousting of the Moslem Brotherhood from office. However, the GCC were active in identifying certain projects that were deemed socially worthy of support. At the other end of the spectrum lies the IMF support, which was conditional on undertaking reforms to reduce the budget and current account deficits. Some would argue this supply of soft money from the GCC may have delayed the reform process in Egypt, while others would criticise the IMF's conditionality for squeezing these economies when economic growth was sluggish and unemployment high. But it is ultimately the responsibility of policymakers in different countries to diagnose the problems they have to deal with and to figure out the best course of action. Moreover, the IMF conditionality has been the subject of a long and an intense debate for some time, and this is not the place for reiterating different views.

Let us now turn to the topic of external bindings as an anchor of reform. The argument here is that countries on their own may not be able to make credible commitments to reform, and it may be useful to use external anchors as a substitute. Accession to the EU, for example, has served as a critical basis for reform in aspiring countries, including countries of the former Soviet Union and Turkey. In contrast, South-Med countries have not benefited from such a mechanism. The association agreements between EU and South-Med countries have been imperfect (Galal, 2015). They have taken the form of shallow, rather than deep, Free Trade Agreements (FTAs). They have focused on the liberalization of barriers at the borders (through lower or no tariffs), with no commitments to reforms behind the borders (for example, competition policy, public procurement, intellectual property rights, etc.). The benefits from shallow FTAs tend to be modest (depending on the magnitude of trade creation versus trade diversion), while reforms behind the borders tend to generate significant economic gains. In terms of coverage, the agreements have included neither agriculture nor trade in services. Instead, they have been limited to manufactured goods for which Southern countries have limited comparative advantages. Furthermore, the dicey issues of labour mobility (or migration) and capital flows have not been addressed.

Notwithstanding these reservations, the main point is that external actors can play a positive role in easing the pains of

the transition in South-Med countries and there may be some room for improving their support. However, the destiny of the transition in the South-Med countries will be determined at home, through a dynamic process involving different groups/institutions and their relative power.

5.6 Conclusions

This chapter has attempted to propose a normative road map for South-Med countries to set their economies and politics on a trajectory of sustainable and shared prosperity for all citizens. It was argued that the prospects of making inroads in the future will require a break with previous development models, which have failed to meet the aspirations of the population for freedom and shared prosperity. Furthermore, the new strategy should aim at achieving the dual overarching objectives of consolidating the post-transition democratic polity, on the one hand, while making the transition towards a dynamic and equitable economy, on the other. The two objectives are bound together in a symbiotic relationship; hence, both challenges must be addressed simultaneously in order to achieve a successful outcome.

To this end, it has been suggested that South-Med countries ought first and foremost to deal with the pressing challenges of the day, including restoring macroeconomic balances, reigniting economic growth and working to reduce unemployment, especially among the youth. Both fis-

cal and monetary policies need better coordination, clarity of objectives and the more effective use of counter-cyclical rules. In terms of growth, they need to significantly improve the business environment, primarily by getting rid of privileges and cronyism, providing better protection of property rights and taking measures to enhance competition. They also need to pay more attention to promoting export, especially in relation to their real exchange rate policy, along with a revision of their industrial policy to ensure that it serves well the objective of long-term diversification. On employment, the short-term actions include active national labour programs and the support of SMEs. In the medium-term, growth is likely to create jobs if the incentive structure does not favour capital at the expense of labour, if the economy is open and export-oriented, and if manufacturing and agriculture receive the attention they deserve.

On the social front, it was noted that South-Med interim governments have been responsive to popular demands. They have adopted several measures to do away with energy subsidies, along with other measures to strengthen safety nets for the poor and to improve the delivery of social services. However, the measures undertaken to protect the poor leave out too many deserving families. They also fall short of offering protection for the elderly, the sick and the unemployed. Furthermore, they seem to have focused too greatly on increasing expenditures on social services, where resources

were available, as if this would cure the problem. What is needed is a major rehabilitation of the education and health systems that involves not only the building of schools and hospitals, but a holistic approach centred on students with greater autonomy and accountability on behalf of the service providers.

The above recommendations are reasonably well known. The problem lies in the capacity and willingness of the emerging political regimes in Tunisia and Egypt to undertake these reforms. Here, it was argued that Egypt, with an emerging regime of political dominance on account of fighting terrorism, is likely to be able, in the short-run, to make better progress in the social agenda than Tunisia, where the emerging regime is essentially moving toward competitive politics. In the medium-term, Tunisia is likely to do better thanks to the plurality of voices and accountability mechanisms. Governments in both countries are likely to face difficulties in getting rid of crony capitalism in the short run. And both countries may have to strike a bargain with the private sector if they are to entice them to invest heavily and engage more actively in economic activities.

Perhaps the biggest change in the wake of the uprisings is that the new rulers now have to reckon with the voices of the "street". The new rulers now have to respond to the emerging capacity of citizens to use their newly-earned freedom to voice their economic and political preferences and to attempt to influence how and who should

be governing them or managing their economies. This 'voice' can arguably shape the political economy debate, which will ultimately determine the future of both polity and the economy in South-Med countries. Initially, these voices asserted their desires in what have often been uncoordinated and often contradictory popular demands. In the future, the hope is that different social groups will be drivers for plural democratic participation. Also, that they will elicit, from the newly elected transitional authorities, a 'demand for different' and a new transformative social contract, with radically different rules of the game regarding the underlying public discourse on political and economic freedoms, social and economic justice, and the future role of the state.

Finally, on the possible role of external actors, they have provided South-Med countries with some support in the form of finance, technical advice and to some extent as an anchor for reform. However, it is doubtful that this support came in time, at the level required to smooth the transition or that it was sufficiently credible to make reform possible. At any rate, external actors cannot substitute for local actors who will ultimately determine the future of their countries.

Overall, South-Med countries are at a crossroad. They hold an enormous potential, that has been held back by modest economic performance and extractive political institutions. The uprisings, which began in December 2010, provide these countries an opportunity to fol-

low a new development path. In line with the slogans during the uprisings, the new development path should cater for the majority of the population and provide an incentive structure that rewards hard work. Beyond economics, it is also a model of an open society, with more tolerant values and norms. There is no room in the new development model for extending privileges to small elites, tolerating cronyism or neglecting social justice. The call is for bold changes, not marginal ones. Are South-Med countries willing and able to meet the challenge? The answer remains to be seen.

Notes

1. The real exchange rate concept adopted in this chapter refers to the price of tradeables to non-tradeables. A decline (rise) in the RER means appreciation (depreciation); and the RER is overvalued (undervalued) when its lower (higher) than its corresponding "notional" equilibrium level.

References

- Aghion, P., P. Bacchetta, R. Ranciere and K. Rogoff (2006) "Exchange Rate Volatility and Productivity Growth: The Role of Financial Development" *NBER Working Paper* no. 12117, May.
- Aguirre, Á and C. Calderón (2005) "Real Exchange Misalignments and Economic Performance", *Central Bank of Chile Working Papers* No. 315, April.
- Assaad, R. ed. (2002) "The Egypt-

- tian Labor Market in an Era of Reform", *the American University in Cairo Press*.
- Calderón, C. and L. Servén (2004) "The Effects of Infrastructure Development on Growth and Income Distribution", *World Bank Policy Research Paper* No. 3400.
- Elbadawi, I., L. Kaltani and K. Schmidt-Hebbel (2008) "Foreign Aid, the Real Exchange Rate, and Growth in the Aftermath of Civil Wars", *World Bank Economic Review*, vol. 22, no. 1, January, pages 113-140.
- Elbadawi, I. and N. Loayza (2008) "Informality, Employment and Economic Development in the Arab World", *Journal of Development and Economic Policies*, vol. 10, no.2, July.
- Elbadawi, I. and R. Soto (2012) "Resource Rents, Political Institutions and Economic Growth", *ERF Working Paper* No. 678, May.
- Galal, A. (2015) "Rethinking the EU's Mediterranean policy after the Arab Spring", *Europe's World*.
- Galal, A., H. Selim, I. Atiyas, L. Achy, S. Ghali, A. El-Haddad, et al. (2015) "Structural Transformation and Industrial Policy: A Comparative Analysis of Egypt, Morocco, Tunisia and Turkey", FEMISE – ERF Report published by the European Investment Bank.
- Galal, A. Ed. (2008) "Industrial Policy in the Middle East and North Africa: Rethinking the Role of the State", *the American University in Cairo Press*.
- Galal, A. (2002) "The Paradox of Education and Unemployment in Egypt", *the Egyptian Center for Economic Studies Working Paper* No. 67, March.
- International Monetary Fund (IMF) (2012) "Subsidy Reform in the Middle East and North Africa: Recent Progress and Challenges Ahead"
- ____ (2011) "Regional Economic Outlook – Middle East and Central Asia", April.
- Razzaz, O. (2013) "The Treacherous Path Towards a New Arab Social Contract", *Issam Fares Institute for Public Policy and International Affairs*, November.
- Rodrik, D. (2008) "The Real Exchange Rate and Economic Growth", *Brookings Papers on Economic Activity*.
- Sekkat, K. ed. (2010) "Market Dynamics and Productivity in Developing Countries: Economic Reforms in the Middle East and North Africa", *Springer*.
- United Nations Industrial Development Organization (UNIDO) (2009) "Industrial Development Report 2009 – Breaking In and Moving Up: New Industrial Challenges for the Bottom Billion and the Middle-Income Countries".
- World Bank (2009) "From Privilege to Competition: Unlocking Private-Led Growth in the Middle East and North Africa"
- World Bank (2004)
- World Bank (1993) "The East Asian Miracle – Economic Growth and Public Policy"

This report analyzes the transition experiences of five Southern Mediterranean countries in the wake of the Arab Spring: Algeria, Egypt, Jordan, Morocco and Tunisia. It assesses the consequences of the uprisings, governments' responses and their appropriateness. The analysis is multidimensional and comparative, covering macroeconomic management, economic growth, social concerns as well as political developments. The concluding chapter prescribes a new course for a better future for the region.

