

## TOWARDS A NEW MED REGION: ACHIEVING FUNDAMENTAL TRANSITIONS



*Illustration Alain Soucasse*

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EURO-MEDITERRANEAN PARTNERSHIP**

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October 2011

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## «TOWARDS A NEW MED REGION: ACHIEVING FUNDAMENTAL TRANSITIONS»

### INTRODUCTION

#### *A new paradigm*

The Arab Spring surprised all the economists who thought that the efforts made to open up trading, increase the attractiveness of foreign direct investment and develop international co-operation had finally placed the Mediterranean countries on a trajectory of convergence with their major European neighbours. GDP growth rates in the past few years were nearing the threshold that would have allowed these countries to truly catch up (broadly greater than 4% per annum on average over the period 2000-2009). In some cases considerable progress had been made in productivity (Egypt, Jordan, Morocco, Tunisia), based on the penetration of the knowledge economy; in others significant direct investment inflows had been generated, encouraging some countries to start carrying out operations aiming to achieve the convertibility of the capital account (which means moving towards the complete liberalisation of financial flows, as was the case in Egypt).

In the past, FEMISE had underlined the danger of an unbalanced transfer equation in the context of the Euromed agreements. This imbalance reflects a substantial trade imbalance with Europe, due to asymmetrical tariff dismantling (which hardly concerns agricultural products and has been accompanied by a massive increase in the technical and sanitary-related standards imposed by Europe) and also due to the difficulty in compensating for it by means of migrant transfers, tourism and long-term funds. It had also been explained that the reduction in poverty was insufficient because it was lower than the growth rate, meaning that a one point gain in growth was accompanied by a half-point increase in inequalities, that little girls were dying more frequently than little boys in rural areas, and that poverty there was more severe.

Finally, every report underlined the high level of unemployment among young people with qualifications and those without any official recognition of their education.

Nevertheless, these factors could be considered controllable and in fact fairly common to countries with lower than average income moving towards being considered as emerging countries. Free trade naturally creates inequalities, while generating an overall net gain, since it favours sectors with comparative advantages to the detriment of others (non-competitive sectors and sectors with so-called non-exchangeable goods), and can cause serious social problems if the State does not provide proper compensation for those who lose out. When the supply of qualifications is not appropriate, foreign investments have few spill-over effects and tend to be concentrated in relatively restricted areas, usually located in coastal regions or near major urban centres.

So in that case, why has the Arab Spring been such a surprise, and what is the fundamental explanation for it? The first reason is the way in which the overall movement towards emergence has been conducted. This is a central point for transition, which is going to pose considerable difficulties in the future. This movement can be explained by a development model which favored an elite consisting of closely linked politicians and business figures (see Ahmed Galal, 2011)[1]. This is particularly the case in Egypt and Tunisia. It follows that the usual ratings highlighting the lack of competition, the deficiencies of the employment market, the role of banks and corruption were not calling into question a deep-rooted collusion between the operators and political power. Over the years, this collusion has affected every sphere of society at very different levels, such as choosing the operators for a major project, winning a public tender, developing a specific region as a priority, granting a loan to an SME, finding a job in the civil service, etc. and even ... obtaining a permit to be a street-vendor. This is a complex issue for the transition, since it is these operators and this political power, protec-



ted by the press, that have contributed to the previously described economic progress. So it is hardly possible to bypass most of these operators without opting for a complete change of the system. But, in that case the system would be too far away from the dominant economic trend. Meanwhile, all this has to be accomplished in a context of complete transparency, where operators are separated from political power, independent agencies are responsible for ensuring fairness and evaluating main decisions, where freedom of the press is a given and people can participate to the social choices, in other words a true democracy.

The second reason is the natural instability caused by a more profound integration into the world economy. This process of integration has to continue, in particular by developing South-South integration. But it has to be properly regulated. We know, that for more than 40 years, all the Arab revolts have taken place when the prices of basic food products increased significantly. This was particularly the case in the late 70s in Egypt, Morocco and Tunisia when the IMF missions recommended that the prices of essential commodities (wheat, sugar, oil) should no longer be subsidised to allow local production to develop. Although this recommendation was justified in economic terms, it had poorly-assessed social repercussions. As a result Tahrir Square was invaded, some hotels were burned down in Cairo, after which President Sadat decided to cancel the measure. Moreover, the rise of the Muslim Brotherhood dates back to these events. The same phenomena occurred in Rabat and Tunis, to a lesser extent, three months later but for the same reasons.

Before the Arab Spring revolutions, we did indeed see a considerable increase in the prices of these products. In fact they were subsidised using ineffective means which were felt to be unfair. This was no doubt a major cause of the explosion. It seems the lesson has been learned, since the G8 recently decided to create a fund to regulate the prices of food products which do not have to depend on the

anticipatory actions of operators in Chicago. How is it possible to explain to the mother of a poor family (around 20% of the people living on less than \$2.40 per day in the Mediterranean countries) that the price of wheat she uses to prepare couscous and which represents around 30% of her regular consumption has increased by 15% in three months because the operators in Chicago bought future contracts on an upward trend due to a series of fires in Russia? Moreover, we should appreciate the fact that the President of the World Bank, Robert Zoellick, declared that «in 2011, food should be considered the region's number one priority».

The third reason, linked to the first, is the exclusion of young people from decisions and employment. The current Moroccan authorities have understood this and have included in the constitution an obligation for citizens aged under 40 to be represented in Parliament. This struggle against a patriarchal society also concerns women, who were very active in the revolution. It will be a long struggle and requires the development of student unions, their engagement in political life and above all education, training and employment. The Arab countries have a very high proportion of young people with no qualifications who are not classified as unemployed, and therefore excluded from any consideration by society. They also have a substantial proportion of unemployed people with qualifications, which obviously constitutes a time bomb. This explains why the new authorities immediately proposed to create public sector jobs reserved for young people with qualifications. Although we can understand the immediate reasons for these decisions, clearly they will hardly solve the problem. The solution is in the longer term. It relates to the quality of education and training, its relevance to the needs of the economy, the possibility of creating and developing small businesses, entry into the knowledge economy, the penetration of a culture of skills and risk.

The fourth reason that explains, for example, why in Tunisia the movement originated from the cen-

tre of the country is the extraordinary territorial disparities that exist in all the countries concerned. Development takes place in the major urban centres and coastal regions. The rural territories in the centre and South are very much deprived. In these areas jobs are rarer, the essential infrastructure is often lacking and these areas have little control over the decisions that affect them. This re-appropriation of the rural territories and rural population will be decisive for the future. Here again, it requires democracy to make progress through forms of decentralisation involving as much as possible the local concentrations.

All of these aspects call for a more systemic and better coordinated approach than has been adopted in the past. If the Arab Spring countries cannot continue their march towards liberalisation and progress by relying on the most dynamic elements of their societies and achieve better internal integration, where economic gains are not the only criteria for success, then we are entitled to believe that the transition will not usher in a new era of progress. This will be accomplished by mobilising all existing energies, as well as new players. In many respects, it would seem that the authorities currently in power have decided to adopt this strategy: «move towards stronger growth, not move backwards, but make this growth more inclusive and participatory». The driving force is obviously a true democracy, since it will enable new energising factors to be unleashed. If on the contrary, people wait for the situation to settle down and return to business as usual, there is a strong risk that the advance of democracy itself will be threatened.

### ***What kind of transition?***

Although the situations are markedly different in terms of how the democratic uprising has manifested itself, the elements identified to explain this transformation in Tunisia and Egypt are to be found everywhere.

In the countries most affected by the transformation, the question of an insufficiently consolidated future

has to be posed. As has been underlined where Egypt is concerned (A. Galal 2011), «the failure of past policies left an intellectual vacuum and made it abundantly clear that we urgently need clear answers to the following three questions at least:

✓ Which development model should the countries concerned follow in the wake of the revolution?

✓ What can be done in the short-run to deal with the economic downturn while ensuring that the measures adopted do no harm to future economic reform efforts?

✓ Finally, once the dust settles and a new political system emerges, what can be done to achieve faster economic growth with greater equality among all citizens?»

For the others who are suffering, albeit to a lesser extent, from the same fundamental difficulties, we must anticipate this new social demand, which is spreading at different speeds. Those who have understood this are implementing reforms (Morocco, Jordan, Algeria) or trying to persuade their populations that they intend to do so (Syria).

Finally, there are countries that are some way ahead in terms of the penetration of democracy (Lebanon, Turkey) and they can become reference points if they are capable of inventing new forms of democracy founded on a steady march towards social and economic progress. From this point of view, Turkey today seems to be the most advanced country, despite the difficulties to be described below.

Talk of the transition of Mediterranean countries conjures up memories of the 90s when the Eastern block collapsed and underwent the transition to a market economy. The common point here is that, in the short term, the transformation of the political system will generate considerable costs for any adjustment. The difference is that the issue here is not how to allow market forces to penetrate, but how to ensure they are no longer controlled by illegitimate forces.

It is therefore a question of obtaining an open, more inclusive model for growth, that the population can take ownership of because they can directly perceive its results. The route to be followed is narrow, insofar as trends are already emerging today to move from a model of economic growth to a distributive model that would involve a return of state control and even state ownership. The FEMISE standpoint is therefore that the benefits accumulated since the early 90s in terms of the liberalisation of markets, the opening up of the trade in goods and capital and the circulation of ideas, must be consolidated and even accentuated, especially in relation to the integration of the Southern region. But they must also produce results that are more fairly shared, which will involve the creation of several mechanisms that are entirely missing:

- ✓ a clear strategy for the chosen development model, approved by the majority of the population with a roadmap,

- ✓ a mechanism under the authority of the prime minister to set up and monitor this strategy, including evaluation of the impacts of the implemented projects on specifically targeted population groups (the poor, young people, women, etc.).

- ✓ at the same level, a strengthening of the procedures for selecting projects and of the transparency of the tendering process,

- ✓ a strict separation of power between political, administrative and judiciary authorities,

- ✓ Freedom of the press and free access to independent surveys carried out by national statistics offices on the level of inclusion of the poor, young people, women, rural populations and populations isolated from decision-making centres.

This is the price to pay in order for this transition, which is a «soft transition», to be considered credible.

### **Report content and plan**

The aim of the *first chapter* is to provide an *overall panorama of the macro-economic situation*. More particularly, it seeks to characterise the current situation and to evaluate the short-term costs

associated with the different internal events in the countries of the region, the consequences of the uncertainties concerning expectations and the effects of the slump in external demand in Europe and the United States. However, since this report is based on the assumption that these initial costs will be compensated by long-term gains, it also proposes a number of recommendations to boost growth in the future.

The first recommendation is to continue working towards liberalisation. This is an important factor to reinforce long-term stability by mobilising new players. In addition, it makes it possible to re-allocate capital and labour for the benefit of productive services and sectors with comparative advantages.

The EU must confirm its role of anchor, which means it must review the position of the Mediterranean countries within the neighbourhood policy, clarify the respective roles of the Union for the Mediterranean and the Commission, and make sure that the G8 commitment to support transition can quickly be converted into concrete actions. Following the G8 Deauville initiative, the European Union is to adopt a new definition of its Euro-Mediterranean policy (the «partnership for shared democracy and prosperity») and increase the resources devoted to the Mediterranean by the end of 2013. These additional resources are conditional upon democratic progress, and are split in two: half from EIB loans and half from donations to support reforms and emergency social measures.

At the meeting on 10 September 2011 in Marseille, the Deauville partnership was extended to include 17 nations, and mobilised 10 «international support organisations» including the five international financial organisations (World Bank, International Finance Corporation-IFC, EIB, BAfD and BERD) as well as the four Arab financial institutions. Four points are highlighted: (i) a capital deficit which requires direct aid, (ii) a collapse of trade flows making it necessary to support the relevant countries' access to the markets of developed countries

and to boost inter-Arab integration, (iii) the need to establish more inclusive growth founded on the boom in the local private system and a reform of the business climate (iv) funding of technical assistance for the necessary institutional changes and to deal with emergency situations (see Henry Marty-Gauquié October 2011).

Secondly, as the reforms that will complete the transition towards a market economy take place, the government has a responsibility for providing social protection. Those who lose out due to the transition process must be compensated by unemployment benefits. Health and education policies must be maintained in the short-term and developed in the medium to long-term. Support for the prices of energy and foodstuffs must also be maintained and made more effective. Long-term structural policies must be introduced, to produce new specialisations in promising sectors, create an equilibrium between territories and develop the knowledge economy.

Thirdly, it is necessary to make sure that as far as possible the major macro-economic balances are maintained, which means that substantial international aid must be mobilised to avoid an excessive burden being placed on public expenditure (the J curve effect is inevitable), that greater nominal flexibility must be accepted (particularly in relation to monetary policy and the exchange rate) in order to avoid real adjustments being too brutal. The risk in this case is a considerable increase in inflation. But if the structural reforms are implemented quickly enough, monetary policy should be able to find an acceptable point of equilibrium between the necessary nominal adjustment and the real adjustment.

An examination of the situation in the third quarter of 2011 shows the initial conditions for a controlled transition are quite favourable (relatively low budget deficit, currency reserves at around 5 months of imports, debt as a percentage of GDP close to less than half that of many European countries, single digit inflation, official unemployment rate slightly above 10%) compared to the situation of

the Eastern block countries at the beginning of the 90s after the first wave of reforms.

However, although the macro-economic conditions are relatively favourable, the basic living conditions, the quality of education, the struggle against inequalities, corruption and the delay in institutional changes are lagging far behind. The challenge at stake over the next few years is very clear. How far can we go to improve these basic conditions, which are now vital in order to obtain sustainable growth, with the help of the international community, without doing too much damage to the major macro-economic balances?

The ***second chapter*** examines in detail the ***collapse of the authoritarian bargain model*** which prevailed before the crisis (and which still prevails today in certain MPs) to ascertain what steps should be taken to transform it into a democratic model.

The first question concerns the way in which the transition of centrally planned and self-centred systems towards a market economy finally led to a form of authoritarian and captor capitalism which gradually lost popular support to the benefit of an influential urban middle class in search of unearned income and a rural elite consisting of landowners. These two populations had created networks founded on privatisations and policies conducted to stimulate the private sector.

The second question tackled in this chapter is to understand the reasons why the majority of people did not accept the terms of the bargain. The fundamental reason is that a larger, younger, better educated and more urbanised population decided, at a particular moment in time, to give greater importance to the values of freedom, dignity, and social justice than to any economic benefits they could obtain from the authoritarian regime.

The third question examines the factors that accelerated the process of rupture. The standpoint set

out in this chapter is that in addition to the erosion of the authoritarian bargain, three factors played a central role: (i) the magnitude of inequality which rose dramatically in recent years, (ii) the endemic corruption which proliferated beyond redemption in the inner circles of each regime, (iii) the social media which provided an opportunity for increased awareness for the population.

The conclusion is that instead of unearned income for patronage, the governments in the region need to conceive appropriate incentive schemes based on considerations of economic efficiency and social justice. On this basis, four groups of recommendations are presented:

- ✓ review the fiscal policy and aim for a more equitable system that implies: direct taxation more than indirect taxes, progressive income taxes, combat against fraud and evasion and unjustified exemptions especially on companies (individuals pay more compared to companies: in Tunisia for example, the former pay 65% and the latter 35%),

- ✓ design an appropriate industrial /structural policy with comprehensive medium long term strategy,

- ✓ design adequate incentives to channel resources toward selected high-value and knowledge-intensive sectors to absorb educated labour,

- ✓ strengthen market mechanisms and reinforce transparency for efficient allocation of resources; this means strengthening the competition authorities and introducing regulations to encourage competition.

The **third chapter** discusses the reasons why **youth should be considered the main resource to be deployed**. The aim here is to demonstrate the decisive importance of young people in the Mediterranean countries for another twenty years or so. At the end of this period, the Mediterranean countries will themselves be confronted with the problem of an ageing population and will have problems financing retirement pensions. To preserve long-term equilibrium it

is therefore vital to satisfy the expectations of young people in the Mediterranean countries without delay.

This chapter provides an overview of the present schooling situation in all educational cycles and in employment. The conditions for access to the employment market are analysed, as are the differences in treatment between the private sector and public sector. In general, the participation and employment rates in Mediterranean countries are considerably lower than those observed in the global economy, which results in massive unemployment, particularly for drop-outs and graduates from higher education. The duration of unemployment is tending to increase.

The main conclusions and recommendations in this chapter, which also demonstrates the limits of State intervention currently prevalent in this field, are:

- ✓ to adopt a systemic overall approach insofar as the supply and demand for labour are both concerned, as well as the relations between the two.

- ✓ to target two categories: drop-outs from the school system and graduates from the higher education system, since the secondary system is less affected,

- ✓ to increase development of vocational training, counselling into shorter training courses, guidance into vocational fields in the most promising sectors. In this respect, it would be desirable to be in possession of a common core of basic skills relating to business creation and management, which could be delivered at the end of the period of compulsory schooling, and accredited by IT means. The skills-based approach should also be adopted to define the additions to be made to general education and training, in view of the new types of occupations that are emerging. In general, it is important to develop a skills-based approach in complementarity with the diploma-oriented approach.

- ✓ to develop the possibilities for creating small businesses (state start-up funds, specific loans, etc.)

✓ to set up second chance schools as already exist in Europe for drop-outs,

✓ to aim to improve the overall quality of the education system by making widespread use of Pisa evaluations,

The **fourth chapter** deals with the **additional trade potential** which could be mobilised between the EU and its Mediterranean partners. There are two good reasons to consider this issue.

The first reason is that the creation of a free trade area with the associated institutional changes was at the heart of the Barcelona process. The question raised here is to determine how far we have progressed compared with the other major operations of this type around the world (in particular Nafta, Asean and Mercosur). Can we hope for major growth potential thanks to additional trade liberalisation?

The second reason is that in their initial reactions to the Arab Spring, the developed countries (including the EU) tended to say «finish opening up to trade, in particular in services, make the associated institutional changes and you will naturally find yourselves on the path to sustainable growth». This position avoids any major financial commitment and any anchoring mechanism of the type that Eastern block countries benefited from for their transition. Is this realistic, taking account of what has been said previously about the Arab Spring?

This chapter is based on Pareto-type methodology models, taking into account not only the trade in goods, but also factor movements (migrations and capital). It highlights several points: (i) there is a limited potential for additional trade gains which does not appear to be sufficient to place Mediterranean countries in a situation of much stronger growth, (ii) the potential for additional trade with the EU is insignificant and corresponds exactly to the level predicted by the Pareto-type model, (iii) the trade potential observed in the

Euromed region corresponds to the results observed in Nafta, Mercosur and Asean.

Although this means that, at least on the basis of this model, it is no longer possible to show obvious backwardness in relation to the other trade liberalisation operations, it does not mean to say that if the environmental conditions change, additional trade development might not take place. In addition, the comparison drawn with the other zones does not take account of the quality aspect and the level of integration of Mediterranean countries in the value chains developing with the EU (level of integration considerably weaker than in Asean).

Several tools can be mobilised to increase the level of Mediterranean country exports, even though today, we can consider this level to be normal as an absolute level and in comparison with the performance of the other free trade areas.

The first tool consists in making progress to reduce exchange costs and non-tariff barriers (NTB). In Algeria, Egypt and Morocco, NTBs in tariff equivalent represent 40% on average, which is much higher than in many other countries.

The second tool is an improvement in logistics performance, which is relatively low particularly in infrastructures for customs, transport, and IT.

The third tool is an improvement in governance and the development of migration, which is a growth factor for exports from Mediterranean countries to the EU. The same applies for FDI, a phenomenon which contributes to the development of exports from the EU to Mediterranean countries.

Finally, a strengthening of the partnership with the EU, in areas relating to education, training, innovation as well as the environment, would make an important contribution to developing new values based on new regional specialisations, which would naturally bring with them a development of trade.

In the ***subsequent chapters***, this work presents the individual situations of the MPs.

## **Endnotes**

1. Ahmed Galal (2011), «Egypt Post January 2011: An Economic Perspective», ERF Policy Perspective July 3.

2. Henry Marty-Gauquié (2011), «Retour sur la transition démocratique, défis et réponses» to be published in the Esprit magazine October 2011 edition.

## **CHAPTER 1. THE EXPECTED CONSEQUENCES OF THE REVOLUTIONS**

### **Introduction**

Up until last year, the Mediterranean partner countries (MPs) were judged to have relatively fared well in terms of their economic performance in the face of the effects of the 2008 financial crisis. The region's growth slowed from around 4.7% in 2000-2007 to just 3.1% in 2009 and while the US and EU stagnated in deep recessions. And despite a short-term cost in terms of a decline in potential output growth, a temporary rise in unemployment (which was already high) and increased public spending (to stimulate the economy) that led to higher budget deficits, the region was considered to be on a fast-track recovery with growth rebounding in 2010.

Yet, the political upheaval in the Mediterranean, which is exceptional and new to a politically dormant region, has clearly interrupted this recovery. The near-future of the region may be uncertain but the revolutions offer an opportunity for democracy and for a shift towards a growth model based on democratic capitalism, which can be more inclusive and more equal in distributing its economic gains and thus put the region on a sustainable development path. However, some short-term losses must be endured during the transition before reaping the long-term gains of democracy.

The political and economic transformations underlying the Arab spring appear to be similar in some aspects to that of Eastern European spring of 1989. Many lessons could be learnt, policy mistakes could be avoided and their experience could be a benchmark to assess the performance of Euro-med economies during the transition.

This chapter assesses the immediate consequences of the revolution and also suggests reforms that ensure a smooth transition towards democracy based on the experience of Central and Eastern Europe (CEE) Economies. It mainly argues that, like the case of CEE,

the transition towards democracy in the southern Mediterranean region, will be associated with some short-term costs in terms of economic growth, unemployment, rising current accounts and fiscal deficits. These short-term costs could be offset by the long-term gains derived from democracy, provided two crucial sets of pre-requisites are provided: (i) political reforms, their transparency and the return of security. In this respect, the announcement of a detailed political transition road map can help reduce uncertainty and build credibility of the political authorities, (ii) the speed and sequence of adoption of reforms. The economic recovery is likely to be largely dependent on the pace of adoption of reforms, particularly stabilization and liberalization policies. Another important factor is the sequence of reforms. In fact, an important lesson learnt from CEE is that the establishment of sound institutions is definitely important but initial achievements with respect to reducing macroeconomic imbalances account for most of the recovery. Finally, it is also important to address the root causes of the revolution and ensure that the growth model balances growth, employment and distribution.

This chapter is divided into 3 main sections. The first presents the rationale behind the idea of short-term losses and long-term gains. The second presents an overall assessment of the economic situation before and after the political uprising. Finally, the last section draws lessons from the CEE in order to ensure that the democracy generates the expected gains.

### **I. Short-term losses VS long-term gains: the rationale**

This section explains that the long-term gains derived from democracy require some short-term adjustment costs during the transition.

#### **I.1 Democracy and long-term gains**

The literature suggests that democracy could contribute to better economic outcomes through several channels. First, the clear separation of powers between executive and legislative bodies helps prevent the abuse of power by politi-



cians (Persson et al., 1997). Second, democracy is often associated with improved checks and balances mechanisms which limits rent-seeking behavior and prevents massive theft of public wealth (Dethier et al., 1999). In addition, because it increases accountability, democratic institutions serve to constrain political leaders to adopt harmful “opportunistic” policies (Rodrik, 1999). Third, it leads to higher growth because it lowers economic uncertainty, delivers better institutions and helps countries better adjust in the face of external shocks (Rodrik, 1999). Fourth, democratically elected governments have greater legitimacy to implement much required institutional reforms even if such reforms bear high short-term costs (Giuliano et al., 2010). Finally, democracy can also guarantee property rights and individual liberties which foster creativity and entrepreneurship (Leblang, 1996).

However, the idea that there is a positive correlation between democracy and reforms has been counter-argued by the experience of countries like Chile and South Korea where economic reforms were undertaken under dictatorships. Some arguments have thus been put forward underlining that democracy leads to more reforms if reforms are adopted sequentially, i.e. first liberalize then become democracies (Giavazzi and Tabellini, 2005). Also, another strand of the literature suggests that the positive effects of reforms on economic performance may be undermined by weak institutions (Rodrik et al., 2002).

In addition to these theoretical arguments, there is strong empirical evidence that democracy can promote long-term macroeconomic stability. Sathanath and Subramanian (2004) find that one standard deviation increase in democracy can reduce instability nearly fourfold. Moreover, the link between macroeconomic stability and democratic institutions is the most robust relationship compared to conflict and openness. Interestingly, Persson and Tabellini (2009) provide evidence that a large stock of « democratic capital » - de-

defined as a country’s long tradition of democratic rule as well as being surrounded by well-functioning democracies - stimulates growth. Moreover, their findings suggest the existence of a virtuous circle whereby being a stable democracy promotes economic development which helps further consolidate democracy; this in turn leads to the accumulation of more democratic capital, with additional positive effects on growth and democratic stability. In contrast, autocracies are more likely to stagnate because they cannot initiate this virtuous circle of consolidation and growth. Moreover, if they happen to become democracies, they remain vulnerable and unstable until they have accumulated enough democratic capital.

A large avenue of research focused on the correlation between reforms and democracy. In this respect, the experience of transition economies showed that democracy was able to trigger benign structural transformations that put them on a path of sustainable development. In general, this work found evidence that democracy facilitated economic liberalizations (Grosjean and Senik, 2011; Fidrmuc, 2003; and Dethier et al., 1999). Finally, democracy has a positive and significant impact on the adoption of both macroeconomic reforms (Giuliano et al., 2010 and Giavazzi and Tabellini, 2005).

## **1.2 Transition and short-term costs**

Yet, while democracy leads to improved economic outcomes, they do not occur instantaneously. The first part of the answer is related to the costs of transition. The puzzle that transition had short-term costs was first witnessed during the political transformation of the CEE. And while economists believed that eliminating economic distortions would lead to improved efficiency and output increases in these countries, the opposite just happened. And instead of a j-shaped short-term adjustment, deep and protracted recessions were followed by gradual recoveries starting only in the second half of the 1990s (Fidrmuc, 2003, Svejnar, 2002, Fischer and Sahay,

2000 Wyplosz, 2000, and EBRD, 1999). CEE countries experienced on average a cumulative output drop of 28%. Employment adjustments were also severe with large initial reductions in industrial employment occurring in Hungary (over 20%), followed by Slovakia (over 13%), Poland (over 10%). The employment decline reached 15 to 30% in the 1990s for most economies. Moreover, unemployment, which was unknown beforehand, soared to double-digit levels two years after the transition (16% in Bulgaria and Poland, 12% in Hungary and Slovakia). The initial level of inflation was high and rose further as a result of either subsidy elimination or financial distress (reaching 2000% in countries like Ukraine or Kazakhstan). Most economies also suffered substantial current account deficits (reaching 10% of GDP in countries like Albania and Bulgaria), and saw their fiscal balances sharply deteriorate, in some cases to more than 15% of GDP, as a result of the inability to raise revenues and increased investment spending.

The U-shaped pattern of output response reflected an initial output decline (and increase in unemployment), associated with a reallocation of factors of production as the economy made a complete shift from central planning to market forces and from old to new activities. This occurred in a wider context of « disorganization », resulting from the systemic changes and production and trade disruptions (following the disappearance of the state as a main market player). In addition, stabilization policies (reduced fiscal spending, real exchange rate adjustments) may have contributed to the contraction of aggregate demand. The growth recovery was associated with the restructure and reorganization of existing state-owned production which led to productivity increase, as well as the emergence of a private sector that absorbed some of the employment losses from restructuring but only sufficiently to maintain unemployment constant until the transition is achieved (EBRD, 1999 and Blanchard, 1997).

The second part of the answer of why reforms take a long time to reap their benefits is related to the political constraints to reform. First, reforms may be resisted ex-ante because they may create losers, especially in terms of employment losses and this could mobilize support for reform (Roland, 2002 and Fidrmuc, 2000). In addition, resistance to reform could be due to potential high reversal costs of reforms that may turn out to have disastrous outcomes (Roland, 2002). When enacted, reforms may also face ex-post political opposition from those who experience economic hardship.

The transition to democracy in the euro-med region is already underway. Yet, democracy is a gradual perception that is accumulated over time and does not occur overnight. The process will thus not be easy and the experience of CEE shows that it is normal to expect some costs, until stabilization reforms - albeit painful ones - are undertaken and institutions are re-formed for markets and the private sector to function better. In particular, the institutional reforms inevitably take time to implement because they require not only the enactment of new laws and regulations but also a fundamental change in experiences, incentives, and attitudes and most importantly the capacity for rule enforcement.

## **II. Macroeconomic and sectoral estimates**

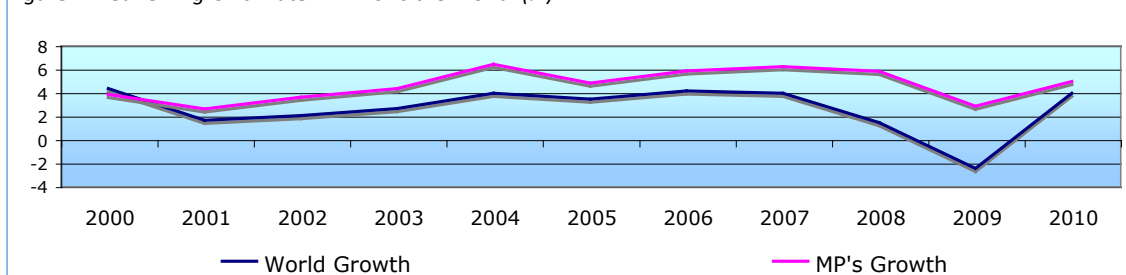
### **II.1. Situation before the political uprising**

#### ***1. Higher rates of growth were achieved***

The recent social crisis came as a next step following both the economic crisis and decades of political stagnation. But, one must not forget that it hit MP's at a time when the region had started experiencing marked improvements in its economic situation for the first time in almost two decades.

Until late 2008, the region was considered to have achieved remarkable growth. In the 2000-

Figure 1. Real GDP growth rate in MP's vs the World (%)



Source : EIU

2007 period the regional rate of growth averaged 4.7% (versus 3.9% in 1995-2000), while it accelerated to 5.2% throughout 2008. Furthermore, the region was judged to have weathered the 2008 global financial crisis relatively well. After decelerating to 3.1% in 2009, growth picked up in 2010 with a rate close to 4.9% equaling pre-crisis levels. This could be explained by the region's limited financial integration and a high concentration of Mediterranean exports in a few products (oil, materials and light manufactures) that were not as sharply affected by the crisis as capital goods (IMF, 2011).

A significant opening-trend in goods and services trade, more openness to FDI and increased capital attraction, positive spill-overs as well as a series of reforms to integrate the region into the world economy became a reality, helping the region maintain a growth momentum above the world average throughout the decade.

## 2. More openness in trade and financial flows was apparent

The region made significant progress in increasing openness to foreign trade and FDI inflows over the past 15 years. As seen in figure 2, the simple average of MFN customs duties was sharply reduced to 14% in 2009, down from 20% in 1995 (and from 24% when Morocco is included). The Association Agreements with the EU seem to have contributed to this trend. All MP's currently have tariffs with the EU below 18% for agricultural products and 5% for non-agricultural products (FEMISE-EIB, 2010).

According to a recent FEMISE-EIB study, the Euro-Mediterranean free-trade area allowed for better integration within the global economy. In the case of traded goods, openness (measured by the ratio of trade to GDP) has continuously increased since 1995 for all MP's. In particular, it increased from 47% in 2000 to 66% in 2008. In the case of

trade in services, openness also increased, from 17.4% to 22.1% over the same period (FEMISE-EIB, 2010).

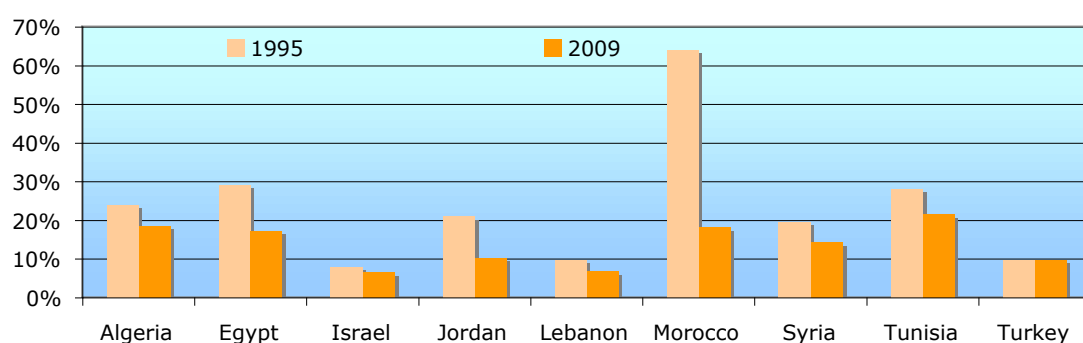
Finally, foreign direct investment inflows started to pick-up in the latter half of the decade as showcased by figure 4. Foreign investment was among the major growth engines in the latest half of the prior decade, solidifying the Mediterranean vis-à-vis foreign capital holders. The Mediterranean region had gai-

Table 1. The real growth rate in MP's until 2010

	Real growth rate (% annual average)			
	2000-2007	2008	2009	2010
Algeria	4,1	4,5	2,1	4,1
Egypt	4,6	7,2	4,7	5,1
Israel	3,1	4,2	0,8	4,8
Jordan	6,1	5,8	2,3	3,1
Lebanon	3,9	9,3	8,5	7,2
Morocco	5,1	5,6	4,9	3,7
Syria	6,4	4,5	6	3,2
Tunisia	4,9	4,6	3,1	3,7
Turkey	4,4	0,7	-4,8	8,9
MPs (simple average)	4,7	5,2	3,1	4,9

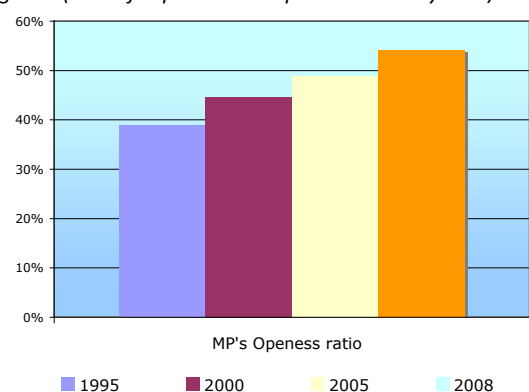
Source : EIU

Figure 2. Simple average of MFN customs duty by country



Source : World Trade Organization, Tariff Profiles, FEMISE 2005 Report : 10 years after Barcelona, Note : MFN customs duty data for Syria is for 2002 and 2009

Figure 3. Evolution of the MP's Trade Openness Ratio in goods (sum of exports and imports divided by GDP)



Source : COMTRADE

ned in attractiveness, foreign investment flows multiplied by almost 7 between 2002 and 2008 with continuous improvements in the business climate and a newly found interest for emerging sectors. As already noted by FEMISE (2009), the improvements made by MPs considerably enhanced their attractiveness in relation to the Eastern countries as well. Countries such as Egypt, Jor-

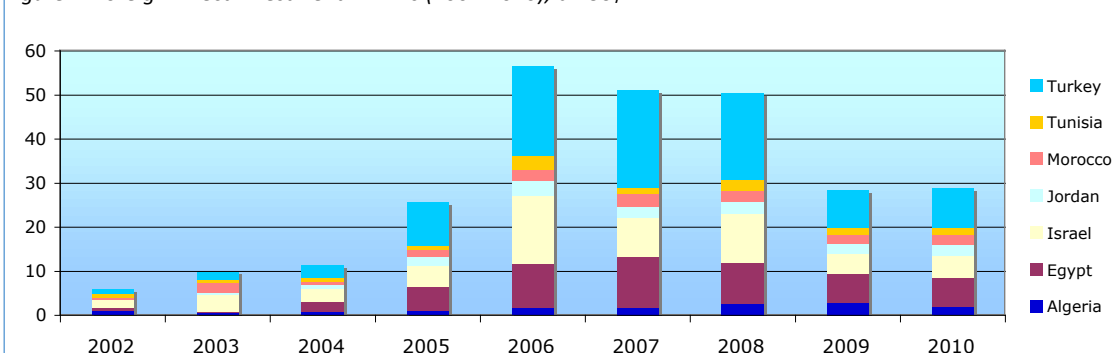
dan and Tunisia were boding considerably well in great part due to improved workers' qualifications, availability of labour and a better business climate. As a result, the regional share in investment flows, while still far from the one of neighbouring countries of the Gulf, was close to 6% in 2007. The international crisis might have led to a substantial reduction in FDI, but even so, foreign investments were still much higher in end 2010 than at the beginning of the 2000's ...

### 3. A growth model that nonetheless had important limitations

Shy calls were already being made about the limitations of the region's growth model. This is because :

v this model was essentially based on significant **capital accumulation**. The long-term GDP growth in MP's was mainly fueled by demo-

Figure 4. Foreign Direct Investment in MP's (2002-2010), bn US\$



Source : EIU, ANIMA

graphic growth and capital accumulation while Total Factor Productivity (TFP) growth contributed only marginally. Regarding per capita GDP growth, accumulation of human capital (through education and training) had a positive but limited effect, it was the accumulation of physical capital that was the main driver of GDP per capita growth especially in countries such as Egypt, Morocco, Palestine and Turkey, setting MP's apart from the rest of the developing world (On Egypt, see Herrera et al. (2010)). As for the contribution of TFP it was mostly negative or null in the 80s and 90s for most of the region, before starting to contribute slightly more in the 2000's (FEMISE-EIB, 2010).

√ Notwithstanding the importance of the capital accumulation-based growth (through domestic investment and FDI) in promoting growth, this model failed in **absorbing increasing labor entrants**. FEMISE had calculated that, at constant rates of activity, MPs would have to create at least 22 million jobs by 2020 alone to avoid witnessing deterioration in employment creation and unemployment rates (Femise research report FEM3d-02). Clearly, this did not occur as the pace of job creation in recent years has corresponded solely to coverage for newcomers. Moreover, unemployment is still high and considered to be among the highest in the world in a region where population growth is among the fast-growing in the world, particularly among the youth and educated (ILO, 2011). In fact, the average unemployment rate in the region is around 11.3% and is shockingly higher for youth, at roughly 25.8%.

√ The high growth of past years also coexisted with **high inflation** in some countries especially in recent years. Mediterranean countries saw high inflation rates in 2008 following the upsurge in food and oil prices and strong domestic demand combined with expansionary fiscal policies in some economies. In Egypt, Jordan, Syria and Turkey, the 2008 rate of inflation had risen to 18.3%, 14.9%, 15.% and 10.4% respectively, with a regional rate of inflation averaging

8.9% (EIU). The chronic lack of food security had already contributed to a series of upheavals in several MP's before the 2011 revolutions, highlighting the reaction of Mediterranean populations to changes in price of foodstuffs.

√ MP's lacked an **inclusive growth strategy**. In part because growth did not generate sufficient jobs but also because of the high inflation that persisted, growth did not trickle down to the poorest which increased income inequality and exacerbated social tensions. While poverty remains lower than in many regions (17% of population lived below the \$2 a day poverty line in 2005 in MENA) and has also been declining in recent years, challenges to poverty reduction are related to poverty persistence, a high vulnerability to poverty and rising inequality. In fact, poverty in MENA is concentrated among groups that do not benefit from growth and its reduction requires rapid economic growth (above 2 percent per capita) to (World Bank, 2010). Also, a large share of the population lives close to the poverty line, i.e. are vulnerable to poverty, which means that any external shock (ex. rise in prices) is capable of pulling them below the poverty line and leading to increased poverty. In fact, the 2008 commodity price shock led to an increase in poverty in most countries of the region (World Bank, 2009). Finally, the region has been experiencing a steady increase in inequality and suffers from an asymmetry of poverty changes with respect to positive and negative growth in that recessions have a larger effect on poverty than economic booms, due to unequal distribution of gains from growth (World Bank, 2010).

√ **Inefficient social policies, unequal access to economic opportunities** resulting in low health indicators, poor access to services, are all factors that weighed on long-term development. The social protection systems in MPs have been highly fragmented, with poor management of resources and varying coverage. The social security systems cover a minority of the population, leaving employees from the informal sector and

### **Box 1. Understanding causes of unemployment in the Mediterranean**

*South-Mediterranean countries risk facing an escalating unemployment crisis.*

*Already before the recent protests, unemployment rates had been high, also because of the global economic crisis which started in 2008 and affected employment in export-oriented firms. Even so, the root causes of the unemployment phenomenon are deeper, they are of a structural nature and result from economic growth strategies that were not well-thought. Among others, the growth regimes in the Mediterranean :*

*✓ put little emphasis on the agricultural sector, which resulted into an exodus from rural to urban areas. This consequently led to unbalanced growth, with capitals and the periphery being the main to profit from development.*

*✓ were unable to channel the educated youth towards the labour market requirements which increased unemployment pressures. Furthermore, vocational training initiatives were mostly underdeveloped and job seekers were reluctant to acquire more « specialized » skills.*

*✓ failed to integrate the private sector into economic activity and thus lost a considerable employment creation opportunity, despite various reforms.*

*✓ did not take advantage of FDI projects to create more employment opportunities, especially regarding qualified jobs.*

*✓ failed to sufficiently support SME's which are an important employment contributor*

*✓ did not opt for a policy of circular migration that allows for increased labour complementarities. Thus, the countries with a workforce surplus failed to orient their unemployed to countries with a shortage of labour.*

*All these factors have contributed to Mediterranean economies having among the highest unemployment rates within the developing world, along with the highest jobless rates for the youth and finally the lowest economic participation rate among women.*

*Sources : MEMRI (2011), IIF (2011)*

rural areas without protection. Additionally, few countries have introduced unemployment insurance systems and when they have they are generally poorly developed. As for the regional health and health insurance systems, they generally offer poor coverage, especially for workers from the informal sector (FEMISE, 2009). In its 2009 report FEMISE had already noted that an improvement of social protection systems is necessary to guarantee protection towards loss of employment and that social stability in the region is maintained. The systems based on high price subsidies, that target the poor inefficiently, should have been progressively phased out to allow better resource allocation.

✓ Last but not least, **widespread corruption and weak institutions** did not allow for an equal distribution of economic gains. In fact, the alliance between the state and small privileged rent-seeking business elite was perceived to be an important driver of the political unrest (see chapter 2).

### **II.2. Preliminary assessment of losses and short-term pressures**

It appears that for long, policy makers in the Mediterranean would only measure the potential gains in GDP terms without dealing with the basic issue of growth redistribution for their populations. The lack of a « social vision », combined with growth favouring an elite of few, ultimately led to the recent upheavals. Thus, we now focus on the following question : how is growth in the Mediterranean affected and through which channels ?

The recovery of the Euro-med region from the effects of the 2008 crisis was clearly interrupted by the political turmoil in late 2010 and early 2011 in Tunisia, Egypt and, currently, in Syria and Libya. Overall, the countries of the regions are in different stages in terms of their political transition. Some like Egypt and Tunisia, the first two countries to witness a « peaceful » popular

uprising, succeeded in toppling their autocratic rulers and are currently struggling with the transition to democracy. These frontrunners or Arab Spring countries had incurred some economic losses due to business disruptions during the revolution but now economic activity has somewhat resumed, even if it remains below potential due to the prevalence of political uncertainty. A more affected country is Syria where demonstrations have been taking place and still are since last March but are subject to violent crackdowns from the repressive regime. And while the economic costs are expected to be substantial for the frontrunners, other MP's which are not experiencing significant domestic turmoil are still expected to be affected indirectly as uncertainty surrounds the whole Mediterranean region.

Overall, the countries that are the most affected in the Mediterranean region are those in which the unrests were born, namely Egypt, Syria and Tunisia. Meanwhile, the rest of the region is affected to varying extent. Falls in economic growth, rising unemployment concerns, increasing fiscal deficits and falls in trade, tourism and FDI earnings are materializing and represent the economic impact of recent events.

If we accept that MPs are moving from an authoritarian and corrupt model to a system of democratic capitalism, we shall expect the transition to be abrupt for some countries for a period of few years, with difficulties in the short term that will have to be dealt with to avoid that the transition process is aborted.

✓ Substantial **decrease in growth** due to agents' expectations. Investment funds could face important difficulties for fundraising while entrepreneurs are not expected to take any risks in the Mediterranean.

✓ **Unemployment** is expected to rise in the Arab spring countries but will remain more or less the same in other countries of the region.

✓ **Inflation** is expected to rise as international commodity prices are likely to experience another surge, requiring a tightening of monetary policy.

✓ **An increase in the fiscal deficit** in transition countries due to lower revenues from indirect taxes, the hiring of young employees (which could lead to drastic adjustment plans in some years), inflation, falling reserves (from tourism and transfers), increased pressure on currencies and rising interest rates.

✓ The political instability and uncertainty in recent months will most likely have a constricting effect on the Mediterranean tourism as a whole. This comes at a time when **tourism** perspectives after the international crisis, and right before the Arab-Spring, were quite positive. Now, foreigners are expected to prefer spend their holidays in destinations with a lesser risk of social upheaval, demonstrations and violence, thus affecting not only the core countries of the political revolution but perhaps neighbouring ones as well through slower growth. Early indications point to a 7% fall in value for the sector following an 8.3% fall in tourist inflows,

✓ a decrease in **FDI** following political instability of the last months and the ever-lasting effects of the international crisis. Currently, FDI is estimated to fall by 4.6% after an initial fall of 12.5% in 2010. Moreover, when Turkey is excluded the drop amounts to 19.6% and the region risks becoming insignificant in terms of capital attraction. This comes at a time when at the global level, FDI projects were starting to be reinstated and worldwide flows were picking-up, though still timidly. Hence, the expected trend in the MP's is not similar to the global trend and the number of investment projects in the Mediterranean risks of eroding.

✓ A rate of **export growth** that is lower than the corresponding pre-international crisis one (export growth estimated at 14.4% in 2011 versus approximately 23% for the 2006-2008 period). The limited trade ties between Southern Mediterranean economies limits contagion through this channel.

√ As a consequence, **current account deficits** are expected to increase from 1.8% of GDP in 2010 to 5% of GDP in 2011 in countries of the Arab Spring.

### **1. The sharp slowdown in short-run growth in the frontrunners of the revolutions is also affecting the overall region**

Political uprisings since the end of 2010 and early 2011 in Tunisia, Egypt and Syria already had a substantial economic cost, following **production stoppages, tourist outflows** (due to the travel restrictions issued on these countries) and **uncertainty** which has triggered massive capital outflows from stock markets and still weighs on investment decisions. These factors are likely to lead to a decline in the rate of growth in 2011 to 1.2% for Egypt (versus 5.1% in 2010), 0.2% for Syria (versus 3.2% in 2010) and -0.7% for Tunisia (versus 3.7% in 2010). Uncertainty in these countries is very likely to harm other countries in the region, putting a toll on the overall region's growth which is expected to fall to 2.6% in 2011 from 4.9% in 2010.

Although it is still early to quantify the final impact, while it is also difficult to show the exact share of responsibility of the regional climate in macroeconomic evolutions, **recent estimates** suggest a worsening or a deceleration in the post-international crisis recovery.

#### **In the frontrunners of the Arab-Spring:**

√ An immediate cost was incurred through **production stoppages** and damage to some physical properties. In the case of Tunisia, riots during the first weeks had cost 3 billion dinars to the economy (1.6 billion euros), already equivalent to 4% of GDP. About 2 billion dinars were due to the stop of domestic economic activity. In the case of Egypt, production stoppages led to losses in manufacturing, construction and tourism. Greater Cairo suffered most of the

losses (41.2% of value added in manufacturing and extractions and 82.7% in construction). Losses in the food processing industry were almost 18% of value added. Also, domestic ports, which remained temporarily inactive, saw most of their business deterred to neighboring countries such as Malta and Israel. Such disruptions contributed to **negative productivity** in Egypt and Tunisia (see table 3). Such disruptions contributed to **negative productivity** (see table 3) and also slower year-on-year growth in **exports** for end-2010.

√ Furthermore, several former regime figures, now under arrest or investigation, had ties to major firms. There was a **deep relationship between businessmen and government officials** in Egypt and Tunisia; in the former, more than 70 known businessmen were part of the old parliament (as official members or state allies) while in the latter, about 180 firms were controlled by the Ben Ali clan (Reuters). Thus, while the removal of old regimes could signify that more FDI inflows occur in the medium-run, firms are now concerned about falling under scrutiny by the new authorities and have cancelled or postponed production and investment decisions.

√ Also, Egypt and Tunisia are those most affected by capital outflow and halting of FDI-powered projects with flows falling respectively by an estimated 59.4% to 2.6 bn US\$ and 35.3% to 1.1bn US\$ in 2011. Both countries imminently need to try averting delays in current investment projects and restore their image to the outside world for foreign investors to return. If not, they risk seeing contagious effects from the outflow of capital in the form of insufficient internal demand and reduced opportunities for economies of scale leading to additional difficulties for a proper growth rebound to take place. Finally, Syria appears to be among the most affected as well, with intentions on FDI declining by approximately two-thirds in early 2011 in a climate of rising tensions (ANIMA).

√ Meanwhile, the Libyan crisis also increased domestic pressures through the **return of migrants**, Egyptians and Tunisians representing the largest share of migrants in Libya (respectively by 58% and



Table 2. Main macroeconomic indicators in MP's

	Real GDP growth		Unemployment (% of labour force)			Fiscal Balance		Current Account Balance	
	(% change)		Overall		Youth	(% of GDP)		(% of GDP)	
	2010	2011*	2010	2011*	2009	2010	2011*	2010	2011*
<b>Arab Spring Frontrunners</b>									
Egypt	5,1	1,2	9	12,2	27,2	-8,1	-10,4	-2	-3,1
Syria	3,2	0,2	8,3	8,1	23	-4,4	-8	-1,3	-4
Tunisia	3,7	-0,7	13	16	28,5	-4,6	-9,1	-2,2	-7,9
Average	4	0,2	10,1	12,1	26,2	-5,7	-9,2	-1,8	-5
<b>Rest of MPs</b>									
Algeria	4,1	4,6	10	9,7	21,5	-1,2	-2,1	8,4	10
Israel	4,8	4,3	6,7	5,8	n.a	-3,7	-2,4	2,9	0,4
Jordan	3,1	3	12,5	12,3	26,8	-8,2	-10,8	-3,9	-4,8
Lebanon	7,2	1,3	9,2	9,2	21,5	-7,4	-9,9	-22,4	-28,5
Morocco	3,7	3,8	9,1	9,2	24,9	-4,7	-6	-3,2	-8,1
Turkey	8,9	5,7	12	10,3		-3,6	-1,5	-6,5	-9,8
Average	5,3	3,8	9,9	9,4	23,7	-4,8	-5,5	-4,1	-6,8
<b>Total MP's Average</b>	<b>4,9</b>	<b>2,6</b>	<b>10</b>	<b>10,3</b>	<b>24,8</b>	<b>-5,1</b>	<b>-6,7</b>	<b>-3,4</b>	<b>-6,2</b>

Source : EIU, The Institute of International Finance

12% in 2010). Following turmoil in Libya, about 100000 returnees have been estimated entering Egypt and Tunisia.

Moreover, tourism, a major industry in all 3 countries, has endured an important setback with the outflow of tourists following the revolutions. Not surprisingly, Egypt and Tunisia are expected to experience the largest decline in tourism. Egypt, after enduring an instant loss of 1bn US\$ since one million tourists left the country when the upheaval erupted, is facing a considerable attendance fall. Tourism in Egypt dropped by 28% from January to July following the revolution according to the latest figures from the Egyptian Tourism Authority (ETA). The country received 5.7 million tourists from January to July compared to 8.2 million visitors during the same period in 2010. The number of UAE visitors to Egypt declined by 58%, visitors from Kuwait dropped 52%, Saudis by 48% and Jordanians by 17% per cent from January to

July. The number of Arab tourists visiting Egypt declined by 18.6% while in July alone, their numbers fell by 28.5%. But, there are expectations that with the removal of Mubarak tourism could bounce back in the coming months (Gulfnews.com, 2011). If not, this might generate a substantial decrease in foreign exchange reserves and a serious hit to the balance of payments. As for Tunisia, it was announced that revenues and visits had fallen by roughly 40% in January 2011, furthermore, the number of tourists dropped by an additional 40% from January to mid-April compared to 2010. This trend was expected to continue for the rest of the year ; the fall in tourism volume was expected to go as far as 50% with a corresponding 25% decline in tourism earnings. Recent news suggest that the tourism sector has plummeted by more than 50%. A 2 billion US\$ loss in tourism revenues and trade has been announced, in great part due to the war in Libya, taking into account that two mil-

lion out of the seven million tourists that visit Tunisia annually are from Libya (The Big Issue, 2011). Negative developments in the Egyptian and Tunisian tourism sectors are also joined by those of Syria. The Syrian tourism sector showcases a very low amount of booking suggesting a massive impact for the year to come for a sector that represents 12% of GDP.

✓ Last but not least, uncertainty prevents economic agents from making informed long-term decisions about consumption and investment (and savings). Regarding Syria for instance, Qatar announced that it would put on hold the construction of two electricity plant while foreign investors are no longer investing. In all 3 countries, domestic spending (both private consumption and investment) have sharply slowed down.

These elements contribute to a rate of growth falling to 1.2% for Egypt (versus 5.1% in 2010), 0.2% for Syria (versus 3.2% in 2010) and -0.7% for Tunisia (versus 3.7% in 2010).

Meanwhile, in the **rest of the region**, disruption in economic activity varies from country to country while it is limited overall:

✓ **Foreign direct investment** is likely to be impacted as foreign investors adopt a more cautious stance. But, not all MP's are in the same state of affairs and a differentiation among them shall be made : **Firstly**, one finds a group of coun-

Table 3. Total factor productivity growth in MPs

	2009	2010	2011*
Egypt	2,6	1,8	-3,3
Tunisia	0,7	0,6	-3,3
Algeria	-1,4	0,7	1,9
Israel	-1,6	1,3	0,5
Jordan	-1,2	-0,7	-0,6
Morocco	2,2	-0,5	-0,1
Turkey	-5,8	3,3	0,4

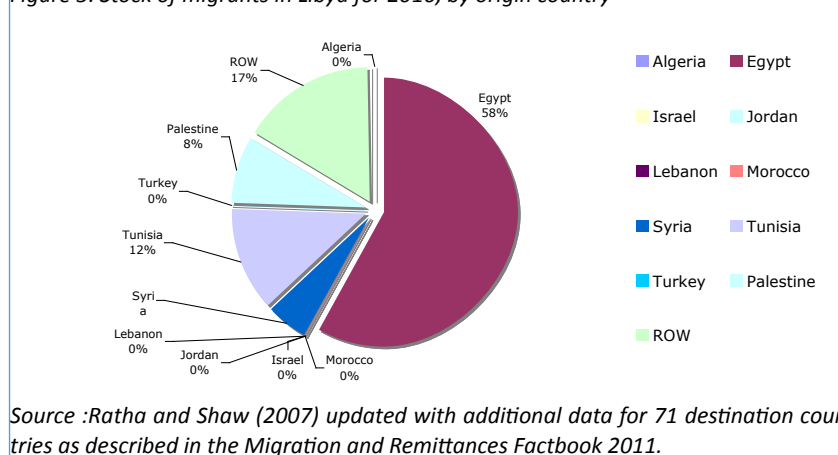
Source: EIU, estimations for 2011

**tries concerned by political stability issues** though to a lesser magnitude, they include Morocco and Israel. The former has been facing protests recently for more democratic reforms and has been mostly affected by the April 29th bombing which has tarnished its image of stability and scared investors, in the short-run at least, leading to an estimated FDI decline of 10% in 2011 to 1.95bn US\$. The latter is expected to see a slight increase to 5.8bn US\$ which remains far from the 15.3bn US\$ worth of FDI in 2006. The cohesion of the coalition in Israeli politics is being constantly put to test and the ousting of Hosni Mubarak provides scepticism as to future Israeli relations with its neighbours, a fact that might explain the reticence of foreign investors.

**Secondly**, there is a group of countries with **solid investment outlook** for 2011 due to an image of political stability that has not been yet affected, either due to democratic efforts or because of the wealth of the domestic economy,

guaranteed to generate revenue even when the region is at an unstable phase. Among this group are Turkey and Jordan. The first has traditionally been a case apart in terms of FDI attraction, primarily due to the size of its economy and the efforts conducted in recent years in terms

Figure 5. Stock of migrants in Libya for 2010, by origin country



Source :Ratha and Shaw (2007) updated with additional data for 71 destination countries as described in the Migration and Remittances Factbook 2011.

Table 4. Mediterranean partners exports to their neighbours in 2009

	Exports (value)	share in total exports (%)
MPs to Algeria	\$2 873 015 027	2,15
MPs to Egypt	\$3 604 810 799	2,69
MPs to Israel	\$177 054 218	0,13
MPs to Jordan	\$312 386 427	0,23
MPs to Lebanon	\$1 401 861 932	1,05
MPs to Morocco	\$1 607 880 994	1,2
MPs to Palestine	\$167 389 353	0,12
MPs to Syria	\$2 826 064 014	2,11
MPs to Tunisia	\$1 478 131 612	1,1
MPs to Turkey	\$4 285 120 700	3,2

Source : COMTRADE

of increasing macroeconomic and political stability. Thus, foreign capital inflows in Turkey should increase by 29.4% in 2011 to 12bn US\$, which remains however far below the pre-crisis value of FDI. As for Jordan it faces an FDI growth estimated at 6%.

√ The political and social climate in the region could affect on the number of **tourists** for MP's where unrest has not occurred. For instance, in Lebanon, recent data from the Ministry of Tourism suggests tourist arrivals in the first six months of the year were down by almost 20% compared to the same period of 2010. It appears, the impact affected the hotel industry, but also real estate, construction, transport, retail and other services sectors (EIU). But, at the time this report was written, estimations indicate that the tourism sector in the rest of MPS has not been overly affected. In Morocco, prior to the April 29th bombing, estimations were pointing towards an 8% revenue growth for the sector, with arrivals about 10% higher than in 2010. However, since the attack there was some concerns as to tourists progressively cancelling their trips with a possibility that this would affect the service balance. But, tourist revenue in Morocco in the January-July period rose by 8.5% to 33.1 billion dirhams. Interestingly, one should note that the Arab spring is fuelling a « Turkish summer » as Saudis, Kuwaitis and other tourists from

the Gulf states who would have previously spent summers in Syria or Egypt look further north. Bookings from Saudi Arabia and Kuwait were up by 75% and slightly before the beginning of Ramadan, hotels in Istanbul and the northwestern city of Bursa were fully booked (Guardian.co.uk, Monday 25 July 2011).

√ Overall, data on tourist trends for the entire region is limited and mostly seasonal which means that the final amplitude for the year 2011 is still far from known.

## 2. Unemployment pressures on the rise in Egypt, Syria and Tunisia

The revolutions have shown clearly that unemployment across MP's has increased and it has done so more than in the past. Meanwhile, the resulting political instability impedes on investments that provide employment creation opportunities. Thus, the Mediterranean region faces an immediate challenge : it must match the increasing demographic growth and the rise in the labour force in a context of instability that halts economic activity and thus employment. In 2011, the number of jobs in the region is expected to increase less than the workforce (2.2% versus 2.7%). This, along with the recent layoffs of temporary workers following the revolutions, explains why unemployment has been on the rise throughout 2011 after marking a fall during the prior year. As a consequence, the total number of the unemployed is expected to grow by more than 6.5% in the entire region (figure 7). A new level of unemployment is expected to be reached that is above the 12% mark in selected MP's, primarily those from which the protests originated.

In Egypt, Syria and Tunisia the revolutions brought an immediate increase in unemployment figures. The average rate of unemployment in these three countries increased throughout the first months of the year and is anticipated to reach 12.1% in 2011 (versus 10.1% in 2010). In Egypt,

**Box 2. Current Account deficit widens but trade channel has limited effects**

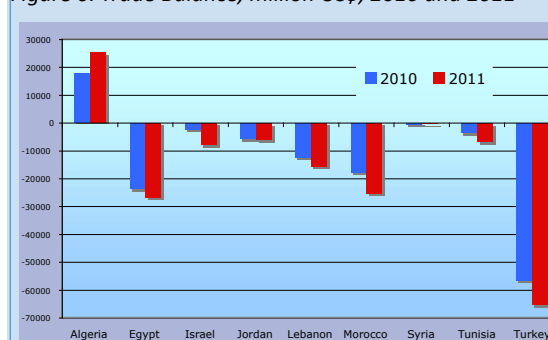
*In MP's, the external current account deficit is expected to widen from a simple average of -3.4% of GDP in 2010 to -6.2% in 2011. This deterioration is greatly due to a sharp drop in earnings from tourism, in countries such as Egypt, Lebanon, Syria, and Tunisia, and a substantial increase in the import bill following the rise in oil prices (especially in Jordan, Morocco, and Lebanon) (IIF, 2011).*

*Following the recent uprisings in Egypt and Tunisia one would ask if exports would constitute an important channel that would negatively affect growth. Surprisingly, one should note that while in Egypt the disruption to exports is considerable the same cannot be said for most countries of the region.*

*On the one hand, Algeria and Turkey keep following their post-international crisis upward trend with impressive export-led growth. In the former, this is greatly due to rising oil-exports, which traditionally amount to more than 90% of Algerian total exports, following consecutive oil-price increases. As for the latter, improved conditions in European markets and relative domestic political stability have contributed to 26.5% percent year-on-year rise in exports in April 2011. Overall, in the first four months of 2011, exports rose by 22.4% to 43.3 billion U.S \$. To a lesser extent, Morocco also keeps benefiting from the rise in trade. In 2010, most export sectors saw a rise in traded value (with the exception of energy exports) and preliminary data for early 2011 suggests that exports are anticipated to rise by 13.5%. This rate of export growth is however lower than the one achieved in 2010 or prior to the international crisis, a fact that also applies to the Lebanese and Syrian cases which registered positive growth in 2011 though below traditional levels.*

*The limited impact of uprisings on exports of the rest of the region can be partly explained by the fact that MP's exports to their neighbours only account for a marginal share of total exports. As highlighted in Table 4, MP's exports to Egypt amounted to roughly 3.6bn US\$ in 2009 which is less than 3% of regional exports to the entire world. Meanwhile, regional exports to Tunisia only amount to 1.1% of total exports.*

Figure 6. Trade Balance, million US\$, 2010 and 2011



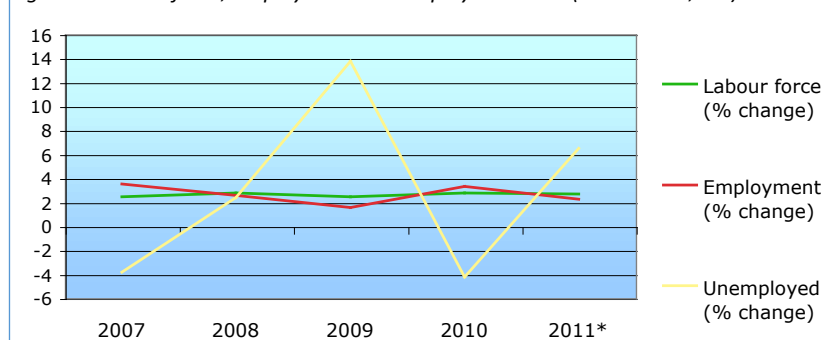
Source :EIU, estimates for 2011

*Thus, the limited South-South trade integration has also reduced the risk of contagion from the closing of ports and reduced economic activity in countries of the Arab spring.*

*Nonetheless, imports are increasing throughout the region, stil faster than exports, increasing the disequilibrium in the external balance. One thing appears for certain, the region is still an import-dependent one, and would gain by increasing its exports volume with major trading partners such as Europe. Uptil now, a number of MP's have build on existing agreements to promote integration with foreign markets. But such efforts have mostly favoured European exports while access to markets that would provide for increased export potential for MP's (such as agriculture) remain closed. Until now there have only been limited cases in which MP's took advantage of their geographical proximity to the EU to promote exports, an exception to be found in the textile and fast-fashion industry.*

*as the private sector laid-off many temporary workers, there was a sharp increase in unemployment (to approximately 12% in Q3-FY11 up from 9% the prior year) particularly for men and in urban areas (16% up from 12.5% a year ago). Meanwhile, in Tunisia, it was announced that the number of jobless people would probably reach 700000 in 2011, a 34% increase compared to the 520000 jobless in the prior year. During the revolutions, 10000 jobs were already lost, while some positions remain frail, meanwhile the Libyan conflict saw the return of thousands of Tunisians which added pressures to the domestic labour market (TunisiaLive, 2011). Additionally,*

Figure 7. Labour force, employed and unemployed in MPs (% variation, an.)



Source : FEMISE calculations, EIU

growing employment demand is also expected from the rising inflow of university graduates. Thus, unemployment is estimated to reach an unprecedented 16% in 2011, from 13% the prior year (EIU).

But, in the rest of the region unemployment is expected to remain close to its 2010 levels. This relative resilience can be explained by the fact that these countries have not endured revolutions that are of the same magnitude as in Egypt and Tunisia. Revolts, while still expressing a social incomfort, have been of a lesser magnitude. Meanwhile, events in the core countries of the Arab spring have pushed the authorities in the rest of the region to adopt measures that could help avoid political instability in the short-run. For example, the recent Algerian Complementary Finance Act should provide support to small firms for more employment creation in the northern territory, in high altitude and in southern provinces that have been neglected in the past. It should also ensure the expansion of the existing price subsidy mechanisms for consumption products to help Algerians in difficulties.

One could fear that the revolutions in Egypt, Syria and Tunisia could signify an increase in returning migrants to other MP's putting additional pressures to the domestic markets. But, as seen in figure 9, the interdependency of Mediterranean labour markets is limited at best. The stock of MP's migrants in the three selected economies is comprised of algerians (41%),

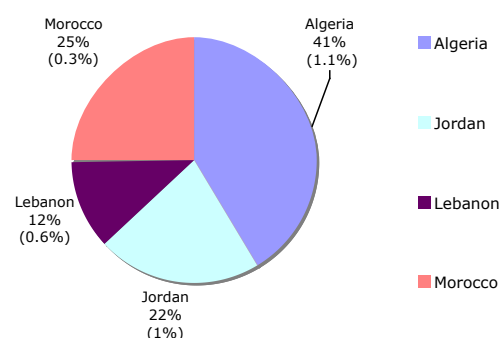
moroccans (25%), jordanians (22%) and lebanese (12%). But the share of migrants who chose to migrate in the countries of the Arab spring is very small, only 1.1% for Algeria followed by 1% for Jordan, 0.6% for Lebanon and 0.3% in Morocco.

One should note at this

point that Palestine is an exception to this rule. About 53.3% of palestinian migrants are located in the Arab-spring group of countries, thus, one should not rule out that the revolutions could mark an increase in returning Palestinian migrants to domestic territories or to other parts of the Mediterranean.

But overall, in the rest of the region unemployment is expected to average 9.4% in 2011, a slight decrease compared to the rate of 9.9% in 2010, considerably less than in the core countries of the revolutions. Still, the employment issue remains a major challenge for the Mediterranean as a whole. In that respect, for job creation to be sustainable and not just the result of sporadic attempts to ease short-term concerns,

Figure 8. Origin of all Mediterranean migrants (excluding Palestine) located in Egypt, Syria and Tunisia (2010, by origin country)



Source : FEMISE calculations based on Ratha and Shaw (2007), Migration and Remittances Factbook 2011.

Note : In parenthesis, ratio of migrants who chose to migrate in the countries of the Arab spring divided by total number of migrants.

a competitive private sector is probably needed (World Bank, 2009).

### 3. Inflation is likely to increase following international prices

As mentioned earlier, **inflation** has been a persistent problem in some of the Euro-med countries over the past few years. Headline and core inflation have accelerated recently across the region, mainly driven by higher international commodity prices which are expected to increase even further in the short-term. In general, inflation is primarily driven by higher global food prices which filter through domestic food prices, representing a large share of household budgets in MPs. The pass-through from international to domestic food price levels is high for countries such as Egypt and Palestine, but rather low in Tunisia and Algeria. In fact, a 1% increase in international food prices results into the domestic price of food rising by more than 0.44% in Egypt, 0.39% in Jordan and Morocco, 0.18% in Lebanon and 0.06% in Tunisia (World Bank, 2011).

As a result, the year-on-year inflation rate is expected to rise by 5.7% in the entire region, inflationary pressures will be substantial in Egypt, Syria and Tunisia (8.1% anticipated rise on average) while they will remain limited in the rest of MPs (4.5% rise expected for 2011). If such price shocks prove to be persistent, central banks will have to adopt a tightened stance of monetary policy. This could prove problematic for relaxing monetary policy required to boost domestic economic activity in the face of a possible recession. Upward pressure on policy rates will also come from a rising global interest rate environment and increasing sovereign risk premiums. A limited number of oil-rich economies, mainly Algeria, are expected to benefit from oil-price rises, but for the vast majority of oil-importing economies the rise in oil and food prices could materialize into a loss of roughly 3% of GDP (IMF, 2011b).

Table 5. Inflation and Fiscal Balances in MP's

	Inflation (CPI)		Fiscal Balance	
	(av, %)		(% of GDP)	
	2010	2011*	2010	2011*
<b>Arab Spring Frontrunners</b>				
<i>Egypt</i>	11,1	13,3	-8,1	-10,4
<i>Syria</i>	4,4	7	-4,4	-8
<i>Tunisia</i>	4,4	4	-4,6	-9,1
<b>Average</b>	6,6	8,1	-5,7	-9,2
<b>Rest of MPs</b>				
<i>Algeria</i>	3,9	4	-1,2	-2,1
<i>Israel</i>	2,7	3,4	-3,7	-2,4
<i>Jordan</i>	5	6,4	-8,2	-10,8
<i>Lebanon</i>	4	5,2	-7,4	-9,9
<i>Morocco</i>	1	2,2	-4,7	-6
<i>Turkey</i>	8,6	5,9	-3,6	-1,5
<b>Average</b>	4,2	4,5	-4,8	-5,5
<b>Total average</b>	<b>5</b>	<b>5,7</b>	<b>-5,1</b>	<b>-6,7</b>

Source : EIU

Commodity price increases have implications for the sustainability of subsidy schemes, which are widespread in some countries of the region and exert continuous pressure on the fiscal budget. In Egypt for instance, food subsidies amount to about 2% of GDP while fuel subsidies are close to 8%. Both subsidy systems are considered to be poorly targeted towards the poor, benefit the rich more than the poor and suffer from considerable leakages (World Bank, 2010). In light of recent developments, previous plans to remove subsidies have been suspended in the short-term and subsidies are not expected to decline, if not increase, in 2011. In Egypt, an increase in subsidies of about 0.2% of GDP was announced due to the rise in global food prices (World Bank, 2011). Meanwhile, Moroccan authorities announced that US\$2 billion worth of subsidies would be injected to avoid massive price-rises for staples. Similarly, in Jordan additional subsidies worth US\$ 550 million were announced to



subsidize the price of sugar, as well as of rice and frozen poultry.

Several MPs have, or are expected, to revise their fiscal laws and increase their fiscal deficits to address social constraints. Furthermore, civil service wage and pension increases, additional cash transfers, tax reductions, and other spending increases are being put in place to prevent discontent arising from regional instability and socio-economic conditions. For instance in Syria, a decree was issued providing government employees pay rises within the 20%–30% range, while payments to retired military personnel and government employees were promised. Meanwhile, in Jordan the salary of civil servants, the military, and retirees was raised by 28US\$ a month, for a total cost of 233 million US\$. Such measures are considered essential to at least provide for a short-term relief. But as a consequence, fiscal budgets are again being strained by such expansionary fiscal measures.

All of the MPs have been operating with persistent negative fiscal balances. Only Algeria, Israel and Turkey manage to relatively contain their deficit, estimations for 2011 suggest a fiscal deficit respectively of -2.1%, -2.4% and -1.5%. Leaving these countries aside, 2011 prospects point to a deterioration of deficits to minimize the social impact. The political upheaval in the region, combined with weaker economic activity, is expected to widen the fiscal deficits of the frontrunners of the Arab Spring to

Table 6. Fiscal Policy Measures Announced between end-2010/ late March 2011

	Subsidies	Social Welfare and/or Cash Transfers	Government Salary/Benefit Increases	Tax Breaks or Other	Annual Cost (Percent of GDP)
Algeria	Yes	Yes	Yes		Increased public spending by 25% of GDP
Egypt	Yes		Yes	Yes	0.8 of GDP
Jordan	Yes	Yes	Yes	Yes	2.1 of GDP
Lebanon				Yes	1.0 of GDP
Morocco	Yes	Yes			
Syria		Yes	Yes	Yes	2.0 to 3.0 of GDP
Tunisia	Yes	Yes		Yes	1.4 of GDP

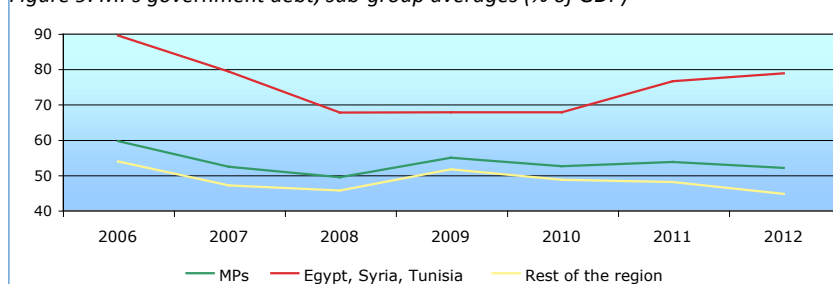
Source : IMF (2011c), World Bank (2011), Notes: Annual cost does not include higher costs of preexisting subsidies owing to higher commodity prices.

an average -9.2% deficit in 2011, from -5.7% in 2010. But now that MPs are running even higher deficits there is a danger of making budgetary cuts in initiatives that would favour infrastructural development and employment creation. On the whole, the long-awaited fiscal reforms will have to wait a little longer in those countries, especially in Egypt where the fiscal balance is anticipated to reach a negative -10.4% in 2011 according to EIU.

#### 4. Outfall on debt, foreign reserves and exchange rates

Naturally, the extent of the deterioration of the fiscal balance has an impact on debt. More so than an economic issue, the extent of the deterioration of public accounts can increase threats to the social stability of MPs. While some MPs can afford this extra spending, others have a

Figure 9. MPs government debt, sub-group averages (% of GDP)



Source : FEMISE calculations, EIU

Table 7. External debt in MP's					
	Total external debt		Total external debt		
	(% of GDP)		(bn US\$)		(% variation)
	2010	2011*	2010	2011*	2010-11
<b>Arab Spring Frontrunners</b>					
Egypt	15,7	14,5	35,3	36,9	4,5
Syria	n.a	n.a	n.a	n.a	n.a
Tunisia	53,2	56,3	21,5	25,9	20,5
Average (weighted)	18,1	19,5	28,3	32,8	15,901
<b>Rest of MPs</b>					
Algeria	2,9	2,4	4,3	4,4	2,3
Israel	48,7	43,7	106,1	107,9	1,7
Jordan	29,4	26,8	7,3	7,3	0
Lebanon	n.a	n.a	n.a	n.a	n.a
Morocco	29,7	30	27,1	29,6	9,2
Turkey	39,6	43,8	290,8	313,9	7,9
Average (weighted)	34,9	34,5	86,9	92,9	6,9
<b>Total average (weighted)</b>	<b>31,5</b>	<b>31,5</b>	<b>70,1</b>	<b>75,7</b>	<b>8</b>
Source : EIU					

very limited fiscal space and will have to rely on external financing that is expected to put an additional burden on debt.

Government debt as a share of GDP is expected to remain stable in the region as a whole. In 2010 it averaged 52.4% of GDP and is expected to slightly increase to 53.6% of GDP in 2011. Even so, in the countries of the upheavals the ratio has been on the rise and could go as far as 76.4% of GDP in 2011, up from 67.6% in 2010. The country with the highest total public debt in terms of GDP among the three countries being Egypt, with an anticipated 92% debt/GDP ratio for 2011 (EIU). Even so, MPs have in the past used a share of their growth to clear debts (FEMISE, 2009). Thus most of them have regained some space and remain below the levels that were prevalent 5 years ago. Thus, although the forecasts for 2011 indicate an increase in public debt in Egypt, Syria and Tunisia

the levels will still remain well below those of the recent past. This is a situation that allows for some leeway when compared to the one of large industrialized countries.

As for external debt a similar pattern has been followed, with stable regional perspectives at 31.5% of GDP and an increase in the countries of the Arab Spring. Meanwhile a very slight decrease in the rest of the region is expected (to 34.5% of GDP) though this is primarily due to the considerable reduction in Israeli external debt. Apart from Israel, Jordan and Algeria, who managed to reduce their debt in relation to GDP, all other MPs are expected to see a rise. Thus, some MPs could face difficulties in servicing debt denominated

in foreign currency. If the trade balance stays negative and if foreign capital remains hesitant towards the Mediterranean then a lack of liquidities could manifest and foreign reserves could be reduced.

In most MPs, exchange rates, even those of the Arab Spring, have not come under significant pressure with serious repercussions on external sustainability. However, if the unrest continues, then further downward pressure could occur even in countries where currencies have not been affected (EIU). If foreign capital remains hesitant towards the Mediterranean, then a shortage of liquidity could occur and foreign reserves could be diminished.

However, this sustainability of exchange rate appears to have been achieved at the expense of foreign re-



serve depletion. This already appears to be the case in Egypt where the Central Bank drew around US\$ 8 billion of official reserves between January and May 2011, bringing official reserves down to US\$ 27 billion, its lowest level in three years, and covering only 6.5 months of imports. The import cover ratio is expected to increase to 7.5 months in 2011. In Tunisia, Foreign exchange reserves excluding gold in Tunisia fell to 9.39bn US\$ in April 2011, equivalent to a 13.1% decrease in three months (EIU). Total international reserves would cover for 4.4 months of imports but their fall signifies that the import coverage ratio could fall below 4 months for Tunisia. The exchange rates are likely to come under further downward pressure, as a result of a worsening of market expectations due to uncertainty. A large depreciation could induce large pass-through effects to domestic inflation. Alternatively, intervention through reserves to limit the depreciation is dependent on the stock of foreign exchange reserves.

As for the rest of MPs the situation is not worrisome. Most particularly, in the case of Algeria foreign exchange reserves amount to more than 3 years of imports of goods and services and are still on the rise following the continuous increase in oil-prices.

Finally one should note that regarding exchange rates, if a situation of unrest is sustained in most

Table 8. Exchange rates (monthly, average), domestic currency to US\$ and €

	2010-8	2011-1	2011-8	Variation (2010-08 to 2011-08)
Egypt:US\$ (av)	5,69	5,80	5,95	4,6
Israel:US\$ (av)	3,79	3,58	3,54	-6,6
Morocco:US\$ (av)	8,57	8,32	7,86	-8,3
Tunisia:US\$ (av)	1,48	1,44	1,38	-6,8
Turkey:US\$ (av)	1,57	1,56	1,60	1,5
Israel:€ (av)	4,89	4,79	5,09	4,1
Morocco:€ (av)	11,07	11,14	11,27	1,8
Tunisia:€ (av)	1,89	1,92	1,97	4,2
Turkey:€ (av)	1,92	2,09	2,30	19,7

Source : EIU, July for Egypt,

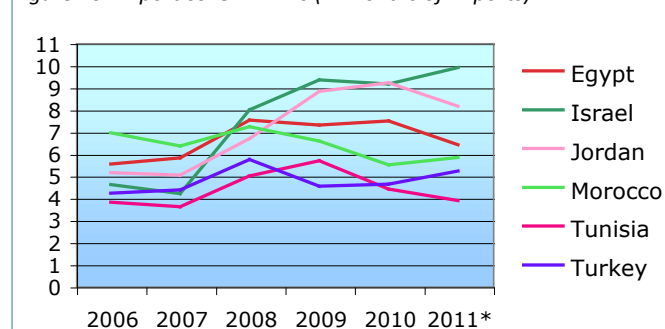
MPs, then downward pressures could be applied even in countries where currencies have remained resilient until recently (EIU).

## 5. Higher risk in financial and credit markets, threats to banking sector stability

We shall note that the share of international finance is rather limited in the region with few exceptions. There is an important dilemma that MPs have to face: on the one hand, the use of international capital markets is needed to cover financing needs and maintain the volume of investment, on the other hand, it requires convertibility of the capital account, hence more volatility and dependence towards market expectations, in a context of social and political tension.

One must note that challenges to macroeconomic stability—if not addressed quickly—could undermine confidence, lead to a widening of credit-spreads and consequently derail the pursuit of any new social agenda. Uncertainty brings extreme caution from foreign investors who choose to halt FDI and portfolio flows, affecting growth and the financing of current account deficits, consequently putting non-negligible pressures on the credit profiles of MPs such as Egypt.

Figure 10. Import cover in MPs (in months of imports)



Source : FEMISE calculations, EIU, IMF

Table 9. Selected CDS Spreads, basis points, 5-year maturities

	End Dec, 2010	Recent data*
Egypt	243	311
Israel	115	140
Lebanon	305	351
Morocco	126	172
Tunisia	120	176
Turkey	140	174
Ireland	609	792
Portugal	501	798
Greece	1010	2100

Source : IIF (2011), CMA (2011), \* data from Q2 2011

The turmoil across Arab nations has raised risk premia in the financial markets of all MPs. Among MPs, CDS spreads have widened for Egypt (311 bps), which was more integrated in international finance than some of its neighbours, and Lebanon (351 bps), but remain within lower levels in the rest of the region even if they are on the increase (140 basis points for Israel, 172 basis points for Morocco and 176 basis points for Tunisia). Furthermore, the levels attained across the region remain well below the spreads in Ireland, Portugal, and Greece. Even so, the Mediterranean region appears to be witnessing a “repricing of the political risk,” increasing the volatility of agents’ anticipations through the rise in CDS spreads (Wall Street Journal, 2011).

Stock markets throughout the Mediterranean were hit hard by the unrest, particularly in the first half of March 2011. One must note that MPs markets have traditionally not attracted a considerable share of international portfolio flows, due to relative lack of development and access. But, both Egypt and Tunisia had become a destination of interest for investors. Following the revolution the Egyptian stock market suspended its activity and then saw a massive cash outflow, meanwhile the impact on the Tunisian stock exchange could be qualified as an unparalleled one as well.

The problem is the following: investors might be «wary of companies that are too associated» with the old regimes. As noted earlier, in Egypt, more than 70 top businessmen were part of the old parliament while in Tunisia about 180 companies were controlled by associates of the Ben Ali clan. As a result, a blacklist of companies associated with the old regimes has been in the hands of new authorities. But, it appears that a certain number of successful companies had maintained good relations with the prior political regimes. Thus, some also show concerns that more capital outflows could be following, resulting from the recent effects conducted by Mediterranean countries’ domestic authorities (Reuters, 2011).

Figure 11. MPs stock-market developments



Source : Bloomberg

Table 10. Banking Sector Indicators (2009)

	Bank overhead costs/ Total Assets	Net interest margin	Bank concentration	Bank ROA	Bank ROE	Bank Cost- Income ratio	Bank Z-Score
Algeria		0,114	1	0,103	0,799	0,97	10,942
Egypt	0,039	0,03	0,53	0,061	0,059	0,425	2,409
Israel	0,021	0,024	1	0,014	0,224	0,614	37,991
Jordan	0,021	0,035	0,862	0,014	0,085	0,419	13,651
Lebanon	0,012	0,013	1	0,018	0,063	0,515	18,914
Morocco	0,013	0,034	1	0,01	0,221	0,36	
Syria	0,031	0,038	0,33	0	0,03		
Tunisia	0,018	0,04	0,591	0,336	0,831	0,331	6,745
Turkey	0,037	0,043	0,392	0,021	0,517	0,297	21,35
MPs	0,024	0,041	0,745	0,064	0,314	0,491	16
Lower Mid. Income	0,043	0,06	0,687	-0,014	-0,167	0,614	10,126
High Income	0,027	0,025	0,786	0,095	0,208	0,639	11,749

Source : World Bank Financial Structure Database

Investors are also preoccupied with the situation in Arab countries in which there have been protests, but no regime change as in the case of Morocco. The stock-markets of Jordan, Lebanon and Morocco also followed downward paths, suggesting the existence of a general lack of confidence of investors towards a politically tense region.

Prior to the revolutions, the MPs displayed similar indicators with respect to banking sector cost and performance. As seen in Table 10 overhead costs as a share of total assets were in the region roughly around 2.4%, close to high income countries. However they were much higher in Egypt (3.9%) and Turkey (3.7%). The net interest margin averaged 4.1%, but dropped to 3.2% when Algeria was excluded, which means that the cost of financial intermediation is closer to developed countries and lower than the one in other lower middle income economies. Finally, regarding the cost to income ratio, the Mediterranean average bodes well, with an overall at 49.1%.

Regarding banking performance, the Return on Assets (ROA) averaged 6.4% for MPs, but dropped to 2% when excluding Algeria and Tunisia. In the Return on Equity (ROE) indicator, one would find

solid performance of banks in Tunisia, Algeria and Turkey while ROE in Syria, Egypt and Jordan is of lesser magnitude.

The z-score in most MP's, an indicator of bank stability (ratio of return on assets plus capital-to-asset ratio to the standard deviation of the return on assets) appeared to be above the average of high income countries suggesting the region as a whole has a more stable banking system. But, it was already below average in Egypt and Tunisia and now, following the revolutions, the Egyptian and Tunisian banking sector's outlook looks worrying, with five Egyptian banks downgraded and five Tunisian banks given a negative outlook (FEMISE, 2011). Both Moody's and Standard & Poor's attributed a downgrade of Egypt's foreign-currency deposit ceiling to B1 from Ba3, the bank financial strength rating (BFSR) of the National Bank of Egypt was downgraded to D-, while it was downgraded to E+ for Banque Misr, remained at D- for Banque du Caire but with a negative outlook, while it was also downgraded for the Commercial International Bank to D and for the Bank of Alexandria to D- (GFSNews, 2011). Furthermore global local currency ratings have seen a reduction as well.

Undeniably, the financial and banking risks have increased in the region. Perhaps more than ever, it is time for MPs to acquire « efficient credit markets » and promote policies that establish more discipline and stability. This could be done through a step-by-step approach by ensuring more stability for the banking sector, building market infrastructure, introducing a framework for competition and innovation, and finally allow for the sharing of risk with the private sector to correct for any possible market failures (World Bank, 2009).

But one should note that stability of the banking system does not necessarily mean one that offers « improved and open access to credit ». Authorities in MP's should also remove cumbersome regulations that increase the cost of bank lending to firms all the while ensuring that « sound risk management practices » are implemented (World Bank, 2009).

All in all increased access to finance can increase growth in Mediterranean economies. Macroeconomic stability is essential but policymakers can also foster growth by improving the banking sector and domestic stock and bond markets by improving the conditions to participate in financial transactions, strengthening legal frameworks for creditor and shareholder rights, streamlining insolvency regimes, developing both primary and secondary markets for government securities, removing excessive controls on credit and interest rates (IMF direct, 2011).

### **III. How democracy and credibility are expected to generate considerable gains**

Beyond the immediate challenges discussed in the previous section, the recent uprisings provide a great opportunity for a genuine democracy that could reverse the adverse short-run effects. The first section has shown that democracy could trigger many of the much needed reforms. What policies should the Euromed region adopt to reap maximum benefits of the revolution? In this context, the experience of CEE could be very rele-

vant. This section thus draws on their experience to stimulate the debate on the upcoming policy choices to be made and also suggests some areas of both short and long-term reforms required to ensure a smooth transition.

#### **III.1 What could MENA learn from CEE: Policy choices to be made**

The performance of CEE countries during the transition has fallen short of expectations mainly because they were the first to undergo political and economic transformations and had no benchmark either in theory or practice to assess their performance or guide the process. As a result, the economic problems they faced were underestimated and policymakers had to take a number of policy measures in a context of acute uncertainty. In fact, there have been controversies about the speed of reforms, privatization methods, the role and organization of the government. These controversies were not only ideological but also reflected to a large extent the initial ignorance and unpreparedness of policymakers and economists with respect to the large-scale institutional changes implied by the transition from communism to capitalism (Roland, 2001).

Yet, while the countries had to rely on “learning by doing”, their experience could serve as a learning experience for the Euro-med. This section does not give straight answers but aims at triggering the debate on some the political choices that need to be made to build democracy and ensure credibility gains.

##### **1. Stabilization and liberalization are important for recovery**

From the outset of transition, there was little doubt on the reforms to be adopted. They fell into two types according to Svejnar (2002). Type I reforms aimed at shifting economies from central planning to market economy. They typically focused on: (i) macroeconomic stabilization (including inflation stabilization, restrictive mo-

netary and fiscal policies, adoption of a single exchange rate), (ii) structural reforms including price liberalization and, (iii) dismantling the institutions of the communist system. Most countries also removed barriers to trade and creation of private firms and banks.

Macroeconomic stabilization and price liberalization were associated with improved economic performance but it was less effective in economies where public finances remained weak (De Melo et al., 1996 and 1997; and Havrylyshyn and van Rooden, 2000, Fischer and Sahay, 2000). Moreover, economic liberalization has been an important element of stabilization, even at the expense of some short term losses, which were offset by long-term gains from economic liberalization (De Melo et al., 1996 and 1997). In particular, liberalization has permitted the allocation capital and labor from industry towards services, many of which were previously repressed, and this contributed to a quicker recovery. It is also important to mention that CEE benefited from an external long-term anchor, being EU accession, which motivated rapid progress of macroeconomic reforms through the nominal convergence and structural criteria which imposed long-term constraints on fiscal laxity and macroeconomic policies (Deppler and Schiff, 2002).

Type II reforms focused on institutional reforms including the development and enforcement of laws, regulations and institutions that would ensure a successful market-oriented economy like establishing labor market regulations and institutions related to public employment and retirement schemes, property rights and market competition as well as a healthy financial system. They also included privatization of large and medium enterprises. It is worthwhile to note that these reforms are no substitute for good economic policies or type I reforms. In fact, country experience showed that institutional reforms accelerated once liberalization efforts had been comprehensively implemen-

ted. In other words, the development of an institutional framework (rule of law, property rights, competition and bankruptcy laws) has a positive impact on growth after macroeconomic stabilization and adopting reforms are achieved (Havrylyshyn and van Rooden, 2000).

Most CEE countries adopted type I reforms but two factors determined whether a country could adopt II reforms: their ability to collect taxes with which to finance reforms and their ability to minimize corruption and rent-seeking behavior. In particular, type II reforms required that government had some resources to set-up market institutions, enforce laws and legal framework and to avoid being dominated by special interests (EBRD, 1999).

On the one hand, the frontrunners of the revolution seem to be less in need of type I reforms than the CEE. This is not to say that stabilization measures, particularly fiscal and inflation, is not warranted. However, some countries like Egypt and Tunisia have already started their transition to the market economy before the revolution, as early as the 1970s for Egypt. Moreover, economic reforms and structural adjustment programs implemented with international financial institutions in the 1990s involved some price liberalization, trade openness, privatization and promoting the private sector as well as a restructuring and strengthening of domestic financial systems. However, the transition to the market economy is not fully complete since the private sector is still weak and food and energy subsidies still exist. On the other hand, the absence of market-supporting institutions (especially absence of competition and a sound legal framework for private sector development and law enforcement) shows that most countries of the region seem in dire need of type II reforms. In fact, weak market institutions have created an arbitrary business environment where only a privileged few were able to benefit from economic gains.

## **2. “Big bangs” or “gradualism” in the adoption of reforms?**

While there was some consensus on the reforms to be adopted, a major debate took place about how to do it: “big bang” or “gradualism”. On the one hand, big bangs meant undertaking as many reforms as possible in the shortest time possible. It was assumed that such an approach would quickly establish functioning markets, induce firms to restructure, facilitate private sector emergence and thus create a strong demand for supporting institutions. It was also believed that the quick adoption pace of painful reforms would guarantee against policy reversal and stagnation (World Bank, 1996).

The merits of this approach are that it ensures policy complementarity (i.e. to be fully effective, most measures must be implemented together), it reduces policy uncertainty related to delays in reform implementation which may lead to greater inefficiency and finally it allows to exploit the political window of opportunity during which « extraordinary » reforms could be adopted with greater tolerance from the population to economic hardships in the short-run and before opposing groups are mobilized (Wyplosz, 2000 and EBRD, 1999). However, the main risk of this shock therapy is the large adjustment costs in terms of unemployment and fiscal deficit (as the government compensated the losers of reforms) but also exchange rate fluctuations and political credibility (Wyplosz, 2000 and Dewatripont and Roland, 1992).

On the other hand, gradualism implies slower partial reforms and thus lower adjustment costs. The sequencing of reforms could be helpful if some reforms are pre-conditions for others, like the need for sound institutions and a well-functioning financial system for the emergence of a private sector. Moreover, sequency could help build credibility when reforms prove successful, thus building supportive constituencies for future reforms (Roland, 2002).

However, the risks of this strategy is that partial reforms – making markets and central planning coexist for a while - would preserve rents and create powerful vested interests that could block further reforms (EBRD, 1999). In practice, those countries that enacted reforms early and quickly recovered faster (De Melo et al., 1996 and Wyplosz, 2000).

To conclude, most transition economies opted for the big bang approach but that this meant that it was feasible for them, given their starting circumstances (Svejnar, 2002). The decision often reflected a trade-off between the financial cost and political constraints of reforms versus the immediate gains of reforms. In part, some failed performances of partial reforms in the past as well as an overall level of chaos “combining a disintegrating economy with a rapidly weakening government” reduced the scope for gradualism (World Bank, 1996). However, a very important lesson is that regardless of the approach adopted, sustained and consistent reforms pay-off.

## **3. It is not just about policies, initial conditions matter for recovery**

The previous sections showed that the great variation among the reconvert of CEE economies was in part due to the speed and nature of reforms. However, the more challenging the country-specific initial conditions (such as large macroeconomic distortions, inherited economic structure and institutions as well as interdependence with the communist trade system), the larger are the costs of change and this makes reforms more difficult to be accepted (Fidrmuc, 2003; Fischer and Sahay, 2000; and De Melo et al., 1997) find that severe initial macroeconomic and structural distortions are associated with slower reforms and economic performance.

Some initial conditions for the Euro-med are better than for CEE. Their economies may still suffer from macroeconomic distortions such as

widespread subsidies, structural fiscal deficits, and weak market institutions, but as mentioned earlier, their transition to the market economy had started decades ago. This stands in sharp contrast to the CEE economies which had to make a complete shift in their economic system, from communism and full-fledged central planning to free markets. Such factors are likely to make the Euro-med transition smoother and less costly. However, citizens in most CEE economies were better-educated with almost universal primary and lower secondary enrollment, high levels of literacy and impressive levels of engineering skills – is likely to complicate the transition towards democracy (World Bank, 1996). In general, it has been found that the tendency for democracy increases with the level of schooling (Barro, 1999). This is because poorly educated citizens have received less “civic culture” and have thus less aptitude to understand political content and are thus less likely to participate in political life and this could weaken support for democracy (Glaeser et al., 2007).

#### **4. What role for the state during the transition?**

In many Euro-med countries, the “old state” has failed in terms of providing them with a decent standard of living. It is perceived to be corrupt, distributing the economic gains to a privileged few. In other words and as mentioned in the beginning of the chapter, it had limited success in employment and social policies.

In order to ensure a smooth transition towards democratic capitalism, the CEE experience showed that there is a need to recreate trust in the state (World Bank, 1996). In other words, there is a need to balance between the need for a strong/credible law-enforcing state and the need for constraints on state power to prevent abuse of power and ensure individual rights. In the immediate term, the government has a responsibility in stopping organized crime and this should help it build credibility. This requires strict law enforcement and an

efficient and law-abiding security apparatus. In the longer-term, constraining the power of the state can occur with strengthening rule of law. The government itself must be ruled by law and trusted not to intervene arbitrarily in markets and deliver on its obligations (World Bank, 1996). An important element is curbing corruption. Judicial reform is also crucial for dispute resolution, law enforcement and oversight of political reform and would also help the development of the private sector.

Second, as reforms that will complete the transition towards market-economy take place, the government has a responsibility in providing social protection. Because the CEE transition created some “losers” and led to increasing poverty and inequality, governments put in place unemployment compensation and social security benefit schemes, measures that also increased support for reforms (Svejnar, 2002 and World Bank, 1996). During the transition, social expenditures were maintained (education and health) and others rose (energy and housing allowances replaced subsidies) (Fischer and Sahay, 2000). As mentioned earlier, current levels of spending on human capital are low in many Euro-med countries and should be increase to improve outcomes, especially in education. This will exert even more pressure on weakened public finances.

#### **5. To borrow or not to borrow?**

An important debate taking place in some of the frontrunners of the revolution is whether or not to rely on external financing to finance reforms during the transition. The same debate took place in CEE during their transition, especially that private capital inflows were very limited in the absence of Western guarantees (Svejnar, 2002b). And while CEE economies never benefited from a major assistance program like a “Marshall plan”, they borrowed for balance of payments and budgetary support and debt relief and to support stabilization policies or and to finance institutional reform (Svejnar, 2002b). Developed economies have already shown in-

terest in providing financing for the Euro-med region. During the G8 summit (in Deauville in May 2011), they decided to give US\$40 billion in assistance over three years (20 billion in the form of multilateral assistance and 20 billion as bilateral assistance) to support democratization efforts in Tunisia and Egypt. In addition, the IMF stands ready to allocate about US\$ 35 billion to the region if requested (IMF, 2011c). Clearly, the transition process is of great concern for developed nations since prolonged political instability and unrest could result in a mass exodus of populations to EU countries. Also, for the United States, it would be preferable to ensure a path to democracy than see the rise of extremist political actors to power (IPS, 2011). However, external assistance is nationally resisted in some countries (namely Egypt) because of loan conditionality, and there is a preference for a home-grown path for development.

To conclude, this section has shown that in the case of transition, it is crucial to adopt stabilization policies early and quickly, that institutional reforms can be adopted once the economy stabilizes, that the country needs to have the financial resources to finance reforms and that initial conditions are determinant of economic recovery. Also, the government has a responsibility in providing social protection to mitigate economic hardship related to reforms. External borrowing could be an option but should have public support. Finally, initial conditions related to initial macroeconomic distortions and imbalances are less challenging in the Euro-med than for CEE. However, the absence of a long-term anchor and poor human development may slow down the transition pace.

### **III.2 The Euro-med economies: the way forward**

The social and political turmoil in the Euro-med region has interrupted the recovery from the effects of the 2008 financial crisis. More particularly, the heightened uncertainty is affecting the region's short-term economic prospects. This

chapter has argued that there will be short-term costs in the transition phase, especially with respect to output growth, unemployment, public and external finances. This means that the policy reforms could be painful and their rewards are likely to occur slowly. In the long-term, gains from democracy could put the region on a path of sustainable development.

However, how can this help draw some policy recommendations for the transition in the Euro-med?

In the **short-term**: first, political certainty and security are crucial pre-requisites for economic improvements. The announcement of a detailed political transition road map can help reduce uncertainty but also build credibility of the political authorities. These two factors are important for long-term consumption and investment decisions but also for the return of foreign investors and tourists.

Second, it is crucial (particularly for the frontrunners) to quickly stabilize the economies. On fiscal policy, as it may be difficult to reduce public expenditure in the short-run, changing their composition could be helpful in stimulating the economy (Galal, 2011). In particular, increasing spending on education could have high returns since the initial level is low. On monetary policy, it is critical to manage upcoming challenges including curbing inflationary pressures, dealing with downward pressures on the pound (which requires an easing of monetary policy) and accommodating the economic slowdown. Once stabilization occurs, institutional reform can follow at a later stage. This is likely to take years to pay off.

Third, governments must quickly implement measures that ensure employment creation and improve rates of employability especially for the youth. In addition to youth oriented training programs and tax incentives to SMEs, estimations (IMF, 2011a) suggest that an investment in labor-intensive infrastructure of 1% of GDP



could create about 87 000 new jobs in Egypt and 18 000 jobs in Tunisia in the short-run. Also, incentives to private sector firms through a temporary holiday on payroll taxes and temporary on-the-job training subsidies may help increase hiring. Other short-term measures could include introducing a minimum wage to ensure that employment guarantees a decent standard of living people out of poverty (Galal, 2011).

Fourth, major changes in social policies must accompany the move to the market to relieve poverty and to counter the adverse effect of reforms. Governments must put in place compensation mechanisms for the « losers » of reforms related to trade openness and that may exacerbate social imbalances (Reiffers, 2011). However, such schemes would provide temporary assistance to cushion the present shock and should not be allowed to reduce the incentive for the jobless to seek work.

Fifth, borrowing from international institutions could finance some of the reforms during the transition as long as the funds are used prudently and adequately (Galal, 2011). Dependence on foreign borrowing should be considered temporary until reforms create an environment that attracts private capital. Most international financial institutions use conditionality, a concept that is resisted in some countries, where there is support for home-grown reforms. Should there be public support for external assistance; the latter could be targeted in the following areas:

- √ Provide social support for those who endure economic hardships (pension reform and unemployment benefits),
- √ Reduce regulatory and other barriers to facilitate private sector entry,
- √ Finance education/training programs for the youth,
- √ Guarantee more market-access for MPs,
- √ Strengthening of human rights and governance institutions,
- √ Aid for the development of the Mediterranean civil society.

In the **long-term**, the region needs a more inclusive model that balances growth, employment and distribution. A key question to be addressed is how to ensure pro-job growth. This issue is intimately to improving education and training in order to better equip graduates with required skills. Also, this should be done within a comprehensive employment strategy that also seeks to reduce (regularity and access to finance) barriers to SMEs (particularly informal ones) improve the business environment and address labor market rigidities that discourage the private sector from hiring (Galal, 20011 and IMF, 2011c). A socially inclusive agenda must be implemented to ensure that growth is broadly shared and to ensure equality of opportunity to citizens. This can be achieved through reviewing the composition of public expenditure to make it more socially equitable and increase spending on human capital. Finally, initiating institutional reform and strengthening supporting market institutions (competition policy, anti-trust laws...) are crucial and will also help foster private sector development. Also, anti-corruption measures should be implemented in a wider context of civil service reform.

The challenge of the success of these painful reforms is that they must be underpinned by broad political support and social consensus. In the end, it is important to say that region has enormous potential, the most important of which is its dynamic and young population, who if they become healthy and educated, will also become more productive and will provide the region with an opportunity for higher long-term growth and development.

## CHAPTER 2. THE BREAKDOWN OF THE AUTHORITARIAN BARGAIN

### Introduction

The uprising that erupted in Tunisia and swept across the region took most governments, experts and international organizations by surprise. The former rulers of Tunisia and Egypt have been deposed. Other authoritarian regimes in the region, such as in Libya and Syria are embattled. Political concessions and hand outs in different forms are made in Algeria, Morocco and Jordan to face mass protests and dissatisfaction and avoid the revolutionary winds.

The regimes survived over decades in which democratic waves rolled across different regions from Latin America to Eastern Europe and Sub-Saharan Africa. For a long time, the authoritarian bargain model explained the dynamics in the region and its resilience to change [1]. Authoritarian regimes, according to the model, share state resources between repressing opponents and rewarding supporters. They implement selected economic and social policies through which they channel benefits to their constituencies. Some policies such as land reform, nationalization of private assets or privatization of state owned assets alter social balance of power by changing property rights' structure. Other policies take the form of recurrent flows of benefits granted to the whole population (universal consumption subsidies and free public health and education) or to specific segments (welfare programs, trade protection, guaranteed lifetime jobs to civil servants, cheap credits to industries and subsidies for farmers).

For a long time, such policies offered a strong social base to support the authoritarian regimes in the Arab Mediterranean region. Even with structural adjustment programs and a number of market reforms, the regimes managed the contradiction between market transformation and persistent authoritarianism. Whenever budget constraints come into sight, the

regimes make careful trade-offs to preserve their resilience. Austerity measures were targeted to specific segments, generally the weakest economically and the less vocal. In the meantime, the regimes co-opted or harshly repressed dissidents and potential rivals. Sporadically, the regimes granted some degree of freedom and political rights as security valve to avert radical uprising and secure their survival.

Until recently, the Arab Mediterranean regimes seemed to maintain a significant level of political stability and to secure sufficient support for their regimes. The recent uprisings showed that their façade's stability was a mere chimera and called into question the foundations of the prevailing authoritarian bargain. Two non-exclusive arguments seem plausible to explain the historical shift.

**First, the authoritarian regimes violated the terms of the old bargain and did not offer any credible and viable alternative.** The transition from state-led to "market oriented" economy implemented in a context of hardship led the authoritarian rulers to slash or stop to provide economic benefits to large segments among their traditional supporters. The regimes shifted gradually their core social base from the masses of workers, peasants and civil servants to a minority of influential urban rent-seeking bourgeoisie and rural landed elite and built new networks of patronage through privatization and other private sector related policies. Rapid demographic growth and massive flows of educated jobless imposed severe dilemmas for the regimes. Although, they managed to achieve some economic growth, inequality and exclusion have been on the rise. The inability of the authoritarian regimes to buy loyalty and obedience of large segments of their populations or to offer any viable alternative; eroded their legitimacy and "raison d'être" for the majority, which in the end chose to rebel against the status-quo.

In all countries in region, the first reaction after the uprising began was to increase wages in the public

sector and expand subsidies and other social transfers to mend the old bargain and put an end to the radical political demands. An oil-producer country such as Algeria has been able, so far, to inject large amount of public money in the form of transfers and wage increases to maintain the regime alive. Morocco, with much limited financial resources, had instead made political concessions by reforming its constitution. In Egypt and Tunisia, the rulers attempted a combination of repression, economic benefits and political concessions. However, both countries failed to weather the storm and their authoritarian regimes collapsed.

**Second, the authoritarian model is no longer valid because the majority of people no longer accept the terms of the bargain.** Over the last decades during which the authoritarian regimes have been ruling, fundamental changes occurred in the Arab Mediterranean societies. Their populations became larger, younger, more educated and urbanized. Unlike their parents, the new generations, which account for almost two thirds of the total population; challenge the legitimacy of their rulers and point more comfortably to their failures [2]. They also value “freedom”, “dignity” and “social justice” more than any economic benefits they can get from an authoritarian regime [3]. Political rights and economic gains can no longer be substitutes as the old authoritarian bargain stipulated.

The chapter argues that in addition to the authoritarian bargain’s erosion, three factors were at the heart of the massive uprising in the region. First, the magnitude of inequality went up dramatically over the last years as did economic exclusion and social frustration. Second, endemic corruption proliferated beyond redemption in the regimes’ inner circles. Third, the social media by enabling people to share awareness, overcoming official media’s censorship and easing coordination among a very large number of individuals; exposed the authoritarian regimes to unprecedented challenges.

## **I. For a long time, the authoritarian bargain reigned**

The Economist Intelligence Unit’s Index of Democracy classifies countries into four types of regimes: full democracies; flawed democracies; hybrid regimes; and authoritarian regimes. This classification is based on five criteria: electoral process and pluralism; civil liberties; the functioning of government; political participation; and political culture. Except Lebanon and Palestine Territories considered as hybrid regime, the rest of the Arab Mediterranean regimes are rated as autocracies.

The authoritarian regimes lack popular legitimacy [4] and are not subjected to any checks and balances. Those regimes combine coercive and incentive-based policies and share state resources between repressing opponents and rewarding supporters. To survive in power, they establish their authority on the basis of security apparatuses and a system of competition for public patronage they can arbitrate.

### **Provisions of Economic Benefits**

Despite some differences among the countries, overall Arab Mediterranean regimes behaved during the past four to five decades in line with the authoritarian bargain model.

Most Arab Mediterranean countries set up land reform policy, which broke up the vast holdings of the feudal landlords and distributed some of the expropriated land to landless and small farmers. The implementation of land reforms allowed the rulers to weaken the landed elites and form a strong social basis for their regimes. It was a pivotal policy of the regimes in their attempt to consolidate their power and win the allegiance of poor rural communities. The literature indicates that heavy land redistribution tends to occur more often in autocratic regimes and those that engage in more redistribution early in their tenures were likely to remain longer in power [5].

**Box 1. The politics of land reform and agriculture policy  
The case of Egypt and Syria**

Nasser's regime in Egypt and Baath regime in Syria, for instance, enjoyed strong legitimacy due to land reforms. The Nasser regime issued the first land reform law in September 1952, which placed a 200 feddans ceiling on land ownership [6]. Large landowners' share decreased from around 27 percent of total land ownership to only 6.5 percent and the share of the 95 percent smallest owners rose from 35 percent to 57 percent [7]. The government reduced the ceiling to 100 feddans in 1961; then to 50 feddans per person and 200 feddans per family in 1969.

In Syria, after the takeover by Ba'ath Party, the government enforced radical provisions against landowners in the decree law of March 1963. It has restricted individual ownership to between 15 and 45 hectares of irrigated land and 80 to 300 hectares of rainfed land depending on the area. From early sixties to mid seventies, the government in Syria distributed 40.5 percent of total cropland and allowed 25 percent of farm families to acquire land. Land reform program in Syria led to a sharp decline in land concentration due to ownership ceiling stipulated by law (Keilany 1980). The government was able to broaden its social base in the countryside and secure support by the segment of the peasants at the expense of landlords. Until the nineties, land reform in Syria improved living conditions of the poor peasantry; reduced income inequality in favor of the rural population and made its participation as one of the key pillars of the social foundation of the Syrian political system. Growth in agricultural output reached an annual average of 4.4 per cent during the sixties and increased to 8.6 percent in the seventies [8]. Public investment in rural infrastructure and social development intensified; irrigated areas more than doubled, fertilizer consumption increased four times and food production per head was almost maintained above the average level that prevailed in the early sixties despite instable rainfall and a steady population growth of 3.5 per cent per year.

The policy change in Syrian agriculture since the nineties have taken opposite direction and generated perverse effects on the landless and small-sized land owners. The government ended its monopoly in import and distribution of inputs and opened agricultural land to foreign ownership. The downsizing of the public sector and the sale of state

farms led to the emergence of large capital intensive private agricultural enterprises of 2,000 hectares on average and drove small farmers out of business and forced them to compete for paid work. The decision to freeze the distribution of expropriated land, which was retained by the government and partly used as state farms or leased out to tenants; increased the landless population both in absolute and relative terms. The 2003/04 Household Income and Expenditure Survey found rising rural poverty and deepening inequality within agriculture and between agriculture and the rest of the economy [9]. Interestingly, the survey found the poverty outlook particularly alarming in the administrative districts (muhafazat) with over 60 percent of rural population [10] such as Al-Hassaka, Al-Raqqqa, Daraa, Deir ez-Zour, Hamah, Idlib and Tartous [11]. Interestingly, those same regions have been leading the uprising in Syria over the last four months.

Similar adjustment policies were implemented in the early nineties in Egypt: phasing out of area quotas and delivery of crops; ending state interference in crop pricing; phasing out subsidies to fertilizers, pesticides, seeds and farming machines as well as interest rates, privatization of state land and companies and liberalization of the cultivated land market. These policies reduced budget and balance of payment deficits but their effect on agricultural sector were negative. They hit particularly poor holders (of less than two feddans) because their real revenues decreased [12]. The proportion of poor holders may have approached 60 percent of the total holders [13].

**The politics of land reform and agricultural policy**

The regimes promoted landless and small farmers through land expropriation and redistribution. Insecure property rights and state supervision of agricultural activity led to lasting contract of patronage and clientelism between the authoritarian rulers and the rural smallholders.

First, property rights granted by the state to beneficiaries were most often incomplete. The evidence shows that by granting incomplete property rights, the political regime can secure future control over land recipients and their descendants [14]. Second, farmers through their membership in state-run cooperatives

had to rely on state policy for credit, input subsidies, warehousing and transport, marketing and output administered prices. By doing so, the state created for itself a burden it can barely assume. When under fiscal constraints and changing policy trade-offs the state cut the delivery of these complementary services, or shifted its policy towards large farmers; most small farmers encountered difficulties and often fell into poverty and marginalization.

To deliver benefits and secure loyalty to the authoritarian rulers of the educated elite and urban dwellers, the regimes created a large bureaucracy. Nationalization of economic assets, use of central planning and adoption of explicit or implicit job guarantees led to substantial expansion of public sector employment. In most countries, the size of the public sector increased to exceptionally high level, compared to international averages, during the seventies and the eighties. Public sector guaranteed lifetime employment with generous wages and other non wage benefits.

*Table 1. Size of the Public sector employment in Arab Mediterranean Countries*

Country	Year	Government	State owned enterprises	Total public sector
Algeria	1984	22.7	35.9	58.6
Egypt	1986	21.3	10.8	32.1
Jordan	1987	40.9	3.8	44.7
Syria	1980	22.9	10.0	32.9
Tunisia	1982	12.8	7.2	20.0
Morocco	1988	9.8	2.2	12.0
Average (weighted)	--	20.0	13.7	33.7

Source: Mona Said (1996), ERF paper

Some countries in the region guaranteed civil service employment for graduates of secondary and higher education; others operated as employers of last resort [15]. Till the mid 1980s, employment in the public sector represented, on average, more than one third of total employment in the Arab Mediterranean countries (20 percent in the government sector and 13.7 percent in state-owned enterprises). Public jobs were one of the most important tools for the regime to extend favors and exert its political and social control.

## Box 2. Food Subsidies in Tunisia

*The subsidy program absorbed significant fiscal resources in the last eighties, reaching 7.2 percent of the total government budget and nearly 3 percent of GDP in 1989. This can be explained in part by the universal coverage of subsidies, as well as the high rate of unit subsidy. For example, the bread subsidy was equivalent to 40 percent of the total unsubsidized price of bread, and for locally-produced sugar, the subsidy share in total value amounted to 70 percent. Self-targeting measures were introduced in an effort to channel benefits to low income groups, gradually leading to lower program costs, which have declined since 1990. Whereas consumers obtain significant benefits from food subsidies, the institutional organization and de facto monopoly control of production and distribution by the various sector marketing boards has also contributed to the high costs of the subsidy program (Table 2).*

The provision of free education and health services and heavily subsidized basic goods was another key component of the authoritarian economic and social bargain in the region. These

*Table 2. Fiscal Cost of Explicit Consumer Food Subsidies in Tunisia, 1988-95*

	1988	1989	1990	1991	1992	1993	1994	1995
% GDP	2.3	2.8	2.4	1.9	1.9	1.9	1.8	1.7
% total Government expenditure	6.0	7.2	6.2	5.0	5.4	5.1	4.7	4.5

IMF (1999), Consumer Food Subsidy Programs in the MENA region

benefits improved living standards of the poor and middle groups, strengthened political stability reduced the pressure for political reforms. According to IMF (1999), subsidies cover about 40 percent of total domestic production costs for wheat products in Tunisia and approximately two thirds in Egypt. About half the sugar consumption in Egypt and Jordan and bread flour consumption in Morocco is subsidized, while almost all rice and powdered milk consumption in Jordan was subsidized in the early 1990s.

## Use of fear and repression

The provision of subsidies, social benefits and public sector employment can only partly explain the lon-

gevity and resilience of the authoritarian regimes in the region. The authoritarian bargain faced opposition, from its early days, and was challenged either by those who never accepted the terms of the “contract” and refused to trade freedom for bread or by the crowds that occasionally took the streets to express their anger and dissatisfaction. In combination with economic benefits, the authoritarian rulers developed three repressive strategies to deter potential dissidents, contain their influence and punish them; using exceptional procedures and legal provisions stipulated in emergency and anti-terrorism laws and regulations.

First, authoritarian rulers developed emotionally powerful rhetoric to control society and justify repression. The Arab nationalist rhetoric, predominant in the sixties and seventies, enjoyed considerable popular appeal and led to the imposition of a single party system in most countries [16]. It helped the authoritarian regimes in the region to mobilize the masses, buttress their legitimacy and consolidate their power. The late sixties represented a dramatic turn, however. After the *naksa* [17], the rulers shifted to pragmatism and narrow national interests. The political discourse emphasized the priority of national security, unity and sovereignty against foreign conspiracy over any other political, economic or social issues. This argument was systematically used to dismiss any real or potential threat for the regime’s stability and as pretext for state repression.

Second, the authoritarian rulers implemented legal means of repression through Emergency Laws that restrict individual freedom and allow use of unchecked power by the state. Such laws prevailed in Algeria, Egypt and Syria and only lifted after the beginning of the Arab revolts. Despite some minor differences, emergency laws restrict people’s freedom of assembly, movement and residence. The law allows the arrest of suspects who threaten “public security” and detain them, and permits inspections of persons and places without restriction by the Criminal Procedure Code.

In Egypt, more than 1,000 civilian defendants were tried in military courts between 1992 and 2000 under the emergency law. This resulted in 92 death sentences and 644 life imprisonment [18]. Human rights organizations estimated the number of Islamists and other political prisoners who were detained under emergency law in Egypt ranged between 13,000 and 20,000 by end of 2001 [19]. In Jordan, Morocco and Tunisia, anti-terrorism laws empowered the security forces through exceptional provisions and resulted in recurrent human right violations and serious restrictions on fundamental freedoms [20] [21]. In Tunisia, as many as 2,000 persons were detained, charged, and/or convicted on terrorism-related charges between 2004 and 2009 [22].

Third, in many cases the authoritarian regimes in the region resorted to massive and disproportionate use of force and violence against bread riots and peaceful protesters, mass arbitrary arrests, cruel torture and widespread intimidation [23].

## **II. Unsustainable Bargain**

Under the authoritarian bargain, countries in the region manage in the sixties and part of the seventies to achieve relatively high economic growth and improve their human capital indicators due to populist redistributive policies. The countries enjoyed large financial flows that allowed them to finance such policies. Egypt, Syria and Tunisia were small producers by international standards but had significant oil resources. Oil accounted for a large share of their exports and government revenues. Morocco and Jordan were major producers of phosphates, the price of which increased five-fold after 1973.

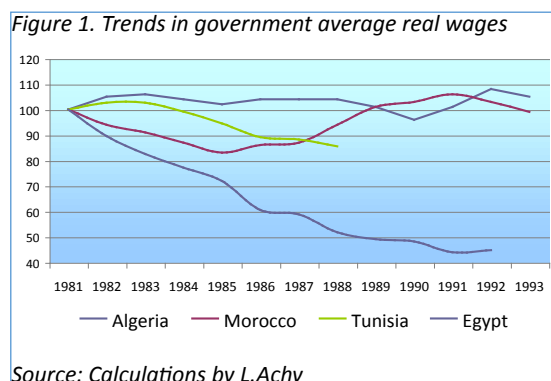
During the 1980s much of this pattern was reversed. The decline in government revenues due to the collapse of oil and phosphate proceeds; the decline in migrant remittances and aid from the Gulf States imposed severe restrictions on their budgets. The prevailing social bargain became unsustainable.

The economic reforms implemented hurt large segments of the population in the Arab Mediterranean countries, without offering real political opening through which grievances might be expressed [24]. Under adjustment programs of the eighties and nineties, the terms of the bargain were dramatically affected. The liberal policies slashed or phased out most of the benefits, reversed land reforms by promoting land concentration, and pushed a large number of small and medium-sized farmers into poverty.

But by the late eighties, the public sector was overstaffed and inefficient, and its wage bills represented a huge burden for the state budget. It accounted for 55 percent of the government current revenues in Morocco, 52 percent in Algeria, 42.5 percent in Tunisia. In addition to job stability and other non-wage benefits, public sector jobs offered relatively higher wages compared to those prevailing in the private sector [25].

The state reacted by reducing the number of new positions offered in the public sector. The contribution of the public sector to total job creation dramatically declined in the late eighties and early nineties in Algeria, Morocco, Egypt and Jordan. The impact was felt mostly by educated jobseekers (particularly female educated) who usually perceived civil service as a natural and guaranteed option after they complete their degrees. This impact translated into higher unemployment rates and longer queuing/waiting time for a job. Free education and increased access to secondary and tertiary education made things worse. Unemployment rates among educated youth surged to more than 20 percent up from negligible levels. As a result, authoritarian regimes in the region lost one key avenue through which they used to acquire their legitimacy and exert their control.

In order to limit the burden of the wage bill on state budget, public sector wages were kept frozen or occasionally raised but not enough to offset for eroding effect of price liberalization and inflation. The purchasing power of civil service wages declined



sharply in countries such as in Tunisia and Egypt. In the latter, the average wage in the government sector lost 60 percent of its value during the nineties. The process of wage erosion persisted in the years 2000 at a faster rate in the public administration compared to other economic sectors. Reductions in food and other subsidies resulted in riots, but they were reversed at times to preserve social peace and political stability.

Increasingly however, the authoritarian regimes started to lose their legitimacy within their traditional supporters, mainly landless and small-sized farmers, public sector employees and poor and middle-class households.

Over the past decade, Arab Mediterranean countries have seen an increase in strikes, demonstrations, and other forms of social protests as well, motivated by economic and social grievances [26]. The anger and frustration swept across the poor in the countryside, educated jobless, marginalized street vendors and impoverished civil servants. The stability of the regimes was not, however, called into question. The authoritarian rulers were able to come up with a number of strategies to preserve their power and also renew some part of their eroded legitimacy.

### III. Alternative survival strategies

To preserve the regimes and strengthen their resilience, three strategies were developed. First, the regimes shifted gradually their social base to a minority of influential business elite and built new networks of patronage through privatization

and other private sector related incentives. Second, the regimes granted some limited degree of freedom and political rights as security valve to avert radical uprising. Third, the regimes seized the opportunity of escalating international terrorism in the early 2000s to secure support from the West and establish themselves as vital partners in the international war against terror. At the same time, they consolidated their police and security forces to crackdown on protesters and dissidents when necessary.

### **Networks of patronage with the business elite**

The authoritarian regimes used the opportunity of privatization policy to create a form of crony capitalism in which businessmen are heavily dependent on the state for access to power and favors. By doing so the regimes goal was twofold. First, create a new social coalition for the regime as a counterweight to the traditional supporters hit by market reforms, cuts in subsidies and other social benefits. Second, preserve the control of the economy and avoid any potential challenge that may emerge from an independent business community. As a result, the regimes were able to create a loyal elite of entrepreneurs made of private sector capitalists, landed elites, the military officer corps and top state officials [27]. All of them secured windfall profits by purchasing the privatized assets sold at nominal prices. Many cases of undervaluation or underpricing of public enterprises privatized were reported. Privatization turned out to be an extension to the power of the state and its entrenchment in a new socioeconomic model.

The regimes also used costly incentive schemes, tolerance to tax fraud, and easy access to finance and public procurement as tools to control and discipline the private sector. In Tunisia, for instance, the government gave up every year between 50 and 60 percent of due corporate taxes in the form of tax incentives during 2000-2007 [28]. The sluggish private sector investment and the failure to reduce unemployment call the relevance of these incentives into question.

### **Timid steps toward political reform**

The authoritarian rule in the region was both persistent and dynamic [29]. In addition to provision of economic gains and use of different repressive strategies, the resilience of the authoritarian regime in the region was also due to its ability to introduce marginal political reforms to manage internal or external pressures for democracy. Despite their imperfections, the shift to multiparty system and the regular organization of elections conferred the authoritarian regimes in the region some façade legitimacy.

Most countries in the region started to hold regular legislative elections (since 1976 in Egypt and since 1989 in Tunisia and since 1991 in Algeria) and allowed for some degree of pluralism. Syria launched elections to its People's assembly in 1990 and the Baath party's congress endorsed the idea of independent political parties in 2005. Egypt, Tunisia and Algeria introduced nominal competitive presidential elections in the mid-1990s. However, incumbent regimes controlled electoral processes from the voters' lists, to parties and candidates enabled to participate, modes of elections and use of media in electoral campaigning. By doing so, the regimes succeeded to avert undesirable electoral outcomes and subverted political openness [30]. Instead of weakening the incumbent regimes, these timid reforms produced new authoritarian systems that integrated liberal economic policies, new ruling alliances, some superficial pluralism and electoral legitimization tactics [31]. Unlike a genuine process of democratization, the top-down and shallow political reforms of the last two decades in the region did not lead to the redistribution of power and slipped into reverse in some cases.

### **Secure western support through war on terror**

The September 11 terrorist attacks prompted the debate on political reforms and democracy in the Arab region in the US foreign policy. The Bush administration accused authoritarianism as being responsible for the expansion of terrorism and made the commit-



ment to promote democracy in the region. Following various electoral experiences in the region between 2001 and 2004, the US realized that democratization will likely lead to Islamist domination of Arab politics. The risk is that Islamist governments would be much less willing to cooperate with the United States than are the current authoritarian rulers [32].

The authoritarian regimes seized this unexpected opportunity to renew their discourse and establish themselves as vital partners in the international war against terror. The “fear of Islamists” argument was used to deter all forms of domestic opposition and justify excessive repression. As a result, the West tolerated human right violations and manipulation of elections and preferred to support authoritarianism in the region and preserve its interests instead of promoting a risky democratization process.

#### IV. Factors that accelerated the breakdown

During the past six years, economies of the region expanded, at relatively higher economic growth rates compared to the nineties; and most of them seemed to have had curbed the impact of the international economic crisis. Three factors, at the heart of the massive uprising in both countries, have however affected the resilience of the authoritarian bargain model in the region and led, so far, to its collapse in Tunisia and Egypt. First, the fruits of economic growth were very unequally shared among the different social groups. The magnitude of inequality went up as did economic exclusion and social frustration. Second, endemic corruption proliferated beyond redemption in the regimes’ inner circles. The situation reached boiling point in Tunisia with the release of wiki leaks that gave robust momentum to people’s frustration. Third, the social media by enabling people to share awareness, overcoming official media’s censorship and easing coordination among a very large number of individuals; exposed the authoritarian regimes to unprecedented challenges. Bouazizi’s self-immolation provided fuel for social explosion that spread across the whole region.

#### Rising inequality and growing exclusion

Household surveys, on the basis of which inequality indicators are computed, focus exclusively on income or consumption inequality. Bibi and Nabli (2010) emphasized that in comparison with the rest of the world, income inequality in the Arab region has remained moderately high with GINI coefficients lower than Latin America and Sub-Saharan Africa, comparable to those of East Asia but higher than those of Europe, Central and South Asia. Bibi and Nabli argued that there is an overall decline in income inequality in the Arab world. This finding, however, dissimulates diverging trends among countries as shown in the table.

For methodological reasons, household surveys underestimate the true level of inequality because of extremely limited information on the richest individuals and the degree of underestimation can differ from one country to the other rendering international comparisons of meaningless. For instance, inequality in earnings appears to be relatively higher in Arab Countries compared to other regions, and the distribution of other non-income indicators such as education, health, and land ownership reveal that the Arab countries are among the most unequal worldwide [33].

Table 3. Trends in inequality in Acs			
	High inequality	Medium inequality	Low inequality
Only one observation	Comoros	Oman and United Arab Emirates	Lebanon
No trend		Jordan if 1992 Gini is considered	Syria
Stable	Mauritania from 1995, Tunisia from 1990	Jordan if 1992 Gini value is ignored	Kuwait and Egypt
		Morocco	
Increasing	Morocco and Tunisia	Algeria	Syria and Yemen from 1998
Decreasing	Tunisia between 1980s and 1990s	Algeria	
Source: Sami Bibi and Mustapha Nabli (2010)			

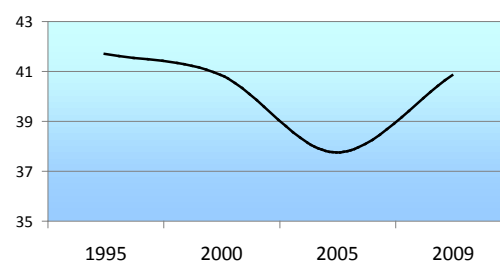
### Box 3. Growing regional inequalities in Tunisia

Available estimates on income inequality in Tunisia confirm that the gap between the rich and the poor is worsening during the past five years. The Gini index declined between 1995 and 2005 but increased since then. Three factors in particular have contributed to more inequality: a higher level of unemployment among youth from poor and middle classes, the absence of redistributive tax policies, and regressive effects of public social spending (Figure 2).

Official statistics show that poverty rates have declined and the overall economic situation has improved over the last decade. Large parts of the country were neglected, however, and as a result, regional inequality exacerbated. The gap in poverty rates between the capital city and the rest of the country shows that regional variation in terms of living standards increased between 2000 and 2004 [36]. The gap with respect to Tunis increased in all regions. The north-west and centre-east, which benefited from public investments as well as private sector projects in tourism and offshore manufacturing, are much closer to the capital city. The south and center west, on the other hand are lagging behind. Other indicators corroborate the persistence of large disparities between coastal and interior regions in terms of access to basic infrastructure, education and health services, and job opportunities. The poorest regions lack adequate economic and social infrastructure and suffer from higher unemployment rates. The three most privileged regions (Greater Tunis, Center and North East) are home to 60 percent of the population and almost 90 percent of formal enterprises [37]. On the other hand, the three deprived western regions (North West, Center West and South West) accommodate 30 percent of the Tunisian population and less than 8 percent of enterprises (Figure 3).

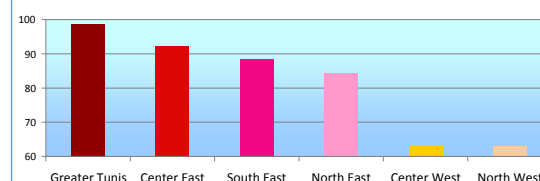
Moreover, in countries plagued by corruption and fraud, data on declared incomes lack relevance and likely to poorly capture the magnitude of inequality. Wealth inequality might be more relevant in such circumstances, but unusually not available. Beyond statistics, public perception of inequality and the feelings of injustice it generates can be much more meaningful. Any visitor to Egypt, for instance, can witness the disconcerting inequality between deprived villages in Giza lacking running water and electricity

Figure 2. Growing regional inequalities in Tunisia (Based on Gini index)



Source: Calculations by L.Achy

Figure 3. Household's access to drinkable water (2010)



Source: Calculations by L.Achy

and the next door Pyramid area, the location of major investments in luxurious hotels, new affluent and secluded residential compounds and world-class museum [34]. Liberal economic policies and the shift in the social base of the authoritarian regimes translated into rising inequality, and extreme forms of social and regional exclusions. The poor and middle class who invested in the education of their children reaped frustration and unmet dreams and expectations. The prevalence of nepotism makes the issue even worse. Unlike youth from richer backgrounds who rely on dense networks, those from unprivileged families usually end up unemployed or stuck in bad jobs.

Over the last few years, sharp swings in international prices led to a double digit inflation on basic products in most countries in the region. As the rich spend only a small share of their income on food, these upsurges hit the poor harder and their sense of inequality and injustice has grown further. A recent IMF study reveals that food prices increases the incidence of anti-government demonstrations, riots, and civil conflict [35].

### Endemic corruption in the regimes' inner circles

The authoritarian regimes in the region have for a long time attributed poverty and unemployment

in their countries to the lack of sufficient domestic financial resources and focused their policies on promoting foreign investments, remittances and occasionally international aid. However, the escalation of high profile corruption, abuse of position and embezzlement of public money by friends, allies and clients of the regimes made people distrustful and angry. They now recognize that corruption and poor governance has been the significant cause of the failure.

Their frustration with scandalous corruption cases was one key grievance expressed in their protests. Corruption infringes the fundamental human rights to fair treatment, unbiased decision-making, and secure civil and political status.

In Tunisia, for instance, members' of Ben Ali's family were taking advantage of their positions in power to build up for themselves a position from which

#### **Box 4. Social media in Egypt**

*Kefaya movement attracted large numbers of apolitical youth. In 2004 and 2005, it organized a series of high-profile protests calling for the end of Mubarak's presidency and the country's emergency law. In 2008, youth activists from Kefaya formed the April 6 Movement in solidarity with textile workers who were planning a strike for that date. The movement attracted 70,000 members on Facebook, making it the largest youth movement in Egypt at the time.*

*Members of both the April 6 Movement and Kefaya were behind the creation of the most important Facebook group in June 2010, called "We are all Khaled Said" in memory of a young man who was beaten to death by police officers in Alexandria. The Arabic version of this Facebook page was managed by an anonymous activist who was later revealed as Google executive (Wael Ghonim). The page attracted more than one million supporters and became the focal point for a number of large protests against state abuses in the summer of 2010. The executive used the page to call for Egyptians to take to the streets on 25 January, commemorated as National Police Day.*

*Source: The Arab Revolts (2011)*

they could accumulate wealth, by monopolizing the function of intermediary financiers in privatizations, in import-export operations, in access to public markets, and in access to information. They also proceeded by intimidation, seizing on a share of capital from flourishing businesses, and increasing the number of 'matrimonial' strategies in order to widen their field of intervention [38]. According to Global Financial Integrity (GFI), Egypt is losing more than US\$6 billion per year during the period 2000 to 2008 in illicit financial activities and official government corruption [39], which is the equivalent of 5 percent of GDP over the same period. Needless explain why Egyptians were upset about Mubarak's regime.

#### **Role of social media**

The use of mobile phones, access to satellite TV channels, Internet and other social media technologies increased tremendously in the region during the past decade. Their affordability and easy access, including among people living in remote areas with poor infrastructure, made them popular. These modern communication technologies allowed ordinary people to overcome censorship imposed in state-controlled media. People in the region become aware of how badly things have gone wrong, and conscious of the differences between their world and the rest in terms of standard of living, achievement, and, more generally, human and cultural development [40].

The social media also lifted constraints imposed on the public sphere through emergency laws and restrictions on freedom of assembly and public demonstrations. Digital activism, through dedicated blogs, and Facebook pages replaced traditional forms of activism. In Egypt, for instance, less than 5 percent of young people belong to political parties [41].

The social media enabled people to built trust and share awareness on the major economic and social issues. Information and Communication Technologies facilitate mobilization on the ground by connecting

like-minded citizens, offering non-official information to anybody interested and inviting protesters to gather in public places, marches or other forms of political activism [42].

Beyond mobilization, the social media enabled online activists to inform the international public opinion through blogs, Facebook updates, cell phone communication, and, most vividly, YouTube videos [43]. The material uploaded by ordinary individuals become a source of information for international press agency and satellite TV channels across the world. Using 'digital activists' uploaded material, Al Jazeera, for instate, played a boosting role in most of the Arab protests. The live stream allowed a global audience to remain informed on what's happening on the streets from the comfort of their own homes and overcome state-sponsored media's propaganda.

Although the authoritarian regimes prosecuted digital activists, shut their blogs and put some of them in jail; they failed to grasp the strong subversive role of internet and social media. The latter challenged key vehicles and instruments that the regimes had tradi-

tionally used to establish their authority. In both Tunisia and Egypt, revolutions have been referred to as "leaderless' revolutions", too many ordinary people for the regimes to identify, repress or co-opt.

## V. The future: from economics to politics and back

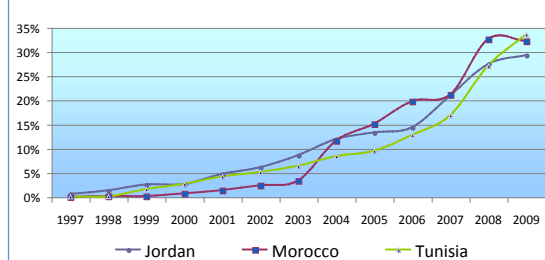
The authoritarian bargain proved to be unsustainable. The transition from authoritarianism, either orderly or through mass protests and toppling of the incumbent rulers, should lead to more inclusive political system with space, in the decision-making process, to political diversity and civil society participation (labor union, private sector organizations, and youth organizations).

The end of the authoritarian bargain requires a clear shift from patronage-based legitimacy to rational legitimacy built on constitutional means, and performance-based economic and development agencies. But the political openness is not the ultimate objective, it should be reflected in economic and social policies and its effects trickle down to middle and poor segments of the population. By shifting from cooptation and clientelism to merit-based mechanisms of appointment and promotion in the public sector, more opportunities should be available for young and female leadership, and other under-represented social or ethnic segments.

Instead of rents for patronage, the government in the region need to design appropriate incentive schemes based on economic efficiency and social justice considerations. To be effective, policymakers need to focus on four pillars.

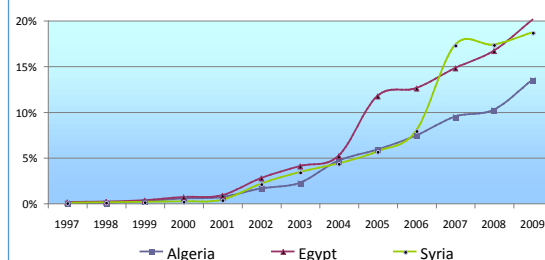
First, review the **fiscal policy** and aim for a more equitable system: direct taxation more than indirect taxes, progressive income taxes, combat fraud and evasion and unjustified exemptions. In most countries in the region, there are more indirect taxes than direct taxes. For instance, only one third of Tunisia's taxes are coming from direct taxes compared to two thirds from indirect taxes [44]. The burden of indirect taxes falls much more on the poor as they

Figure. 4. Internet penetration rates in Jordan, Morocco and Tunisia



Source: Calculations by L.Achy

Figure. 5. Internet penetration rates in Algeria, Egypt and Syria



Source: Calculations by L.Achy

usually consume their entire income. The rich can escape indirect taxes and can benefit from tax favors by saving or investing part of their income. Regarding direct taxation, individuals pay more taxes compared to companies (65 percent for the former and 35 percent for the latter). The modest contribution of corporate taxes is not due to a low nominal corporate tax rate, which is set at 30 percent, but to a generous system of fiscal incentives granted to a selected set of companies under the investment code. Over the period 2000-2007, the government gave up every year between 50 and 60 percent of due corporate taxes in the form of tax incentives. In Egypt, non-oil private sector companies make a very modest contribution to the state's revenues.

Second, design an **appropriate industrial policy** with a comprehensive medium to long term economic strategy. The countries in the region need to reform existing distortions in their trade policies and streamline their incentive schemes. There are lessons that they can learn from the Turkish and South Korean experience.

Third, policy makers in the region should design adequate incentives to channel resources toward **selected high-value added and knowledge-intensive sectors** to absorb educated labor. The contribution of the most export-oriented sectors to economic growth has been limited due to their low value added and weak integration with the rest of the economy.

Fourth, policy makers in the region should **strengthen market mechanisms and reinforce transparency for an efficient allocation of resources**. To this end, they need to reinforce competition authorities and the implementation of pro-competitive regulations. Most countries have competition laws in line with international standards, implementation issues remain, however [45].

#### Notes:

1: According to Desai et al., (2009), the "authoritarian bargain" refers to an implicit arrangement

or contract between the regime and the population whereby people renounce to their political freedom and political participation in exchange for public goods and other economic benefits

2: According to Richard and Waterbury (2008), the large cohorts of literate, urban Arabs could no longer be contained within the paternalistic authoritarian and repressive regimes

3: The slogans used by protesters in the region insisted more on dignity, freedom and social justice

4: Political legitimacy is the popular acceptance of a regime. According to Max Weber, there are three sources of legitimacy: charismatic authority derived from the leader's charisma; traditional authority earned from tradition (case of a monarchy) and rational-legal authority based on constitutional rules

5: Albertus and Menaldo (2010)

6: One feddan is equivalent to 4.2 hectare

7: El-Ghonemy (1990), *The Political Economy of Rural Poverty: The case of land reform*, London: Routledge 1990

8: UNDP (undated), *Macroeconomic policies for poverty reduction: The case of Syria*

9: UNDP (undated)

10: Rural population accounts for 45 percent of the total population with large regional differences

11: UNDP (undated)

12: World Bank (1992) *Arab Republic of Egypt: An Agricultural Strategy of the 1990s*, Report 11083-EGT, Washington, D.C

13: Mohamed Abou-Mandour (1995)

14: Janvry and Sadoulet (2011), *The three puzzles of land reform*

15: World Bank (2004) suggests that public sector employment in MENA is part of a social contract in which governments guaranteed young educated access to public jobs. *MENA Development Report: "Unlocking the Employment Potential in the Middle East and North Africa"*. Washington, DC

16: Ottaway and Choucair (2008), *Beyond the façade: Political reforms in the Arab World*

17: This word refers to the defeat of the Arab bloc against Israel in the Five Days war in 1967

- 18: Kassem (2004), Egyptian Politics: The Dynamics of Authoritarian Rule
- 19: U.S. State Department, 2001 Country Reports on Human Rights Practices: Egypt
- 20: Amnesty international (2006), Jordan's anti-terrorism law opens door to new human rights violations
- 21: UN CCPR (2004), Human rights body criticizes anti-terror law in Morocco
- 22: Congressional research service (2011), Tunisia: recent developments and policy issues
- 23: According to Friedman the slogan among the Arab autocrats was: "Rule by fear -- strike fear in the heart of your people by letting them know that you play by no rules at all, so they won't ever, ever, think about rebelling against you. <http://www.nytimes.com/2011/08/03/opinion/the-new-hama-rules.html>
- 24: Richards and Waterbury (2008), p 323
- 25: Pissaridies
- 26: Ottaway and Hamzawy(2011), "Protest movements and political change in the Arab world"
- 27: Stephen King (2009), The new authoritarianism in the Middle East and North Africa
- 28: Author's calculation based on fiscal data in Tunisia and "La fiscalité tunisienne et la question de cohésion sociale » UGTT (2006).
- 29: Stephen King (2009)
- 30: In the 2000 parliamentary elections, independent candidates won more than half of the seats of the People's Assembly compared with 38 percent for the ruling National Democratic Party (NDP). However, as most of the independents later joined the NDP bloc, the ruling party enjoyed a solid 87 percent majority in the assembly. See for details, Dunne and Hamzawy (2008) in Marina and Choucair
- 31: Stephen King (2009)
- 32: According to Gregory Gause (2005), no one can predict the course a new democracy will take, but based on public opinion surveys and recent elections in the Arab world, the democracy seems likely to produce new.
- 33: Sami Bibi and Mustapha Nabli (2010), Equity and inequality in the Arab region", ERF Policy Research Papers
- 34: Extract from "Egypt on the Brink" (2010) that refers to Petra Kuppinger ("Pyramids and Alleys")
- 35: IMF (2011), Food prices and political instability
- 36: These are the most recent data available. Other more up to date statistics reveal that the regional divide has exacerbated since 2004
- 37: We used the ad hoc definition that defines a formal enterprise as an enterprise with more than 5 employees
- 38: Hibou, Meddeb and Hamdi (2011), Tunisia after 14 January and its social and political economy
- 39: [http://www.gfip.org/index.php?option=com\\_content&task=view&id=366&Itemid=70](http://www.gfip.org/index.php?option=com_content&task=view&id=366&Itemid=70)
- 40: Bernard Lewis (2005), Freedom and Justice in the Modern Middle East, Foreign Affairs
- 41: National Human Development Report (2010)
- 42: Ritter and Trechsel (2011), On the Role of Texts, Tweets, and Status Updates in Nonviolent Revolutions
- 43: Ritter and Trechsel (2011)
- 44: The figures are based on the data on fiscal revenues (not including revenues from oil companies) during the period 2005-2009
- 45: acknowledgement to very valuable research assistance provided by: Joulán Abdulkhalek and Peter Gruskin



## CHAPTER 3. YOUTH EMPLOYMENT IN THE MP'S

### Introduction

The issue of young people employability (15-24 years old) in Mediterranean countries (MENA countries) has grown so much over the past ten years to initiate the revolt of the “Arab Spring”. Indeed it is quite relevant to note that the event which triggered this wave of protests was the self-immolation by fire of a young Tunisian university graduate following an altercation with a policeman about his “informal” business as a street vendor. The persistence and worsening difficulties in integrating the young people into the labor market during the past decade have generated deep discontent between young people, especially the most educated, and society. The social cohesion in force did not resist the deterioration of young people’s living conditions resulting from a long-term exclusion from the labor market. This economic exclusion has also reinforced a sense of social and political exclusion. Indeed, the opening to the world through the media and especially information and communication technologies (ICT) has changed the aspirations of the younger generations in MENA countries and the way the society works and the role they could play in it. Consequently, the generation gap regarding adults and public authorities, still rooted in a traditional mindset, has widened quickly, up to the split for Tunisia and Egypt.

The aim of this chapter is to assess the current situation of young people in the labor market in MENA countries so as to draw conclusions about the long-term actions to be taken. Although young people in MENA countries account for a significant force (Section 1), and more educated force (Section 2) their integration into the labor market is still difficult (Section 3) marked especially by an insecure relationship between education and unemployment (Section 4). The difficulties met by young people to land a job are a matter of both macro-economic and micro-economic (Section 5) and cover a wide spectrum of public intervention (training-education, specialized production, financing business...). Faced with these systemic

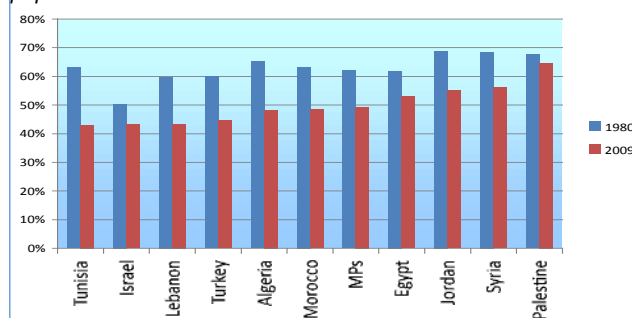
challenges, the undersized and badly coordinated public policies implemented have not been as successful as expected (Section 6).

### I. Young People, a real source of wealth for MENA Countries provided they are mobilised

Although most Mediterranean countries (MENA Countries) [1] have made their demographic transition, the proportion of young people (15-24 years old) in the population is still very high. In 2009, half of the 280 million inhabitants in MENA Countries was less than 24 years old (Table 1), this ratio was 60% in 1980 (Figure 1). The 0-14 years old who accounted for 40% of the population at the beginning of the 1980s represent only 30% while the share of the 15-24 years old remained stable at around 20%. The average growth rate of the population of MENA Countries which was 2.5% per year over the 1980s is now at 1.5% and should be less than 1% over the next two decades (Figure 2). Recent demographic changes seem to work towards a lower relative tension on the labor market.

Nevertheless, the demographic growth will weigh on the labor market because, according to UN projections, the population of all MENA countries is expected to increase by a quarter by 2030 to approximate a total of 350 million people. The 15-24 years old would then account for around 70 million people against 55 million today. This perspective implies that the labor market would have to be able to absorb these

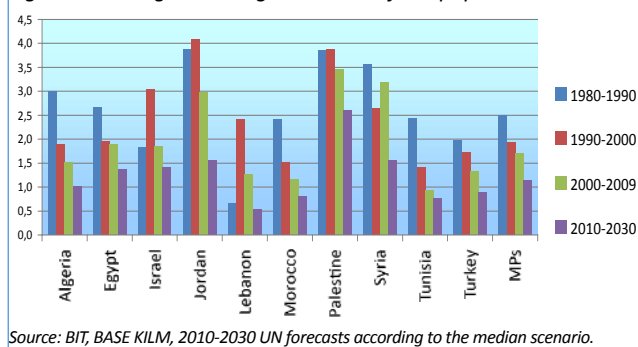
Figure 1. Share of the young people (0-24 years old) in the total population



Source : BIT, BASE KILM



Figure 2. Average annual growth rate of the population



Source: BIT, BASE KILM, 2010-2030 UN forecasts according to the median scenario.

additional millions of people in the next two decades.

## II. An increasing number of young graduates

### A Widespread access to primary and secondary cycles of education

Education has been the stronghold of the period after the independence. The self-centered regimes introduced from the outset had as a main objective to disseminate knowledge as widely as possible. For example, in 1955, Tunisia had around 65,000 students for the 350,000 originating from European countries against 3,500 students corresponding to the 6 million native people. Therefore a major quan-

titative effort had to be made, and this was done at the cost of considerable public engagement.

This effort was intensified in recent decades which has enabled MENA countries to catch-up much of their delay. Now, in most MENA countries, the literacy rate of young people is above 90%. Two countries stand out as exceptions, Morocco (80%) and to a lesser extent Egypt (86%). The primary school was widely widespread among the population. The gross primary school enrollment ratio is virtually 100%. In high school, whereas it was lower than 50% in most MENA countries prior to 1990, the gross enrollment ratio is now close to or exceeds 80% (Table 2). Morocco, Egypt, and Syria have gross secondary school enrollment ratio far behind. Morocco, despite a major effort since the 1990s, is still lagging behind in this domain with a gross secondary enrollment ratio lower than 60%. Despite their progress, MENA countries should keep up their efforts to catch up in terms of education compared to some Asian countries or even Latin America countries. With the slowdown in demographic growth, MENA countries should not have difficulties to catch up this quantitative delay in the next decade.

Table 1. Population of the MPs and share of young people (0-24 years old)

	Population				Share of the total population			
	(in thousands, 2009)		Pop. of working age (15-64 yrs old)	Total population	(in %)		0-24 yrs old	15-64 yrs old
	0-14 yrs old	15-24 yrs old			0-14 yrs old	15-24 yrs old		
Algeria	9529	7341	23752	34895	27	21	48	68
Egypt	26816	17148	52400	82999	32	21	53	63
Israël	1989	1112	4459	7170	28	16	43	62
Jordan	2177	1305	3909	6316	34	21	55	62
Libanon	1068	764	2847	4224	25	18	43	67
Morocco	9082	6414	21197	31993	28	20	48	66
Palestinian Terr.	1919	847	2233	4277	45	20	65	52
Syria	7669	4616	13537	21906	35	21	56	62
Tunisia	2387	2030	7195	10271	23	20	43	70
Turkey	20060	13282	50350	74816	27	18	45	67
MENA Countries	82696	54858	181878	278868	30	20	49	65

Source : BIT, BASE KILM

The first point that is a problem today and which has been highlighted by all the reports of international organizations is the improvement in the quality of their education system. Moreover, the rapid increase in the secondary and tertiary gross enrollment ratio has not been accompanied by a rise in education spending, the share of public spending in GDP has remained relatively stable over the period (around 5%-6% of GDP). The PISA survey conducted by the OECD on 15 years old shows that Tunisia and Jordan, which are the only countries in the area to have the courage to submit to this assessment, are among the worst ranked countries (55th place out of 65 countries) in reading, mathematics and sciences (Table 3). The TIMSS Score (Trends in International Math and Science Study) shows the same result: the average level for MENA countries (401) is slightly lower than that of Latin American countries (406) but significantly lower than

**Table 2. Gross enrollment rate (GER) and Net enrollment rate (NER) in Mediterranean countries, 2009**

	TBS Primary	TBS Secondary	TNS Primary	TNS Secondary	TBS Tertiary
Algeria	108	96	94	66	31
Egypt	101	67	93	65	28
Jordan (2008)	97	88	89	82	41
Libanonon	103	82	90	75	53
Morocco (2007)	107	56	90	...	13
Palestinian occupied Terr.	79	87	75	85	46
Syria	122	75	...	69	...
Tunisia	108	90	98	...	34
Turkey (2008)	99	82	95	74	38
Israel	111	89	97	86	63
World	107	68	88	60	27
Arab States	97	68	85	59	22
Central and Eastern Europe	99	88	93	81	65
Central Asia	98	96	89	88	25
Eastern Asia and the Pacific	111	78	94	65	28
Latin America and the Caribbean	117	90	94	73	37
North America and Western Europe	102	100	95	90	72
Southern & Western Asia	110	56	87	...	10
Subsaharan Africa	101	36	76	24	6

Source : Unesco

**Table 3. Performance of students in reading, mathematics and sciences, from PISA (2009) [2]**

Rang		Comprehension of written text	Culture mathematics	Culture science
	Average OCDE	493	496	501
1	Shanghai-China	556	600	575
22	France	496	497	498
32	Greece	483	466	470
33	Spain	481	483	488
37	Israel	474	447	455
41	Turkey	464	445	454
44	Chile	449	421	447
46	Bulgaria	429	428	439
48	Mexico	425	419	416
49	Roumania	424	427	428
50	Thailand	421	419	425
53	Brazil	412	386	405
55	Jordan	405	387	415
56	Tunisia	404	371	401
57	Indonesia	402	371	383
58	Argentina	398	388	401
64	Azerbaijan	362	431	373
65	Kyrgyzstan	314	331	330

Source : PISA 2009 database of the OECD

that of East Asian (466). Even, when the score is adjusted to take into account the difference in GDP per capita and secondary gross enrollment rate, the result is still lower in MENA countries. The adjusted score reveals, for example, that in Jordan, Lebanon, and Egypt students have lower score than GDP/capita and gross enrollment would predict (World Bank, 2008). For Egypt, Hamer (2007) listed the main weaknesses of the training system in universities. It mentions the fact that the courses are mainly provided by badly or poorly trained students, with very high absenteeism rates among both teachers and students, very high rate of drop-outs especially in the first short cycle of two years (50% drop-out), an obsolete curriculum and unsuitable for the labor market, etc...

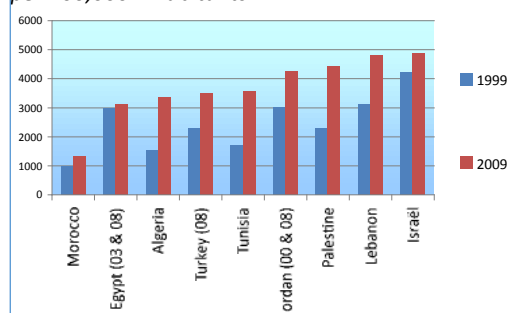
The second problematic point, still related to the quality of the education system, is the rising number of drop outs consistent with the rise in enrollment rate. The drop out includes both compulsory educa-

tion (15-25%) secondary and tertiary education. Indeed nearly half of adults continuing their education beyond the compulsory school leave the education system without validating their training (World Bank, 2008). With the influx of students in higher levels of education, the case of drop out can become a major issue for MENA countries if they do not put in place alternative systems such as schools of second chance

### A very rapid increase in the number of university students

In MENA countries, since the mid-1990s, the number of young people continuing their studies at a higher level in high school has increased dramatically. For example, in Tunisia, the number of university students has increased threefold since the mid-1990s from 100,000 to over 360,000 in 2009, and the new students who were 25,000 in 1995 have gone up to 90,000 in 2008 (Table 4). In Algeria, the rise was just as significant, the number of students in higher education increased from 300,000 in 1995 to over 1.1 million in 2009. If we compare the number of students in the higher education to the population, MENA countries, except Morocco, have between 3,000 and 4,800 students per 100,000 people (Figure 3). Morocco, which had nearly three times as many students in higher education as Tunisia in the 1990s is now set back with only 1,300 students per 100,000 people. These rapid changes in student numbers result in a rapid rise in the number of graduates who enter the labor market. Thus, Egypt and Turkey have more than 400,000 new graduates arrive on the labor market every year. In Algeria, the figure is 150,000, in Tunisia and Morocco it

Figure 3. Number of students in tertiary education per 100,000 inhabitants



Source : Unesco

Table 4. Number of students in tertiary education

(in thousands)	1990	1995	2000	2005	2008	2009
Algeria	259	298,8	.....	792,1	.....	1149,7
Egypt	733,3	.....	.....	2397,4	2488,4	.....
Israel	122,6	182,8	255,9	310,9	325,2	342,7
Jordan	69,4	87,5	142,2	217,8	254,8	.....
Libanon		815,9*	1160,1	1657,3	1966,8	1996,6
Morocco	253,9	294,5	276,4	366,9	401,1	418,8
Syria	214,2	215,7	.....	.....	.....	.....
Palestinian Terr.	.....	.....	71,2	138,1	180,9	182,6
Tunisia	62,7	102,7	180	311,6	350,8	360,2
Turkey	685,5	1174,3	1588,4	2106,4	2532,6	.....

Source : Unesco, Public and private. Full and part time \*1996

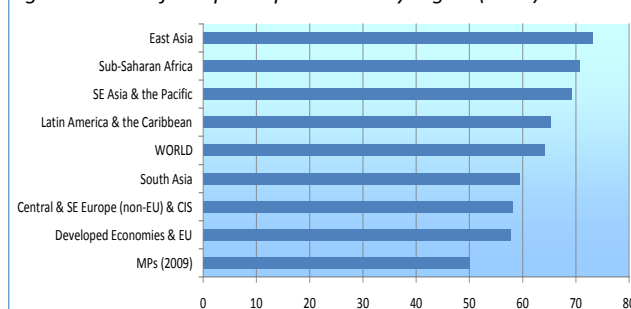
is close to 70,000. These countries then need to provide jobs matching the skills and the expectations of these new graduates, both in terms of salary and working conditions.

### III. A difficult transition from education systems to the labor market

#### Very low labor force participation rate

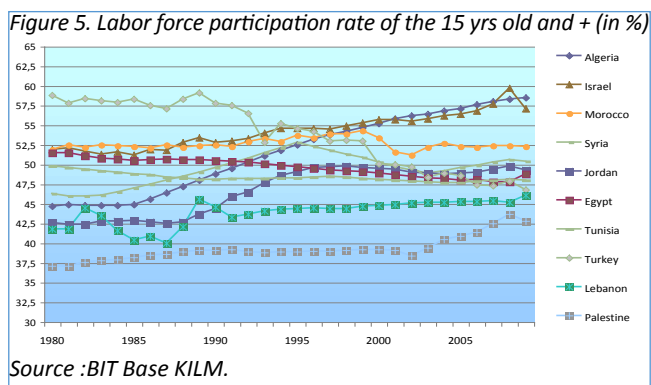
Mediterranean countries are characterized by the lowest labor force participation rate among the major regions of the world. Indeed, on average, one person out of two aged 15+ works in Mediterranean countries whereas this rate is close to 60% in EU countries and is 65% on a world global scale (Figure 4). This low participation rate is mainly due to that of women that being less than 25% [3] in most MENA countries, against an average of 52% on a global scale. The participation rate for all MENA countries remained stable over the period 1980-2009, as it was 52% in the early

Figure 4. Labor force participation rate by region (2008)



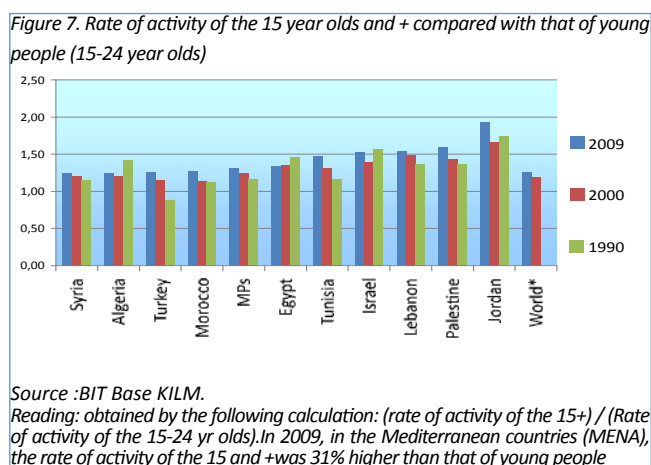
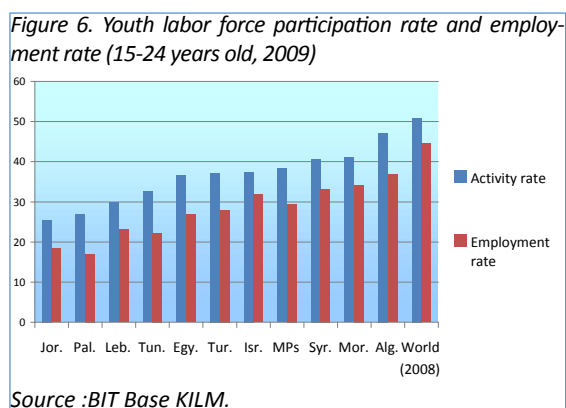
Source :BIT, BASE KILM

MENA countries: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine, Syria, Tunisia and Turkey



1980s. However, some countries such as Turkey and to a lesser extent, Tunisia, saw their participation rate decrease over the period, unlike Algeria and Israel for which we observe a rise (Figure 5). The level of education plays an important role in the participation of women in particular. For example in Turkey, the female's participation rate is 15% for those with a level of education lower in high school while it rises to 75% for those whose level of education is higher in high school (Dovis and Kocoglu, 2009).

For the young people, the participation rate in MENA countries is relative to the other parts of the world much lower: 38% against 51%. This discrepancy is explained, as noted above, in large part by the female's low participation rate. The participation rate of young people in most MENA countries is on average 30% lower than that of the 15 year olds and older (Figure 7). This gap of participation rates between young people and the entire population is comparable to the one observed on a global scale and reflects mainly the fact that young people continue to study. This gap has tended to increase over the past two decades, meaning that a larger part of the youth tends to pursue their studies over a longer period.



To sum up, if we assume that the activity rate (especially of women) in MENA countries will converge to other regions of the world, the demographic effect will then be added to the second "activity rate" effect involving employment needs in the next decades. By projecting the population dynamics, Blanc (2011) estimates that the MENA countries would need to create a minimum of 34 million new jobs by 2030 simply to keep the participation rate and the unemployment rate at their current level. This figure rises to 90 million if the aim is to provide a job to all the new entrants into the labor market. In other words, the number of job creations has to double if the number of job seekers does not change.

#### Youth face high unemployment rate[4]

MENA countries are by far the region of the world in which the youth unemployment rate is the highest: 25%, that is to say, twice as much as the world average (Figure 8).

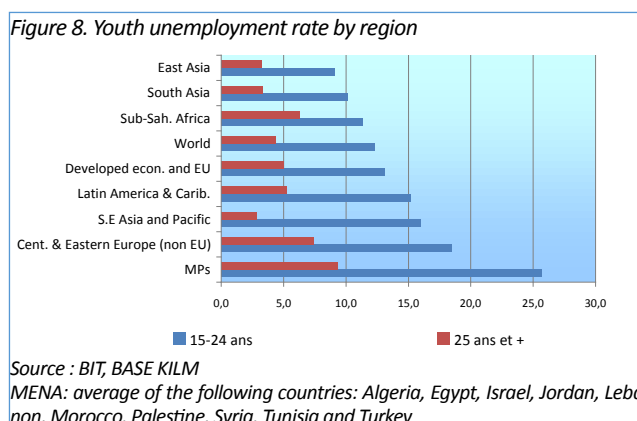
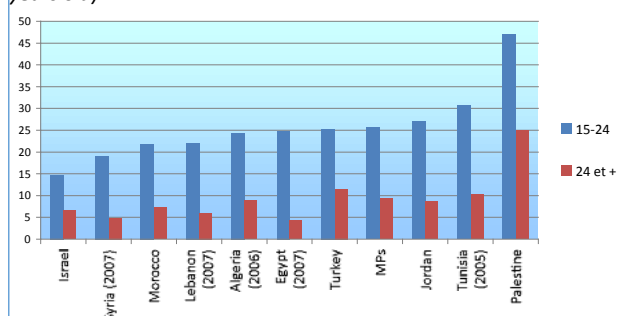


Figure 9. Youth unemployment rate in Mediterranean countries (15-24 years old)



Source : BIT, BASE KILM

MENA: average of the following countries: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine, Syria, Tunisia and Turkey

The situation of young people with the exception of Israel is critical for most MENA countries especially Egypt and Tunisia (Figure 9). Egypt in fact stands out with a youth unemployment rate nearly six times higher than that of adults. Tunisia [5] and the Palestinian Territories have the highest level of youth unemployment rate in the region with respectively 30% and 45%. Thus, young people in MENA countries (except Israel), account for one third and 60% of the unemployed (Figure 10). This ratio tends to increase with the financial crisis as a result of the drop in labor demand, precarious contracts for young people who are victims of the “last-in first-out” rule (Scarpetta et al. (2010)) and their lack of experience (Perigini and Signorelli, 2010). Moreover, the crisis increases the structural problems which affect the transition between the educational system and work; young people have to find a job “to survive” in particular in the informal sector.

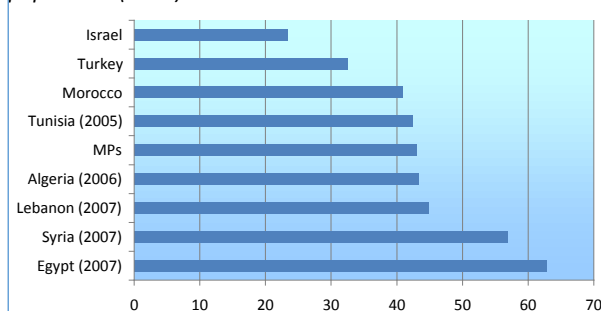
This situation of high unemployment rate for young people represents the main challenge for MENA countries insofar as it has important consequences on the dynamics of the economy, the inter-generational balance and the relationship of young people with society and may have important political repercussions, as was shown by the events of the “Arab Spring”.

We shall firstly analyze youth unemployment according to the level of education and then take an interest in the average length of youth unemployment.

#### IV. The education/unemployment relationship: a source of major concern for the youth

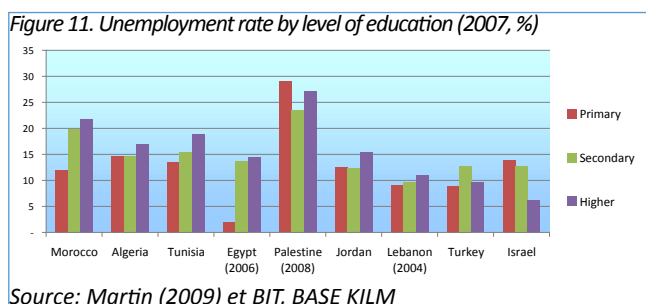
From a macro-economic perspective, investment in human capital is justified because it is one of the most important sources of economic growth (Maguain, 2007, Aghion and Cohen 2004, for a review). From a micro-economic perspective, investment in education is justified in human capital theory by the perception of a wage premium and/or a lower risk of unemployment. This result holds generally: the higher level of education an individual has the greater the chance he has, for a given specialty, to get better job and a higher wage. Econometric studies on the private rate of return to education in MENA countries clearly show a significant positive effect between the level of education and wages but the level of this private return is very heterogeneous. It seems relatively low in Morocco and Algeria, countries where the extra year of education provides a gain in terms of wage less than or equal to 5%. For Egypt, Tunisia and Turkey, the results are fairly consistent with those obtained for the developed countries, between 5% and 15% (Dovis and Kocoglu, 2009). In MENA countries, the private rate of return to education seems to increase with the level of education in contrast to results obtained in other parts of the world. This result could be linked to the important share of public employment for graduates of secondary and higher education (World Bank, 2004). These results should be taken with caution since these studies are re-

Figure 10. Share of youth unemployed out of the total unemployed population (2009)



Source : BIT, BASE KILM

MENA: average of the following countries: Algeria, Egypt, Israel, Lebanon, Morocco, Syria, Tunisia and Turkey



latively old and therefore they partially account the recent deterioration of young graduates' insertion in the labor market. Then, if the positive relationship between education and wage seems robust, that between education and employment is more fragile. In developing countries, and particularly in MENA countries, this result may indeed be questioned because of market imperfections in the labor market and/or a serious imbalance between supply and demand for graduates.

#### **University graduates are more likely to be unemployed than non-graduates**

The rapid increase in graduates' supply (Table 4) has not encounter the expected number of jobs, in consequence the youth graduates' unemployment rate has increased. Although the available database about the unemployment rate by level of education from the ILO is very incomplete, data reveal, for most MENA countries, a growing relationship between the unemployment rate and the level of education (Figure 11). This result highlights the mismatch between graduates' labor supply on the one side and the graduates' labor demand on the other side. The case of Tunisia is a good illustration of this imbalance.

#### **The graduates' high unemployment rate enigma in Tunisia**

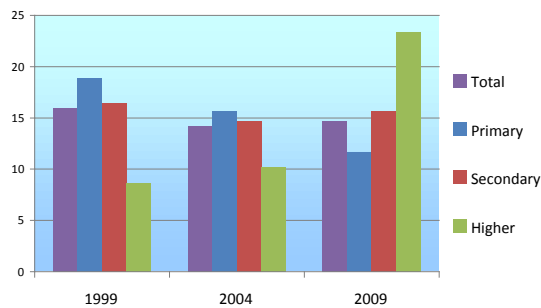
Over the 1999-2008 period, the pace of Tunisian economic growth was good, equal to 5% per year on average. However, while this performance was enough to keep the overall unemployment rate constant, it failed to fight against a phenomenon that has become a concern in most MENA countries: the significant increase in the university

graduates' unemployment rate. This trend was so marked that over one in five university graduates are unemployed, while the unemployment rate for the whole of workforce is 14%. How can we explain the inverse relationship appears between the level of education and unemployment rate despite high level of economic growth?

Analysis of the Tunisian labor market shows that university graduates represented 17% of the 3.7 million labor force in 2008 against only 8% in 1999. This rate has doubled in less than ten years reflecting the strong increase in the graduate workforce on the Tunisian labor market. The rise in the university graduates' unemployment rate, especially from 2004, shows that the labor market has not been able to absorb this new workforce. Indeed, the graduates' unemployment rate has more than doubled over this period. It went from 8% in 1999 to over than 23% in 2009 while the unemployment rate for the whole of labor force remained relatively stable at around 14%. University graduates are well gone from being «relatively protected from unemployment» to «first victims of unemployment» in Tunisia (Figure 12). Also, out of nearly 600,000 active university graduates in Tunisia, 128,000 are unemployed and a quarter of unemployed are university graduate in Tunisia (Benhalima et al, 2011). For other categories of the population (lower degree than university level or no diploma) the unemployment rate did not experience this strong rise. For graduates of primary school, it decreased from 19% to 12% and for high school graduates, it would have remained stable at around 16%. These figures would highlight that the unemployment crisis is specific to university graduates in Tunisia. Since 2007, we have seen in Tunisia a positive relationship between unemployment rate and the level of education. Stampini and Verdier-Chouchane (2011) also found, from an econometric model performed with data from the labor force survey (LFS), having a university diploma increases the probability of being in unemployed.



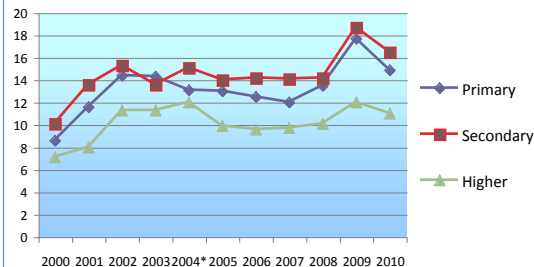
Figure 12. Unemployment rate by level of education in Tunisia



Source: Ministry of Employment and Occupational Integration of Young People

The 2004 survey conducted jointly by the Tunisian Ministry of Employment and the World Bank on the insertion in the labor market of a sample of nearly 4,800 university graduates shows results even more negative on the situation of graduates. Indeed, 18 months after graduation, 46% of youth are unemployed and only 31% are in employment. If the situation improved in the second wave of survey 3.5 years after graduation, it is still very negative. Only one out of two young graduate had a job and 30% is still unemployed,

Figure 13. Rate of unemployment according to the level of education in Turkey, (whole of the population)



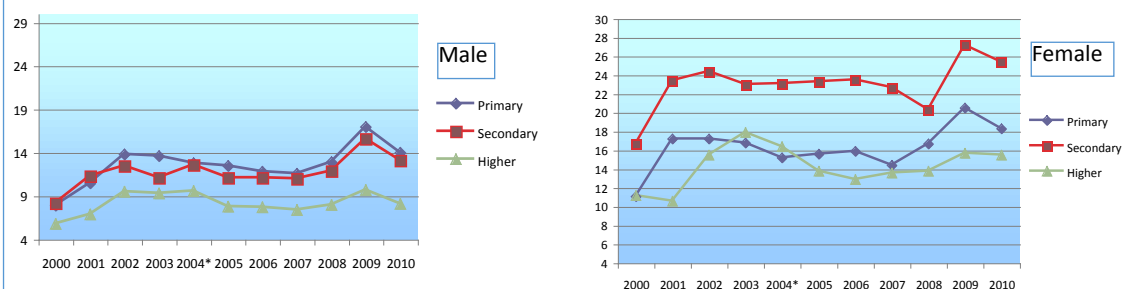
Sources : Turkstat , \*Change of methodology in the employment survey in 2004

a large majority in a pattern of persistent unemployment (World Bank, 2009).

### The particular case of Turkey

In Turkey, graduates' unemployment rate is, as predicted by the theory, lower than that observed for primary and secondary school graduates. In contrast, high school graduates have a higher or identical unemployment rate than a lower level graduates. In Turkey, the bell-shaped relationship between the level of education and the unemployment rate is not new and can be seen over the period 2000-2010 (Figure 13). This result is related to the relationship between the level of education participation rate and unemployment rate for women. In Turkey, female's participation rate is generally very low but it increases quite sharply with the level of education. The participation rate of women increased from 15% for those whose level of education is primary to 30% for secondary and 70% for the university level. A high participation rate may then lead to a greater unemployment rate if female graduates do not find a job. While for female graduates from the university the unemployment rate remains in the national average (15%), it is higher (26%) for high school graduates (Figure 14). Also, the bell-shaped curve relationship between education level and unemployment rate observed in Turkey is due to the very high unemployment rate of women with a secondary education level. In Turkey, the structural trend shows an increase in the level of

Figure 14. Unemployment rate by level of education in Turkey, (total population)



Sources : Turkstat  
\*Change of methodology in the employment survey in 2004

education especially for women. Currently 9% of female have a higher level than the high school against 13% for male. But with the new generations, women are much more present than men in higher education: for the generation 1977-81, 25% of women have reached a higher level of education in High School against 21% of men. This increase of the level of education of women could lead initially to an increase in unemployment rate by the transition effect from being non-active to active but have a long-term positive effect on Turkish economic growth (Dovis and Kocoglu, 2009).

## V. How can the youth graduates high unemployment rate be explained?

Despite a satisfactory growth rate in the region (5% per year on average) the unemployment rate for university graduates increases this means number of job creations for graduates is insufficient compared with the demand. This result indicates that the relationship between the economy growth rate and the net creation of skilled jobs is weak because of growth path with poor total factor productivity gains (Blanc et al., 2007).

### An exaggerated public sector bias

Historically, the public sector was the main outlet for university graduates in MENA countries (World Bank, 2004). Although this distortion of skilled jobs to the poorly productive public sector may be sub-optimal for long-term dynamics, because it hampers the total factor productivity (TFP) gains, it may provide some social cohesion between young people and society. This social contract has slowly disintegrated under the effect of a double evolution. On the one hand, as described above, the numbers of graduates has increased rapidly while, on the other hand, there is a decline or a slowdown in hiring in public sectors. Indeed, MENA countries have committed themselves during the 1990s, under the impetus of structural adjustment programs, to privatization and liberalization policies for their economy

and have faced severe budgetary constraints. For example in Morocco, the share of the public and semi-public sector in total employment (including non-graduates) rose from 11% in 1999 to 8.5% in 2010 [6]. In Egypt, where the public sector has much greater share, the share of public employment has rose from 35% in 1995 to 31% in 2004 (Amer, 2007) and in Tunisia from 19% in 1997 to 13% in 2003 (INS). The public sector offers numerous advantages compared with the private sector, such as employment protection, access to social security fund with favorable conditions for the pension system and, what is another important element, a higher starting wage. In most MENA countries, wages in the public sector are actually higher than in private sector. The gap is particularly important in Morocco with an average wage in the public sector 75% higher than in private sector (Table 5). These benefits, in particular the wage gap, affect the job-search strategy of individuals by changing among other things, their reservation wage especially for graduates.

Using the survey on the integration of Tunisian 2004 university graduates, Ben Halima and al. (2010) show that graduates who find a job, 18 months after graduation, receive, all things being equal, a higher average wage than those who find a job in the private sector. These wage benefits in public jobs are based solely on the integration of a Master's degree. Indeed, if the latter succeed the entrance examinations in the public sector, they will access to employment, especially in Education, with an average wage of about 520 Dinars. However, if they fail the entrance exam, they are either unemployed or have access to low-paid jobs (on average

*Table 5. Average wages paid in the private sector and in the public sector (in euro per month)*

	Morocco	Algeria	Tunisia	Egypt	Palestine	Jordan	Libanon	Syria
Public Sector	489	180		153	349	335		150
Private Sector	281	220	338	106	315	268	484	144
Minimum wage	163	120	133,5	102		157	256	103

Source: Martin (2009), table 2.3.1



290 Dinars) in the private sector and mostly in the informal sector. For the other degrees, the authors find no significant wage differences between public jobs and private jobs. This latter result shows that the private sector is not, in terms of wage, sufficiently attractive for graduates. The report of World Bank on the situation of these graduates 3.5 years after graduation confirms these results: the wages of the graduates employed in the civil service are on average 36% higher than those employed in the private sector. In Morocco too, we observe that starting wages in the public sectors are on average 40% higher than those in the private sector (Boudarbat, 2004). Thus the combination of a scarcity of public sector jobs and the rapid growth in the number of graduates has led to the formation of long “waiting lists” as described in the “job competition” model (Thurow, 1975). The young graduates of MENA countries would be more likely in rent-seeking strategies with obtaining job in public sector and thus steer away from more productive activities for growth (Pissarides, 2000). Consequently, young people are likely to choose courses of generalist training which provide higher chance to access to public sector jobs, to benefit from social advantages and better wage. Then, after graduation, they would wait for a job corresponding to their expectations in terms of wages and working conditions which the public sector is best able to provide them (Boudarbat, 2004).

These studies on the bias introduced by the share of the public sector still remain nevertheless to be consolidated by micro-econometric studies especially by questioning student’s strategy as to their choice of training and their behavior in the “queue”. Furthermore, studies on the importance of public sector in MENA countries date from the 1990s [7], and in the absence of recent statistics on the subject, it is difficult to analyze more precisely the role of the public sector on the employment of young graduates over the last decade. Finally, it is difficult to have an in-depth statistical analysis of the private sector since informal sector plays a major role in the economies of MENA countries.

## **The difficult transition towards the knowledge economy**

The recruitment of graduates in the private sector has on its side remained relatively non-dynamic absorbing only a very low proportion of the additional graduates. Indeed, the productive structure of the MENA countries is till turned towards sectors with low level needs in highly qualified labor (agriculture, services, tourism, manufacturing industries with low technological content). In Tunisia, for example, 90% of the jobs in the textiles/clothing sector is made up of operational agents, with executives representing less than 5% of jobs (source: ONEQ). If we continue with the example of Tunisia, we observe that from the labor demand side, the evolution has been relatively stable since the beginning of the 2000s: the Tunisian economy generates, on average, each year nearly 80,000 new jobs which is sufficient to contain or even slightly reduce the unemployment rate among working people as a whole. However, the nature of the jobs proposed does not correspond to that of the work offer. It would be necessary to create a minimum of 50,000 new for university graduates and 30,000 for lower levels of education. Yet the Tunisian economy currently proposes the opposite: 50,000 poorly qualified jobs and 30,000 qualified jobs (Zaïbi, 2008).

This inappropriateness between the dynamics of the offer and that of the demand for work hence explains, from a quantitative point of view, the important rise in the unemployment rate of university graduates. However, the evolution of the productive structure towards a growth mode more focused on the knowledge economy requires structural economic policies (other than those based upon financial aids to companies hiring young graduates, cf. above) and long transition times. It should be noted that the rapid development of the level of education has not been translated, unlike the predictions of the standard economic models, by very large gains in productivity (Blanc et al, 2007). This underlines

the fact that the growth regime of these countries still remains a majority extensive with a very weak growth of the TFP. This is the paradox of the productivity associated with the MENA countries, to take up and adapt the famous Solow formula (1987) [8]: the graduates are everywhere except in the productivity statistics. This situation is harmful both on the growth dynamics level for the young graduate human capital is not used to support growth and sends a negative signal for the future generations who may renounce investing in education, preferring a less qualified job or emigration.

The integration of the generation of young educated people requires the development of a formal private sector which should be more oriented towards qualitative sub-sectors which favor the emergence of high added-value activities such as the new technologies in Tunisia, for example. The corollary of this upgrading of the productive structure is a drop in the importance of the informal sector which represents, according to the estimations and methodology chosen, between 30% and 60% of private jobs excluding agriculture in the MENA countries. Such an important weight of the informal sector, while it provides a certain flexibility to the labor market and offers a minimum amount of income, hampers the development of the activities with high productivity gains and reduces the efficiency of economic policies (Blanc et al., 2007).

### **Mismatch between skills supply and demand**

The different reports of the World Bank (Kabbani and Khotari, 2005 for example) used by other studies (Martin, 2009 for example) on the question, present mainly the inappropriateness of the training of young people compared with the needs of companies as a major cause. University training may be too oriented towards generalist education and may neglect technical and scientific training and the quality of university education is likely to be of a relatively low level (Martin, 2009). For example, according to the survey carried out on a sample of Tunisian graduates in

2004, the unemployment rate is highest among the higher technical operatives and those holding Master's degrees notably those graduates from the sub-sectors of law and the human and social sciences (World Bank, 2009). To escape from unemployment, young people may accept a job which does not correspond to the level of their diploma, they are then in a situation of declassification. For example, according to the results of the survey of Tunisian graduates of 2004, the declassification [9] affects 35% and 28% of them respectively 18 months and 3.5 years after they have obtained their diploma. Those with a Master's degree are the most affected by this phenomenon especially those graduates in the tertiary sub-sectors such as law, the human sciences or the economic and management sciences: between 50% and 60% of declassifications 3.5 years after obtaining their diploma. It would thus appear that these university graduates only rarely find a job given the high unemployment rate and when they find one, it generally does not correspond to their level of qualification [10] or is not at all in the special field of their training. Correcting this problem would require rethinking the system of university training so as to adapt it more to the needs of the private sector, this, for example, is what the World Bank reports recommend. However, data from UNESCO on the share of the numbers in technical/professional education in the secondary cycle does not reveal the systematic backwardness of the MENA countries compared with the developing countries in other regions. Thus, in Egypt, Turkey and Lebanon, for example, the students in the secondary cycle in occupational training represent between 15% and 20% [11] of the total of students; that is the same ratio as in China or Mexico, for example.

The problem is not likely to be linked solely to the volume of students trained but to the quality of the training and its appropriateness to the needs of businesses. There exists, at least in the minds of recruiters, if not in the facts, a difference between obtaining a diploma and having a particular com-

petence. Companies are looking for competence and the diploma is not, in the case of countries with a high rate of graduate unemployment, the vector by which the young people signal their competence and their level of productivity to companies. We are likely then to be seeing the failure of the signal effect of the diploma by two effects. The first is linked to the rapid rise of the numbers in secondary education: according to the signal theory (Spence, 1973) the effectiveness of the signal effect sent by the diploma will only be effective if the training plays the role of filter and hence that obtaining the diploma necessitates a large investment. Too easy an access, or assumed so to be by recruiters, brings about a rapid depreciation of the diploma and would cancel the signal effect associated with the diploma. The second effect concerns the quality of the training and the range of competence required to obtain it. While recruiters are convinced that obtaining the diploma in question reveals no information on the potential « productivity » of the individuals, they will not be able to use the diploma as an element of the selection of candidates. Furthermore, this result would be even stronger as the students are heavily concentrated on a very small number of diplomas. In fact, in the theory of the filter (Arrow, 1973), the heterogeneity of the positions available on the labor market requires in return a heterogeneity of competence. If the university “produces” homogeneous individuals for the civil service its role of filter would disappear. Faced with this devaluation of diplomas, young people seek other “signaling” strategies such as using family or social networks, or acquiring experience through jobs requiring lower skills. One of the challenges for educational policies to come would consist in modifying the perception that recruiters, especially from the private formal sector, have diplomas to give renewed credibility to the signal sent by the training.

As pointed out previously, training in the MENA countries is of a relatively poor quality (cf. Table 3) which is also an explanation put forward to explain

why the private sector does not use graduates in greater number. Furthermore, the rapid rise in the rates of schooling in the secondary and tertiary cycles added to strong budgetary constraints have not enabled an evolution in the quality of training (Dessus, 2001). The company managers quote the poor quality of training as one of the major obstacles to the hiring of young graduates (Assaad and Roudi-Fahimi, 2007). Finally, the reproach is also made to training in the MENA countries that it does not prepare young people to become entrepreneurs and therefore create their own job. While this idea is attractive it comes up notably against the difficult access conditions to loans in the MENA countries as well as the various administrative blockages and other market imperfections which limit the creation of businesses (entry barriers, high transaction costs, corruption).

#### **Economic and social exclusion: an ever present risk for the youth**

The unbalance between on the one hand the offer of a qualification which is poorly adapted to the needs of the labor market and a demand for graduate labor less dynamic than the offer over the past decade, has brought about a rise of the stock of graduate jobseekers. The persistence of this imbalance has had as a consequence a prolongation of the “waiting list”. In the theoretical approach of “job competition”, individuals may, when the waiting list gets longer, either choose to prolong their wait therefore the length of their unemployment, or change waiting list by postulating for jobs which are less in phase with the expectations (job in the formal private or informal sector). Given the duration of unemployment of graduates especially the first to leave the educational system, it would seem that the young people choose to remain in the list (O’Higgins, 2003). For example in Morocco more than one young unemployed person out of two is new entrant on the labor market (Lakhroua, 2010). In Tunisia, the average duration of unemployment is 28 months for graduates from the university against 19 months for non-graduates (Stampini

and Verdier-Chouchane, 2011). In Egypt, the average time taken to find a job for young people is 29 months. This problem may be accentuated by the segmentation into three components of the MENA countries' labor market: the public sector with high salaries and good social protection, an informal market with low salaries and an absence of protection and the formal private sector with average salaries and a high degree of rigidity. The latter reflect notably through an indicator which measures the difficulties of highest redundancies than in other regions of the world (Figure 15). These rigidities on the labor market are often presented as the main causes of long term unemployment in the MENA countries as well as the large and growing weight of jobs in the informal sector. While the MENA countries have adopted since the middle of the 1990s measures facilitating access to the labor market with especially the development of short term work contracts, on the redundancy side, on the other hand, little noteworthy evolution is to be signaled. Also the economic redundancy procedures remain administratively very complex and costly for the companies. In this context, the informal sector is developing for it represents an alternative both for young people awaiting a « quality » job in the public sector or in the formal private sector and for companies which escape from the weight of the administrative procedures and fiscal contributions.

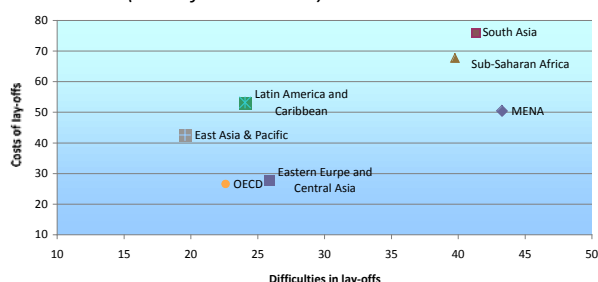
The problem of the length of the unemployment of young graduates is a central issue in several respects. Firstly, the estrangement of young peo-

ple from the labor market makes any back-to-work initiative costly and uncertain. It leads to a depreciation of the human capital which is their main asset on the labor market. It may turn away future generations durably from investments in education and encourage young people to emigrate. We are then witnessing the appearance of a discouraged class of young workers who may fall into the trap of "exclusion unemployment". The leaving aside of the more highly educated young generations than the older generations but installed on the labor market is likely to create a situation of "generational rupture": the adults reproach young people for their poor motivation in occupying a position in the private sector and the young reproach their elders for blocking their situation.

### Migration, a way out?

The MENA countries are living through large exit migratory flows which affect especially the qualified labor force. These exit flows are oriented essentially towards the countries of the Arabian Peninsula and Europe. Migration may represent one response likely to face up to the imbalance present on the Southern Mediterranean labor markets. Nevertheless, the size of the employment challenge in the MENA countries over the next 10 to 15 years is such that there is no realistic scenario in which migration would be able to solve the problem. Migration, on the one hand enables transfers of income which have played a fundamental role as a result of their volume in the social stabilization up to the world

Figure 15. Doing Business indicators related to the difficulties of redundancies (index from 0 to 100)



Source : Angel-Urdinola and Arvo Kuddo, (2010), *DoingBusiness 2010*

Figure 16. Education level of migrants coming from the MENA countries into the OECD (2000)



Source : Adams (2006)

economic crisis. The remittances from migrant workers currently represent an essential element for the economies of the countries considered, for their volume exceeds that of FDI and government aid (Aita, 2008). On the other hand, even if the migration of the young people limits the pressure on the labor market, the brain drain leads to the loss of human capital which is harmful for the long term development dynamics of the MENA countries. For the whole of the MENA countries, brain drain represents 9% of its graduate population while at the world level the average is 5% (Blanc et al., 2007). Migration of graduates concerns mainly the countries of the Middle East (Egypt, Israel, Jordan, Lebanon, Syria) for which graduates from higher education make up more than half of all migrants (Figure 16). For the countries of the Maghreb (Morocco, Algeria and Tunisia) the great majority of migrants has a low level of education. However, these data cover the year 2000 and would deserve to be re-actualized to take account of the consequences in terms of migration of the degradation of the situation of graduates on the labor market. The motivation of candidates for migration is mainly a question of economics. The national surveys on the subject show clearly that the main “push” factors are linked to integration into the labor market and increasingly large differences in salary level (Martin, 2009). However, the relatively high level of migration introduces a de facto selection among candidates, the higher level graduates are hence the most mobile at the international level. The migration demand from young people in the MENA countries comes up against, on the one hand, the restrictive immigration policies of the EU countries and on the other hand the competition from immigrants from the Asian countries into the oil producing countries of the Arabian Peninsula.

## **VI. Active labor market policies for youth**

The public authorities, which have become aware of the problem of the employment of young people and especially university graduates, introduced from the beginning of the 2000s measures of aid and support for their integration. These

measures are a combination of several types of program (BIT, 2010). Firstly, the governments have introduced policies of subsidies for the employment of young people which, if they are well-targeted, may enable young people to find a place on the labor market. This type of measure comes up against the well-known problem of the wind-fall effects for companies as well as the effects of substitution between the targeted population and the rest of the population. Furthermore, the jobs created with this system run the risk of disappearing with the end of the subsidy. Other public policies try to favor occupational training of young people to enable them to acquire an experience in the business world. However, the training is not enough to guarantee access to employment, it still has to create jobs. Governments have also tried to improve the follow-up of the unemployed to help them in their search for a job or even develop public “young person” jobs for general interest missions. Finally, policies of aid for the creation of businesses are likely to respond to the economy’s needs for the creation of jobs and the expectations of the young people in terms of independence and freedom. In the MENA countries, the governments have tested these types of public policy with limited success. The example of Tunisia is a good illustration of it.

## **Poor results of active labor market policies**

As in the majority of countries, Tunisia has adopted a series of programs to limit the risks linked to unemployment and stimulate employment. These active programs for the labor market include: placement services; subsidies for the cost of labor (salaries and/or social contributions); the training programs and the employment-generating programs such as the financing of small projects. In Tunisia these programs consume nearly 1.5% of GDP (Ben Halima et al. 2011). The programs intended for graduates from higher education include notably Courses of Initiation to Professional Life (SIVP), the terms and conditions of which were revised in January 2009 so as to make them

more effective and respond to the consequences of the international crisis on youth unemployment. These programs are intended for young graduates from higher education. In this context, the young trainees who are first-time job-seekers receive during their training course a monthly indemnity provided by the State which varies between 100 DT and 250 DT, plus social cover as well as an extra indemnity which the companies grant them. The course lasts one year renewable once if necessary for the integration of the trainee. The companies which recruit trainees at the end of their training course are exonerated from social contributions for one year. The joint report of the World Bank and the Tunisian Ministry of Employment provides some elements on the effectiveness of the SIVPs (prior to the reform of January 2009). Over the period 2004-2007, more than one out of four graduates (27%) benefited at least once from an SIVP contract. While the SIVP concerns all types of diploma, out of the 10,200 SIVP contracts, almost all concern the holders of a Master's degree (50% of the SIVPs) and qualified technicians (42% of the SIVPs). As Table 6 underlines, the effectiveness of the integration contracts is quite relative. Compared to other diplomas, the young people who had followed an SIVP have on average a slightly lower unemployment rate (30% against 36%) but the integration rate with an unlimited contract job is less impressive (22% for SIVP against 28% for other). If we add the windfall ef-

fects for the employers, which are always present with policies of recruitment subsidies, the cost-effective ratio of this measure would not seem to be very favorable. A more in-depth econometric study would enable this effectiveness to be assessed more precisely. The Tunisian government has introduced other types of public policies such as for example the 21-21 Fund, the aim of which is to support young people (not solely graduates) in the reconversion or the development of a project such as the creation of a business. These different measures have not for the moment succeeded in bucking the trend on the integration of university graduates, even if they have had some positive results. The demand for work, notably from the private sector, addressed to them remains highly insufficient. Further, the active employment policies target more particularly graduates and leave less place to young people without skills, making their situation yet more difficult.

Morocco has also adopted a series of programs since the middle of the 90s to favor the employment of young people (complementary training, re-organization of the National Agency for the Promotion of Employment and Competence, support for the creation of businesses) but these measures have not met the expected success in terms of the integration of young people (Bardak et al., 2006). In 2002, Jordan had started a vast program of training with the help of the army, notably, but

Table 6. Situation of university graduates with or without SIVP experience

	All graduates		Master graduates		Qualified technicians	
	SIVP	NON SIVP	SIVP	NON SIVP	SIVP	NON SIVP
Permanent contract employee	22	28	23	29	18	19
Fixed term contract employee	26	14	25	12	26	16
Others	14	6	12	6	15	9
Non employed	3	4	2	3	5	5
Unemployed	29	36	31	36	29	43
Inactivity	7	12	7	14	7	8
Total	27	63	100	100	100	100

Source: World Bank (2009). The table concerns the situation in 2007 of university graduates who obtained their diploma in 2004. Results of the survey among a sample of 4,763 graduates

this program, lacking results, was abandoned at the end of three years. De Gobbi and Nesporova (2005) stressed that the active employment policies in Egypt did not have the success expected as a result notably of the inappropriateness of the training of the unemployed compared to the needs of businesses, as well as a lack of access to the sources of financing for the promoters of projects for the creation of businesses. Access to bank financing for the promoters of projects is in fact a major obstacle to economic activity in the MENA Countries. The World Bank survey among banks from the MENA region throws light on the fact that access to financing for SMEs encounters more restrictions in the MENA Countries than in the other emerging regions, with only 20% of SMEs benefiting from a loan or a line of credit. The loans to SMEs represent only 8 % of the total volume of the loans granted by the banks in the region, the objective being to bring this rate to 20%, which is the rate observed in the other regions of world (World Bank, 2009). The financing of SMEs is based to a large extent on public banks. The World Bank survey helped to identify the main factors which hamper the granting of lines credit to SMEs. The lack of transparency of the SMEs, the bad quality of information about loans available and the lack of protection of the rights of creditors are the main elements put forward. Hence, improving the integration of young people through the development of SMEs also necessitates a policy aiming to improve the system of financing the economy .

To resume, the active employment policies in the MENA countries generally suffer from insufficient targeting, a difficult even partial implementation, a heavy independence on the financing from external partners such as the World Bank or the EU (Assaad and Barsoum, 2007), and very limited access to the credit market for SMEs in general and the young project promoters in particular. Finally, impact or evaluation studies of the active policies are very rare even non-existent making feedback and the coordination of the different policies very difficult and limiting the effect of “learning by doing”.

## **VII. Conclusion and recommendations**

### **The need for a systemic approach**

The issue of youth employment in MENA countries is now an absolute priority for the next twenty years. By then the pressure from young job-seekers will be attenuated and the equilibrium reached at the end of this period will be persistent. It is therefore urgent to put this issue at the heart of the social contract and get a large consensus for that. The above developments show perfectly well that we are facing a systemic problem which concerns listening to the expectations of the youth, its participation in the strategic choices and their representation in power-sharing. If education and training are at the heart of the problem, many other elements are concerned like the functioning of the labor market, the creation of businesses, bank financing, the terms and conditions of recruiting in public sector and the collective dynamism of society particularly in its ability to create new values (scientific, technological, cultural).

This global movement should be promoted and controlled at all levels of decision-makers. It involves an impetus at the highest level of the State which should result in a rejuvenation of the leaders and elected representatives (Mediterranean societies are still marked by patriarchy), trade-offs at Prime Minister level which favor this target in the structural policies and the implementation of large projects as well as systems for evaluating results. Thus, especially the examination of large projects, authorization for installations, including FDI, should systematically include an assessment of expected effects on youth employment. The minimum being that the National Statistics Institutes regularly undertake the necessary labor force surveys, which is far from the case today.

Besides the necessary national impetus decentralized procedures (regional and local) enabling the territories to advance in line should be added. It has to be said that current decisions to create

public jobs reserved for young people or temporary aided jobs, if they are understandable in the short term to answer the demands of the “Arabian Spring”, are by no means long-term solutions. Too pronounced they get the risk of putting an exaggerated strain on the public budgets and especially of avoiding the fundamental social contract revision which was discussed above.

### **Changing relations between education/training and the labor market**

As we have seen, in terms of employment, we have, on the one hand, a labor supply with a rapidly changing nature, it becomes more and more skilled (hence, in Tunisia, among the new entrants in the labor market the university graduates are now the majority). On the other hand, the labor demand seems to remain attached to the old system of specialization in unskilled work. From this inadequacy stems high unemployment for young people which has two particularities with important consequences: (i) It affects particularly the young graduates from higher education and the no skilled “drop outs” (ii) it is long-lasting. These two elements lead to a phenomenon of “social exclusion” for some young people, even the most highly educated for whom the queue to access a job matching their skills and competences is very long given the weak demand dynamics for skilled workers.

This is an issue common to all countries, which is more special in MENA Countries. Indeed, these countries have already used most of their available tools with limited success: development of technical and occupational education, alternating apprenticeship, introduction of short term contracts, University Institutes of Technology, modifications to the orientation systems, etc... The results have been limited, firstly because the means available are low (the countries in the region already have a high rate of education and training expenses), on the other hand, because there is a strong preference for the branches of human and

social sciences, which traditionally open the doors to the entrance exams for public sector jobs. Note that this choice of youth is rational given the gap in wages and status between the public and private sectors which play in favor of the public sector. The solution is therefore clearly on the labor demand side which must evolve in the direction of a higher demand for skills, which implies that the productive systems of MENA countries increase their quality in value chains by increasing technological content and the quality of productions. In addition, the creation of business should be systematically facilitated and encouraged, especially in the activities of the future (by seed funds, support for innovation, low interest loans), in the context of total transparency.

### **Targeting two categories**

The issue of youth employment therefore particularly concerns two publics that should be differentiated: the public of young people without training (“drop-outs” from the educational system or non-participants) on the one hand, and graduates on the other. All studies show that the two extremes posed the most difficulties, the secondary school level which corresponds to medium-skilled jobs are the least badly affected by unemployment.

### **Four questions should be dealt with:**

**A first question** concerns these two groups. The aim is to facilitate the penetration of a skills-based approach in addition to the diploma-based one which is an approach focused on the mastery of a set of knowledge validated by obtaining the overall average in a large number of subjects. It is obviously a system which, while it may reinforce civic identity (which was justified in the period of the reconstruction of a social identity), has the drawback of eliminating students who have one or two highly developed competences but not the ability to acquire the complete spectrum required. It is both an explanation of the large number of « drop



outs » and the difficulty to provide some key competences to bring graduates in social and human science of the company's world.

**A second issue** concerns particularly out of school youth without diplomas (drop-outs) with an unemployment rate that is very high and with very poor work conditions. One could imagine taking inspiration from the functioning of the schools of the second chance to adapt the concept to the needs of Mediterranean countries. This school functions on three pillars: (i) obtaining a foundation of basic skills at school leaving age level, delivered largely by computer and accredited (this fund of competence should be completed by a business management package), (ii) alternating training course by immersion in professional domains, (iii) social support to address the various students' challenges (health, accommodation and others). The urban area as well as the rural are concerned.

**A third issue** concerns more particularly the graduates' unemployment. Here, the following problematic is concerned: orientation towards the short track training; development of apprenticeship and alternating with training; complements in terms of professional skills that can be provided in all the Master's degrees, in particular in the human and social sciences (how to read a balance sheet and an operating account, writing a business plan, conducting an investment plan, calculating the neutral point, minimal skills in computer technology and in ICT). All Master's training should be concerned because it is one of the keys too develop the ability to create business that requires not more than a couple of days training and can easily be acquired by means of a computer (business games, distance learning, etc...). In this respect, it would be desirable to have a common offset of core competencies in terms of the creation and management of business which could be provided at the end of obligatory schooling and accredited by the use of computer facilities. The competence approach should also be chosen to define the additional training to be provided to the generalist one given the new businesses which are developing. It has been es-

timated that 10% of new products appear each year in international trade that require as many changes to existing professions.

**A fourth issue** concerns the global educational system quality and its measurement, issues which are very weakly developed in the Southern Mediterranean and which require that MENA Countries accept to submit to tests similar to the PISA type.

#### Notes:

- [1]: In the text the acronym MENA stands for the group of ten countries under study. Namely: Morocco, Algeria, Tunisia, Egypt, Israel, Palestinian Territories, Jordan, Lebanon, Syria, Turkey.
- [2]: The OECD PISA survey covers in addition to OECD countries, some partner countries including Tunisia and Jordan.
- [3]: Among the ten countries studied, female participation rate is greater than 25% only in Algeria (37%) and in Israel (52%)
- [4]: The unemployment rate mentioned here concerns the total population (rural + urban). However, in MENA countries the weight of jobs in the agricultural sector remains high. The urban unemployment rate is significantly higher than the unemployment rate in rural areas. For example, in Morocco, the rural unemployment rate is 4% while in urban areas it is 14% for an average rate of 10% of the total population.
- [5]: The data published by the INS for the year 2009 confirm this diagnosis: the unemployment rate of the 15-19 yr olds is 33.6%, that of the 20-24 yr olds 29;9% for a rate of unemployment of 13.3% at the level of the population.
- [6]: Source: High Commission of the Plan Morocco
- [7]: For example, Kabbani and Khotari (2005) develop this argument on the basis of data going back to the beginning of the 1990s concerning the weight of the public sector in the economy
- [8]: The Solow or productivity paradox reminds us of the declaration of the latter, "We see computers everywhere except in the statistics of productivity"

[9]: We talk about declassification when a graduate is recruited for a job beneath his level of qualification. See OECD (2007) for an application in occupational integration of immigrants in the host countries

[10]: We talk about declassification when a graduate is recruited for a job beneath his level of qualification. See OECD (2007) for an application in occupational integration of immigrants in the host countries

[11]: This ratio is however much weaker (5%) for Morocco, Syria and Jordan and intermediate for Algeria and Tunisia (10%)



## CHAPTER 4. SOME NEW INSIGHTS INTO TRADE POTENTIAL BETWEEN THE EU AND ITS MP'S

### Introduction

Almost 50 years after the conclusion of the first trade agreements between the EU and its Mediterranean partners (MPs) and 15 years after the implementation of the Barcelona agreement [1], the elimination of tariffs has been almost completed between MPs and the EU. This has made possible to increase trade to some extent between these two areas. Some authors argue that additional trade gains can be expected through deeper integration, especially through the reduction in Non Tariff Barriers (NTBs) both vertically, i.e. between the EU and MPs and horizontally (across MPs)[2] .

However, in addition to regional trade negotiations, there are several other channels through which trade can be enhanced in the Euromed area. A first channel is related to additional trade cost reduction, not only in terms of NTBs, but also in terms of infrastructure and logistics performance. Secondly, factor movements can also help increase trade, as expected by the new trade theory. It states that in an imperfect competition framework, migration and FDI can be complementary to trade. Consequently, the trade-migration-FDI relationship can be self-reinforcing. Finally, institutional factors, especially governance, are also expected to have significant effects on most key economic variables, including trade.

To sum up, recent analyses tend to show that trade does not only depend on traditional variables like openness, regional integration and transport costs. Consequently, the process of openness and regional integration must be continued and deepened, but this process must also be complemented by additional policies which include the new channels mentioned above.

Moreover, the question of social equity must be central as a policy objective for succeeding these various policies. In other words, the process of regional

integration, openness and the development of the channels mentioned above must be accompanied by appropriate social policies so that the economic gains can be socially sustainable. In particular, the question of income convergence both within and across countries is becoming a central issue to be dealt with. This can be achieved for example by appropriate fiscal policies aimed at achieving a more equal distribution of the economic gains which are derived by the various trade related policies.

This chapter deals with these trade issues by focusing on the trade potential between the EU and MPs. Trade potential can be defined by the difference between the observed trade between two countries or areas and the trade which would be expected if these countries behaved like the other countries (the anti-monde). If the observed trade is below the expected one, this means that there is a trade potential between these two countries.

Regarding the Euro-Mediterranean area, the existing research studies generally conclude that MPs' export potential toward the EU is significant but of limited magnitude. For example, Péridy (2006) shows that MPs' observed exports to the EU are about 10-20% lower than exports expected (fitted) by the model (depending on the econometric specification). Some exceptions concern Lebanon and Jordan, for which the export potential is greater (about 30-50%). Some other studies provide similar results. For instance, Yu-Feng and Gohar (2010) show limited evidence of export potential, except concerning exports of agricultural products. This research has also been extended to the Gulf Cooperation Council (GCC) or GAFTA. It is shown that trade potential between GCC countries on the one hand and the EU and the US on the other hand is also limited (Boughanmi, 2008). It is also shown that trade potential across GAFTA countries, though significant, is also restricted, especially when the exporting country is oil producer (Abedini and Péridy, 2008). This is mainly explained by the lack of complementarity in the trade structure of GAFTA members.

Hence, although the existing literature provides some insights into trade potential between the EU and MPs, the present chapter aims to go further in this analysis by including several new contributions. First, it is based on a comparative analysis which makes it possible to compare the MP-EU trade potential in the recent period (2000-2009) with that corresponding to other trade groups, such as NAFTA, MERCOSUR as well as ASEAN.

Second, it is based on new gravity models which follow Anderson and Van Wincoop (2003) by explicitly including trade costs, i.e. tariffs, non tariff barriers (NTBs, in ad-valorem equivalents, AVEs) but also logistics performance indexes (LPs) as a measure of transport costs (World Bank, 2001). It also includes factor movements, such as bilateral migration flows as well as bilateral FDI. Indeed, the new trade theory generally states that in an imperfect competition framework, international trade itself fails to achieve factor price equalization (FPE) (Markusen (1983), Venables (1999)). As a result, other factor movements such as labor or capital flows are required to achieve Factor Price Equalization (FPE). Hence, modeling trade flows cannot disregard migration and FDI, which are explicitly included in our model.

Governance is the final additional key variable which is also accounted for in this model. This variable seems particularly crucial in the present context of riots and demonstrations in most MPs. In this regard, a large set of political indicators will be tested (rule of law, corruption, political stability, etc.) based on Kaufmann et al. (2010).

Basically, taking these additional variables into account is necessary for both theoretical and empirical reasons. From a theoretical point of view, all these variables are interconnected. For example, a better specification of trade costs (through tariffs, NTBs and logistics) is necessary since all these components directly affect trade. Similarly, the variables corresponding to factor movement cannot be disregarded in the trade equation since the

trade theory states the existence of a relationship between trade, migration and FDI. Finally, it is now unbelievable to disregard the role of governance in a trade model, since governance does not only affect trade directly through transaction costs and expectations but also indirectly through factor movements.

From an empirical standpoint, taking into account these additional variables makes it possible to reduce the bias due to omitted variables which is commonly found in the existing research studies. This bias may lead to underestimate exports' fitted values and thus to overestimate trade potential.

As a final contribution, the econometric modeling relies on recent and specific estimators which are designed to correct the most important biases in the estimation of export potentials, especially omitted variables, endogeneity or selection issues. The final objective is to calculate reliable values of export potential while explaining properly trade patterns within the Euromed area.

The results are expected to have significant policy implications, concerning not only trade potentials directly, but also through the sign and the magnitude of the key variables in the model. In particular, the relationship between trade flows on the one hand and migration and FDI on the other is of crucial importance. In other words, do migration flows and FDI create additional trade or destroy existing trade? In addition, is the persistence of NTBs so detrimental to trade? Does logistics performance significantly matter for explaining trade in the Euromed area? What is the impact of governance? Are corruption and the lack of economic freedom actually trade reducing? If so, to what extent?

This chapter is organized in three sections. The first analyzes basic stylized facts concerning trade between MPs and the EU in comparison with those in other Preferential Trade Arrangements (PTAs) such as NAFTA, MERCOSUR as well as ASEAN. The second section develops the methodology and

describes the results with regard to trade determinants and trade potentials. All technical details are left in the annex. The conclusion and the policy implications are discussed in the last section.

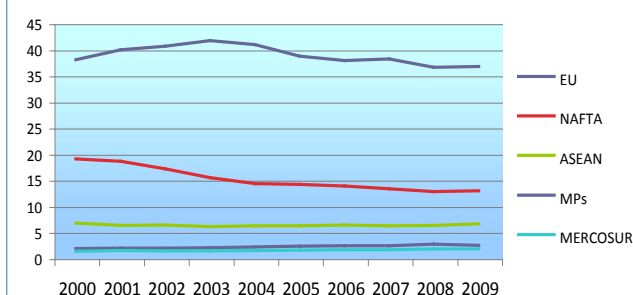
### I. Selected stylized facts concerning trade between MPs and its EU: A comparative analysis.

This section focuses on selected trends and indicators with regard to trade between MPs and the EU. Since there is an extensive literature dedicated to detailed trade patterns with regard to these countries [3], we here concentrate on specific trends which can give first insights into the main topic of this study, i.e. export potential between MPs and the EU.

As a first insight, Figure 1 shows that MPs account for a limited share in world exports. However, this share has slightly increased in the past decade, from 1.8% to 2.4%. Moreover, this share, though much lower than the other economic areas, such as ASEAN, is comparable to MERCOSUR.

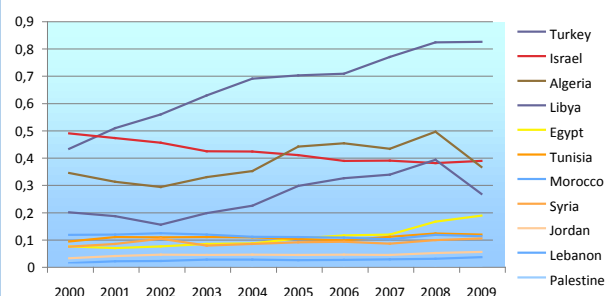
Figure 2 exhibits a breakdown by country. It shows that among MP countries, Turkey is the country which contributes the most to world exports (0.8% with a clear increasing trend). The second contributors are oil exporting countries (Algeria, Libya and Egypt) together with Israel (they account each for about 0.2-0.4% of world trade). The other MP countries represent each less than 0.1% of world exports. However, in this last group, some countries have slightly increased their share in world exports, namely Tunisia, Jordan and Lebanon.

Figure 1. Share of MPs and other PTAs in world exports (2000-29, %)



Source : UnctadStat

Figure 2. Share of MPs in world exports: breakdown by country (2000-2009, %)



Source : UnctadStat

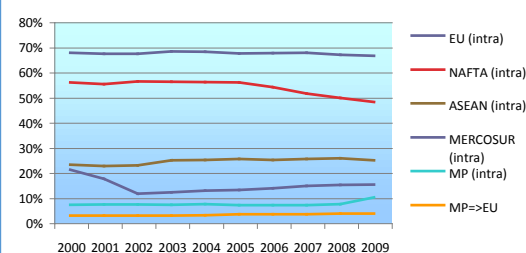
Turning to MP exports to the EU, Figure 3 shows that these countries still account for a limited share in world exports to the EU (3.5%). This means that within the Euro-Mediterranean area, MPs' exports to the EU are still limited compared to total exports to the EU. Moreover, a comparison with other PTAs shows that trade of MPs within the Euromed area is lower than intra trade in the other regional areas, including ASEAN, MERCOSUR and even intra-MP trade.

In spite of this apparent limited export performance of MP countries toward the EU, Figure 3 shows that MPs have progressively increased their export share as a total of EU imports, i.e. from 2.7% in 2000 to 3.5% in 2009. In addition, the share of MP countries in EU imports is greater than that in world imports, as shown in Figure 1. This means that MP countries exhibit a better export performance toward the EU than toward the rest of the world.'

A breakdown by country (Figure 4) provides additional details by showing that most MP countries have increased their exports to the EU more than the other countries. In particular, Jordan, Turkey, Lebanon and Tunisia have increased their exports to the EU by more than 10% (annual average) and Egypt by more than 20%, which is much greater than the world average (8%).

To sum up, MP countries still represent a limited share in world exports. However, this share has been slightly increasing in the past decade and more importantly, this share is greater with regard to the EU market. At this stage, it is difficult

Figure 3. Share of intra-trade in total exports of PTAs



Sources : UnctadStat

to infer any conclusion about export potential. Indeed, accounting for a limited share in EU total imports does not necessarily mean that there is a huge export potential between MPs and the EU, since the magnitude of exports depends on many variables which must be controlled for, namely country size, distance, trade costs as well as many other variables which will be selected and described in the next section.

Finally, Table 1 displays a set of general trade indicators which highlight the following features. First, MPs may be globally considered as open economies, even if for some oil exporting countries, such as Algeria, Syria and Libya, the trade/GDP ratio is biased upward due to oil exports. This ratio is on average equal to 76.5% which is above the world average. It is even greater than that recorded for NAFTA, the EU and MERCOSUR, though it is lower than that in ASEAN. Small countries like Tunisia and Jordan are particularly exposed to international competition because the trade/GDP ratio is greater than 100%. An implication of this result is that for most MP countries, we cannot

expect the existence of trade potential due to the lack of openness. A similar remark also applied to trade in services, which is higher in most MP countries than in the other trading areas. This is an additional indication of openness of these countries.

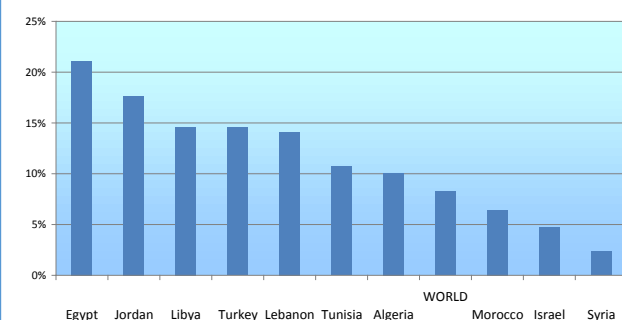
The export growth indicator correlates the finding presented previously, i.e. the annual average growth rate is substantial (6.6%) and greater than that recorded for the EU, North America and MERCOSUR (it is however lower than that recorded in ASEAN).

The MPs' export structure by product categories is similar to that in MERCOSUR, except in terms of high-tech exports, which only account for 4% of MP exports whereas it is 12% in MERCOSUR and even higher in the EU (13%) and ASEAN (25%). The lack of innovation in the production and the export processes is a major detrimental feature of the export composition of MP countries. We will get back to this issue in terms of policy implications in the conclusion.

Finally, MP countries also show some similarities with MERCOSUR in terms of market concentration and diversification [4]. As a matter of fact, exports are more concentrated in these two areas than in the EU, North America and ASEAN. With regard to MPs, this can be mainly explained by hyper specialization in oil products, agriculture or specific manufactured products (textile-clothing). Similarly, the diversifica-

tion index, which measures the deviation of the country share from the world structure in terms of product composition, is similar in MPs and MERCOSUR but greater than in the other trading areas. This means that in these countries, trade strongly departs from world average in terms of product composition not only in oil exporting countries but also in the other MP countries due to their specialization and the lack of intra-industry trade. The implications of the export structure by products fall beyond the scope of this paper

Figure 4. % increase in MP countries exports to the EU (yearly average 2000-2009)



Source : UnctadStat

Table 1: Selected Trade indicators for MP countries

	Trade	Export growth	Fuel Exports	Food Exports	Man. Exports	High tech Exp.	Trade in services	Number of products exported	Diversification Index	Concentration Index
	(% of GDP)	(av. 2000-09, %)	(% of total)	(% of total)	(% of total)	(% of total)	(% of GDP)			
Algeria	76,5	2,2	97,7	0,3	2,0	1,0	n.a.	106	0,799	0,558
Egypt	56,9	13,1	44,0	10,6	37,0	1,0	18,8	245	0,586	0,166
Israel	66,8	6,6	0,0	3,3	94,0	16,0	20,0	248	0,551	0,242
Jordan	108,5	4,8	0,6	16,6	73,0	1,0	33,2	210	0,576	0,167
Lebanon	69,2	9,9	0,5	16,3	71,0	0,0	90,3	210	0,629	0,217
Libya	94,8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	132	0,820	0,761
Morocco	68,1	5,8	2,0	9,3	65,0	9,0	21,1	212	0,694	0,151
Palestine	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	83	0,524	0,281
Syria	69,6	6,8	38,6	22,0	35,0	1,0	13,2	209	0,638	0,211
Tunisia	107,3	4,1	13,6	9,2	75,0	5,0	21,4	213	0,546	0,159
Turkey	47,7	6,4	4,0	10,8	80,0	2,0	8,2	259	0,508	0,083
MP (1)	76,5	6,6	22,3	10,9	59,0	4,0	28,0	193	0,625	0,272
EU	70,3	3,7	5,1	9,1	75,0	13,0	17,7	260	0,207	0,060
MERCOSUR	42,1	4,3	21,1	18,0	60,0	12,0	5,9	211	0,668	0,270
ASEAN	97,0	9,9	8,0	7,6	70,0	25,0	9,5	260	0,335	0,128
NAFTA	27,3	2,5	10,8	10,6	64,0	20,0	6,5	259	0,333	0,118

(1) Unweighted average

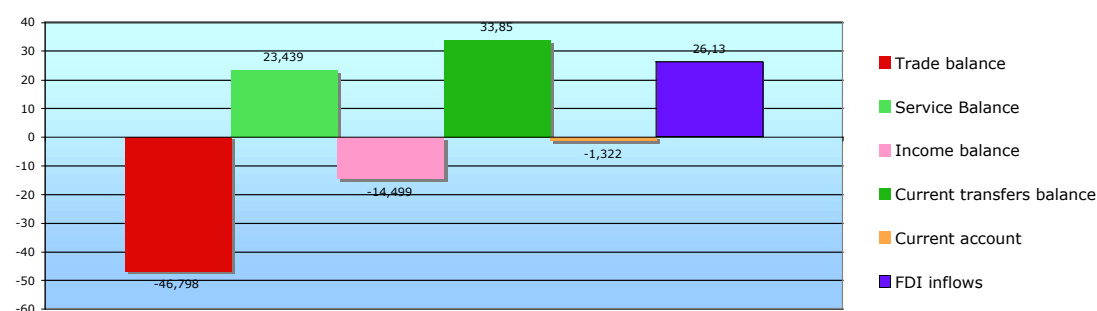
Sources: World Development Report 2011 (World Bank), UNCTAD Handbook of Statistics 2010, World Development Indicators

which focuses on overall export potential. However, this is a critical problem which leads some MP countries to strongly depend on specific products in terms of export capacities. Besides, the lack of intra-industry trade, which is expected to concentrate on processed and innovating products (car industry, etc...) is also a crucial issue for these countries for their insertion in the world economy.

A final set of figures are presented in Charts 5a and 5b. They provide the current account balance of MPs (excluding Turkey) as well as the FDI.

They highlight the specificity of MPs with regard to their external account. Overall, these countries face a significant and increasing deficit in their trade balance. This deficit must be financed by the service balance (tourism), remittances of migrants as well as by the current transfer balance. This situation makes it sometimes hardly possible to equilibrate the current account. As a matter of fact, the overall current account balance was negative in 2010. In these conditions, FDI inflows are particularly required to balance the overall external account.

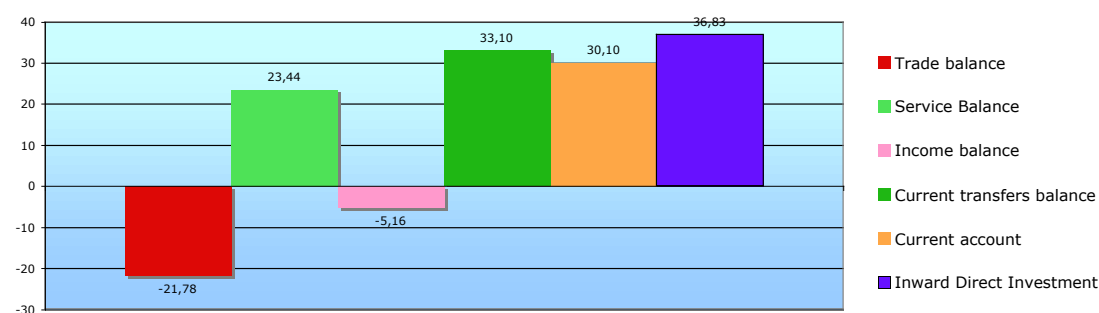
Figure 5a. 2010 Current account Balance and FDI inflows: MP countries (excluding Turkey, bn US\$)



Source : UnctadStat



Figure 5b. 2006-2008 Current account Balance and FDI inflows: MP countries (excluding Turkey, bn US\$)



Source : UnctadStat

The overall situation remains fragile as MPs are greatly dependent on tourism and remittances to equilibrate their balance of payment. But they are also dependent on external demand on goods, especially from the EU. In this regard, the 2008-2009 economic crisis in Europe contributed to increase the trade deficit in MPs given the weakness of EU import demand.

These results highlight the interconnection between trade, migration and FDI. This interconnection will be further investigated in the next section when exploring the trade determinants and the role of factor movement.

## II. The trade potential between MPs and the EU: A comparative analysis

This section is dedicated to the calculation of trade potential through appropriate methodologies based on new developments in gravity models. Methodological issues are presented first, leaving all technical details in the Annex. Then, the results are presented in order to quantify the effect of each variable on trade. Finally, a last sub-section provides the calculation of the trade potential between the EU and MPs as well as a comparison with NAFTA, MERCOSUR and ASEAN.

### a. Methodological issues

The calculation of the trade potential relies on the econometric estimation of a model which explains trade flows with a set of appropriate variables. The starting point is the new developments in gravity models by

Anderson and van Wincoop (2003) which make it possible to better understand bilateral trade flows.

Basically, the model presented here explains bilateral trade flows by the following variables. A first set of variables include the traditional gravity variables:

- ✓ The **GDP of the exporting country**. It is assumed that the greater this GDP, the greater the size of this country and thus the greater its capacity to export.
- ✓ The **GDP of the importing country**. Indeed, as this GDP increases, the demand for foreign commodity also increases and thus there is a rise in its imports (the exports of its partner country).
- ✓ The existence or not of a **common language** between the two partners. It is expected that if two countries speak the same language, they are more likely to trade because transaction and information costs are lower.
- ✓ Past **colonization** is also expected to increase bilateral trade, because of tighter relationships (economic, political and cultural) between two countries.

A second set of variables are linked to **trade costs**. They include tariffs, NTBs as well as infrastructure, such as logistics. **Factor movements** are also expected to influence trade. Indeed, trade cannot be explained independently from labour and capital movements as stated in the traditional and new trade theory. The later theory expects a complementary relationship

### Box 1 - The model specification

The following equation has been estimated:

$$\log X_{ijt} = a_0 + a_1 \log GDP_{it} + a_2 \log GDP_{jt} + a_3 \log TAR_{ij} + a_4 \log NTB_{ij} + a_5 \log LPI_i + a_6 \log LANG_{ij} + a_7 \log REG_{ij} + a_8 \log COL_{ij} + a_9 \log MIG_{ij} + a_{10} \log FDI_{ij} + a_{11} \log SERV_{ij} + a_{12} \log POL_i + a_{13} \log X_{ijt-1} + \alpha_i + \beta_j + \varphi_t + \varepsilon_{ijt}$$

Where  $X_{ijt}$  denotes exports from country  $i$  to country  $j$  at year  $t$ .  $GDP_{it}$  and  $GDP_{jt}$  respectively reflect GDP in country  $i$  and  $j$ . Trade costs are captured by three distinct variables: bilateral tariffs charged in country  $j$  to products originating from country  $i$ ; NTBs, in ad-valorem equivalent, applied in country  $j$ ; Transport costs, which can be captured by logistics performance indexes (LPI).  $LANG_{ij}$  captures the existence of a common language between the two partner countries.  $REG_{ij}$  and  $COL_{ij}$  relate to regional integration and colonial links, respectively;  $MIG_{ij}$  and  $FDI_{ij}$  correspond to factor movement, i.e. bilateral migration and FDI.  $SERV_{ij}$  corresponds to bilateral trade in services. Finally,  $POL_i$  reflects the quality of political factors in the exporting country. The equation also includes country and time specific effects which are aimed at capturing the omitted variables and accounting for country and time heterogeneity.

The equation is estimated over the recent period (2000-2009) for a matrix of 67 countries, of which: the EU-27 countries, nine MPs (Algeria, Morocco, Tunisia, Turkey, Egypt, Jordan, Syria, Lebanon and Israel), NAFTA and MERCOSUR (including Chile), the ASEAN+4 group, i.e. ASEAN, China, Japan, Korea, India, as well as Gulf countries, Australia, Norway, Switzerland and South Africa. These 67 countries account for more than 80% of world trade. This is a reasonable basis for the creation of the anti-monde which will be used for the calculation of trade potentials. Overall, taking into account the bilateral country dimension as well as the time period, the total number of observations amounts to 44,890.

As described in details in the Appendix, several estimators have been used to estimate the equation. These are Hausman and Taylor, the two step Heckman procedure as well as ABB for the dynamic model. The estimators are also controlled for cross-sectional heteroskedasticity and serial correlation of the error term by using respectively the Huber-White Sandwich estimator and the AR1 Cocrane-Orcutt transformation.

### Box 2 - Data and sources

- ✓ Bilateral exports are measured in constant Purchasing Power Parity (PPP) ; source: UNCTAD (Comtrade database)
- ✓ GDPs are measured in constant PPP; source: Cepii (Chelem database)
- ✓  $TAR_{ij}$  is captured by the applied weighted average tariffs of the importing country  $j$ ; source: world Bank (World Development Indicators). As a sensitivity analysis, the Market Access Overall Trade Restrictiveness Indexes (MAOTRI) captures the barriers faced by each exporter when selling in other countries; source: Kee et al. (2008, 2009).
- ✓ NTBs are proxied by ad-valorem equivalents (AVEs) calculated in Kee et al. (2009). The methodology is fully described in the technical annex
- ✓ LPI is a larger proxy than transport costs; This indicator is built from information gathered in a worldwide survey of the companies involved in logistics services. Seven areas are covered by this index, namely: efficiency of the clearance process by customs and other border agencies, quality of transport and information technology infrastructure for logistics, ease of arranging international shipments, competence of the local logistics industry, ability to trace and check international shipments, domestic logistics costs as well as timeliness of shipments in reaching destination. The LPI is a weighted average of these variables. It ranges between 1 (worst) to 5 (best); source: World Bank (2011)
- ✓  $LANG_{ij}$  is a dummy variable which takes the value of 1 if a common language is spoken by at least 10% of the population in each country pair (exporter and importer) and 0 otherwise; source: Cepii Chelem
- ✓  $COL_{ij}$  reflects colonial relationships over a long period of time with substantial participation in the colonized country's governance. This variable is equal to 1 in case of colonial links and 0 otherwise. It accounts for cultural and historical relationships which are expected to increase trade flows between some EU countries and Mediterranean countries. Source: Cepii (Chelem database).
- ✓  $REG_{ij}$  (Regional integration) is proxied by a bilateral dummy. It takes the value of 1 if a country pair belongs to the same regional area and 0 otherwise. As a result, a positive relationship is expected between this proxy and exports because as countries belong to a regional area, trade is expected to increase; source: WTO (RTA database)
- ✓  $MIG_{ijt}$  is measured by the bilateral migrant stock in country  $i$  originating from country  $j$ ; as a sensitivity ana-

lysis, it is measured both in value and as a percentage of the exporting country's population; source: World Bank (Bilateral Migration and Remittances 2010)

- ✓ *FDI<sub>ij</sub> is captured by several proxies: inward and outward bilateral stock or flows (in value and as a percentage of GDP); sources: World Bank (World Development Indicators); UNCTAD (Handbook of Statistics and World Investment Report.*
- ✓ *SERV<sub>ij</sub> is measured by trade in services (source: UNCTAD)*
- ✓ *POL<sub>ij</sub> is captured by several alternative proxies: voice and accountability, which measures to what extent citizens are able to participate in selecting their government, political stability and the absence of violence and terrorism, government effectiveness, regulatory quality, rule of law as well as the control of corruption (for more details, refer to Kaufman et al. (2010)).*

between trade on the one hand and factor movement of the others. Trade in services is also added in the final specification, as trade in goods is expected to be complemented by trade in services (e.g. transport services are necessary for trading goods).

As last crucial variable, **political factors** are also expected to play a significant role in international trade. In particular, the lack of democracy is suspected to restrain trade flows as well as growth in these countries. In this regard, the recent political events in MP countries provide a good opportunity to test the impact of these political factors on trade. Interestingly, the recent literature has made considerable progress in the measurement of political issues and governance, especially with the World Governance Indicators database (Kaufmann et al., 2010). This makes it possible to measure three aspects of governance: the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies and the respect of citizens.

Finally, the gravity model can also include a **dynamic component**. In other words, current exports also depend on past exports. This dynamic feature has its own theoretical justification, based on the existence of sunk costs. Indeed, as firms must face significant sunk costs when entering the export market, they must first ensure that they will be able to amortize these costs

### **Box 3 - The calculation of export potentials**

*The choice between the in-sample or out-of sample prediction depends on several factors. First, Egger (2002) argues that the out-of-sample approach may avoid a misleading interpretation of the residuals. Second, if the countries considered have not fully achieved is their integration into the world economy (countries in transition), the out-of-sample prediction seems more appropriate, as it makes it possible to calculate what these countries' exports would be if they behaved like the countries which are fully integrated into the world economy. Given these considerations, we will use the out-sample methodology. As a sensitivity analysis, the in-sample method has also been carried out and it proved to provide very close results.*

*One important issue is the choice between the static or dynamic specification regarding the calculation of trade potentials. Indeed, although the advantage of the dynamic equation is to account for past inertia in trade flows, one drawback is that it tends to even out both levels and variations of trade potential for a particular country, as well as differences in trade potential between countries. In the present study, the final results present the calculation of trade potential as the ratio between actual and fitted exports using the HT estimator (static), so as to provide greater differences across countries. This ratio indicates how much observed exports differ from fitted exports assuming that the countries considered behave like the other countries in the sample. Hence, if calculations show that the MPs' observed exports to the EU countries are below their potential level, this only means that the MPs export less to the EU than they should to, once all the trade determinants have been considered.*

(Baldwin and Krugman (1989)). As a result, a firm which starts exporting is likely to go on exporting in the coming years. This is why the level of current exports is partly explained by the past level of exports. Details about the model specification, data and sources are presented in Box 1 and Box 2 whereas all econometric considerations are left out in the Appendix. Once the estimation of the model is properly implemented, the calculation of export potentials (especially MPs export potential with regard to the EU) can be carried out from the estimation of the residuals of the model (refer to the detailed description provided in Box 3). As already explained in the introduction, trade po-

tential can be defined by the difference between the observed trade between two countries or areas and the trade which would be expected if these countries behaved like the other countries (the anti-monde). If the observed trade is below the expected one, this means that there is a trade potential between these two countries.

#### **b. The results: What are the main trade determinants?**

Table 2 shows the results for one estimator, i.e. Hausman and Taylor. All detailed results are presented in the Appendix. One striking feature in Table 1 is that the parameter estimates are almost all significant at the 1%-level and all show the expected sign. For instance, the traditional gravity variables, such as GDP, common language, colony and regional agreements are all positive, as expected previously. In addition, the trade costs variables are also all significant: Tariffs and NTBs exhibit a negative sign whereas logistics performance shows a positive parameter estimate. These variables are more relevant than the traditional distance variable, which is too general as a measure of trade costs.

Factor movements are also greatly significant with a positive parameter estimates. This means that FDI and migration are complementary with trade. This is expected by the new trade theory which states that trade of goods cannot ensure factor price equalization (FPE). It must be complemented by capital and human movements. This result is of particular importance since it shows that FDI and migration are both trade-creating. The same remark also applies to trade in services, which is complementary with trade of goods.

Governance, measured here first by the rule of law, is also positive and significant at the 1%-level. This means that the quality of institutions and political factors do play a significant role in the creation of trade.

To go further in the analysis, Table 3 displays a sensitivity analysis which takes alternative proxies for regional agreement, trade costs, governance and

FDI (in bold characters). Starting with regional integration, the breakdown into the various preferential trading areas (PTAs) shows that they are all trade creating. However, the parameter estimate for the Euromed agreement is of lower magnitude than those corresponding to the other parameters. This suggests that the Barcelona process has been less trade creating than the other regional agreements considered in this area. This result is not surprising since the regional integration process is not completed in the Euromed area. In particular, during the period considered (2000-2009), MP countries did not complete their tariff removal with regard to the products originating from the EU. In addition, the persistence of NTBs, the lack of market access into the EU for agricultural products originating from MP countries, the lack of integration in terms of services and FDI, etc... contribute to explain that the trade creation of the Barcelona agreement, although positive, is limited (see Péridy, 2010a for additional details). However, this does not mean that the trade potential between MP countries and the EU is more important than in the other areas, since it does not only depend on the effects of regional agreements but also on all the other trade determinants. This will be checked later on, when calculating trade potentials between the EU and MP countries.

Additional sensitivity analysis concerns trade costs. In this regard, the traditional distance variable has been tested. It is unsurprisingly negative and significant. Another test takes the Market Access Overall Trade Restrictiveness Index (MAOTRI), which captures tariffs and NTBs faced by each exporter when selling to other countries (Kee et al. 2008 and 2009). This variable is negative and very significant. Finally, we provide a breakdown of the logistics performance index into its various components, i.e. customs efficiency, quality of infrastructures, efficiency in arranging international shipment, competence of the local logistics industry, ability to track shipments as well as timeliness of shipment. All these components are very significant in explaining bilateral exports. They stress the key impact of the various logistics aspects in the trade creation

Table 2: Estimation results of trade determinants	
<u>TRADITIONAL VARIABLES:</u>	
GDP reporter	0.8186***
GDP partner	0.7719***
common language	0.3356***
colony	0.5165***
<u>TRADE COSTS:</u>	
tariffs	-0.2624***
NTBs	-0.0396***
logistics performance	2.7629***
<u>FACTOR MOVEMENT:</u>	
migration	0.2744***
FDI stocks	0.0274***
services	0.1778***
<u>REGIONAL INTEGRATION:</u>	
regional agreements	1.7549***
<u>INSTITUTIONAL VARIABLES:</u>	
Governance: rule of law	0.2025***
<u>OTHER:</u>	
Intercept	-31.0560***
*** significant at 1% level; ** significant at 5% level; * significant at 10% level	

process. This has important policy implications for MP countries which generally exhibit poor logistics efficiency compared with most other emerging or developed countries (refer to section 3 for policy discussion).

In the same way, additional tests various governance indicators. It includes “voices” which measures to what extent citizens are able to participate in selecting their government, political stability (and the absence of violence and terrorism), government effectiveness, regulatory quality, rule of law as well as the control of corruption (for more details, refer to Kaufman et al. (2010)). Interestingly, all these variables are significant and the 1% level. This means that the quality of the governance is a key factor in the trade creation process. Again, the poor quality of governance indicators in MP countries has major implication on trade. The corresponding policy implications will be further investigated later on. Some other tests provide other measurement of FDI, in terms of stocks or flows or in terms of value or as a percentage of GDP. Parameter estimates are generally greatly significant whatever the proxy. The only exception is FDI stocks in US dollars, which are significant at 10% only.

Table 3: Sensitivity analysis	
<u>TRADE COSTS</u>	
tariffs	-0.2488***
NTBs	-0.0444***
Distance	-0.0001***
logistics: all	2.3451***
logistics: customs	0.6831***
logistics: infrastructure	0.5673***
logistics: shipment	0.6216***
logistics: competence	0.6388***
logistics: track	0.7677***
logistics: timeliness	0.1496***
MAOTRI	-5.7572***
<u>FACTOR MOVEMENTS:</u>	
migration	0.2566***
FDI: stocks (%GDP)	0.0302***
FDI: stocks (US\$)	0.0030*
FDI: flows (%GDP)	0.0496***
FDI: flows (US\$)	0.0551***
services	0.2654***
<u>REGIONAL INTEGRATION:</u>	
regional agreements: All	-
regional agreements: EU	2.1510***
regional agreements: Euromed	0.3696***
regional agreements: Nafta	0.9095***
regional agreements: Mercosur	3.0979***
regional agreements: Asean	1.9566***
regional agreements: Gafta	2.4279***
<u>INSTITUTIONAL FACTORS:</u>	
Governance: rule of law	0.1393***
Governance: political stability	0.5224***
Governance: government effectiveness	0.6299***
Governance: regulatory quality	0.5059***
Governance: voice	0.1929***
Governance: control of corruption	0.2072***
<u>TRADITIONAL VARIABLES:</u>	
GDP reporter	0.7750***
GDP partner	0.7937***
common language	0.2620***
colony	0.7125***
Intercept	-30.6389***
Adjusted R-squared	0.7536
*** significant at 1% level; ** significant at 5% level; * significant at 10% level	

To sum up, the estimation results described in this section show that bilateral trade cannot be only explained by the traditional gravity equation which

Table 4: The export potential of MPs with regard to the EU (observed/fitted exports ratio)

importer\exporters	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia	Turkey	MP average
Austria	0,744	0,852	0,997	1,000	0,808	1,072	1,111	1,004	1,000	0,954
Belgium	1,172	1,088	1,184	1,068	1,023	1,090	1,060	1,117	1,035	1,093
Cyprus	1,146	1,157	1,296	1,098	1,150	0,993	1,084	1,150	1,149	1,136
Czech Rep.	0,665	0,971	1,084	0,899	0,890	1,031	1,012	0,971	1,090	0,957
Denmark	0,974	0,930	1,047	0,938	0,868	0,907	0,813	0,992	1,034	0,945
Finland	0,999	0,967	1,064	0,950	0,810	0,991	0,789	0,838	1,018	0,936
France	1,061	1,007	1,033	0,908	0,893	1,049	1,061	1,084	1,011	1,012
Germany	0,998	0,970	1,033	0,891	0,875	1,011	1,097	1,081	1,004	0,995
Greece	1,165	1,058	1,074	0,937	1,022	1,107	1,072	1,056	1,058	1,061
Hungary	0,683	0,933	1,068	1,069	0,766	0,945	0,882	0,979	1,076	0,933
Ireland	0,736	0,972	1,023	0,899	0,885	1,052	0,680	1,019	1,067	0,926
Italy	1,205	1,060	1,067	1,019	0,939	1,042	1,137	1,144	1,059	1,075
Lithuania	1,009	1,021	1,100	0,927	0,796	0,999	0,761	0,874	1,121	0,956
Luxembourg	1,046	0,792	1,052	0,792	0,760	1,035	1,013	1,036	1,021	0,950
Netherlands	1,250	1,103	1,118	1,102	0,952	1,066	1,084	1,125	1,011	1,090
Poland	1,080	0,943	1,056	1,031	0,832	1,104	0,998	1,084	1,014	1,016
Portugal	0,770	0,968	1,050	0,978	0,832	1,124	1,033	1,058	1,077	0,988
Romania	1,298	0,983	1,037	1,032	0,966	1,056	0,895	1,027	1,136	1,048
Slovakia	0,899	0,999	0,990	1,052	0,687	1,156	0,669	1,126	1,077	0,962
Spain	1,202	1,091	1,080	1,027	0,972	1,112	1,110	1,153	1,023	1,086
Sweden	1,102	0,918	1,033	0,875	0,910	0,956	0,812	1,038	1,014	0,962
Switzerland	1,041	0,927	1,142	1,150	1,116	1,099	0,776	1,146	1,070	1,052
United Kingdom	1,114	0,983	0,997	0,934	0,935	1,073	1,026	1,112	1,036	1,023
EU average	1,016	0,987	1,071	0,982	0,899	1,047	0,955	1,053	1,052	1,007

includes GDP, distance, language and regional integration. Three sets of new variables are also of crucial importance, namely trade costs (including NTBs and logistics), factor movement (migration and FDI) as well as governance. Disregarding these variables when calculating trade potential may lead to a bias due to omitted variables. In this case, the residuals of the model would include the effects of these variables and trade potential could be overestimated. Conversely, by explicitly taking the new variables into account, it is expected that fitted exports better match observed exports. Thus, trade potential may not be as significant as in traditional studies.

### c. The calculation of trade potential

Table 4 exhibits the observed/fitted export ratio of MPs with regard to the EU. When this ratio is below one, this means that observed exports have not reached the level which is expected by the eco-

nometric model. Consequently, there is an export potential. Conversely, if the ratio is equal or greater than one, there is no more export potential available. Exporting countries are presented in line whereas importing countries are presented in column. The last line and the last columns provides country average for exporters and importers.

Overall, the export ratio is very close to 1. For example, the average MP exports to the EU is equal to 1.007 times the expected exports. Hence, MPs exports to the EU are on average exactly equal to the exports predicted by the model. This result slightly differs from that found in some existing studies which shows a small export potential (Péridy (2006), Yu-Feng and Gohar (2010)). One reason is related to the considered time period, which is the most recent in the present study. This suggests that MP countries have reached their “expected” export levels vis-à-vis the EU in recent years. Most



importantly, the main reason which explains this difference is the econometric specification which includes a larger number of variables, especially trade costs, factor movements and governance. In particular, the significant migration and FDI flows (or stocks) contribute to increase MPs exports to the EU. Disregarding these variable would lead to a bias related to omitted variables which in turn would increase the residuals in the model and thus show artificial export potential. In other words, migrations, FDI and services are significantly trade creating and thus contribute to explain why export potential is not significant.

There are however slight differences across countries. For example, Table 3 shows that there is a small export potential concerning Mashrek countries, especially Lebanon and Syria. These countries are traditionally less trade-oriented toward Europe. Conversely, there is no more potential for Maghreb countries and Turkey, which show a ratio greater than one, due to more trade openness and integration vis-à-vis the EU.

There are also differences across country pairs. For example, the first column of Table 1 shows that the observed/expected export ratio is much above 1 between Algeria on the one hand and Belgium, France, the Netherlands, Spain and Italy on the other. This means that Algerian exports to these countries are greater than expected. This can be

Table 5: The export potential in the NAFTA (observed/fitted exports)				
importer\exporter	Mexico	USA	Canada	NAFTA aver.
Mexico		0,996	0,994	0,995
USA	0,997		1,005	1,000
Canada	1,026	0,999		1,013
NAFTA average	1,011	0,998	1,000	1,003

Table 6: The export potential in the MERCOSUR (observed/fitted exports)						
importer\exporter	Argentina	Brazil	Chile	Paraguay	Uruguay	MERCOSUR
Argentina		0,998	0,922	1,022	0,991	0,983
Brazil	1,002		0,980	1,010	1,009	1,000
Chile	0,986	0,964		1,071	0,980	1,000
Paraguay	1,019	1,003	0,970		1,083	1,019
Uruguay	0,988	0,977	0,963	1,236		1,041
MERCOSUR average	0,999	0,985	0,959	1,085	1,016	1,009

explained by the role of migration from Algeria in these countries.

From an import side, there is a small trade potential with Eastern and Northern EU countries whereas there is no more potential with the other EU countries (especially Southern countries). In spite of these small geographical differences, the major feature of Table 3 is that MPs' export potential with the EU is insignificant. This result has important policy implications which will be discussed in the next section.

Tables 5, 6 and 7 provide and interesting comparison with other geographical areas. Interestin-

Table 7: The export potential in the ASEAN (observed/fitted exports)												
importer\exporter	Cambodia	China	India	Indonesia	Japan	Malaysia	Philippines	Rep. of Korea	Singapore	Thailand	Viet Nam	ASEAN aver.
Cambodia		0,993	0,901	1,074	0,924	1,081	0,940	1,017	1,130	1,104	1,096	1,026
China	0,849		0,897	0,982	0,963	0,974	0,985	1,005	0,984	0,990	1,002	0,963
India	0,827	0,947		0,998	0,888	1,006	0,839	0,945	0,979	0,959	0,924	0,931
Indonesia	0,837	0,916	0,885		0,917	1,013	0,937	0,953	1,079	0,990	0,970	0,950
Japan	0,914	0,951	0,870	1,036		1,031	1,017	0,936	1,009	1,016	1,045	0,983
Malaysia	0,974	0,965	0,958	1,091	0,996		1,078	1,013	1,129	1,105	1,107	1,042
Philippines	0,886	0,961	0,878	1,054	0,989	1,079		1,022	1,066	1,073	1,122	1,013
Rep. of Korea	0,922	0,952	0,879	0,998	0,922	0,997	1,001		1,006	0,952	0,984	0,962
Singapore	1,082	0,942	0,939	1,085	0,984	1,088	1,010	1,024		1,067	1,080	1,030
Thailand	0,956	0,947	0,934	1,056	1,014	1,110	1,057	1,006	1,113		1,075	1,027
Viet Nam	0,966	0,955	0,922	1,055	0,965	1,049	0,988	1,023	1,053	1,012		0,999
ASEAN average	0,921	0,953	0,906	1,043	0,956	1,043	0,985	0,994	1,055	1,027	1,041	0,993

gly, the conclusion is identical to the previous one, i.e. there is no further export potential within the other PTAs, namely NAFTA, MERCOSUR and ASEAN, despite small potentials for selected bilateral flows. This means that MP countries exports toward the EU are not different from those on the other PTAs. In other words, there is no specificity of trade relationships between MPs and the EU relative to the other PTAs.

### III. Conclusion and policy implications

The main result of this study is that MPs have reached their export potential with the EU. In other words, the current export level from MPs to the EU is just equal to the level predicted by the model.

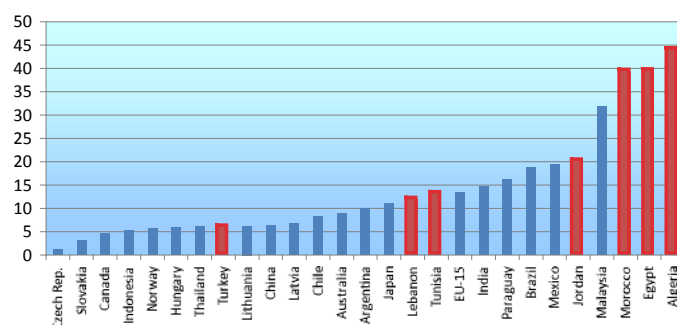
It has also been shown that there is no specificity of the MP-EU trade potential in comparison with the other main PTAs (NAFTA, MERCOSUR and ASEAN) which have also reached their trade potential. This result is based on an econometric specification which takes into account some new explanatory variables which are generally omitted in the previous studies. These include trade costs (tariffs, NTBs and logistics), factor movement (migration and FDI) as well as governance.

The policy implications of the results are the following. First, the fact that MP countries have reached their export potential just means that MP exports to the EU are at a “normal” level compared to the other trading areas in the world. However, this does not mean that exports cannot increase in the coming years. This can be achieved by the following tools which can be implemented to increase MPs export performance:

#### v Progressing in reducing trade costs, especially NTBs

Recent research in this area tends to show that NTBs are very significant in MENA countries. As an illustra-

Figure 6. NTBs in MP countries: a comparison with selected other countries (average in tariff equivalent, %)



Source : Kee et al.(2009)

tion, Figure 6 shows that the average equivalent (AVE) of NTBs amounts to about 40% in Algeria, Egypt and Morocco. This is very much higher than in many other countries. In this regard, the econometric model presented previously clearly showed that the presence of NTBs is trade-reducing. Consequently, it seems that MENA country could significantly increase their trade by reducing NTBs. This is not to say that NTBs must be completely removed, since some of them may be useful for the protection of specific consumers or industries. However, a downward move toward world average would help creating trade [5].

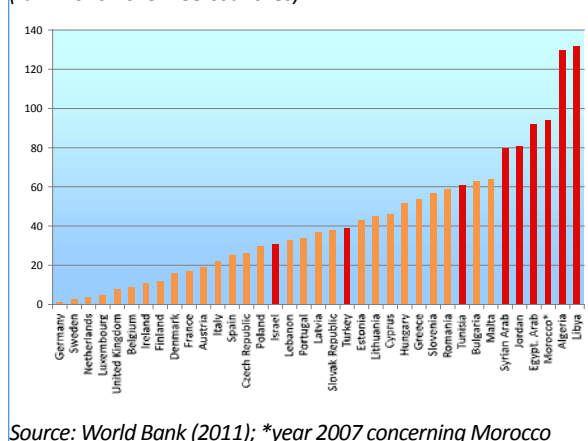
#### v Improving logistics performance toward EU standards

The recent World Bank study on logistics performance reveals that MENA countries are far away from international standards in this area. As a matter of fact, Figure 7 exhibits the country ranking in the euro-mediterranean area. It is striking to observe that over a total of 155 countries, there is a huge gap between on the one hand EU countries, which are amongst the most performant in the world, and MENA countries on the other hand which are generally much below the world average, especially Libya and Algeria which are at the bottom of the list.

Some countries have recently made real efforts. In particular, by developing “Tanger Méditerranée” with accompanying road and other infrastructure developments, Morocco should significantly goes up in the list in terms of country ranking. However,



Figure 7. Country ranking for the Logistics Performance Index (rank 2010\* over 155 countries)



Source: World Bank (2011); \*year 2007 concerning Morocco

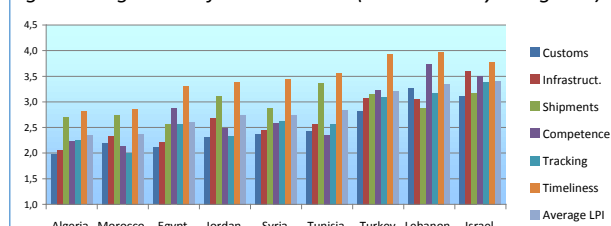
similar efforts should be made in other countries in order to increase the efficiency and the competitiveness of their trade. For these countries, as suggested by Figure 8, particular efforts should be made toward improvement of the efficiency of the clearance process regarding customs (and other border agencies), the quality of transport and IT infrastructure for logistics, the efficiency in tracing and tracking international shipments as well as the competence of the local logistics industries. These efforts are expected to provide significant trade gains, since 1% increase in the LPI leads to 2.76% in exports, as shown by the econometric results in Table 2.

#### ✓ Improving the governance

According to Kaufman et al. (2010), which have proposed several indexes for governance, MENA countries are generally well below the world average. In this regard, Figure 9 displays the value of the various governance indicators in MENA countries, in comparison with the areas already considered in this study (EU, NAFTA, MERCOSUR, AESAN). It is striking to observe that most MENA countries show an average below 0, which reflect a poor performance in the governance process, especially in Syria, Algeria, Lebanon, but also Egypt, Morocco and Tunisia to a lesser extent.

The recent riots observed in these countries are obviously related to the poor quality in governance. Besides that, governance has a significant impact on the

Figure 8. Logistics Performance Index (breakdown by categories)



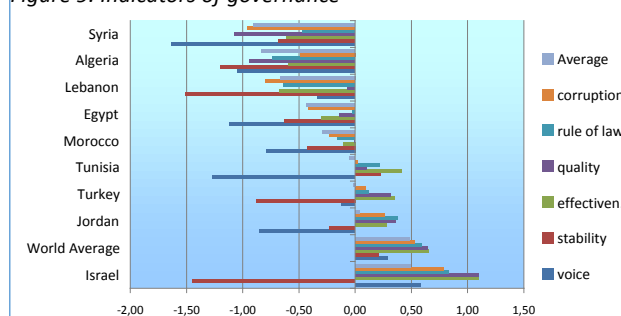
Source: World Bank (2011); \*year 2007 concerning Morocco

economy, especially trade as shown previously. As a matter of fact, Table 1 and 2 clearly showed that an increase in any governance indicator leads to a significant trade increase. According to Figure 9, significant efforts should be made concerning especially: i) “voice”, which measures to what extent citizens are able to participate in selecting their government (Syria, Tunisia, Egypt, Algeria, but also Jordan and Morocco); ii) political stability (Lebanon, Israel, Algeria, but also Turkey and Egypt); iii) the control of corruption (Syria, Lebanon, etc...); iv) the rule of law, government effectiveness and the regulatory quality should also be improved, particularly in Algeria, Syria and Lebanon.

#### ✓ The role of factor movement in the trade creation process

One original aspect of the present study is the inclusion of factor movements as trade determinants. As explained in the previous section, considering a world in imperfect competition leads to the complementarity between trade and factor movement, as trade itself cannot equalize factor prices. The present study validates this theoretical assumption by clearly accepting the complementarity relationship between trade and migration. For example, it has

Figure 9. Indicators of governance



Source: from Kaufman et al. (2010)

been shown that 1% outward migration stock leads to an increase in exports by about 0.2%. This means that MENA countries, which have exported people to the EU have consequently created exports. As a result, migration can be viewed as a tool to create exports from MPs to the EU. This result is not new in the literature but it is clearly highlighted in the present study for the EU-MP relationships [6]. In the same way, our model showed that 1% increase in FDI outward stocks (as a percentage of GDP) leads to 0.03% increase in exports. As a result, FDI can be seen as a tool for EU countries to create exports to MENA countries. In other words, it seems that the trade-migration-FDI relationship is self-reinforcing. This means that if the EU and MENA countries have a common objective which is to develop trade relationships, then appropriate migration and FDI policies can contribute to achieve this objective.

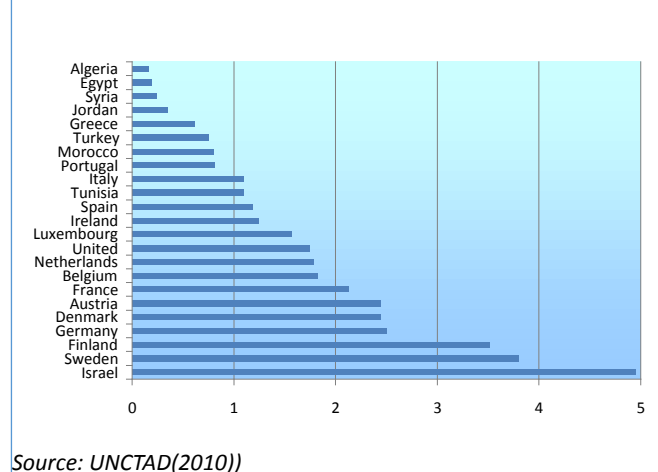
In sum, the remarks developed above show that trade policy (regional integration based on tariffs and NTB policy) cannot no longer be seen as the only tools designed at developing trade relationships between two areas. Indeed, as shown previously, trade can be developed by many other tools or policies involving especially logistics performance, FDI, migration and governance.

#### **Rethinking the EU-MP partnership towards new challenges: education, research, innovation and environment**

In addition, the EU and MP countries can also rethink their partnership toward new tools that can also create trade, job and growth in the future, i.e. education, research and environment.

Education and research is the first major challenge. Indeed, this makes it possible to upgrade the average skill levels in an economy, which in turn can boost the innovation process. In this regard, there is an increasing literature which shows the

Figure 10. R&D in the Euromed area (as a % of GDP, last year available)



link between education-research-innovation on the one hand and trade-growth-employment on the other (Amable, 2000; Milanovic, 2006; Périody, 2010b). In spite of real efforts recently undertaken in some MENA countries, the gap is still large with emerging or developed countries, especially the EU in terms of education and research, as shown in Figure 10.

As a final point, environment is about to become a central issue not only at worldwide level, but also for MENA countries specifically. For example, the problems of wastes (treatment and recycling), de-pollution (grounds, air and sea) as well as the development of clean energies (solar, wind, etc.) are becoming critical issues for sustainable development in MENA countries. In this regard, there is a huge work to be made in this area. From an economic point of view, dealing with environmental aspects can directly create a lot of jobs, while creating trade and growth in MENA countries. This win-win approach (in terms of environment and economics) is a central policy issue which must be dealt with by policymakers very soon.

#### **Notes**

1: The first Association Agreements were signed in the 60s with Turkey, Morocco and Tunisia. They granted tariff preferences to imports originating from these countries toward the EC. These agreements have been progressively extended

to all MPs, i.e. Maghreb and Mashrek countries and the Barcelona process paved the way for the implementation of a free trade area (FTA) between the EU and its MPs

- 2: For a recent survey about the effects of the EU-MP trade integration, refer to Péridy (2010a).
- 3 : See for instance many FEMISE researches and more specifically Gallal and Reiffers (2010)
- 4: For a complete definition of these indicators, refer to UNCTAD, Handbook of Statistics, 2010
- 5: For additional information about NTBs in Mena countries, refer to Augier and Péridy (2010)
- 6: Concerning the trade-migration relationship, refer for instance to Co and al., 2004, Izanzo and Péri (2009) as well as Bran et al. (2009)
- 7: See Anderson and van Wincoop (2003) for the complete derivation of the model
- 8: Basically, the first stage estimates a pure fixed effects model to obtain an estimate of the unit effects. The second step implements an instrumental regression of the fixed effects vector on the time invariant variables. This makes it possible to decompose the fixed effects vector into a first component explained by the time-invariant variables and a second component, namely the unexplainable part (the error term). It also addresses the endogeneity problem. In the last stage, the model is re-estimated by pooled OLS, including all explanatory variables, the time-invariant variables and the error term. This third step ensures the control for co-linearity between time-varying and invariant right hand side variables.
- 9: It can be estimated in several stages. The first stage estimates a Probit model (test for the probability of country *i* to exports to country *j*). In a second stage, provided that exports occur, the effects of trade barriers and other variables can be estimated through the choice of an appropriate estimator (Heckman, 1979, Greene, 2006). This method seems particularly interesting in the present research study because it specifically takes into account the information contained in the zero or missing data. The main problem is to choose the appropriate selection variable.

Recent research at firm level (Melitz, 2003) suggests that in case of different productivity levels between firms, the existence of fixed costs produces a selection of the firms. As a result, only the most productive ones succeed in exporting whereas the others remain on the domestic market. This suggests that productivity at firm level can be used as the selection variable in this kind of model. Unfortunately, in the present research, data are not available for all countries at firm level so that this selection variable cannot be implemented. Instead, the lagged export variable will also be used as the selection variable. As already explained in section 2, this can be justified by considering hysteresis in international trade (Baldwin and Krugman, 1989).

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## **DETAILED SITUATION IN MP's : COUNTRY SHEETS**



## ALGERIA : A new found growth due to oil but with little diversification and openness

The Algerian economy is back to its pre-crisis growth-trend, after an ephemeral slump where growth decelerated to 2.2% in 2009, GDP rose by an estimated 4.1% in 2010 which is equal to the 2000-2007 annual average rate. As always, when oil prices rise so do Algerian exports and by now there is no need to remind how the domestic regime has been both a blessing and a curse. In terms of international reserves it has allowed Algeria to attain skyrocketing heights and provide for its budgetary needs. But, the maximum growth potential, one that could be achieved through the development of more productive sectors of the economy, has not been attained.

In previous reports, FEMISE (2009, 2010) had noted how oil-led growth contributes to maintaining frail structural foundations, to sustain an import oriented economy when oil is excluded and to impede on the development of a knowledge economy. Recent events in the region allow stressing how the domestic authorities have long had an autocratic regime that constitutes a barrier to both international opening and democracy, despite some efforts being conducted in the past. Unfortunately, the risk for the adoption of protectionist behaviour is always there and could signify Algeria misses the opportunity for long-term stability through democratic openness, choosing instead a progressively closed regime. It would be a waste of efforts conducted in the end of the 1980's when the country decided to move away from a centrally-planned structure.

One thing is clear, in light of uprisings in the Mediterranean, the challenge has to be dealt imminently. Simply put, while the country has managed to respond to the threat of the international crisis of end-2008 in a relatively effective manner, it still has a long way towards a growth-regime that relies less on capital accumulation and more on productivity, and that allows for stability in the social structure in a context of regional turmoil.

In the Algerian case, the following elements merit particular attention :

✓ A 26.6% rise in goods exports took place in 2010 and an increase of 37.2% is estimated for 2011 bringing the total to 78.5bn US\$. Hence, the trade balance bounced back impressively in 2010 and is now expected to 28.7bn US\$ in 2011.

✓ Foreign investment could fall by as much as 5.4% to 3.5bn US\$ which remains relatively high. Even so there are still chronic issues regarding foreign capital participation that have to be dealt with.

✓ The country has ample foreign currency reserves that amounted to approximately 3 years of imports of goods and services in 2010 and have been on the rise during the first months of 2011. Meanwhile, external debt is low, at 6.6% of GDP in 2010, and has remained stable in the first half of 2011. The rise in oil-prices obviously contributes to making the cost of servicing more sustainable.

✓ As was expected, economic activity in 2010 recovered, even surpassing its pre-crisis levels of growth, attaining 4.1%. It is expected to reach the 4.6% mark in 2011 following sustained growth in public spending and investment.

✓ The unemployment rate slightly declined in 2010 to 10% from 10.2% in 2009. After the first six months of 2011 estimates point towards a further reduction of the rate to 9.7% for the entire year.

✓ The rate of inflation (3.9% in 2010, estimated at 4% in 2011), while certainly not as high as in neighbouring countries, could create social unrest by further diminishing the purchasing power of the poor. This explains why authorities have promised wage increases, especially in the public sector, to avoid unrest following regional events.

✓ In 2010, authorities maintained an expansionary fiscal policy and made efforts to reduce the impact of lower oil-exports in the previous year. Now, with public spending expected to keep sustaining growth in 2011, the fiscal balance should remain in deficit but at a lower level (at an estimated -2.1%).

✓ Labour productivity growth has failed to be consistent through years and penalizes the rate of growth of per capita GDP. Authorities need to reform education and the vocational training system in order to facilitate the diffusion of innovation and improve the quality of human capital.

✓ Finally, about 100000 students marched in protest demanding democratisation of universities, transparency in the classification and better correspondance between university degrees. A long-term framework for youth employment creation is needed, one that favors the participation of private actors. Authorities should also render the labour market less rigid and target sectors with the greatest potential for employment creation through employment-intensive investment initiatives.

## I. Political economy situation and its implications

### 1. The political model in a crucial transitory phase

Though it has not faced situations similar to those of Tunisia and Egypt, the domestic political scene is more turbulent than it used to. The Algerian president has been in place for 12 years and is now at his third mandate following constitutional amendments to allow prolonging his stay. Currently, the domestic population has not yet rebelled, perhaps still marked by the events of civil war in the 1990s, as in neighbouring Egypt and Tunisia. But if the promises for change do not quickly materialize then the discontent of the young population (70% of Algerians are less than 30 years old) might grow to untenable levels (NPR, 2011).

The graph below positions Algeria on the world J-curve. The latter shows how the country bodes in terms of political stability and democratic openness. Countries that have authoritarian regimes are generally stable and when opening-up their regimes to democracy, they enter a short phase of instability before reaping the benefits of a more demo-

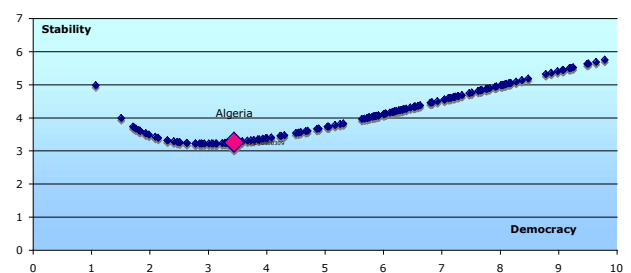
cratic economy and institutions. Before the end of the 1980's, Algeria was stable because it was closed, with limited possibility for external factors to undermine the domestic authorities. However, after a policy shift through which authorities decided to adopt a more liberal regime, the country moved on the right side of the J-curve and went past the transition period through which one observes a tradeoff between openness and stability.

But, what the figure also shows is that Algeria is still relatively close to the turning point which means that if democratization efforts cease then the country risks to fall back to a period of political instability. In light of what is happening in the Arab world, Algeria has two choices: it can keep making efforts to reform its institutions and economy towards more democracy since it is already past (though not by much) the crucial turning point. Or it can fall-back to a protectionist stance in an effort to maintain the political status-quo. Recent events suggest that the situation could evolve either way.

### 2. Governance has improved but reforms have still a long way to go

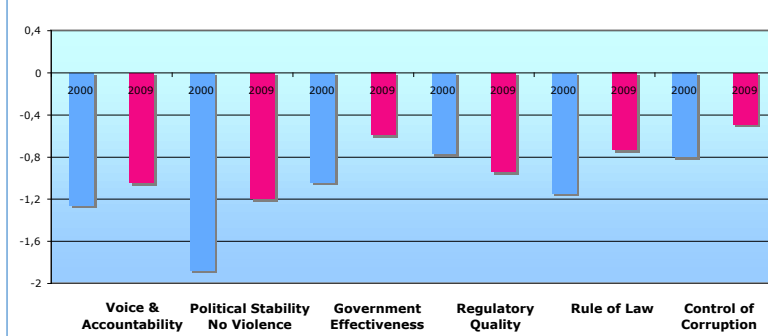
Indicators of governance can provide valuable insights, explaining how Algeria is in a slightly more stable political situation than some of its neighbours. As shown by figure 2, while all of Algeria's governance scores have remained negative in 2009, improvements have occurred in almost all measures.

Figure 1. Algeria on the world J-Curve (2010)



Source : FEMISE calculations based on EIU Political Instability Indicator, Index of Democracy [1]

Figure 2. Algeria's Governance Indicators



Source : Worldwide Governance Indicators 2010, World Bank.

Note : Values vary from -2.5 (bad governance) to 2.5 (good governance)

More specifically, the government effectiveness indicator, which includes perceptions of the quality of services provided by public authorities but also offers a measure of credibility and policy implementation quality, is suggested to have greatly improved between 2000 and 2009. Meanwhile, control of corruption appears to have improved, probably reflecting the efforts of Algerian authorities in recent years to combat corruption. Let it be noted that in 2010, and following the instigation of the anti-corruption law of 2006, authorities approved the creation of a central anti-corruption agency to improve the country's effectiveness to combat domestic corruption, especially in major infrastructure projects that are of strategic importance to the domestic economy. Furthermore, authorities have made efforts for the training of managers who handle public financial resources, while financial inspection within ministries has been increased (Source: Magharebia 2010).

Even so, Algeria's measures to fight corruption have not prevented a low ranking at the international level. In its 2010 edition, the Corruption Perceptions Index (CPI) of Transparency International ranks Algeria 105th out of 178 countries and despite a slight improvement (the country was 111th in the 2009 CPI edition) Algeria remains among the most corrupt economies in the region. Meanwhile, a lot remains to be done regarding freedom of expression, as suggested by the low levels of the voice and accountability indicator, a fact that should be taken into account by domestic authorities if they

wish to genuinely proceed to reforms for more democracy.

Last but not least, it appears that in a decade Algeria has worsened in terms of rule of regulatory quality (WGI, World Bank 2010), that is in the capability of local authorities to develop and apply policy measures that facilitate the development of the domestic private sector.

Recently, FEMISE had noted

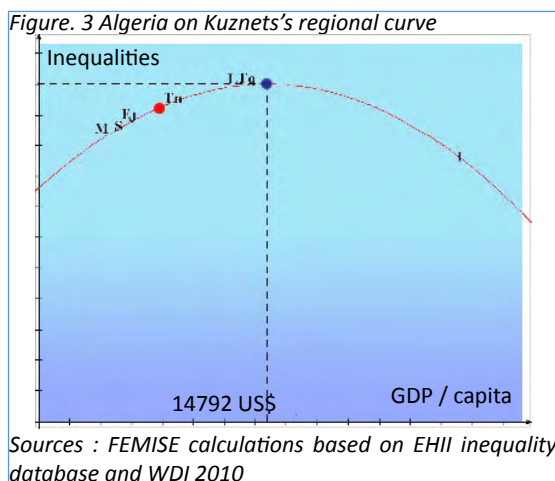
how authorities appear to be following an inverse trend compared to the rest of the region, moving towards a more protectionist stance of « economic patriotism ». While such approach could provide assistance to local firms, by restoring the role of public authorities as a protector from market deficiencies, it could also further impede on the development of the private sector by limiting the presence of foreign capital and trade (FEMISE-EIB, 2010).

### 3. A growth model that still does not decrease inequalities

In a previous report, FEMISE (2009) had already noted how past social policies led to some limited distributional shifts in favor of the poor. But while the poorest decile did benefit from income growth, it barely received 3% of total income in the 1988-1995 period.

Meanwhile, the following figure suggests that the Algerian regime of economic growth does not yet allow for the reduction of inequalities. An increase in GDP per capita actually increases inequalities domestically since the distribution of wealth mainly favors richer deciles of the population. As in the case of almost the entire region, Algeria is still too far from the tip-over point after which the growth effect alone can reduce inequalities.

Thus, one would ask the following: is Algeria rapidly progressing to the tip-over point to make



such inequality level more « bearable » ? A study by Cherkaoui et al (2009) suggests that Algerian efforts for a pro-poor growth regime that reduces inequalities have had some positive results in the first half of the 2000's though poverty has followed an erratic path. The rate of poverty rose from 8% in 1988 to 14% in 1995, and gradually fell to 12% and 6.8% in 2000 and 2004 respectively. However, the poor still appear to be highly concentrated in southern regions and rural poverty (according to national poverty line) in 2000 was at 14.7% of the total population. Furthermore, it appears that, *ceteris paribus*, the unemployed Algerians, those issued from large households, with limited access to potable water and electricity, as well as those with a low education level, have the highest probabilities of being poor (Cherkaoui et al, 2009).

But, one must not forget that the Algerian case is a specific one. The human development level has either risen or fallen with each variation in oil-prices and consequent revenues (the Algerian HDI value for 2010 is of 0.677 and the country is 84th out of 169). This signifies that domestic efforts to reduce poverty, especially those of the Plan in Support of Economic Reactivation (PSRE), still overly depend on the oil economy. It appears that there is no real convergence between Algerian regions. As noted by Belarbi and Zouache (2008) there might be « convergence clubs » in Algeria since there is a tendency for rich regions to stay rich and for poor regions to stay poor. The authors suggest that the sectors that carry domestic growth (especially

hydrocarbons and construction) do not produce the necessary positive externality on the local economy.

All in all, the domestic regime of growth, while perhaps more efficient than the ones in some neighbouring MP's, still needs reform and a more diversified structure in its sources of income to sustain poverty alleviation.

## II. Recent Developments: Real and Financial Transmission

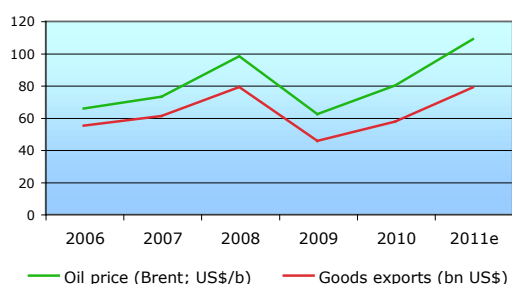
### 1. Real sector relatively unaffected by regional tensions

The domestic real sector has been left relatively unaffected by recent events in the region. One would note:

- ✓ A 26.6% rise in goods exports for the year 2010 to 57.2bn US\$ and an estimated increase of 37.2% in 2011 to 78.5bn US\$,
- ✓ A 2.7% rise in the imports bill in 2010 and an expected 29.7% rise in 2011 which would bring it to an anticipated 49.8bn US\$,
- ✓ The domestic trade balance bounced back impressively in 2010 to 18.8bn US\$, it is now expected to rise by an additional 52.7% to 28.7bn US\$ in 2011,
- ✓ It remains to be seen if tourism will be affected by recent events, the service balance is expected to fall by 26.5% in 2011 to a deficit of 10.5bn US\$,

As suggested by FEMISE (2010), the domestic economy is more open than the Mediterranean average in the case of goods trade, with a trade openness ratio (sum of exports and imports divided by GDP) close to 70% in 2008 (versus approximately 53% for the Mediterranean as a whole). Naturally, this is in large part due to oil-exports which traditionally amount to more than 90% of Algerian total exports. Decomposing the structure of domestic **exports** has little meaning since energy exports amounted to 97.2% of

Figure 4. Evolution of goods exports and oil-prices



Source : EIU

exports in the first half of 2011. Algerian trade keeps benefiting from price-rises which are expected to lead to an impressive 37.2% increase in total goods exports in 2011.

On the **import** side, the value of imports grew by 2.7% in 2010 and is expected to rise by 29.7% in 2011, to an anticipated 49.8bn US\$. Both the rise in domestic demand (by 6.8% in 2010 and by an expected 7.6% in 2011) and the ever increasing food prices (with food representing approximately 15% of Algerian imports according to EIU) contribute to the import bill escalating. Even so, despite the import-rise, the trade balance remains largely positive, it bounced back impressively in 2010 to 18.8bn US\$ and is expected to rise by 52.7% to 28.7bn US\$ in 2011. But again, if oil-prices had evolved differently then Algeria would have faced an entirely different scenario, a possibility never to be excluded sometime in the future following domestic dependency to the hydrocarbon sector.

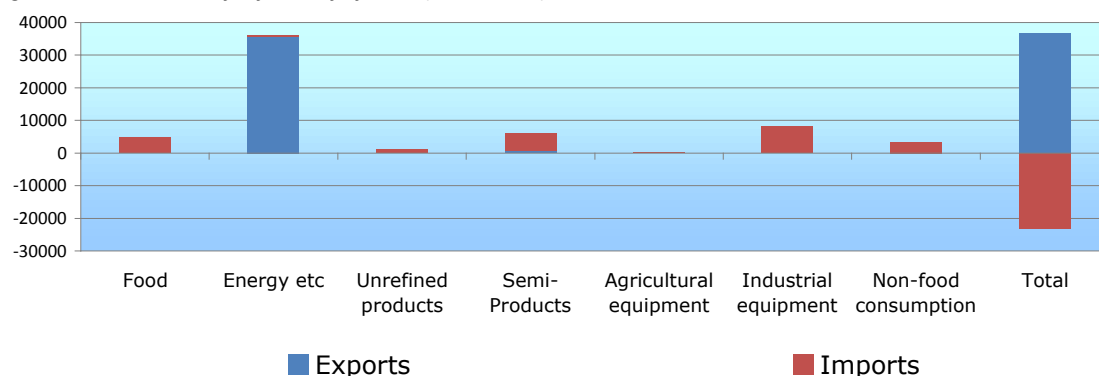
The **service balance** has traditionally been negative since Algeria, which lacks diversification in its production structure, traditionally imports most of its services. Thus, it should come as no surprise that, following the rise in international prices, the Algerian service balance deficit grew even more in 2010, to -8.3bn US\$, while it is expected to grow even further to an estimated -10.5bn US\$ in 2011 (EIU).

Despite uprisings in its neighbours, the country received more than 2 million **tourists** in the past year, which corresponds to an 8.32% growth in 2010 (following a 9.45% growth in 2009) making it one of the continent's major tourist destinations. The fact that about two-thirds of tourists are Algerians living abroad and government efforts in recent years to promote the country as a holiday destination might explain the sector's resilience, however, it remains to be seen how tourism will have performed throughout 2011.

## 2. Financial Sector: Exchange rate slipping due to new method of payment for imports and regional events

Currently, Algeria remains a financial market relatively closed, because of low levels of capital account liberalization and financial liberalization at an intermediate stage (FEMISE 2009, research report FEM33-20). Thus, financial contagion in the context of the regional climate of tension is rather limited.

Figure 5. Trade balance for first half of 2011 (million US\$)



Source : Algex.DZ



## 2.1 Foreign investment on the rebound but chronic issues regarding foreign capital participation have to be dealt with

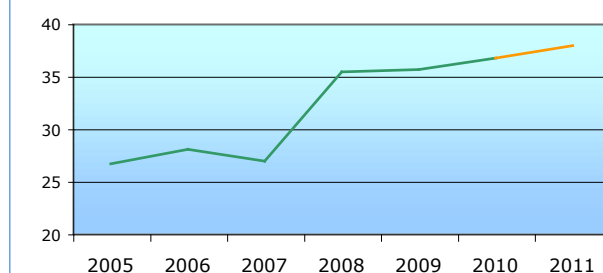
In 2011, FDI might fall by 5.4% to 3.5bn US\$, but the value is relatively high, especially considering the reluctance of investors to invest in the South Mediterranean (EIU). Even so, this does not mean that the investment climate for foreigners is optimal a fact even domestic authorities have recognized since they encourage domestic investment to the detriment of the foreign one. More specifically, one should not forget that authorities impose a 49% ceiling for foreign participation in new projects, a fact that has brought the domestic economy little FDI when the oil-sector is excluded. Furthermore, out of 183 economies, Algeria is only 136th in the ease of doing business (Doing Business 2011, World Bank). Overall, tax policies appear to be an impediment, for instance Orascom Telecom sold its Algerian unit Djezzy (held up by authorities since tax issue has not yet seen a resolution). because of a tax system deemed discouraging.

## 2.2 Stock Market too small for any crisis-induced transmission to occur

The Algiers stock exchange is characterized by its very low level of development. In early 2011, the market would showcase only two listed equities, a hotel owned by public authorities (Egh el Aurassi) and a pharmaceutical company (Saidal), again owned by the government. Meanwhile, the only debt securities to be found were those of three companies: Algerie Telecom, Spa Dahli and Sonelgaz.

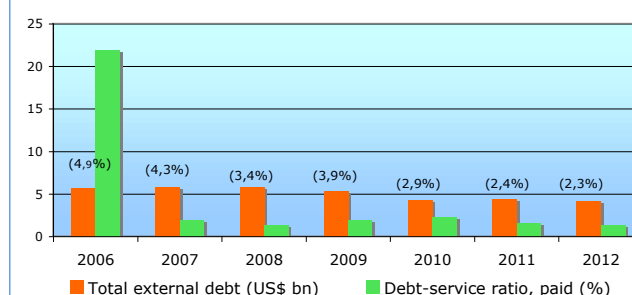
Discussing on potential costs of the revolutions on the domestic stock-exchange serves little purpose, transactions are extremely low (6.74 million US\$ for all 2009), trading activity is resumed to Monday and Wednesday sessions that only last two hours, while the Algerian Bourse is not present in any MSCI indices.

Figure 6. Import cover, in months of next year's imports of goods and services



Source : IMF

Figure 7. Debt Indicators in Algeria, % on GDP in parenthesis



Source : EIU

The private sector is not present in the stock-exchange because it fails to meet accounting standards of transparency that would make it eligible for participation. An exception might be found in the case of Algerian Alliance Assurances which held the first private company IPO (of 20.5 million US\$) in end-2010 before entering the stock-exchange in February 2011.

## 2.3 Foreign Reserves and Debt Indicators are solid

Not surprisingly, Algeria had considerable foreign exchange reserves in 2010 and in early 2011; they amounted to approximately 3 years of imports of goods and services in 2010 and have been on the rise during the first months of 2011 following the continuous rise in oil-prices. As always, foreign reserves act as a cushioning mechanism, protecting the domestic economy from external shocks. The high level of reserves also means that Algeria can keep avoiding international capital markets for external borrowing, relying on its domestic oil-stabilization fund to cover public deficits instead.

As for external debt, it kept following a decreasing trend to 2.9% of GDP in 2010 and has remained sta-

ble in the first months of 2011 and is expected to fall to 2.4% of GDP in 2011. The rise in oil-prices allowed for this and are expected to keep doing so throughout 2011 as well, making the cost of servicing more sustainable. But, one should note that the low level of debt is also due to the prudent macroeconomic management of the last decade, a fact recognized by the International Monetary Fund (IMF, 2011).

#### 4. Recent events contribute to an exchange rate parity in freefall

The exchange rate had been slipping in early 2011 following the recent imposition of the so-called « documentary credit » as a unique means of payment for all imports [2]. While the Algerian dinar had appreciated vis-a-vis the Euro in 2010 it was then depreciating compared to both major currencies (US\$ and Euro). On the formal (interbank) market the Euro was traded for 106 AD, up from 90 AD approximately in early 2010 (EconomicsNewsPapers, 2011).

The credit requirement has pushed importers to take the currency for imports payment into the parallel market, which reacted by pushing up the price of the European currency (means of payment of about 80% of imports). Thus, on the informal currency market, the Euro is now traded for 145 AD, which corresponds to a 40% depreciation for the Algerian dinar in a period of 18 months (EIU). Overall, the dinar is expected to appreciate against the euro from an average of AD102.02:€1 in 2011 to AD91.86:€1 in 2015 as the euro zone continues to be in crisis (EIU). It is also expected to appreciate slightly vis a vis the US\$ to AD72.05:US\$1 in 2015.

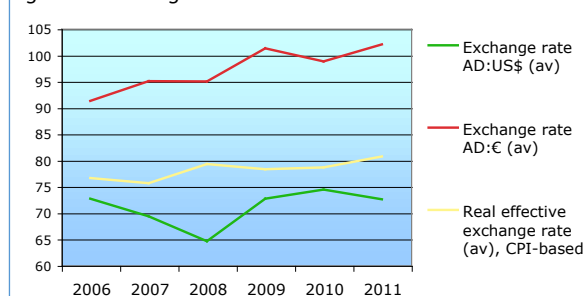
### III. Economic Policy and Macro expectations

#### 1. Main developments

##### 1.1 Economic growth stabilizing in 2011 but still follows a fragmented approach

Growth (expected at 4.6%) follows the development of the industry sector, the latter is expected to account

Figure 8. Exchange rate indicators



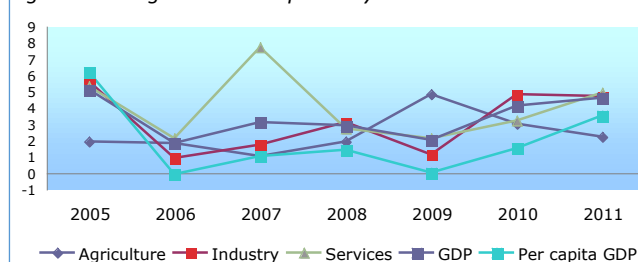
Source : EIU

for approximately 61.6% of value added in 2011 followed by 30.2% for services and 8.1% for agriculture.

The latter sector represents only a small share in total GDP, the arable land is vast (8.2 million hectares) only accounts for less than 3.5% of total land. But, one has to note that agriculture and the food market in general have been developing in recent years and 2011 marks no exception. In an effort to increase productivity and the total levels of agricultural production and reduce dependency on food imports (currently at 75% of food needs), authorities have decided to upgrade the agricultural infrastructure, most notably through irrigation initiatives (TeatroNaturale, 2011). Meanwhile, authorities recently signed a memorandum of understanding and cooperation with Morocco to boost agricultural and rural development in both economies by developing various related fields such as trade, food safety as well as scientific research. New methods of irrigation and water management could increase harvest, render agriculture more reliable and less dependent on rainfall, and contribute, though still much less than oil, to GDP growth.

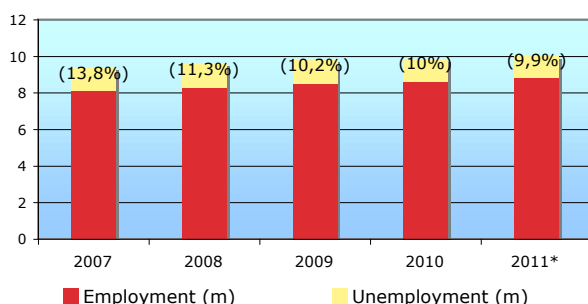
Overall, Algeria has all to gain by using its resources from oil to diversify its sources of economic activity for future growth. But it needs to do so within a cohe-

Figure 9. GDP growth decomposed by sector



Source : EIU

Figure 10. Evolution of the labour force, in millions (rate in parenthesis)



Source : IMF, EIU \* estimations for 2011

rent framework. Currently, authorities appear incapable of developing the economy within a coherent strategic vision. Granted, there is a five-year economic program (2010-2014) of 286 billion US\$ that targets, among others, infrastructure, education and housing. But, it unfortunately appears that a fragmented sectoral approach is being implemented to the expense of the global picture.

### 1.2. Unemployment rate to slightly fall following recent initiatives

The unemployment rate in Algeria slightly declined in 2010 to 10% from 10.2% in 2009. After the first six months of 2011 estimates point towards a further reduction of the rate to 9.7% for the entire year. Even so, the labour force is expected to grow by roughly 1.6% in 2011 (versus 1.3% in 2010) which means that additional efforts should be made to boost the rate of employment creation to cover for both new entrants and the current 1.2 million unemployed.

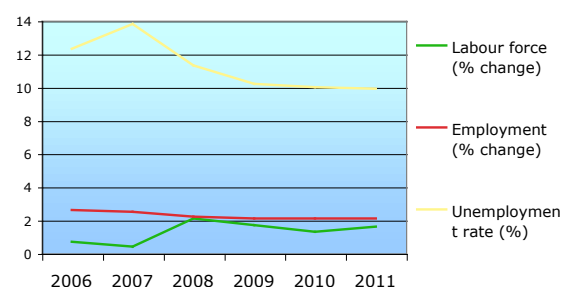
The New Complementary Finance Act is expected to contribute to employment creation and assist the authorities' challenge of creating 3 million jobs for the 2010-2014 period. Initiatives at the local level could provide results as well, in Algiers plans for the creation of 200000 jobs in the 2011-2014 period have been announced through investment projects in sectors such as real estate, tourism and construction.

### 1.3. Persistent inflationary pressures

Inflationary pressures in 2010, though lower than in 2009, remained high following the rise in domestic

demand, the rise in international prices and restrictions on imports. The rate of inflation reached 3.9% and is expected to slightly rise to 4%. Rising prices for agricultural imports could put an additional burden on the consumer price index. In May 2011, the cereals price index had already increased by 69% year-on-year, while the price of sugar rose by 44% in the same period as well according to FAO.

Figure 11. Growth of unemployment and employment creation



Source : EIU, estimations for 2011

#### Box. Incentives for employment, purchasing power and firms development provided by the 2011 Complementary Finance Act

The new Algerian Complementary Finance Act provides a series of incentives for the creation of SME's and the expansion of the existing price subsidy mechanisms for consumption products. Among others, the incentives include:

- ✓ Support to small firms and employment creation for a large share of the population in the northern territory (65% to 80%), in high altitude and in southern provinces (72% to 90%),

- ✓ Creation of a gradual tax targeting small firms, a 70% tax reduction in the first year, followed by a 50% and 25% reduction in the second and third year respectively,

- ✓ Similarly, the creation of a gradual tax with tax exemptions for new activities (tax exemption during the first two years, 70%, 50% and 25% reduction for the third, fourth and fifth years) in an effort to progressively reduce the share of the unofficial market,

- ✓ Customs tax and value-added tax exemption on a series of imported foodstuffs (most notably raw vegetable oil and sugar).

Source : Echoroukonline (2011)

The current rates of inflation, while certainly not as high as the ones traditionally found in countries such as Egypt, Syria and Turkey, could create social unrest by diminishing the purchasing power of the poor. Thus, authorities promised wage increases, especially in the public sector, to avoid unrest.

The government has been used to subsidize foodstuffs and introduce price controls thus maintaining inflation at artificially low levels. The year 2011 should mark no exception, according to EIU, authorities are expected to reduce the impact of international price rises through price ceilings, that is by applying or eliminating specific tariffs and also by managing distribution. Fortunately, the ample oil-revenues should prevent a negative impact on the fiscal balance from rising food subsidies.

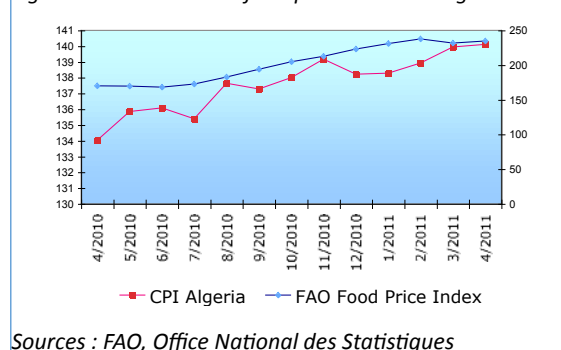
## 2. Demand side: Growth rebound expected to be sustained and fiscal balance recovering

### 2.1 Economic activity that recovers because of public consumption and investment growth

As was expected, activity in 2010 recovered, even surpassing its pre-crisis levels of growth, attaining 4.1% and expected at 4.6%.

While fueling growth by government consumption might hamper the development of the private sector, one must note that government spending has

Figure 12. International food prices and the Algerian CPI



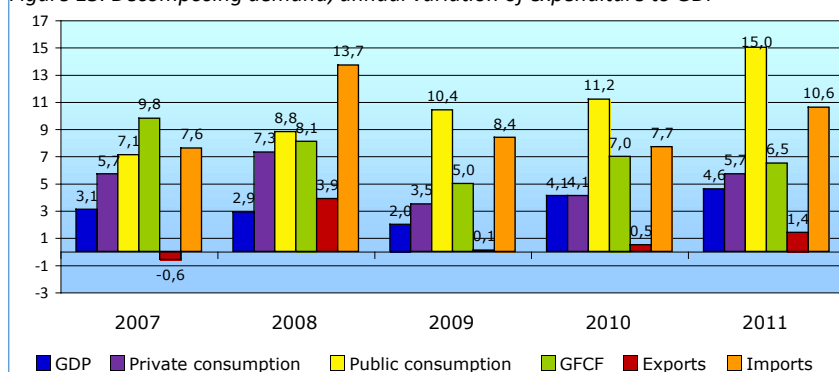
been of support. Public consumption marked a real increase of 11.2% in 2010 and is not expected to slow down, estimates from EIU point towards a 15% increase in 2011 well above prior growth rates.

Moreover, estimates for 2011 indicate investment growth to be resilient, following a 7% rise in 2010 the gross fixed capital formation (GFCF) is now expected to grow by an additional 6.5%. The growth in the GFCF will still be below the rate achieved before the international crisis but in a context of regional political turmoil the rate achieved is considerable.

### 2.2 After a massive deterioration the fiscal deficit is expected to be reduced

After the international crisis, authorities proceeded to increased spending to avoid cases of social unrest. Thus, while the fiscal balance was positive throughout the decade (at 7.4% in 2000-2007, at 9% in 2008) it fell to a record negative of -5.5% in 2009.

Figure 13. Decomposing demand, annual variation of expenditure to GDP



Source : EIU

In 2010, authorities maintained an expansionary fiscal policy and made efforts to reduce the impact of lower oil-exports in the previous year. The fiscal savings would support high spending in public infrastructure investment, of crucial

importance to growth. Rising oil-prices would increase reserves in the "Fonds de régulation des recettes" which would in turn contribute to reduce the fiscal deficit. Now, with public spending expected to keep sustaining growth in 2011, the fiscal balance should remain in deficit but at a lower level (at an estimated -2.1%).

It is also to Algeria's advantage that it has a limited public debt which provides for more room for manoeuvre in sustaining its infrastructure programme all the while providing social assistance to combat unemployment. Even so, the current fiscal stance might have to be contained. As noted by the IMF, a gradual fiscal consolidation would ensure fiscal sustainability in the coming years.

### **2.3 A monetary/exchange-rate policy at crossroads**

The Algerian Central Bank follows a managed float policy of the dinar to ensure exchange-rate stability. A relatively cautious monetary policy, combined with high oil prices and a fiscal policy that used to be prudent, contributed to having large foreign currency reserves, low debt and ample savings in the oil stabilization fund.

But as seen earlier, the domestic currency is now depreciating compared to both the US dollar and the Euro. The decline in the offer of the latter combined with the surge in inflation and regional social risks could mean currency holders see the euro as a safe bet that appears preferable to the dinar.

As noted by the IMF, monetary and exchange rate policies should instead be oriented toward absorbing excess liquidity from the oil-economy and parry inflation emanating from the civil-servant wage increases. In case of persisting inflation, the interest rates might have to be increased, providing a better signal for the cost of domestic credit than the one provided from the state of liquidity absorption.

## **IV. The youth issue**

### **1. General characteristics of youth unemployment**

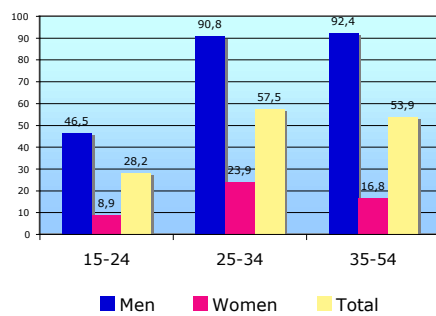
As noted before, the domestic economy is a net oil-exporter, one that may profit from rises in oil-prices to benefit its trade balance and that has ample foreign currency reserves and very little external debt. But, authorities have been incapable to produce sufficient jobs which especially penalizes first-time job-seekers.

The unemployment phenomenon in Algeria mainly affects the youth (ILO estimations suggest a youth jobless rate of 24.3%); the jobless rate for those aged 16-24 reached 21.5% in end-2010, while the rate for adults (older than 25) is only of 7.1%. While the figure appears alarming, its magnitude is even greater when taking into account that about 48% of the population is under the age of 24 and that about 70% of the unemployed in Algeria are under 30 years old.

One has to note that while population growth has been globally declining since the 1980s, labor force participation has been increasing following the entrance of young women into the labour force. Government policies and increasing education for young girls might have been the cause for the shift. The increasing participation of women led to a recomposition of the labor force, their share in labor grew by roughly 50% between 1980 and 2004 and their participation rate by 70% (Kpodar, 2008).

Even so, a glimpse at prevailing activity rates in Algeria shows that there is still a considerable gap between genders. When focusing at the 15-24 youth demographic one notices that the activity rate for young men is at 46.5% versus only 8.9% for young women. But, the gender gap phenomenon is not solely linked to the youth, it is clearly apparent that women of all ages are under-represented in the domestic labor force despite their increasing participation in recent decades.

Figure 14. Activity rates in Algeria, by age and gender, end 2010



Source : Office National des Statistiques

Finally, taking into account labour market rigidity and a demand-supply mismatch one understands that the issue of youth employment is a difficult one to solve. Perhaps, to provide concrete answers for the future generations of Algeria, authorities should prioritize their focus on providing better education.

#### **Box. Understanding the basic characteristics of youth unemployment in Algeria**

✓ About 68.5% of the unemployed are between 20 and 34 years old, 80.4 % are employed in non-permanent positions, 67.7 % in the private sector and 38.5 % have lost their job less than 12 months ago.

✓ Unemployment is high among the educated population and especially women, while the rate among the non-educated is of 7.3%, it reaches 21.4% for those with a degree from secondary education ( affecting men less than women with an 11.1 % rate for men and 33.6 % for women). Overall, about 34% of the unemployed are secondary and tertiary graduates.

✓ Meanwhile, 42% of the unemployed are in rural areas.

✓ At present, the informal economy is the main employer of the youth and especially for women. The informal economy is estimated at about 45%.

✓ Authorities have addressed the issue in a fragmented and non-efficient manner (especially through micro-credit initiatives). Hence, labor productivity during the recent decade has been low. On average, 400000 job-applicants register annually with only 60000 job offers from firms and 45000 job seekers that end up being employed.

Source : Office National des Statistiques (2011), Kpodar K. (2008), Achy (2010)

## **2. The youth issue, poor education quality and labour productivity**

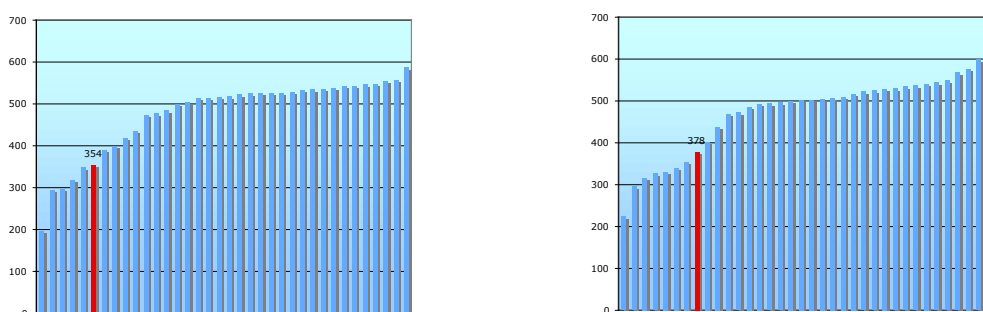
An international assessment of the math and science knowledge of fourth grade students shows that Algerian students are below average in science while they are close to average regarding mathematics (scores under 400 signify only basic knowledge is acquired). Granted, Algerian fourth graders seem to perform better than neighbouring students in Morocco and Tunisia in both fields. Even so, their knowledge level seems low when compared to the ones obtained in Eastern transition economies such as Hungary (536 in science and 510 in math), Latvia (542 in science and 537 in math) and Lithuania (514 in science and 530 in math).

One could say that authorities need to spend more to render the educational system more efficient. But this argument would contradict public spending on education figures which clearly show that Algeria spends more on education than the Arab world on average, with education spending amounting to about 4.3% of GDP, a percentage that is slightly above the average ratio of education spending to GDP in lower middle income economies. Hence it is less a question of quantity spent and more of low quality in the educational reform process.

As highlighted in a recent study (Achy, 2010), since its independence Algeria has pursued several reforms of its education system that did allow for improvements in literacy rates and education access for both genders, however, the quality of education has been receding. Teachers perceive low wages and are only partially invested in their jobs, teaching methods lack modernism and effectiveness and this continues onto university where high joblessness awaits graduates since the system is incapable to cope with labor demands.

The fact that more than a third of the unemployed are secondary and tertiary graduates (mostly wo-

Figure 15. Average science and mathematics scale scores of 4th-grade students, Algeria VS the World: 2007



Source : IES, National Center for Education Statistics, U.S. Department of Education

men) suggests that education is incapable of providing proper orientation as well as the necessary qualifications to the Algerian youth. Thus, it comes as no surprise that the private sector faces a lack of qualified labor with basic skills, noting that roughly 80% of students are enrolled in humanities, social and related sciences, which often signify less employment opportunities, while only about 20% of students are in sciences and engineering which are vital to the labor markets' needs.

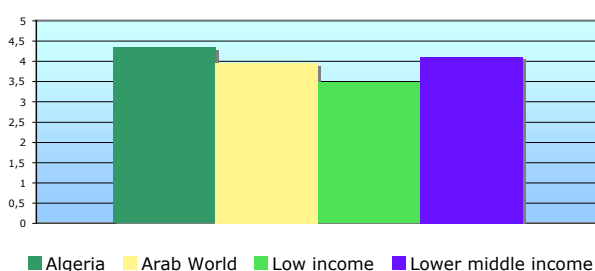
This inefficiency is mirrored into an inconsistent labour productivity growth, one that has failed to be consistent through years and which in turn penalizes the observed rate of growth of per capita GDP. The persistency of relying to great extent on the hydrocarbons sector coupled with international oil-price variations were also a negative determinant to domestic labor. Algerian exports had plummeted in the late 80's following a drastic fall in oil prices which finally lead to the IMF structural adjustment program for Algeria in which about 405 000 public employees were fired but without a private-sector job to accommodate them. While official statistics showed a

drastic fall in unemployment, this program ended-up eroding purchasing power and contributed to the rise of the informal sector, ignoring the longer term and stigmatizing labor productivity compared to other countries of similar development stages. As for recent policies for the youth, they seem to focus too much on public works programs that provide opportunities that are both ephemeral and underpaid, without treating the core of the unemployment issue.

### 3. What policies for the youth ?

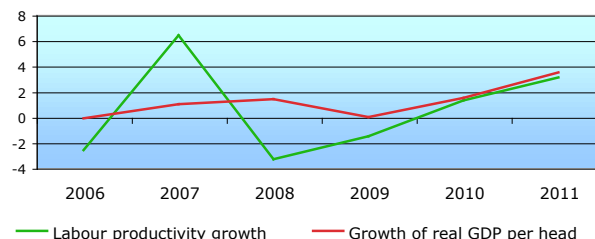
Domestic authorities clearly need to elaborate a long-term youth employment strategy. As expressed by recent events (in April 10th 2011 about 100000 students marched in protest from the Grande Poste to the quarters of the Algerian presidency) the Algerian youth demands democratisation of universities, transparency in the classification and better correspondance between university degrees in the old and new system. They also need to know that their degree will provide them with the opportunities they deserve.

Figure 16. Public spending on education, last date available, total (% of GDP)



Source : WDI

Figure 17. Algeria : Labour productivity and per capita GDP growth in recent years



Source : EIU

But such concerns cannot be met with short-run solutions, they need a long-term framework that may come with the participation of private actors. First, the government should follow reforms to increase labour productivity for a sustainable unemployment reduction. Improving the business environment and focusing on the quality of human capital instead of accumulating physical capital could pave the way towards accomplishing the target. Second, rendering the labour market less rigid, all the while ensuring unemployment insurance coverage is provided, could also be of help allowing for easier and faster employment creation. Finally, Algerian authorities need to target sectors with the greatest potential for employment creation. To do so they should rely on employment-intensive investment, both public and private, that often necessitates hiring qualified employees to carry on projects that often last several years. Intensifying vocational training initiatives to orient the youth towards new sectors that are potential « growth carriers » would also be a wise approach.

Some initiatives have been recently followed with positive, though some times insufficient, results. In 2010 the ANEM plan for the youth allowed 181839 young people to find a job while the DAIP instrument for professional insertion helped for the insertion of 273141 young individuals. Among the latter, 99691 were university graduates (or 26,5% of the total) and overall an estimated 531000 employment positions were created in Algeria for 2010. Different social programs through the ANSEJ initiative have also contributed in creating job positions for the youth in all regions.

But problems remain as suggested by 4000 official employment demand files that currently remain as « suffering » (« en souffrance ») with observed incoherencies regarding the status and treatment of job-seekers, the non-applying of workers rights by responsible authorities and the existence of fictional jobs. This suggests that coordination among agencies is also of imminent necessity if the government wishes to tackle the issue in a profound manner.

## V. Conclusions

The Algerian economy is back to its pre-crisis growth-level, GDP rose by an estimated 4.1% in 2010 and is expected to remain near the 4.6% mark in 2011. Meanwhile, the country moved on the right side of the J-curve and went past the transition period through which one observes a tradeoff between openness and stability. Even so, the Algerian regime of economic growth does not yet allow for the reduction of inequalities and concerns and tension have been rising among the population.

The analysis suggests the following policy recommendations.

First, reforms at the political level are needed with tensions among the youth rising. If democratization efforts are not sustained then the country risks to fall back to a period of instability. Authorities announced that reforms to the constitution will occur for a more representative democracy, but when and how this effort will take place is still unknown. For the first time in more than a decade the state of emergency that had been in force since has been lifted while the National Security Council was convened.

Second, the challenge posed by the recent surge of inflation and the evolving dinar-euro exchange rate parity mean that the fiscal stance will have to be contained within a context of regional turmoil. But, it should provide for better fiscal sustainability in the coming years and growth could be maintained with better use of public spending.

Third, the factors that contributed to the fall of neighbouring regimes such as youth unemployment, lack of transparency and persistent corruption are all present in Algeria. Thus, authorities should address these issues while there is still time, since they have not yet caused a similar revolution domestically.

Fourth, a long-term framework for youth employment creation is needed, one that favors



the participation of private actors. Authorities should render the labour market less rigid and target sectors with the greatest potential for employment creation through employment-intensive investment initiatives. One should also note the following : it had been estimated by FEMISE (2006) that a TFP growth of 0.7% annually combined with a 30% investment rate would be necessary to reduce unemployment by half. Several years later such observation is more relevant than ever, the government needs to follow reforms to increase labour productivity. This implies reforming education and the vocational training system in order to facilitate the diffusion of innovation and improve the quality of domestic human capital.

Finally, targeting sectors that can sustain employment must always be envisaged. In such an effort the authorities appear to be following a plan to stimulate the textile sector through an envelope of 2 bn US\$. This would allow to first buy off the debt of textile firms and second proceed to modernization of the textile industry.

#### Endnotes :

1. The J-curve approximation is obtained plotting the «political instability index» (EIU) to the «index of democracy 2010» (EIU).

We obtain a quadratic equation that represents a simplified relationship between the two indexes and takes the form of :

$$Y = 5.2547 - 8.7419 * \ln X + 9.3128 * \ln X^2$$

where X is the EIU democracy indicator of 2010 and Y the inversed political instability index (political stability)

2. Documentary credit corresponds to a requirement that all importers mobilize prior financial resources to pay for goods and services of import orders (EIU).

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## EGYPT: Paving the way towards more sustainable development

Up until the political uprising in January 2011, the Egyptian economy was judged to have weathered the 2008 global financial crisis relatively well. Growth slowed down from 6.4% between FY05 and FY08 to only 4.9% and was on a recovery path since mid 2010 (around 5%). Despite a fall in exports in the aftermath of the 2008 crisis, the external position remained sustainable. Domestic demand remained robust, sustained by growth in sectors such as construction and communication. Investment (particularly soaring levels of FDI) had an increasing role as a driver of growth before the 2008 crisis. As a result of strong reserve accumulation, the Central Bank of Egypt (CBE) was able to build a comfortable level of reserves (US\$ 35 billion at end FY10) and was closely managing the exchange rate.

Yet, a major shortfall of this high growth was that it favored an elite of crony capitalists. It did not achieve social inclusion, was accompanied by rising inflation - particularly food -, did not lead to job creation (particularly for the youth) and was not inclusive of the poor. As a result of the political upheaval, production stoppages, absence of security and political uncertainties already had a short-term cost. The outlook for FY11 is as follows:

- √ Growth has declined to 1.8%, reflecting a sharp fall in investment and a drop in tourism. Growth for FY12 is forecasted at 3.7%,

- √ As a result, unemployment is expected to increase slightly above 12% as uncertainty continues for the private sector and as migrants return from neighboring countries (particularly Libya) due to the political contagion. Also, informality is likely to increase,

- √ The current account deficit was reduced to 1% of GDP, despite a sharp fall in services exports and tourism falling by 8.6%,

- √ FDI flows sharply fell by 67% and strong short-term capital outflows are likely to continue

to occur especially from the t-bills market (foreigners hold 22%),

- √ Pressures on the exchange rate may induce the CBE to further reserve depletion. By end of August, US\$ 11 billion of reserves have been lost and the current stock only covers 6.2 months of imports from 8.6 months in June 2010,

- √ Inflation is a near term risk and is expected to climb to 16%, as further rounds of global food price increases are highly probable,

- √ Public finances are worrisome with the fiscal deficit forecasted to rise to above 10% of GDP. And while the decision to freeze subsidy reforms is appropriate for the time being, the adopted expansionary measures as a reply to rising popular requests raise fiscal sustainability concerns,

- √ Finally, youth unemployment is the highest (25%) particularly among the graduates. For those who are lucky to be employed, they are engaged in precarious employment that is often of low-quality, low pay and highly unstable. So far, past policies have been shortsighted and have not been coordinated.

This country profile discusses the current situation and underlines the challenges ahead. After presenting the current political context and what led to it, it takes stock of the recent economic costs, in the third quarter of FY11 (January-March), the period right after the revolution. Finally, it addresses the challenge of youth unemployment.

### I. The limitations of the political economy model

Even before the revolution, young Egyptians had been campaigning through social networks (facebook) against corruption, police brutality (especially from the State Security Service who used violence and torture to suppress dissent under the emergency law), and the monopolisation of political institutions by the ruling National Democratic Party. In addition, the conduct of the fraudulent election at the end of 2010 led to mass rallies on January 25th (National Police Day) (EIU, 2011). Inspired by the success of the Tunisian revolution, these rallies led to a popular uprising which top-

pled 30-year old rule of president Mubarak last February 2011.

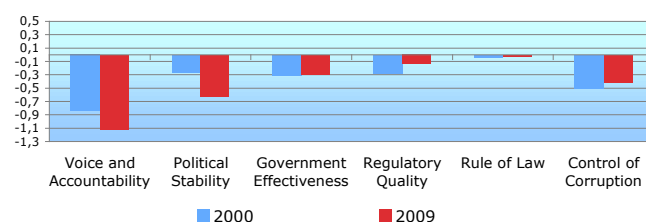
The Supreme Council of Armed Forces (SCAF), which is believed to have put pressure on the president to step down, has been overseeing the transition to a civilian government until new presidential and parliamentary elections are held. It has dissolved parliament, appointed three transient cabinets, and announced a new constitutional declaration that replaced the 1971 constitution. A president should be elected before October 2011 and would then oversee the drafting of a new constitution. The emergency law that has been in place since 1981 is supposed to be lifted ahead of the parliamentary election, which is scheduled for November 2011.

### 1. A period of political instability may have to be endured

Before the revolution, Egypt had been considered a stable political regime, perhaps with some uncertainty closer to presidential elections. Economic liberalization reforms were adopted in the early 1990s, with a boost since 2004. However, the revolution showed that political stability does not necessarily mean political openness, the latter not having gone hand in hand with economic openness.

The J curve (as suggested by Bremmer (2006)) plots state stability (which depends on the presence and quality of institutions) against openness (both economic and political). Up to a certain point, there is a

Figure 2. Egypt's Governance Indicators



Source: Worldwide Governance Indicators 2010, World Bank.

Note: Values vary from -2.5 (bad governance) to 2.5 (good governance)

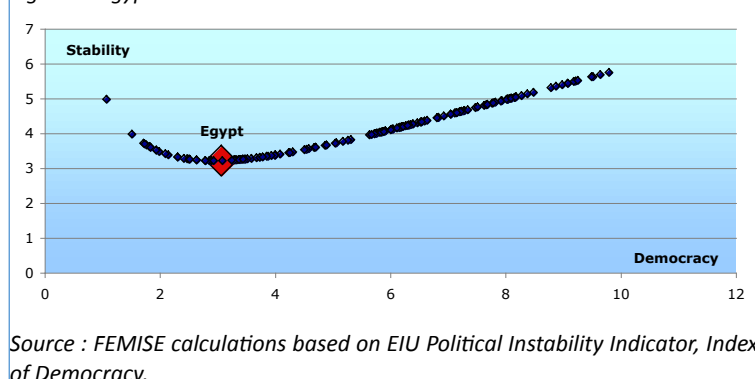
short-term tradeoff between openness and stability. Countries like Egypt could be stable without necessarily being democratic but as they open-up, they become less so for a short-period. In Egypt, the transition towards more political openness had already been in process before the revolution. Even though the Egyptian president still retained full control over executive powers, opposition parties have been permitted but their formation was tightly controlled, freedom of press was tolerated since the early 2000's, compared to neighboring countries. Indeed, the J-curve shows that Egypt, like Tunisia, is very close to the turning point after which the tradeoff between openness and stability, provided genuine democratization efforts are undertaken

### 2. Governance and corruption measures are alarming

Governance indicators could explain to what extent bad governance was responsible for current political outcomes. As figure 2 indicates, all of Egypt's governance scores are negative, indicating a poor performance between 2000 and 2009. In particular, a severe deterioration has occurred in political

measures (the voice and accountability and political stability and use of violence), which confirms the demand of the youth for democracy and political participation. Meanwhile, regulatory quality and rule of law improved, probably reflecting government efforts in recent years to simplify business regulations (Egypt was top reformer 4 times of the doing business report between 2004 and 2009) and to reform property rights and contract enforcement.

Figure 1. Egypt on the J-Curve



However, what is surprising is that the corruption measure also improved, which highlights some reservation on the indicator. Alternatively, Egypt had a score of 3.1 in 2010, ranking 98th out of 178 countries (and 12th in the MENA region) in the Transparency International Corruption Perception Index (0 being highly corrupt and 10 being very clean), together with Burkina Faso and only ahead of Algeria, Lebanon and Syria from the Euro-Mediterranean region (Transparency International, 2010).

In Egypt, corruption was not just associated with the abuse by public officials of their positions but was a direct result of the collusion between money and authority. In fact, the alliance between the state and a privileged rent-seeking business elite was perceived to be an important driver of the political unrest. The crony capitalists also appear to have failed to use the domestic resources to their full advantage (King, 2007). In fact, the share of private investment to GDP was insufficient (even after peaking at 14.4% in 2008) to create the necessary jobs to absorb a growing labor force, and unemployment remains at double-digit levels (World Bank, 2009). In a survey that was conducted for the Center for International Private Enterprise (CIPE) in 2009, results show that 28% of sample perceived the high rate of unemployment (followed by inflation) to be the most important manifestation of corruption. The private businessmen were also able to influence the adoption of policies/reforms that favored them. As a result, reforms related to the informal sector (30% of GDP) were neglected. Some businessmen were also able to maintain policies that were hostile to competition (like in the steel market). Other forms of widespread corruption also include giving credit to unworthy large businessmen, distributing land at subsidized prices (about 20–25 % of the market price and about 50–60 % of the infrastructure cost recovery) and giving privileges to politically connected businessmen (World Bank, 2009). Enterprise surveys conducted by the World Bank also confirm that corruption is the second concern for private sector development followed by anticompetitive and informal practices (World Bank, 2009).

### **3. Limitations of Egypt's growth model**

As mentioned before, Egypt's economic growth was on a recovery path, registering 5.6% in the first half of FY11 (up from 5.1% in FY10). Although these rates were well below those recorded during the recent boom (close to 7%), they were still a positive result against the background of a severe global recession. The Egyptian economy was even classified by the Economist as one of the best six emerging markets during the coming decade. If one thing the recent revolution showed was that past governments may have delivered a better recent macroeconomic performance (measured by high growth driven by unprecedented capital inflows) but their model fell short of providing a decent life for their citizens in terms of better human development, equality, decent jobs and a transition out of poverty.

#### **3.1 Growth without sufficient human development**

Egypt's growth was accompanied by only slight improvement in human development indicators over the past ten years. Between 2000 and 2010, Egypt's human development index rose by only 0.9% annually, which gives the country a rank of 101 out of 169 countries in 2010. This places Egypt below the regional average, lagging behind most countries except Syria and Morocco (UNDP, 2010a). This is not surprising given that the share of public expenditure on education and health in total spending is very low (17 % between 2007 and 2010).

And while access to education improved with higher attendance rates and smaller gender gaps, indicators of quality are alarming. Results from the Trends in International Mathematics and Science Study (TIMSS) show that Egypt's average scale score is significantly lower than the scale average. Even more, the average score for Math and Science declined between 2003 and 2007. Urban-rural disparities are very wide in terms of learning outcomes, especially for young people (between 10-17 years), as indicated by the Survey of Young People in Egypt (SYPE) conducted in 2009. Moreover, El Arabi (2010)

provides evidence that the returns on education (an indicator of quality) in Egypt are very low compared to other developing countries. Moreover, UNDP (2010b) explains that returns to education of young people, especially the educated.

Health outcomes are also alarming. Results from the 2008 Egypt Demographic and Health Survey show that stunting (chronic malnutrition) increased by 26% since 2005 (El-Zanaty and Way, 2009). Currently, 29% of children under five are stunted and 7% are acutely malnourished, which corresponds exactly to the estimate of extreme poverty (the inability to provide for food) (Marotta et al., 2011b). The quality of health services is very poor with the numbers of hospital beds, midwives/nurses and physicians being respectively 1.7, 3.5 and 2.8 per one thousand people. Moreover, out of health pocket expenditure accounts of around 57 % of total health expenditure.

### **3.2 Growth without decent jobs**

Growth between 2005 and 2009 was jobless (Marotta et al., 2011b). In fact, employment contributed negatively to growth during this period, and employment growth fell sharply from 6.3 in 2007 to 3.6% in 2008. Moreover, the 2008 crisis led to employment losses in manufacturing (down by 7%) and tourism (down by 15%). Employment growth partly recovered in 2010 to only low 3.7%. Naturally, unemployment persisted between 8-9% since 2007 and increased in 2009 to 9.4%. Another disturbing fact is the quality of jobs. Assaad and Barsoum (2007) show that in 2005 the proportion of formal jobs for new entrants dropped to 28% in 2006 from 33% in the 1970s and the share of informal employment soared to 72%. In addition, one quarter of total employment is vulnerable (unpaid family workers and own-account workers) (UNDP, 2010a). Finally, Marotta et al. (2011b) also showed that the vulnerable unpaid family workers were the only group that had the highest exposure to poverty and the highest absolute increase in poverty rates. Moreover, they remained poorer than they were before the crisis.

### **3.3 Growth was not inclusive of the poor**

Marotta et al. (2011b) show that poverty increased from 19.6 in 2005 to 22% in 2009 and the near poor (31 million) are estimated at around 40 % of the population (1). Inequality also increased between 2005 and 2008, especially in rural areas (Marotta et al., 2011a). Another source of vulnerability is the inequality of opportunities – due to predetermined characteristics such as gender, parents' employment and education, and place of birth – which constrains access to basic public services and vital inputs. Belhaj (2010) provides evidence that as much as 30% of earnings' inequality in Egypt in the age cohort of 40-49 years is due to unequal access to opportunities. This could thus contribute to social exclusion and to the persistence of inequality (Elbers et al., 2005 and Bourguignon et al., 2007).

Marotta et al. (2011b) argue that growth was not inclusive of the poor because of many factors. First, inflation harmed the poor: the increase in the cost of the subsistence food basket (by 47%) cut the real incomes of the poor and near poor by 20%. Out of the total change in poverty (+2.46 percentage points) between 2005 and 2009, food inflation accounted for a 4% increase, over-powering the poverty reduction effects of growth (-0.39%) and distribution (-0.92 %). Second, the role of fast-growing sectors (manufacturing, transport and communications) as a source of livelihood for the poor actually shrank to less than a quarter. Third, growth did not occur in sectors with a large distribution of poor like agriculture (upon which 40% of the poor rely as a main source of livelihood). Rather, it occurred as mentioned earlier in other sectors (where only 11 % of the poor work). And while the government seemed preoccupied with why growth was not trickling down, it did not necessarily take effective inclusive measures.

## **II. Crisis, response and short-term prospects**

At the onset of the revolution and the resulting lack of security (for a period of 18 days in January and February 2011) and the closure of banks, the eco-

nomy came to a sudden halt. After the President stepped down, economic activity slowly resumed but is still below potential, as security concerns and political uncertainty continue. This section focuses on the crisis (main transmission channels and impact) in the third quarter of FY11 and the government's response.

## 1. Short-term crisis transmission channels

After the revolution, the recovery of the Egyptian economy from the 2008 financial crisis was interrupted. The short-term impact took place through three main channels: the business disruptions and a fall in external trade, causing employment losses and eventually leading to an economic contraction. A third channel is the financial outflows that occurred.

### 1.1. Business disruptions and external trade losses

In fact, official CAPMAS estimates show losses in manufacturing, construction and tourism. All three sectors account for 39% of value added, 24% of employment and 40% of investment. In general, Greater Cairo suffered most of the losses (41.2% of value added in manufacturing and extractions and 82.7% in construction). Losses in the food processing industry were almost 18% of value added.

Current external balances have come under some pressure in Q3-FY11, but figures for the overall FY11 are more positive:

- √ The trade balance contracted to 8.5% of GDP from 11.5% last year, as a result of a decline in both earnings of merchandise exports (to 9.7% of GDP from 11% last year) and imports (to 18% of GDP from 22%), most of the decline occurring in non-oil imports (from 20% to 16% of GDP),

- √ Export services also fell to 8% of GDP (from 11% last year) following a decline in both Suez canal and tourism receipts,

- √ The current account to remained in deficit but was reduced to 1% of GDP from 2% last year,

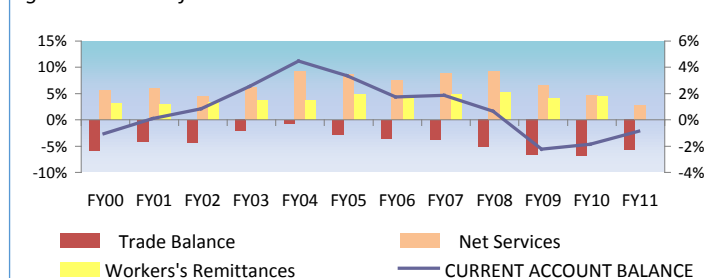
By the end of 2010, the recovery of merchandise exports (both oil and non-oil) from the effects a muffled external demand had been in process. However, the business disruptions in Q3-FY11 due to the revolution exerted a slight pressure on current balances. Despite a narrowing of the trade deficit (to 2.2 from 3% of GDP), the current account deficit widened marginally (to 0.6% of GDP from 0.4% last year). This was due to a large contraction in the services surplus, which was slashed by 50% following a sharp fall in the revenue of all service exports (except Suez Canal), namely tourism down by close to 35%.

However, figures for the full FY11 show that the trade balance contracted to 8.5% of GDP from 11.5% last year, as a result of a decline in both earnings of merchandise exports (to 9.7% of GDP from 11% last year) and imports (to 18% of GDP from 22%), most of the decline occurring in non-oil imports (from 20% to 16% of GDP). Export services also fell to 8% of GDP (from 11% last year) following a decline in both Suez Canal (to 1.8% of GDP from 2.1%) and tourism receipts (to 3.8% of GDP from 5.3%). Meanwhile, remittances marginally recovered to 4.5% of GDP from 4.3%. As a result, the current account deficit was reduced to 1% of GDP in FY11 from 2% in FY10.

One the one hand, tourism (3.5% of value added and 25% of foreign exchange earnings) has suffered the following losses after travel bans were imposed on Egypt:

- √ US\$ 178 million in tourism spending after the departure of 210 thousands tourists,
- √ US\$ 825 million in February alone due to the cancellation of trips to Egypt,
- √ LE 70 million in wages of the temporary workers that were laid off.

Figure 3. External finances



Source : Author's calculations based on Central Bank of Egypt's monthly statistical bulletin.



Several key European countries have recently lifted their travel warning to Egypt. Yet, as security issues remain a concern, tourist arrivals dropped by 45% y-o-y and receipts fell by 34% in the period January- March 2011, considered the high season for tourism. Also, occupancy rates drastically fell from above 70% before the revolution to around 23% in March with an upturn to 40% in August 2011 (IDSC, 2011b). World Bank (2011) report that if tourism receipts decline 18 percent in during 2011, that would imply a direct 1.5% of GDP foreign currency shortfall. On the other hand, Suez Canal revenues have been more resilient. They increased by almost 11% (y-o-y) in FY11 (compared to a contraction of 4% last year but still less than record growth of 21% in FY08), reaching US\$5 billion, reflecting the improved global trade. Rising oil prices have also rendered alternative maritime routes more expensive, especially since the Suez Canal Authority has decided to leave its transit fees unchanged (for the third consecutive year) until the end of 2011.

## **1.2. Financial outflows with manageable consequences**

Financial outflows are expected to continue:

- √ FDI fell by 68%,

- √ Strong short-term capital outflows are likely to continue occur especially from the t-bills market (foreigners hold 22%) as uncertainty continues.

After it had started its recovery following the 2008 crisis, Egypt's financial account surplus turned into a deficit -1.7% of GDP from 3.8% in FY11. This was essentially due to a substantial reduction in FDI inflows (by more than 67 %) to US\$2.2 billion from US\$ 6.7 billion in P, FDI inflows fell to 0.8% from 3.1% of GDP. Short-term outflows (US\$ 6 billion alone from the t-bills market) occurred in the aftermath of the revolution after a strong recovery in the end of the year. As a result, portfolio investments dropped (to -0.9 from 3.6% of GDP last year) and commercial banks increased their assets abroad (an outflow of more than 3 percentage points of GDP). Consequently, the previous balance of pay-

ment surplus turned into a deficit of 3.5% of GDP (US\$ 9.7 billion), the highest in at least 20 years.

The Ministry of Finance expects Egypt's financing needs to increase to around US\$11 billion in FY12 (Ministry of Finance, 2011b). The government already rejected an agreement with the IMF on a 12-month Stand-By Arrangement in the amount of US\$ 3 billion to support the government's economic program for FY12 (EIU, 2011). A planned loan with the World Bank (for US\$4.5 billion) to bridge Egypt's financing needs was also suspended. Egypt's External debt is not high (US\$35 billion in end 2010, and declining as share of GDP, from 15.9 to 14.7%). However, it is unlikely to increase significantly after the government external borrowing plans have been suspended.

The resumption of short-term flows in 2010 had contributed to a good performance of the Egyptian Exchange (EE) in 2010, which outperformed many Middle East stock markets, with the main stock market index EGX30 recording a 15% growth. Yet, the political developments caused shares to plummet (by 16%) during the first few days of the revolution (January 26 and 27). As the political situation worsened, the EE was closed for 38 days, coming close to the 40-day grace period after which it could have been delisted from the MSCI Emerging Markets Index. When the market reopened, authorities instituted provisional regulations that suspended trading after swings of 5% in either direction. A 10% limit has also been imposed on daily trading in individual equities and intraday and margin trading have been suspended. The market has been on a downward trend since March 2011, falling by close to 11% between January and July 2011 but at much quicker pace in year-on-year terms (-20% in July 2011), with the index hitting the lowest level in almost two years (4799) in early August 2011 .

By January 27, 2011, reflecting political uncertainty, Fitch cut Egypt's BB+ country ceiling to negative, a rating affirmed in late June 2011. And as banks closed between January 27 and February 6, Moo-

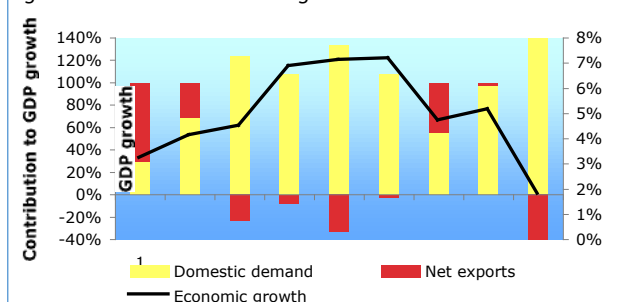
dy's cut its ratings on January 31 on five Egyptian banks (2) and then shortly after downgraded its debt rating by one notch from Ba1 to Ba2, and also changed its country outlook from stable to negative. The rating was further reduced to Ba3 in March 2011. Similarly, Standard and Poor's (S&P) downgraded Egypt's long-term foreign and local currency ratings to BB and BB+, respectively, both with a negative outlook, a rating affirmed early July 2011. Both Moody's and S&P warned that further downgrades may follow if there is significant instability.

## 2. Crisis impact on main macro-balances

### 2.1. A slowdown in economic activity

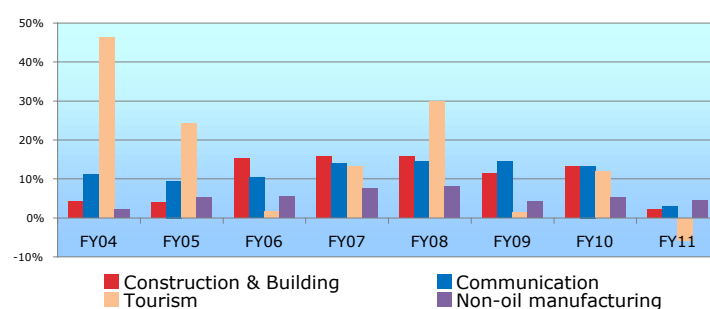
Owing to this business disruptions and the uncertainty of investment and consumption decisions, the economy contracted by 4.2% in Q3-FY11 (figure 4) but the figure for FY11 remained positive (1.8% down from 5.1% last year), down from the 5.6% that was originally forecasted. This was the result of a sharp decline in investment (by 4.4%), particularly private investment which went down to 9% of GDP from 10.5% last year. Growth of private consumption remained positive (up by 4.8%), similar to last year's pace. Growth of exports and imports has remained positive, respectively 3.7 and 7.5%. A new set of incentives to attract investors have been announced by the General Authority for Investment and Free Zones (GAFI) last April including further simplification of start-up procedures

Figure 4. Contribution to GDP growth



Source: Author's calculations based on data from Ministry of Planning and International Cooperation (MPIC)

Figure 5. Sectoral growth rates



Source : Author's calculations based on data from MPIC

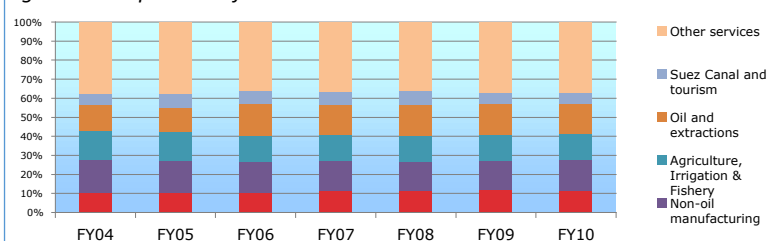
and easing of trade procedures. The impact of such measures is yet to be seen.

On the supply side, most sectors witnessed a contraction during the quarter when the revolution took place. Tourism recorded the highest drop (down by -33%), followed by non-oil manufacturing (-12%), transportation and storage (-9.7%), construction (-9%), trade (-9%) and finance (-5%), following the closure of banks in early 2011. However, in FY11, only 3 sectors posted negative growth rates, tourism (-6% vs. 12% last year), manufacturing (-1% vs. 5%) and extractions (-0.8% vs. 0.9%). Suez Canal posted double-digit growth of 11.5%, following a decline of 3% last year (figure 5).

Taking into account a recovery in the export market but also the political tensions and security concerns, projections for 2012 place GDP growth at 3.7%, up from 1.8% this year. This outlook reflects a pick-up in both private consumption and investment, following loss of confidence, the business disruptions and the drop in tourism.

In order to restore growth to potential, a number of factors are thus important. First, political stability and security should ensure the recovery of private investment. Second, the government needs to pursue further diversification efforts. Oil still represents a bit less than a third of value added. In addition to oil, Suez Canal and tourism, all strongly impacted by external conditions, account for 37% of value added (figure 6).

Figure 6. Composition of Value Added



Source: Author's calculations based on data from Ministry of Planning and International Cooperation (MPIC)

Third, a resumption of reforms is necessary to ensure positive TFP growth (Herrera et al., 2011). TFP growth which responded well to reforms and was positive in recent years is currently forecasted to experience a sharp fall to negative levels. There is a high probability that the current interim government will suspend plans for further economic reform and liberalization in order to focus on stabilizing the economy.

## 2.2. Unemployment soared, particularly in urban areas

Unemployment in Egypt has been a persistent problem and has several characteristics. It is concentrated in urban areas, it is particularly high for females, for the young (in the age-cohort of 15-29), especially graduates. Before the recent political events, unemployment had been recovering from the effects of the crisis. It declined to 8.9% in end of 2010, down from a peak of 9.4% a year ago, driven by a decrease in male unemployment (from 5.3 to 4.8%). Meanwhile, female unemployment had slightly increased (from 21.9 to 22.7%).

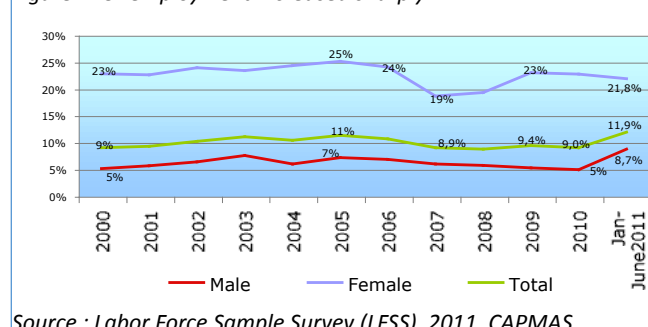
As the private sector laid-off many temporary workers (estimated as much as 49 and 18% in construction and manufacturing respectively) (3) in the wake of the revolution, there was a sharp increase in unemployment particularly for males and in urban areas. In fact, unemployment went up to close to 12% in FY11 up from 9% a year ago, following a substantial rise in male unemployment by 3.7 percentage points, to 8.7% while female unemployment remained more or less the same, around 22% (figure 8). Also, following the disruption of production in urban areas, urban unemployment (particularly for males) climbed to

close to 16% up from 11.7% a year ago. Rural employment also increased to close to 8.6% from 6.9%. More worryingly, there have been some job losses as employment fell by 2.7% between Q3-FY11 and Q2-FY11, particularly male employment down by 3.8%.

However, such losses seem to have stabilized by end of FY11, with employment posting nil growth. Estimates also show that available job opportunities and private sector hiring have contracted in June 2011 by 74 and 4% respectively compared to a year ago (IDSC, August 2011a).

A further increase in unemployment is expected, beyond 12% especially if there is a significant return of migrants because of the political contagion in neighboring countries (particularly Libya). In particular,

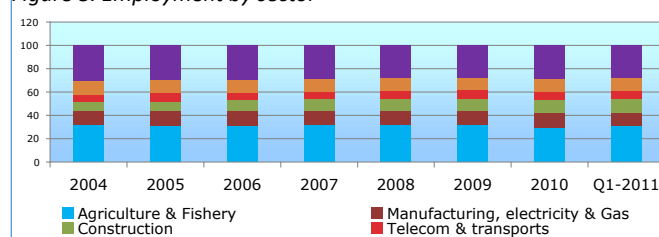
Figure 7. Unemployment increased sharply



Source : Labor Force Sample Survey (LFSS), 2011, CAPMAS

unemployment in urban areas (12%) is likely to increase following the business disruptions, particularly in sectors that were hit like manufacturing and to a lesser extent tourism which account roughly for more than a fifth of total employment (figure 8). In fact, the share of workers in manufacturing in urban areas has gone down from 17 to 13% of the total labor force.

Figure 8. Employment by sector



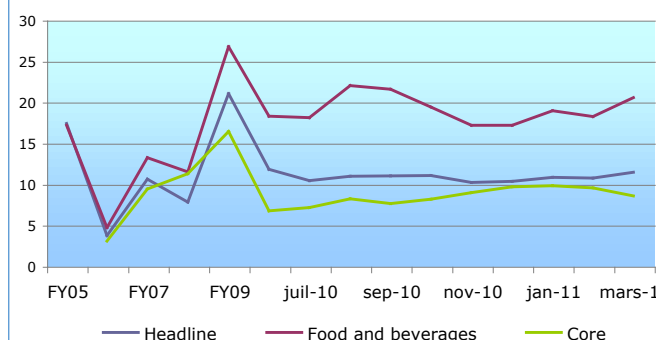
Source : Author's calculations on CAPMAS data

Also, informal employment which constitutes around 39 % of total employment is likely to increase.

### 2.3. Food inflation remains high and is a near-term risk

Doubles-digit inflation has persisted for the past three years, has been on an upward trend since November 2010 and currently remains around 10.4% (July 2011) (figure 9). Inflation of food pri-

Figure 9. Inflation measures in Egypt



Source : Author's calculations based on CAPMAS and CBE data

ces, 40% of the Egyptian CPI basket, has been the main driver of headline inflation and peaked to 30% in August 2008, and has more recently fluctuated between 18 and 22%. Core inflation has also been high and has been fluctuating around 7-9% since September 2009 (4). The CBE has refrained from monetary policy tightening since September 2009 on the back of receding growth.

CPI inflation is forecasted at 16% as further rounds of global food price increases are highly probable. Pressures could be further exacerbated if the ex-

change rate depreciates sharply. Higher inflation is likely to pose a number of challenges: (i) Create further social unrest: inflation is particularly harmful to the poor, especially in the absence of an effective social protection system, (ii) exert pressure on the fiscal deficit as food subsidies are likely to increase, (iii) require a restrictive monetary policy stance, which may not be consistent with CBE's policy of maintaining economic momentum.

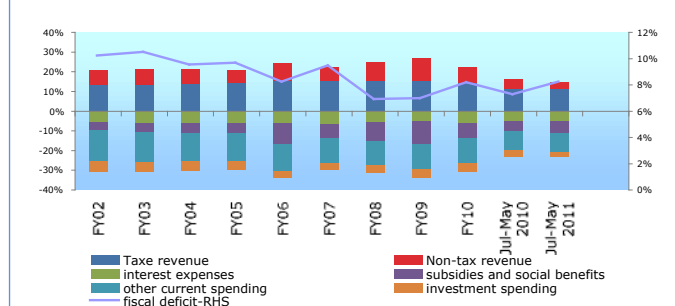
## III. Macroeconomic responses

### 1. Public Finances are worrisome

So far, the budget deficit slightly increased to 8.2 from 7.2% of GDP, between July-May 2011 and the same period last year (figure 10). This occurred following a substantial decline in revenues from 16 to 14.6% of GDP. This reflects cuts in all revenue items, in particular, property income which decreased from 3 to 2.3% of GDP (following reductions in oil revenues and rent, both down by 0.6% of GDP). So far, tax revenues seem to be resilient to the economic downturn (they account for 11% of GDP, the same level last year). Meanwhile, expenditure remained close to 23% of GDP, despite an increase in subsidies and social benefits from 5 to 6% of GDP. In particular, food subsidies doubled from 1 to 2% of GDP.

The fiscal response to the crisis is a bit worrisome. Expansionary measures have been announced as a reply to rising popular requests. They include granting a 15% bonus for civil servants wages and pensions, tax and customs exemptions; permanently hire temporary civil 450 thousand employees. Meanwhile, subsidies and social benefits are expected to increase to around 10% of GDP, following the forecasted increase in international commodity prices. Some measures to increase revenues in FY11 (new taxes on capital gains and on tobacco) will not be enough to offset rising expenditure and also because of tax revenue losses (the plan to introduce a property tax was put on hold and the ceiling for tax exemptions was raised).

Figure 10. Inflation measures in Egypt



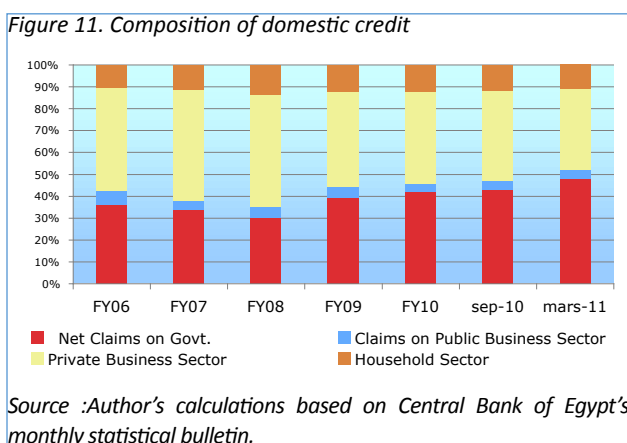
Source :Author's calculations based on data from the Ministry of Finance, Monthly Financial

As a result, the deficit is expected to increase to around 10% in FY11 up from an initial forecast of 8%. The Ministry of Finance still forecasts a deficit at around 8%. The army council approved the FY12 budget envisaging a deficit of only 8.6% of GDP (from a previous forecast of close to 11% of

crease in government risk premium to continue to attract buyers, especially in the absence of an effective secondary market. In fact, the 91-day T-bill rate jumped from an average of 9% before January 2011 to around 11% in February and 13% in late April, the highest since 2008. The ten-year government bond yield has risen from around 12.9% in late November 2010 to 14.5% in May 2011. The government also had several difficulties in raising required amounts for its t-bill auctions since last February, as investors had demanded higher yields.

The government should be able to identify priorities where extra borrowing could be most efficiently spent. More current spending on budget support (including wages and other current expenditure) may be not advisable and a revision of the spending composition is warranted. Fiscal sustainability concerns should be considered when borrowing new funds.

The economic reform program involves a gradual reduction of government debt but only as of FY13.



GDP) but other forecasts put this figure at around 11% of GDP. In any case, the government aims to reduce the deficit to 4% of GDP by FY16. In order to achieve this, the government has plans to increase revenues through the introduction of a value-added tax, raise taxes on tobacco as well as broaden the tax base and revise the income tax law (under which taxes are set at a flat rate of 20%). The net budget sector debt is expected to rise. It is mainly held by banks (40%) in the form of t-bills (two-thirds). Government credit has already jumped by 30% in March 2011 and further to 37.4% in May 2011, bringing its share up in total credit to 49 from 36% during FY06-FY10 (figure 11), at the expense of private credit, the share of which declined from 47 to 37% over the same period. Yet, the banking sector remains liquid with idle deposits since Egyptian banks still prefer investing their deposits in low but safe return of t-bills instead of engaging in somewhat riskier lending activities. There is thus room for commercial banks to give credit to the public sector without necessarily crowding out the private sector.

Another disturbing fact is the increase in the cost of government borrowing which suggests an in-

## 2. Monetary policy response was initially adequate

The CBE seems so far to be managing well the situation. At the beginning of the crisis, it did not impose official capital controls but instituted tight measures in the banking sector, including restrictions on outward daily transfers and repatriation of invested funds and also prohibited the use of LE credit facilities for the purchase of foreign currency. In addition, the CBE launched last March a "seven-day repurchase agreements (repos)" that will allow the CBE to inject market liquidity without influencing interest rates. Repos are issued at an interest rate set at 9.25% and are offered in exchange for t-bills collateral. It is believed that such operations would stimulate feeble demand for t-bills since last February. To give clients more time to repay their loans, the CBE eased regulations for booking provisions on NPLs, extending the period needed to classify a loan as non-performing to three months (up from 30 days) after a payment was due.

So far, these measures avoided a run on deposits and there has been no bank liquidity problems (loan to deposit ratios are about 50 %) but several business reported difficulties in moving funds to branches abroad and in getting approvals for payments and transfers involving companies currently under investigation or whose shareholders include high-profile former regime figures.

On exchange management, the CBE has accommodated only limited exchange rate depreciation and relied mainly on intervention through foreign exchange reserves to do so. In fact, the exchange rate which had already been slipping in early 2011 in response to the political events in Tunisia came under pressure during the revolution. Overall since late January 2011 until June 2011, it has depreciated by only 2.4% and has been stable since last March, due CBE intervention to prevent “excessive speculative activity”. This stability has been achieved at the expense of a depletion of US\$ 11 billion of official reserves between December and August 2011, bringing official reserves down to US\$ 25 billion, its lowest level in three years, and covering only 6.2 months of imports. Unofficial reserves (held by commercial banks) also fell by a further US\$7 billion by end of February, bringing the total loss of reserves to US\$ 17 billion.

The exchange rate is likely to come under further downward pressure, with the sharp drop in all of Egypt’s foreign exchange earnings and a worsening of market expectations due to uncertainty. The magnitude of the risk is likely to depend on the CBE’s response. Excessive depreciation is likely to induce large pass-through effects on domestic inflation, especially that it is occurring in a high and volatile inflation environment. Increased exchange rate volatility will also harm Egypt’s exports. Alternatively, intervention through reserves to limit the depreciation is dependent on the

CBE’s stock of foreign exchange reserves. Finally, imposing capital controls would probably spawn a revival of black-market trading. A policy mix of both exchange rate management and some depreciation could be useful way to manage the exchange rate.

#### IV. The Challenge of Youth Unemployment

According to 2009 CAPMAS population estimates, 31% of Egyptians are between the ages of 15-29. Moreover, that same group constitutes 62% of the labor force. This youth bulge could be productive, if it benefits from appropriate education and health care, and could thus provide Egypt with an opportunity for higher growth and development. In the meantime, these young people exert significant pressure on the education system, the labor and housing markets (Assaad and Barsoum, 2007). In particular, they translated into 850,000 new labor market entrants every year in the early 2000s, double the number in the late 1970s (Assaad, 2007). Nevertheless, youth continue to be disadvantaged in terms of higher rates of unemployment particularly for higher education graduates, lower earnings, and limited job security and stability, with the majority of new entrants finding jobs within the informal economy. This section attempts to provide an understanding of the youth unemployment problem.

##### 1. Youth have the highest unemployment rate

Recent analyses have indicated that unemployment in Egypt is largely a problem of youth insertion into the la-

Figure 12. Unemployment by age group, 2010

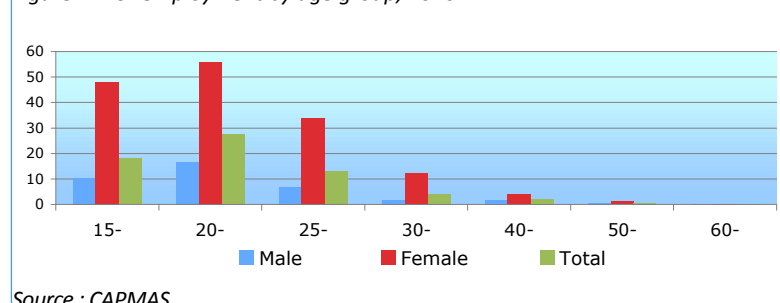
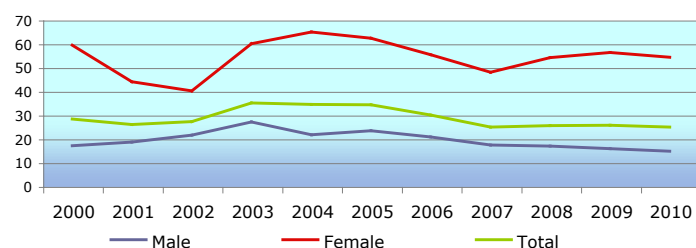


Figure 13. Unemployment of Youth (15-24 years) in Egypt, 2000-2010



Source : CAPMAS

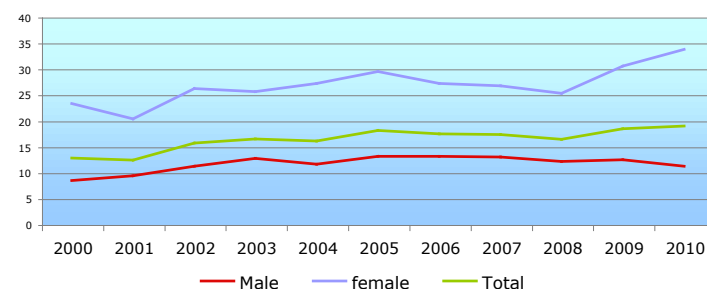
labor market (Assaad, 2007). In fact, youth make up more than 70% of the unemployed (CAPMAS, 2011). These are new entrants to the labor market resulting from the downsizing of the public sector and the limited capacity of the private sector to generate new jobs.

Moreover, the youth (15-29) also face the highest unemployment rate (20%), compared to other age groups (figure 13). The gender gap is also quite noticeable with unemployment rates for young males close to 11% while the figure is a shocking 46% for females. The age group of 20-24 years, the age of completion of university degrees and, therefore, first labor market entry, suffers from the highest unemployment rate of 28%. Figure 14 also shows unemployment of youth (15-24 years) has come down from 35% in 2003 to 25% in 2010.

intermediate degree and above accounted for above 90% of unemployed, of which university graduates represent close to 40%. Unemployment rates remain low (around 3%) for people with low levels of education (below intermediate), but soar to 13% for those with an intermediate degree and are the highest for university graduates (19%) (figure 15).

In fact, unemployment in this group has been steadily increasing since the early 2000s from 12% to 19% in 2010 (figure 16). Assaad (2007) shows that it is the only group to have experienced an increase in unemployment between 1998 and 2006. Assaad and Barsoum (2007) explain that the reason behind the high educated youth unemployment is related

Figure 15. Unemployment of higher education graduates



Source : CAPMAS

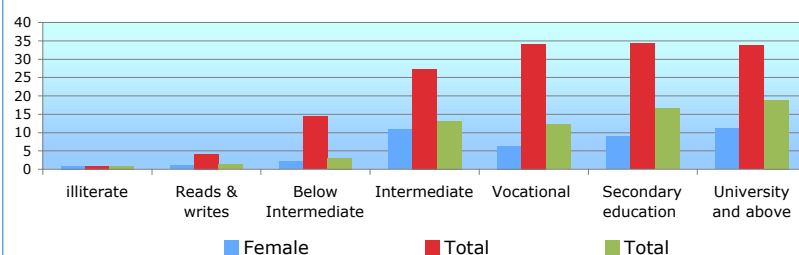
## 2. Youth unemployment is a problem of the educated

Assaad and Barsoum (2007) argue that unemployment is a problem of educated youth, as their higher employment expectations collide with difficult labor market conditions. In fact, in 2010, people with an in-

to government employment policies and education quality. In fact, as the government guaranteed public employment for secondary school and university graduates for the past three decades, the education system failed to produce high-productivity workers that could compete in a market economy. As a result, returns in the form of higher

wages have dropped significantly as youths find themselves facing an increasingly privatized labor market that is not willing to provide premiums for educational credentials if such credentials do not translate into increased productivity (Assaad and Barsoum, 2007). Assaad (2009) argues that the very high unem-

Figure 14. Unemployment by education level, 2010



Source : CAPMAS



ployment rates for educated women is the result of a dramatic contraction in government hiring, which deterred them from joining the labor force altogether. Said et al. (2009) also show that the educated unemployed have experienced the brunt of the recent economic reforms.

### **3. Youth tend to have low quality of jobs**

The above analysis have shown that youths make up the largest group among the unemployed but also are the ones who face the most barriers to getting jobs. Moreover, recent analysis shows that this group when employed, they get low-quality, ill-paid jobs, making it very difficult for them to start families (Assaad and Barsoum, 2007 and UNDP, 2010b).

Moreover, UNDP (2010b) shows that there has been a significant decline in the probability of obtaining either public or private formal employment for young people. Moreover, the report shows that there has been a significant deterioration in job quality between 1998 and 2006, in particular for workers with basic education and technical secondary degrees. In fact, the SYPE survey shows that close to half of employed youth (43%) work in informal private regular wage jobs, without the benefits of a contract or social insurance. Also, close to a quarter (22.6%) work in irregular wage jobs, which, in addition to being informal, are extremely unstable. In fact, youth seem relegated to instability since 46.7% of their jobs are temporary, casual or seasonal. The survey also shows that only 16% of employed youths had a legal contract with their employers and just under 15% of the employed have social insurance coverage. In terms of earnings, Assaad and Roushdy (2006) show that 69% of working youths in 2006 are low earners. Interesting evidence is provided by Said et al. (2009) who show that increased export orientation exerts a significant negative impact on job quality. Also, industries with the highest import penetration levels have the lowest job quality, but also saw large improvements in job quality.

### **4. Vocational training: the skills mismatch**

Technical education continues to cater to a significant proportion of secondary school students, even though they have very poor returns in the private sector and also has a negative impact on wage inequality as the spread of returns drops for higher educational levels (Said et al., 2009). Research has documented that these schools provide insufficient and often irrelevant training (El-Hamidi, 2006). Limited public spending on this essentially expensive type of education, lack of qualified teachers, outdated curricula and a lack of interaction between firms and those setting the curricula lead to poor skill acquisition and a mismatch between what these schools provide and the needs of the labor market. Assaad and Roudi-Fahimi (2007) note that the educational systems in Egypt have been slow to respond to increasingly market-oriented and open economies and that this has resulted in significant mismatches between the skills demanded in the job market and those available to new entrants. This mismatch, combined with the rapidly growing number of entrants, leads to a protracted transition from school to work.

Furthermore, UNDP (2010b) explains that there does not exist a technical and vocational education and training system for youth in Egypt. However, different players operate in isolation of each other. Very recent efforts have been implemented to improve the coordination and direction of all training-related facilities. Moreover, an action plan to support technical and vocational education and training (TVET) was claimed to be in process of formulation in 2010. In addition, the UNDP report points to a number of hurdles facing the TVET system including lack of budget accountability, obsolete curriculum that mismatch with current market needs, lack of hands-on training, failure to keep up with technology, shortages of modern specialization, and financial constraints.

### **V. Conclusion**

The Egyptian economy has entered into a period of uncertainty. The analysis showed that there will



be short-term costs in the transition phase to more political openness. In the long-term, gains from democracy could put Egypt on a path of sustainable development. The analysis suggests the following policy recommendations.

First, political certainty and security are crucial prerequisites for economic improvements. The SCAF had issued some laws in this regard but enforcement is lax. Also, the announcement of a detailed political transition road map can help reduce uncertainty but also build credibility of the political authorities. These two factors are important for long-term consumption and investment decisions but also for the return of foreign investors and tourists.

Second, the short-term may require some tough policy choices but the management of these short-term tradeoffs is determinant of Egypt's medium-term outlook. Immediate challenges are likely to arise from inflation and the exchange rate. Exchange rate management needs to become more flexible and not rely solely on reserve depletion. Expansionary fiscal policy could have long-term sustainability concerns. Instead, the government could revise the composition of its public spending in order to stimulate the economy. Public policy could enormously benefit from more transparency to help reassure the public and also build credibility.

Third, providing incentives could promote private investment but they should not be exclusive to large firms. It is also important to phase out such subsidies in the long-term to make sure they do not lead to distortions in the labor market. It is also high time to revise the minimum wage and index it to inflation to ensure it provides a decent standard of living.

Fourth, there is a pressing need to address the root causes of the revolution, i.e. achieve social inclusion, a fair income distribution, employment and education to ensure a more just distribution of future economic gains. In particular, promoting employment growth and education should be the top priority to be addressed.

#### **Box. Past efforts to insert the youth in the Labor Market**

*A number of measures to boost youth employment were implemented in the past. Many have criticized these interventions as being short-term and lacking coordination among them and with macroeconomic policies (El-Megharbel, 2007). These policies could be grouped into 4 categories:*

*UNDP (2010) mention that a National Action Plan on Youth Employment was prepared and was supposed to be incorporated in Egypt's five-year plan with an amount of LE 17 billion. The plan had 3 priorities: (i) TVET to increase youth employment, (ii) Enterprise development to support micro, small and medium enterprises, and (iii) labor market policies to activate minimum wage rule and its enforcement as well as upgrade employment offices and encourage the establishment of private recruitment agencies.*

*Human resource development programmes were aimed at linking the education with the demands of the labor market. In this respect, the Mubarak-Kohl initiative attempted to institutionalize a dual system of training and apprenticeship in existing enterprises. The Ministry of Education and enterprise associations are jointly responsible for training, managing and financing training courses. More than 20,000 students have graduated from this initiative, of which 85% received immediate job offers. The initiative was transferred to Egyptian partners and is now successfully managed and implemented. Another effort is that of the National Skills Standards Project of Egypt's Social Fund for Development. The framework aims at establishing standards and procedures for testing and certifying trainees. So far, it has developed standards for around 106 trades and upgraded around 50 vocational training centers.*

*Direct job generation projects focused on infrastructure projects using local resources, local temporary workers and labor-intensive construction techniques. The private sector, the target groups unemployed and NGOs are all involved in the identification of projects, and the target groups are requested to contribute financially. The most important intervention is the public works programme (PWP) which aimed at creating short-term and long-term employment opportunities by establishing public infrastructure projects*

*in rural areas. The programme lost some of its prominence when the social development fund (SFD) established in the early 1990s entered its second phase, and the emphasis changed from short-term poverty alleviation measures to long-term development efforts.*

*Finally, support to self-employment and enterprise creation projects were carried out through the desert development programmes directly aimed at unemployed graduates. This project of desert land cultivation (some 5 acres of land per unemployed graduate) hoped also to alleviate urban demographic pressures and increase agricultural production. Various schemes provided training, credits, cattle, housing and equipment. These programmes have proven to be of limited success and also a drain on public resources. Graduates had little sense of ownership since they could only own the land after cultivating it for 30 years. The period between graduation and land assignment was too long and the lands are situated a long distance from cities. This, in combination with a lack of agricultural experience of settlers, led to sub-optimal use of those lands. Thus, there has been a shift in favor of large investors, who rely less on government funding but use capital-intensive and rely on temporary labor.*

*Source: (UNDP, 2010b and van Eekelen et al. (2002).*

To increase employment, there is a need to design a national employment strategy that targets job-creation in the highest employment elasticity. Both macroeconomic and labor market policies should be aligned with the objectives of the strategy (El-Megharbel, 2007). At the heart of this plan, youth employment should be addressed. Employment initiatives should be accompanied by reforming the education system which is still heavily based on memorization and repetition rather than critical and creative thinking. Vocational training is also crucial to facilitate the youth school to work transition and address the education-labor market skills mismatch problem. It is worthwhile to adopt gender-sensitive employment policies to increase female participation rates in the labor market. Also, it is important to increase awareness of training/employment programs. Barsoum (2004) show that young job seekers, especially those who come from

low-income households, lack access to information about available job opportunities, the skills that are in demand, and training opportunities.

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World Bank governance indicators database.

**Notes:**

1. Households with consumption below the lower poverty line (LE 2216 (USD 395)) are deemed poor, and those below the upper poverty line (LE 2806 (USD 500)) comprise the near poor (Marotta et al., 2009a).
2. These banks are: National Bank of Egypt, Banque Misr, Banque du Caire, Commercial International Bank, and Bank of Alexandria.
3. These figures are for 2005/06, the latest available from CAPMAS.
4. Excludes fruits and vegetables and some regulated items.



## ISRAEL : A developed country model that still has room for improvement from a social perspective

When benchmarked against most Mediterranean economies, Israel is among the “closest” to democracy. Because of this, the recent uprisings in its neighbours are not expected to spread domestically. Nonetheless, the situation is not optimal and there are always threats for the political model.

First, despite democracy, the Israeli regime is not the most stable from a political point of view (Ofer, 2008). The electoral system favors the creation of frail coalitions that may cease to exist after the voting period (Bain, 2011). Furthermore, the external relations of Israel with its neighbours could enter a period of tension if countries of the uprisings do not move towards a more democratic regime. Additionally, issues of corruption among politicians have erupted and there is a rising risk for elected officials to be more disconnected to constituents. Moreover, most of Israel’s governance scores have worsened during the last decade.

Meanwhile, the Israeli regime of growth is still imperfect in terms of inequalities. When compared to the average of OECD countries inequalities in Israel are higher by 22%, meanwhile the efficiency of the authorities’ intervention in reducing them has become questionable (National Insurance Institute, 2010). Several communities are in need of initiatives to improve infrastructure the lack of which pushes them deeper into poverty (Abu-Bader and Gotlied, 2009). All of this has contributed in bringing Israel among the top-5 of the most unequal developed countries.

The Israeli economy, did manage to bounce back from the outfall of the 2008 crisis despite being among the worst hit. Now, after a solid economic performance throughout the 2000s, Israel needs to adopt measures that lead to economic growth benefiting the entire population. Among its priorities should be to fight poverty, with already 35.9%

of children in 2007 living under the poverty line. Adopting a new vocational training model and establishing a central authority for coordination of youth programs and strategies could be of valuable help (Nathanson et al, 2010) .

In the current state of affairs, the following macroeconomic elements deserve particular attention :

✓ Growth, which recovered and reached a 4.8% rate in 2010, is expected to grow by 4.3% for 2011, boosted by rising exports, solid investment perspectives and private consumption growth.

✓ The unemployment rate reached an all-time low at barely 5.8% in April 2011 according to official statistics, which corresponds to 186000 unemployed, despite the high rate of growth of the Israeli labour force.

✓ Despite a recent rise, inflation is expected to be close to 3.4% in the following 12 months.

✓ Exports have not been affected by the regional turmoil, goods exports rose by 12.9% between August 2010 and August 2011 and an increase by 12.2% is to be expected for the entire year.

✓ However, following the rise in international prices, goods imports (excluding diamonds) recorded a year-on-year rise of 25.8% during the February-April 2011 period. They are expected to grow by an estimated 21.7% in 2011 adding pressures to the current account, reducing its surplus to 1.2% of GDP.

✓ FDI inflows have been narrowing in recent months, the country received 206 million of FDI in May 2011, a 53% decrease from April 2011 (442 million US\$), while an FDI fall of 11.5% is expected for the entire year.

✓ In light of a recent rise in tax revenues, the fiscal deficit is expected to reach 2.4% of GDP, from -3.7% the prior year, a threshold that is nonetheless higher than the target of 1.5% that was initially set.

✓ Finally, monetary policy is expected to be tightened in the coming years (2013-2015 period) with a policy rate close to the 4.5%- 5% mark.

## I. The current situation and its implications

### 1. The state of the political economy model

The political model in Israel is considered to be the most democratic in a region that is mostly ruled by autocratic regimes. Even so, the regional turmoil and its political consequences in countries such as Egypt are of great interest to Israel, a political change in one or more of its neighbours could signify a change in the Mediterranean political landscape, regional efforts to democracy could mean more stability, while falling back to a more “closed regime” in neighbouring MPs could translate into rising geo-political tensions.

Israel is entering this new political era with an economy that is growing and attracting labor migrants, one could thus say that the country is in a position of strength (Haaretz, 2011a). But, one must not forget that the political outlook is greatly interrelated with the country’s positions regarding the evolution of the progress for peace with the Palestinian. The Israeli government and the population are increasingly inclined to realize that an initiative is of great need, with the major emerging solution being to upgrade the Peace Agreement, recognizing Palestine as an independent state within the borders of the Oslo Accords (Haaretz, 2011a).

### 2. Political instability is always of concern

Political tensions are also common within the country itself, a fact that can be explained by the nature of the voting system which can result in frail coalitions. For instance, the current coalition requires the support of a great number of smaller parties with views that do not always converge, currently, the government only controls 66 seats out of the 120 total.

The domestic political model is a case apart among Mediterranean economies. As suggested by Ofer (2008), although Israel maintains a stable regime, the latter is not considered as being politically sta-

ble since elections take place frequently and governments do not last long enough. The state is governed by a parliamentary democracy, with a 120 member legislative assembly (Knesset). In the early 1990s, the two-ballot system was introduced, according to which each citizen was eligible to vote twice: once to elect the prime minister and once to elect the party of choice. Legislators are elected through a state-wide system in which the country is represented as a single electoral district. A voting list may contain members of more than a single party, thus, smaller political parties often run on a single combined list with one or more other parties. Furthermore, after elections are over, these coalitions may cease to exist within the Knesset (Bain, 2011). Thus, voters send several small parties into the Knesset representing narrow interest groups, impeding on major parties shattered and paralyzing the political system (The Jewish Chronicle, 2009).

Furthermore, the lack of considerable party discipline, frequent reshuffling of ministers, and unstable coalitions contribute to the frail political stability and highlight the importance of introducing structural changes in the parliamentary model (The Jewish Chronicle, 2009).

### 3. Political stability and corruption should be key elements of political reform

What results from the current state of affairs is that Israel would gain a lot by political reforms that favor political stability. It clearly appears from figure 2 that the political stability index has deteriorated

Figure 1. Israel on the world J-Curve (2010)

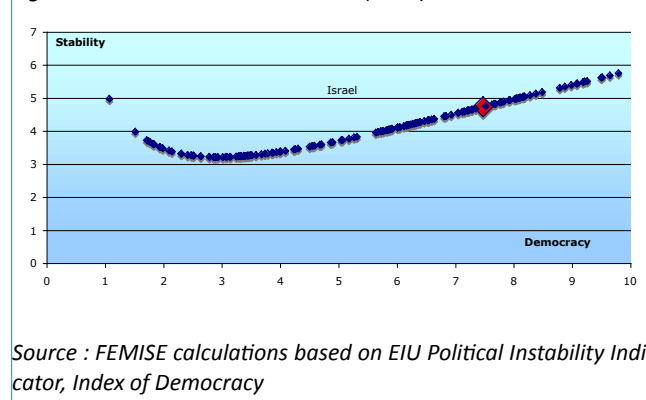
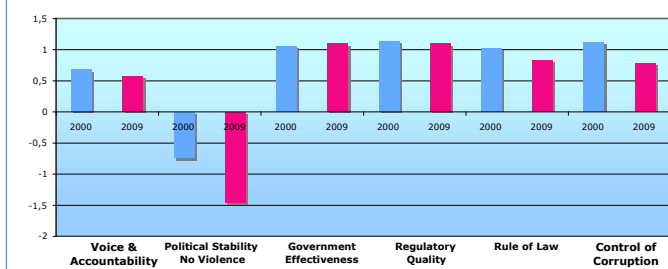


Figure 2. Israel's Governance Indicators



Source : Worldwide Governance Indicators 2010, World Bank.

Note : Values vary from -2.5 (bad governance) to 2.5 (good governance)

in the recent decade reaching a level close to bad governance.

Meanwhile, one should also note that while most of Israel's governance scores are positive they have mostly worsened during the last decade. More specifically, control of corruption appears to have worsened, the country ranks among the most corrupt countries when compared to other OECD members states, it now has a score of 6.1 out of 10 in the Corruption Perceptions Index (CPI), a marked deterioration from the 7.9 score of 1997, ranking Israel 22nd out of 33 members of the OECD (International Transparency Organization).

It appears that politicians have not prioritized the corruption issue, with discussions not being enough to put an end to this phenomenon (Haaretz, 2010). One could find that the root of corruption is the heavy emphasis on « materialism and capitalism » with the list of corruption investigations in Israel in recent years including several prime ministers, presidents and Cabinet ministers (Los Angeles Times, 2010). Meanwhile, not having direct elections means that there is a need for politicians to « find favor with their party and give out favors » with elected officials feeling less « beholden » to constituents and more disconnected.

Recent allegations against foreign minister Lieberman on the transfer of millions of shekels to « shell companies and accounts » (Guardian.co.uk, 2011) of people close to him show how crucial it is for Israeli authorities to tackle the matter imminently. Introducing reforms in the electoral system and strengthening

cohesiveness within political parties would thus seem to be among the pre-requisites needed to improve the governing of Israel.

#### 4. The state of Israel's growth model

##### Growth that favors human development and provides optimism...

The human development level of Israel has reached new heights, the country climbed 12 places in the latest Human Development Index (HDI) and reached 15th place worldwide, the highest rank ever obtained for the country, surpassing developed EU nations such as Italy and Britain.

Surprisingly, while improvements in HDI reduce a country's total fertility rate (Callender, 2011) this appears to not have been the case in Israel. Indeed, Israel's fertility rate is the highest among developed countries, it reached 2.96 in 2009. Meanwhile, the country has the 6th lowest maternal mortality rate, and the 19th lowest infant mortality rate across the world (DellaPergola, 2011).

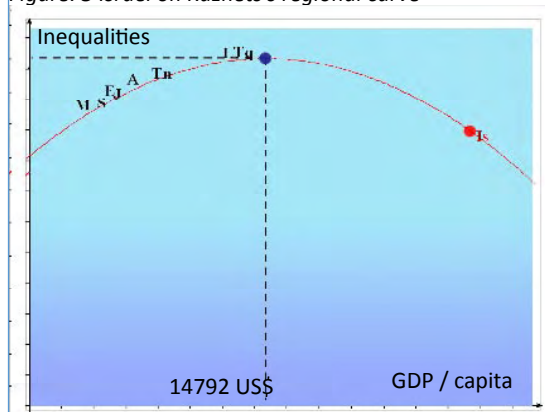
As noted by DellaPergola (2011), one should consider the « persisting centrality » of children in the hopes of the Israeli population and the existence of a « reciprocal relationship between the presence of children and a widespread sense of optimism ». Meanwhile, according to the national social survey of 2008, 87% of Israel's Jews and 83% of Israel's Arabs appear satisfied with their own lives and more than half believe that their lives will improve.

##### ...but growth not always inclusive of the poor

The following figure suggests that, theoretically, the Israeli regime of economic growth is a rare exception in the Mediterranean since it allows for the reduction of inequalities. An increase in GDP per capita can decrease inequalities domestically with a distribution of wealth that may favor poorer deciles of the population. Contrary to the rest of the region, Israel is past from the tip-over point after which the growth



Figure 3 Israel on Kuznets's regional curve



Sources : FEMISE calculations based on EHII inequality database and WDI 2010

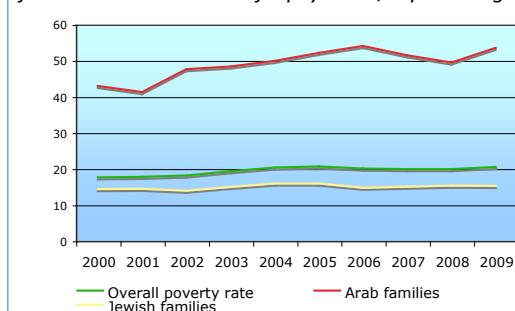
effect alone can reduce inequalities. Nevertheless, with a Gini coefficient of 0.37, Israel is in the top-5 of the most unequal countries in the developed world (BusinessInsider, 2011). When benchmarked against OECD countries, the Gini index is higher in Israel by approximately 22%. It appears that, over time, public intervention has decreased the efficiency of direct intervention in reducing inequalities (National Insurance Institute, 2010). In 2009, the poverty rate increased to 20.5% which is three percentage points higher than it was in 2000. This was in great part a result of the budget cuts made in social security payments during the crisis period of the second intifadah ; since then the poverty rate has not returned to its prior levels (AdvaCenter, 2010).

Thus, as in the rest of the region, economic growth did not always materialize into equal distribution and benefits for the entire population. As highlighted by FEMISE (2009), gender inequalities and discriminations towards Arab and orthodox Jewish communities remain. As noted by the National Insurance Institute (2010), the poorest in Israel are among the ultra-Orthodox and Arabs in Jerusalem and the South, with the proportion of ultra-Orthodox among the poorest population being 3.6 times the proportion among the entire population. The socio-economic situation of the Arab population in Israel is worrying, the economic and social conditions that it faces are largely inferior to those of the Jewish society (Abu-Bader and Gotlied, 2009). Over a nine-year period,

the severity of poverty among Arabs increased and was on average three times higher than in the Jewish (non-ultra-orthodox) sector. The probability of living in poverty for the Israeli-Arabs is explained by traditional variables such as gaps in education, family size and the low number of income earners. But it is also explained by the lack of access to public infrastructure, especially in public transportation, which barely exists for Arab communities and affects them directly since they have a low rate of car-ownership. Thus, lack of initiatives to improve infrastructure for these communities pushes them deeper into poverty and lowers their participation in the labor market even more (Abu-Bader and Gotlied, 2009).

Moreover, most of the immigrants and other Jews (that are not qualified as immigrants or ultra-Orthodox) are in the middle and upper thirds of the poor income range (National Insurance Institute, 2010). There is also a high incidence of poverty among children (approximately 35% of them are under the poverty line) when focusing in the Haredi and minority sectors (Prime Minister's Office, 2007). Meanwhile, having a job is not an effective protection against poverty in Israel since wages are insufficient to raise workers, especially in low-productivity sectors, above the poverty line. The share of temporarily poor families increased in recent years, a fact that could be linked to the international crisis that has a direct impact on the domestic labor and asset market. The later was hit through the deteriorating economic situation of families usually posi-

Figure 4. Poverty Rate among Families in Israel, 2000-2009, after direct taxes and transfer payments, in percentages



Source : AdvaCenter (2010)

tioned at the brink of the poverty line (National Insurance Institute, 2010). There is thus clear need for social policies that better target those in need.

## II. Short-term prospects

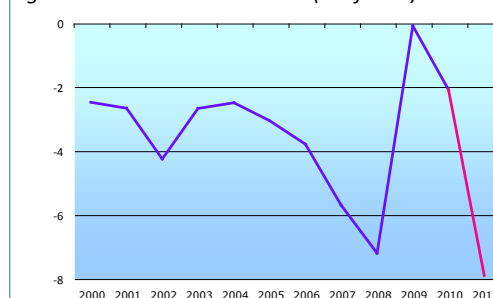
### 1. Real sector relatively unscathed

The domestic real sector has been left relatively unaffected by recent events in the region, with the exception of FDI that is expected to fall in the current year. One observes :

- ✓ An estimated increase in **goods exports** by 12.2%,
- ✓ A 21.7% increase in **goods imports**,
- ✓ A **trade balance** (excluding diamonds) in deficit, at -5.7 billion US\$ in January-April 2011, versus -2.3 billion US\$ in the corresponding period of 2010.
- ✓ A resilient **service balance** marking an estimated 6.1% increase to 7bn US\$ in 2011,
- ✓ A **current account surplus** that is reduced to 0.4% of GDP in 2011,

The Israeli export sector does not appear affected by the regional turmoil. **Exports** have been on the rise, fueled by solid performances of the manufacturing and diamond sectors. In August 2011 the former had recorded an 12.2% year-on-year real increase while exports of polished diamonds would showcase a 41.8% increase during the same period (Central Bureau of Statistics).

Figure 6. Israel's trade balance (% of GDP)

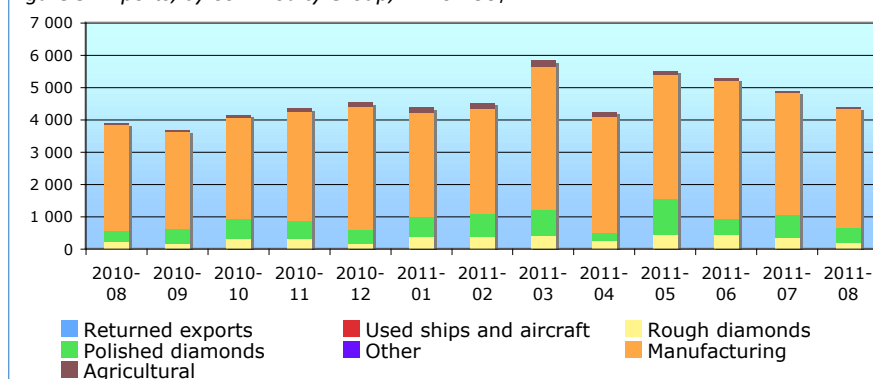


Source : EIU

Thus, goods exports rose by 12.9% between August 2010 and August 2011 and an increase by 12.2% in exports is to be expected for the entire year (EIU).

However, following the rise in international prices, **imports** grew as well. According to the Central Bureau of Statistics, a year-on-year rise in goods imports of 12.4% was recorded in August 2011. It appears imports from EU countries grew by 29.2%, at an annual rate, during the same period. Meanwhile, imports from USA did so by 16% and imports from Asian Countries by 11.6% (Central Bureau of Statistics). Thus, imports are expected to grow by an estimated 21.7% in 2011 reaching a value of 70.6 bn US\$ adding pressures to the trade balance and consequently the current account (EIU). The trade balance (excluding diamonds, ships and aircrafts) showcases an increasing in deficit, at -6.7million NIS in August 2011, versus -4.3 million NIS in the corresponding period of 2010 (Central Bureau of Statistics). The deficit is estimated to attain the -8.1bn US\$ mark by end 2011 (EIU).

Figure 5. Exports, by Commodity Group, million US\$



Source : Central Bureau of Statistics

Meanwhile, the **service balance** remained resilient and is expected to mark an 6.1% rise to 7bn US\$ in 2011. This can be explained by a surprisingly resilient tourism industry, with the number of tourists visiting Israel remaining stable. After the revolutions erupted in early 2011 the impact on Israeli

tourism was small at best, with overall traffic to Israel registering a 2% year-on-year fall in February, to 218000 tourist entries. Still, the number of travelers visiting the country alone had grown by 10% (Haaretz, 2011b). Furthermore, in recent months, tourism in Israel keeps on growing. In May 2011, about 308000 visitors arrived in the country, which corresponds to a 5% year-on-year increase and a 33% surge compared to May 2009 (TheJerusalem-Post, 2011). In August 2011, tourist arrivals by air had fallen but very slightly (-0.57%) compared to August 2010 (CBS).

The rise in the import bill signifies that the **current account** surplus is expected to be reduced to 0.4% of GDP in 2011 (EIU).

## 2. A financial sector witnessing a fall in FDI and the stock-market

### 2.1 Foreign Direct Investment fall following introduction of capital controls

The year 2010 saw Israel increase its inflows of **foreign direct investment** by roughly 18%. Meanwhile, in the first quarter of 2011 FDI grew quarterly by 7.25%. In early 2011, Israel amended its «Law for the Encouragement of Capital Investments» which could improve the Israeli industry's competitiveness in international markets and encourage FDI.

One should note there was a policy change on the behalf of the Bank of Israel, the latter trying to impose capital controls on "disruptive" foreign investment. More specifically, the Central Bank now imposes reserve requirements on domestic

banks engaged in currency swap transactions. Meanwhile, the finance ministry abolished the exemption hitherto granted to foreign capital investors on the "15% income tax levied on interest paid on makam" (EIU, 2011).

But, amendments include reduced company tax rates for "preferred income" derived by a "preferred enterprise" of a "preferred company" (Global Finance, 2011)

### 2.2 Stock Market affected by regional events

Before the revolutions, the Israeli **stock-market** enjoyed healthy fundamentals, a solid banking system and performed well in terms of productivity. As a result, it grew by an impressive 88% and 15% respectively in 2009 and 2010 (TheStreet, 2011). The Tel-Aviv stock exchange (TASE) is considered as one of the largest in the region, with a market capitalisation of \$217bn and 613 listings (EFinancialNews, 2011). In early 2011 efforts were also initiated to encourage Israeli-Arab firms to list on the Israeli exchange since the current listing did not comprise any Arab companies. The latter have also been usually reluctant to raise funds through the Israeli capital market.

But, recent geopolitical events have a direct effect on the domestic stock-exchange. As in other MPs not directly affected by the upheavals, the stock-market went on a downward path during March 2011 an indication of the general worry of investors towards the politically tense region. The Tel Aviv 100 Index stood at a value of 1233 in February 16th and marked a 7.4% fall in one month to reach an index value of 1135 in March 15th. It managed to regain its value in a short pe-

Table 1. Nonresident Investment in Israel (net transactions, million US\$)							
	2010 q2	2010 q3	2010 q4	2011 q1	March 2011	April 2011	May 2011
Nonresident Investment	2071	3727	6891	5148			
Direct Investment	-218	1650	2426	2602			
of which: through banking	1017	819	1073	1160	631	442	206
Portfolio investment	633	322	4349	1698	-1267	-655	-198
Other	1656	1755	116	848			
Source : Bank of Israel							

riod of time climbing back to 1221 in April 21st but only to fall by 10.9% in the following two months to reach a value of 1088 in June 26th (Bloomberg). Overall, the index fell by 9% in January-September 2011 (Globes, 2011).

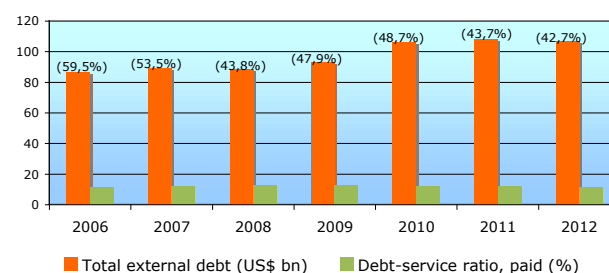
Meanwhile, a state of prolonged instability is looming and every regional event translates into a domestic shake-up. The latest exemple could be found in the announcement of the Egyptian gas pipeline explosion which in July 4th brought a decline in Lamballe company by 85% and a loss of 1 billion US\$ and severe consequences for power investors (Youm7, 2011). Overall, investors are clearly affected by what is happening in the South Mediterranean region and worry if the trends will expand into other MPs, as it happened from Tunisia to Egypt.

### 2.3 Foreign Reserves are still ample and Debt Indicators are positive

**Foreign currency reserves** had slightly fallen to 9.1% months of imports in 2010 from 9.3 months in 2009. Still, they remained ample, only equaled by those of Jordan in months of imports value and surpassed by Algeria. A growth rate expected to be above 4% in 2011, the continuous increase in exports and a tourism sector expected to perform well are expected to bring the import-cover ratio to approximately 10 months in 2011.

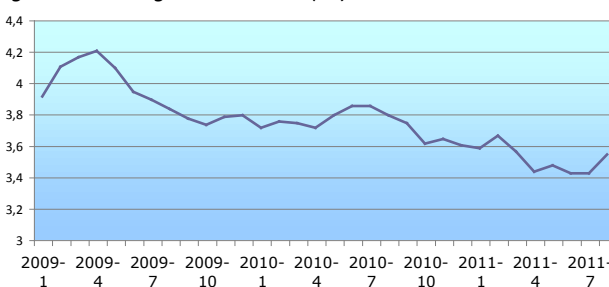
Regarding Israeli **debt indicators**, preliminary figures for 2011 suggest external debt will stand at 107.9bn US\$, which corresponds to a 1.7% increase in absolute terms from the 106.1bn US\$ in 2010 but, an important decrease in percentage of GDP from 48.7% in 2010 to 43.7% in 2011. Thus, Israel is expected to manage to reduce its debt even below the pre-crisis level of 2008 (of 43.8%) and could bring it closer to the 40% threshold by 2013. As for the debt service ratio, it stood at 12% in 2010, down from 12.9% in 2009, with forecasts pointing towards a slight increase in the short-run, to an anticipated 12.3% in 2011 and a fall to 11.6% in 2012.

Figure 7. Debt Indicators in Israel, % on GDP in parenthesis



Source : EIU

Figure 8. Exchange rate NIS:US\$ (av)



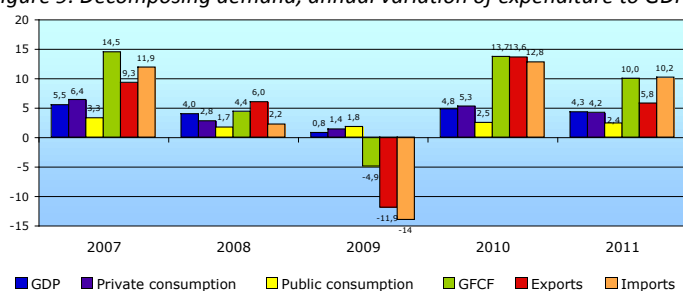
Source : EIU

### 2.4 A strengthened shekel vis-à-vis the US\$ in 2011

The Israeli shekel appreciated by more than 5% vis-à-vis the US dollar in the first 4 months of 2011, driven by the widening interest-rate differential between Israel and developed economies and remained unaffected by regional events.

The currency appreciated by 12.4% against the dollar over the past year, however, it depreciated in May 2011 following the halt in interest rates, which have risen 10 times in the last 2 years, reducing the demand of investors for the domestic currency (Bloomberg). The stronger currency has increased the trade deficit and could slow down growth (to an annualized 4.8% in the first quarter of 2011 from 7.6% in the previous three months). Thus, to reduce the appreciation pressures, domestic authorities have introduced, among others, a 10% reserve requirement on the domestic banking sector's derivative transactions with non-Israeli residents. More recently, the shekel has weakened against both major currencies and the average exchange rate of 1 NIS versus the US\$ is anticipated at 3.53 in 2011 (versus 3.73 in 2010) while versus the euro it is anticipated at 4.97 (versus 4.95 for 2010) (EIU).

Figure 9. Decomposing demand, annual variation of expenditure to GDP



Source : EIU

### III. Economic Policy and Macro expectations

#### 1. Main developments

##### 1.1 Economic activity remains solid

As was expected, activity in 2010 recovered and reached a 4.8% rate of growth on-par with the pre-inter-national crisis rates of growth. As for 2011, real GDP increased by 8.8% year on year in the first quarter, by 5.2% in the second quarter (CBS) and is expected to grow by 4.3% for the entire year (EIU).

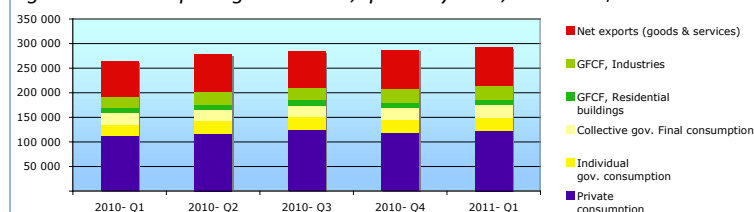
Growth will be boosted by rising exports, solid investment and private consumption growth. Regarding the latter, income tax rate cuts and reduction in unemployment allow for private consumption growth to remain resilient, expected at 4.2% in 2011. Meanwhile, provided political stability and security is ensured, private investment should main-

tain growth to its current potential. But one must note that during the past decade, investments were concentrated in a handful of sectors only. During the 2000-2009 period, hi-tech attracted most investments, growing by an average annual rate of 8%, with the capital stock of the hi-tech sector in 2009 being the double of what it was in 2000. Meanwhile, in the low-tech sector, the average annual rate of growth was only of 2% and the capital stock grew by only 19% in the 2000-2009 period (AdvaCenter, 2010). The government thus needs to pursue diversification efforts that would be of great contribution to the growth regime. Investment is expected to fuel growth, growing by a further 10% in 2011 following a 13.2% the prior year, in large part owing to natural gas exploitation, construction and the high-tech sector. As for exports, roughly representing 40% of Israeli GDP, export performance in Asian markets should cover-up from the timid performance in developed partners markets (EIU).

Regarding the sector-specific composition of growth, the rate of growth in Israel follows the development of the service sector which roughly represents three quarters of domestic GNP. Commercial, financial & personal services represent roughly 31% of GNP and employ more than a third of the labor force, while public services amount to a quarter of GNP, employing about 34% of Israelis (Central Bureau of Sta-

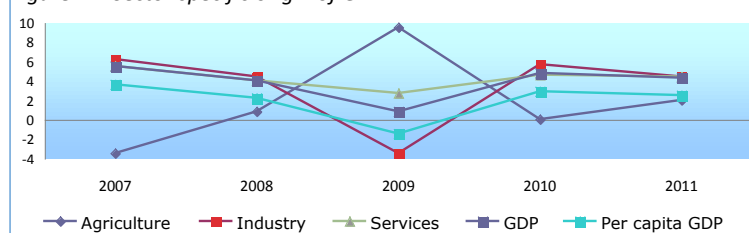
tistics). The service sector is expected to grow by 4.4% in 2011 fueling domestic GDP growth. As for the industry sector, representing more than 20% of GNP, recent trends suggest it could grow by as much in 2011. While the sector has a lesser contribution to domestic production, one should note that it represents about three quarters of Israeli exports, primarily due to a fast growth rate (averaging 8% annually in recent years) in the hi-tech sectors (Israeli Ministry of Foreign Affairs, 2010). Some argue that the Israeli ICT sector is too export-oriented which means that most local industries do not « enjoy the fruits from the ICT-producing sector » (Lach et al, 2008).

Figure 10. Decomposing resources, quarterly data, billion US\$



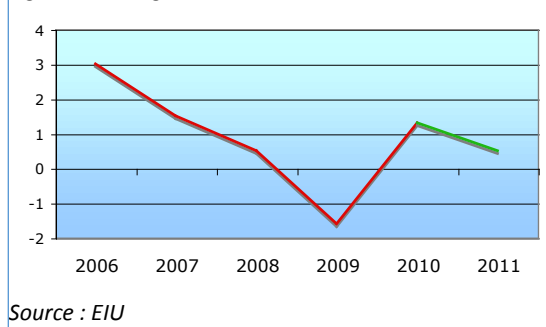
Source : CBS

Figure 11. Sector specific origin of GDP



Source : EIU

Figure 12. TFP growth in Israel



#### Box. Unemployment facts

*Unemployment in Israel has a series of specific characteristics. Primarily it:*

- ✓ Affects Arab localities more than Jewish ones,
- ✓ is higher in Jewish development towns than in affluent towns,
- ✓ is higher among Arab women,
- ✓ affects those without basic education,
- ✓ hits young people who are relatively new entrants into the domestic labor market.

*Let it be noted that one is considered unemployed only when registered with the Government Employment Services. But, many jobless do not register for personal or practical reasons (lack of employment offices), which means that the actual number of the unemployed is higher than that of official statistics.*

Source : AdvaCenter 2010

Meanwhile, the non- ICT sectors appear to not be lagging compared to the rest of the world regarding research and development (R&D).

As noted by Lach et al (2008), the Israeli economy appears to be a “dual economy” in the making. Thus, reforms that facilitate the adoption of ICT in more traditional industries could allow for more balanced growth. Naturally, this could also ensure higher rates of productivity by allowing better performance in the non-ICT economy.

### 1.2 Unemployment reaching all-time low

As seen by the evolution of employment figures in recent decades, the Israeli growth model has allowed

for levels of unemployment that are very low, the lowest among Mediterranean countries. The international crisis fallout brought the unemployment figure to 7.5% in the year 2009, even so, the trend was ephemeral and unemployment fell to 6.7% in 2010.

It appears that the downward path continued in the first months of 2011, indeed the unemployment rate already reached an all-time low at barely 5.8% in April 2011 according to official statistics, which corresponds to 186000 unemployed. This figure is even more impressive considering the high rate of growth of the Israeli labour force which reached 3.9% and 2.4% respectively in 2009 and 2010 (EIU).

Despite a rate of unemployment reaching historical lows in 2011 one should note that a lot needs to be done to improve job conditions. For instance, Israel’s average salary is low, about 60% of employees earn less than 75% of the national average salary, while 40% earn less than half (The Association for Civil Rights in Israel, 2011). During the first quarter of 2011, the nominal wage increased by 0.8% compared with the previous three months, but the real wage fell by 0.9%. Moreover, the minimum wage is expected to increase from a monthly NIS 3,900 to NIS 4,100 starting from July (Central Bank of Israel). Meanwhile, a gender gap persists since women earn 63% of the average salary of men. Unemployment insurance is also among the poorest in the developed world, in 2010, only 25% of the non-working population was eligible for unemployment benefits. Last but not least, cuts in professional training expenses appear to have translated into a lack of public professional training programs (The Association for Civil Rights in Israel, 2011).

### 1.3 Low inflation but on the rise following increasing housing prices

Inflation in Israel has traditionally been among the lowest in the recent decade throughout the



region. After reaching 2.7% in 2010, it went off target in the early months of 2011. The rise in housing prices appears to have an impact on the consumer price index through the rental component of the index (EIU). Meanwhile, higher oil and commodity prices have increased imported inflation (EIU). Annual inflation had reached 4.1% in May but is expected to ease to roughly 3.4% in the following 12 months (Reuters, 2011).

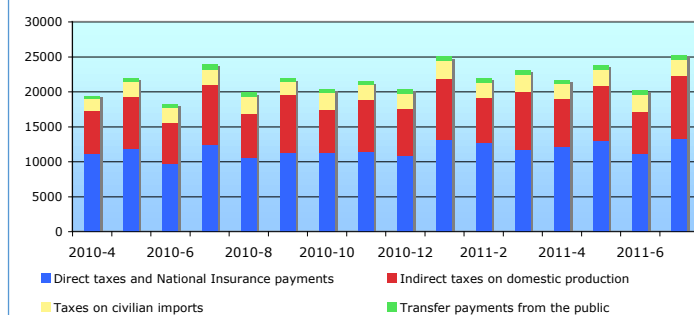
## 2. Macroeconomic responses

### 2.1 Public finances are not worrisome but regional uncertainty could increase defence spending in the short-run

Contrary to the majority of MPs who are seeing their fiscal deficit considerably increase in 2011, the budget deficit in Israel is relatively contained. This is in part due to a rising trend on the revenue side, with direct taxes and indirect taxes on domestic production, representing a combined 90% of public revenues, respectively rising by 6.9% and 5.6% between July 2010 and July 2011. Meanwhile, taxes on civilian imports increased by 3.51% while transfer payments fell by 6.7% during the same period (Central Bank of Israel).

The fiscal stance in a climate of regional uncertainty should be a cautious one. Due to the uncertainty from geopolitical changes authorities might have to avoid aggravating the fiscal balance in the coming years. The defence spending in Israel is expected to increase, taking into account that it already rose by an annual average of 2 billion NIS in recent years

Figure 13. Tax revenues and transfer payments from the public (NIS million)

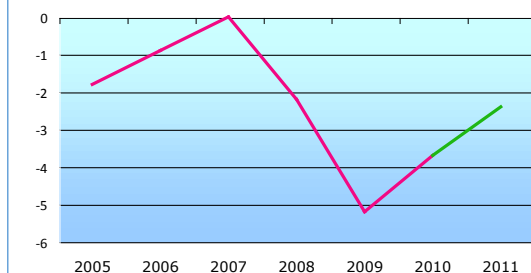


Source : Central Bank of Israel

(from 51 billion NIS in 2005 to 61 billion in 2010) while it exceeded the original budget. Based on current decisions that have been undertaken, the deficit could reach 2.4% of GDP, from -3.7% the prior year, a threshold that is nonetheless higher than the target of 1.5% that was initially set.

Furthermore, civilian spending is relatively low compared to OECD economies, the need for investing in education is still existent, thus, the degrees

Figure 14. Budget Balance (% of GDP)



Source : EIU

of freedom for future policies are rather limited, especially considering that « a downward progression in future income tax rates for individuals and companies » has been set by authorities (Central Bank of Israel). Thus, the rate of growth will have to remain above 5% a year for deficit targets to be respected in the coming years.

### 2.2 Monetary policy that closely monitors international developments

The Bank of Israel is following a policy « consistent with the process of gradually restoring a more normal interest rate environment » that seeks to stabilize inflation and support further economic growth all the while maintaining financial stability (Bank of Israel).

Interest rates were first raised by a cumulative 275 basis points to 3.25%, since the tightening cycle started to take effect in September 2009. Joint measures with the Ministry of Finance were taken regarding the housing market, meanwhile, the shekel appre-

ciated in recent months and there was a decline in commodity prices. Taking into account the marked increase of international risks, in July 2011 interest rates had been left unchanged. But the pace of interest rate increases is not fixed and depends on the inflation environment, domestic and international growth, taking into account the monetary policies of major central banks and the exchange rate environment (Bank of Israel).

Real rates, based on 12-month inflation forecasts, were negative, while the 16% annual rise in house prices is of great concern (EIU). Furthermore, concerns regarding the global growth slowdown and the EU debt crisis which could lead to a slowdown or impediment in the rate of interest rate rises in main economies and thus potential pressures for the appreciation of the shekel that are likely to increase due to the expected interest rate differentials (Bank of Israel). The Bank of Israel decided on September 26th to lower its key interest rate by 25 basis points to 3% because of the international slowdown.

Monetary policy is expected to be continuously tightened in the coming years (2013-2015 period), as capacity constraints become more and more evident (EIU). Delays in further tightening could be a risk for more inflation and would thus result into a need for disinflation. Thus, macroprudential instruments and various forms of capital controls could be of great use (IMF, 2011).

#### **IV. Improving conditions for the youth**

##### **1. Youth conditions in Israel**

Since Israel is the most economically developed country in the Mediterranean and also has a regime of growth that shares principles of democracy one would expect that the domestic youth benefits from better conditions, especially regarding employment, compared to other MPs. Also, one must note that the education system is well developed and also has high enrolment rates.

Even so, youth unemployment is not particularly low (close 16.1% in 2008) and is high for certain parts of the population (ex. Ethiopian new immigrants). Speaking about Israeli youth in a generalized manner is impossible because of the structure of the Israeli society, composed of Arab Israelis, Bedouins, Druzes and working migrants from different countries (Euromed Youth Programme). In 2008, one would count 60000 immigrants aged between 12-17 in Israel, which corresponds to roughly 9% of all youth, 70% of which originate from the former Soviet Union and 12% from Ethiopia (Kahan-Strawczynski et al, 2010).

Among the most common issues faced by the Israeli youth one finds poverty, especially in immigrant and Arab families, with 35.9% of children in 2007 under the poverty line. Furthermore, there is a high risk behaviour of Israeli youth because of the unstable security situation, leading to a rising level of drug abuse (19% of boys at age of 11 drink alcohol at least once a week) and violence (Euromed Youth Programme).

The truth is that there is no real national youth policy in Israel, often changing administrations have stalled potential efforts and a coordinating body, for the sporadic attempts by various ministries on the youth issue, does not exist. Recently, committees have been formed to promote two types of youth strategies, they are 'Youth at the Centre', an initiative sharing best practices and empowering youth work at the municipality level and the 'Youth Law' an initiative that seeks the implementation of legal regulation for the youth (Euromed Youth Programme).

One must also note that another issue, faced exclusively by Israeli youth, is the one of Military service for a long period of time which greatly influences the transition from education to employment. As noted by the Euromed Youth Programme III Study whether or not one has served the Military can have an influence on future social and career chances. One can find great dif-



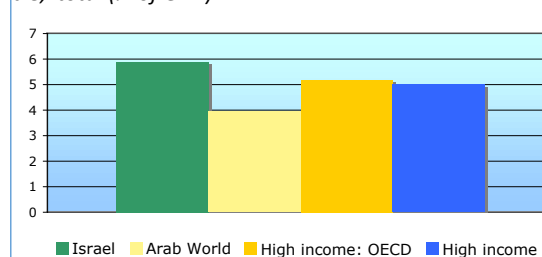
difficulties in finding a permanent job, especially when military service has not been completed and for groups of citizens being excluded from the procedure such as in the case of the Arab population.

## 2. Inequalities in school system for the Arab youth

In Israel, only 46.1% of high school seniors received matriculation diplomas in 2009, which means that more than half failed, while only 39% of the age group qualified to apply for college entrance (AdvaCenter, 2010). The school system in Israel has profound inequalities as seen by the differences in success rates in matriculation exams by different regions. For instance, in the localities of Modi'in Illit and Bene Braq the success rates were only of 5 and 6% respectively versus 76% and 75% for Ra'anana and Giv'atayim. As noted by a recent study (AdvaCenter, 2010) the youth from affluent localities registered high success rates in the last five years (67% average) but those living in Jewish development towns and Arab localities (excluding East Jerusalem) experienced a marked decrease (from 54.2% in 2004 to 47.3% in 2009 for development towns and from 42.2% in 2004 to 34.4% in 2009 for Arab localities).

Meanwhile, only a quarter of the youth appears to go to college in Israel, in 2009 there were only 26.9% of individuals aged 17 years old in 2001 that had made it to college. As seen in the Table above, in 2001 only 75.4% were enrolled in high school (84430 seniors) and the matriculation diploma was

Figure 15. Public spending on education, last date available, total (% of GDP)



Source : WDI

later obtained by only 45.25%. Among the latter some did not qualify for college admission and for those who did they were only 30150 (26.92%) by 2009. As far as inequalities in school performance go, one observes that in 2001 only 66.12% of Arabs were enrolled in high school (versus 75.38% for Jews) and those qualified for college entrance were only 23.67% of Arabs (versus 37.27% for Jews). Only 15.28% of Arabs made it to college versus 31.52% for Jewish students. Figures for academic colleges also show that there was an increase in the number of students from all localities, even so, the proportion of 20-29 year-olds from affluent localities was much higher, at 10.6% versus 6.4% for the youth from Jewish development towns and only 2.1% for the youth enrolled in undergraduate programs originating from Arab localities (AdvaCenter, 2010).

## 3. Vocational training that needs a new model

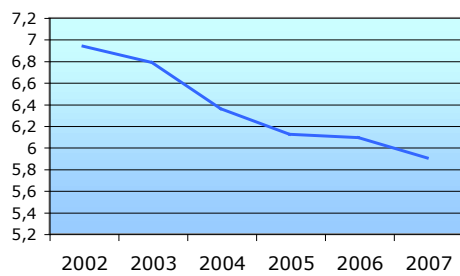
Vocational training in Israel is operated by the Training and Personnel Development Division of the Ministry of Industry, Trade and Employment. Its goal is "to reduce social gaps and to set profes-

Table 2. Percentage of 17-Year-Olds Beginning College by 2009

	Total Population		Jews		Arabs	
	Number	share (%)	Number	share (%)	Number	share (%)
Number that had enrolled in college 8 years later	30150	26,92	27833	31,52	2338	15,28
Number qualifying for college entrance	41740	37,27	36865	41,75	3621	23,67
Number qualifying for matriculation diplomas	50680	45,25	43794	49,6	5340	34,9
Number of seniors	84430	75,38	71193	80,63	10117	66,12
Total 17-year-olds, incl. ultra-Orthodox and East Jerusalem	112000	100	88300	100	15300	100

Source: AdvaCenter 2010

Figure 16. Evolution of public spending on education in Israel, total (% of GDP)



Source : WDI

sional standards in Israel by developing human resources trained in trades” (Nathanson et al, 2010).

The share of graduates of secondary and vocational schools in Israel is high at roughly 84.6% but the share of students who study in the technological/vocational track is rather low at 37%. Furthermore, the domestic technological/vocational track has the lowest share worldwide regarding students who combine training and work (at 3.6%). Meanwhile, Israeli senior high school students enrolled in technological/vocational reach a share of 37% nowadays versus 52% in the late 1970s. Last but not least, the number of classrooms for Israeli students in such courses has been on the decline, while on the opposite side academic classrooms have been increasing (Nathanson et al, 2010).

This could be explained by the fact that, while it still remains above the levels found in high income countries, public spending on education has continuously been on the decline, falling below 6% of GDP in 2007 (WDI). As noted by Nathanson et al (2010), the specific budget for technological/vocational education has been greatly reduced, the 2007 budget being approximately 35% lower than the budget for 2003. Overall, vocational training in Israel has a negative public image and is considered an inferior alternative to traditional studies.

There is a clear need for a new approach to vocational training in Israel. As was already noted by Heidemann (2000) « education and training may be all about individualised preconditions and consequences; but the conditions for participa-

#### Box. Acquiring vocational education in Israel

According to the European Training Foundation (2006) in the domestic youth vocational training one can find:

✓ Industrial schools, in cooperation with large industrial organisations and companies in order to provide paid work placements to about 13000 students, theoretical and practical work.

✓ Apprenticeship schools that cover about 1800 students in which small factories provide a school for apprentices.

✓ Work groups and courses for those aged 15–17 that are not studying/working in collaboration with public institutions and training networks.

Also a recent report (Nathanson et al., 2010) states that the Israeli youth can acquire vocational education through a series of measures, they are :

✓ A TM (technician and matriculation) program that focuses on electrical and mechanical trades and allows young students to become certified technicians (at end of Grade 12). Its nature is very interesting since it is jointly handled by the Ministry of Education, the Israel Manufacturers Association and the IDF thus taking into account the needs of the market.

✓ Advanced secondary studies in Grades 13 and 14 toward the degree of Technician or Practical Engineer.

✓ Purely technological courses, divided into 2 tracks and without providing any actual practical training, they focus on « sciences » and « technological thought ». The first provides specialization in fields such as chemistry, physics and biology while the latter offers specialization in « engineering trends » (electronic, mechanical, software etc), in « technological trends » (communications, industrial design etc) and in « VET trends » (business management, health, tourism etc). These trends are purely technological in nature and do not offer practical vocational training or specialization within a plant or company.

Sources : European Training Foundation (2006) and Nathanson et al. (2010)

tion and the opening up of opportunities require a more general, «collective» form of regulation either by legislation or by collective or company agreements ». A possible approach could be the one that strengthens « individual responsibility » to help individuals find their own way (similar to the British policy for integration and training of young people in the early 2000s) in which every young person has its own potential which « he or she is personally responsible for realising, but society has to open up opportunities and provide support » (Heidemann, 2000).

In a recent study, Nathanson et al (2010) suggest a new approach for Israel entitled « Macro Model for Vocational Training », which would involve providing formal and informal practical work skills to improve each individual's individual chances to find work. The skills would include formal education but also practical and on-the-job training. Establishing a central authority for coordination also appears crucial in the authors view, the authority also having the task "to determine the course of action, pass laws and regulations, employ long-term strategic planning, and supervision of training levels".

Naturally, for a new approach to work, trainers should be up to the task. The process would gain if trainers ceased to be just "knowledge transmitters" but became « facilitators » and « learning advisors » that stimulate learning situations, allowing the trainees to go towards self-learning (InWent, 2003).

Potential lies on the high-tech sector which is already one of comparative advantage and could provide for employment opportunities for the Israeli youth. Recently, the IT Works independent charity launched the Youth Empowerment Program (YEP) targeting the youth-at-risk with no high school diploma, in an effort that combines "technological education with volunteering and personal mentoring". Such initiative could provide valuable help to low income localities and the National Insurance Institute of Israel has already

committed in funding half of 18 YEP cohorts in the next three years.

But one must always keep in mind that a "one size fits all" approach might not work (Nathanson et al, 2010). Multiple models need to be implemented to ensure trainees find opportunities that allow for career progress.

## **V. Conclusions**

Compared to most MP's, Israel has one of the most democratic regimes. Yet, there are always risks for the current political/growth model and new efforts that have to be undertaken.

First, while growth is expected to recover, authorities must lean towards reforms that lead to less inequalities and poverty and stop thinking about economic growth per-se. Authorities need to undertake more efforts to improve education, the vocational training system and access to employment for poorer segments of the population. Also, more investment in infrastructure will be needed to allow communities living in poverty, or at the brink of poverty, to increase their participation in the labor market.

Secondly, the government has probably focused too much on the business sector for instance by reducing government outlays to avoid competition with business over sources of credit, or by reducing corporate taxes to attract foreign capital. But these measures, while beneficial to growth especially in the high-tech industry, were not sufficient to respond to all the needs of the society. One must note that hi-tech and the banking-insurance sector only employ 13% of the total workforce. Thus, the government could orient investment in more sectors of the economy and allow for the low-tech sector to grow as well. Pursuing diversification efforts would allow sustainability of the growth regime but also more employment opportunities for those with lower qualifications.

Finally, for more political stability some observers say that Israel could start thinking about reforming

its voting system that is still over-dependent on narrow interest groups that often paralyze the political scene. In other terms, what the country needs is « a system that increases accountability and stability, even at the cost of a decrease in representation for single issue and minority viewpoints » (Bain, 2011). The current political system also condemns the country to escalating corruption (European Observer, 2010). Fighting against corruption should also be of concern to improve the governing of the country and provide a message of considerable symbolism to the population.

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## JORDAN: Quick attempt to contain political turbulence

Like Egypt, the Hashemite Kingdom of Jordan has achieved high growth prior to the 2008 crisis (an average of 6.5% during 2000-2007), driven mainly by large FDI inflows (15% of GDP) in the construction sector, particularly from neighboring Arab countries. Afterwards, real growth was reduced to 2.3% in 2009 and slightly picked-up to 3.1% in 2010 following some recovery in investment and exports.

However, encouraged by uprisings in Egypt and Tunisia, Jordan soon followed with some anti-government demonstrations in early 2011. And like its neighbors, the discontent was fuelled by rising unemployment, rampant corruption and limited political openness. However, demonstrators have never sought to topple the regime especially that unlike many leaders of the region, the King was quick to act. A new government was formed in February with a mandate of advancing “real political reform.” Nevertheless, political reforms, to date, fell short of the demands made by the opposition.

Taking into account the regional political instability particularly the unrest in Syria, a global risk of a double dip recession with rising food and oil prices, forecast for 2011 are as follows:

- ✓ GDP growth is forecasted close at 3.3%, close to the 2010 level, reflecting a relative strengthening of some of Jordan’s export markets, but a limited recovery in FDI, low capital spending growth and the end of the construction boom,
- ✓ The current Account deficit is expected to narrow from 4.3% of GDP in 2010 to 2.9% in 2011, on the back of export growth following some revival in demand from Asia and Iraq, thus compensating any short-term decline in tourism numbers caused by regional unrest,
- ✓ FDI flows, which sharply declined to 6.3% of GDP in 2010, are not expected to recover,
- ✓ Inflation is expected to increase from 5% in 2010 to 6.4%, following the rise in international commodity prices,

- ✓ The fiscal deficit is expected to slightly widen to 6.2% of GDP (from 5.6% last year) despite strong recovery in foreign grants, following expansion in current spending to meet popular demands,
- ✓ The exchange rate peg may have expenditure-switching effects for Jordan if the US\$ depreciates,
- ✓ Jordanian youth have the highest unemployment rate (18%) particularly among the graduates. The Jordanian labor market is characterized by intensive migration of high-skilled education to oil-rich economies.

This country profile discusses the current situation in Jordan and underlines the challenges ahead. After presenting the limitations of the current political context, it presents an overview of recent economic developments. Finally, it addresses the challenge of youth unemployment.

### I. The Limitations of the political economy model

Despite political reforms undertaken during the late 1980’s, their momentum slowed down under the reign of King Abdullah II (since 1999) who has brought all opposition under royal sway (Yom, 2009). Officially, Jordan has a “democratic constitution” since 1952, but it has been repeatedly bypassed, amended and bent to suit the rule of the monarch and his regime. In this context, demonstrators had already been calling on the previous prime minister, even before the political outbreak in the region, to undertake comprehensive reforms to address corruption and unemployment. When anti-government protests started in Egypt and Tunisia, they were replicated in Jordan albeit at a much smaller scale, echoing complaints of rising unemployment, rampant corruption and limited political openness. And while they have never sought to topple the regime, they called for the dissolution of the unrepresentative and loyalist parliament elected in November 2010 as well as constitutional and political reforms for more effective participation.

Like his Moroccan counterpart, the Jordanian king was quick to act. A new government was formed in February with a mandate of advancing “real poli-

tical reform.” Alongside new economic incentives, the king commissioned two bodies to propose electoral and constitutional changes: the Royal Committee on Constitutional Review (RCCR) and National Dialogue Committee (NDC).

Reforms to date have led to some achievements including the abolishment of military trials of civilians (except for terrorism and espionage cases) as well as the introduction of new human rights guarantees including the outlawing of torture. In addition, the judiciary’s independence has been guaranteed and an independent electoral system was established. Moreover, to increase youth participation, the minimum age for a deputy was reduced to 25 years, while freedom of press was extended.

Despite these developments, there is a number of causes for concern. First, members of both these bodies were appointed and include many regime loyalists. Naturally, the suggested reforms have so far fallen short of the opposition’s demands. Second, unlike the Moroccan constitutional changes which devolved some of the king’s power (at least on paper), the RCCR’s recommendations to amend Jordan’s 60-year old constitution offer only modest changes. In fact, while the constitutional changes weakened the king’s ability to postpone elections and reduced his time to rule in between elections, they still entitle him to detain important powers such as the right to appoint the prime minister and he still has unaccountable influence over policy. Third, the NDC’s recommendations for electoral change were also bland, with the electoral

system still enabling the tribal and rural allies’ of the king to dominate the parliament. As a result, pro-reform demonstrators have clashed with the police and pro-regime supporters. Another cause for concern is that the parliament, which has not yet been dissolved and is still dominated by the supporters of the King, is unlikely to be critical of the amendments.

## 1. Political stability and the Hashemite Kingdom

Like Morocco, Jordan’s position on J-Curve (Figure 1) is right past the turning point of political instability but still remains very close. It is ahead of both Egypt and Tunisia and ranks ahead of them (4th in the region) in the index of economic freedom (produced by the Heritage Foundation) which showed that it had the greatest improvement in the region in 2010. Yet, it is still distant from neighboring Mediterranean countries like Israel and Turkey.

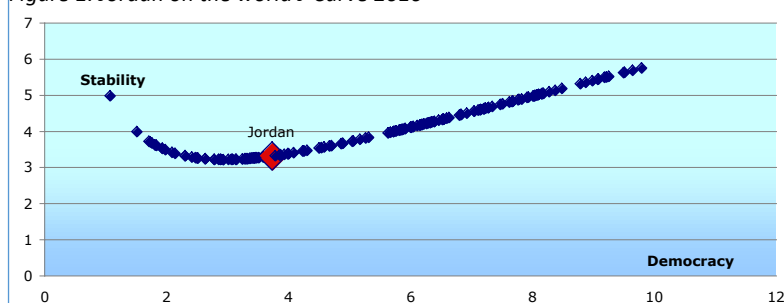
Moreover, Jordan faces a risky dilemma. On the one hand, the King’s regime while not toppled could be at risk of falling if it does not deliver on promises for political reform. However, a genuine democratic parliamentary system in Jordan could bring to power the under-represented Jordanian Palestinian majority who may discard the monarchy altogether.

## 2. Governance and Corruption Measures

Jordan’s record in governance measures is better than other countries of the region like Egypt. Figure

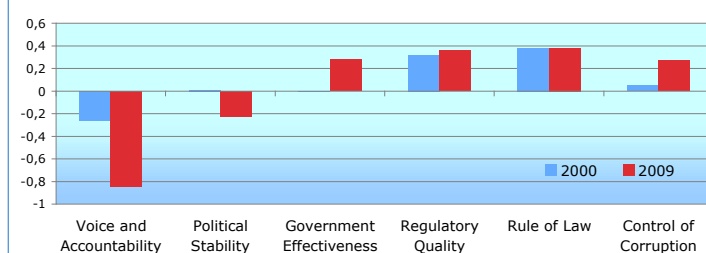
2 shows that most governance measures are positive, with some improvements and deterioration between 2000 and 2009. On the one hand, a very alarming deterioration is noticed in the voice and accountability measure and to a lesser extent in the political stability measure, both recording negative values, unlike the rest. On

Figure 1. Jordan on the world J-Curve 2010



Source : FEMISE calculations based on EIU Political Instability Indicator, Index of Democracy.

Figure 2. Jordan's Governance Indicators



Sources : Worldwide Governance Indicators 2010, World Bank.

the other hand, there are significant improvements in both the government effectiveness and control of corruption. And according to Transparency International's Corruption Perceptions Index of 2010, Jordan has a score of 4.7 and ranks 50th out of 178 countries (and 6th on the MENA region), this outranks both Turkey and Egypt.

## II. Crisis, response and short-term prospects

Unlike Egypt and Tunisia, Jordan's political turbulence has not had led to drastic economic consequences. Economic growth has been recovering slowly from the effects of the 2008 crisis, in tandem with a growth revival in the GCC economies, due to large trade and financial linkages. Nevertheless, regional instability, particularly from Syria, is weighing on Jordan's near-term growth prospects.

### 1. Short-term crisis transmission channels

Following the regional political turmoil, Jordan's external finances, heavily dependent on foreign inflows including grants, remittances, tourism receipts and FDI inflows, have come under pressure. For 2011, the outlook is as follows:

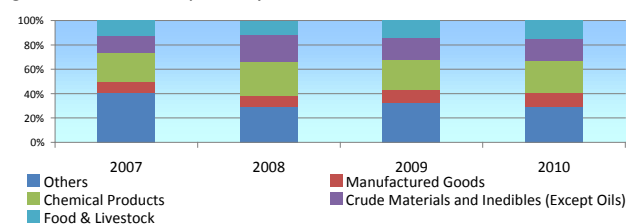
- ✓ Export growth is expected to slowdown slightly to 11% following some recovery in Asia partially offset by the global downturn and regional instability,
- ✓ The important bill is forecasted to grow due to rising commodity prices,
- ✓ As remittances and tourism receipts grow albeit at a slow pace, the current account deficit will slightly narrow, from 4.3% of GDP in 2010 to 2.9%,

✓ FDI flows, which sharply declined to 6.3% of GDP in 2010, are not expected to recover.

### 1.1 Current account widens as remittances recovery has been slow

After a fall in 2009 to 21% of GDP following the aftermath of the 2008 crisis, exports bounced back to 22.5% of GDP in 2010, but they are still far from pre-crisis levels (26.2% of GDP in 2007). The boost in merchandise exports in 2010 was particularly strong in crude materials, manufactured products and chemicals which all account for more than half of Jordanian exports.

Figure 3. Jordan Exports by Sector 2007 - 2010

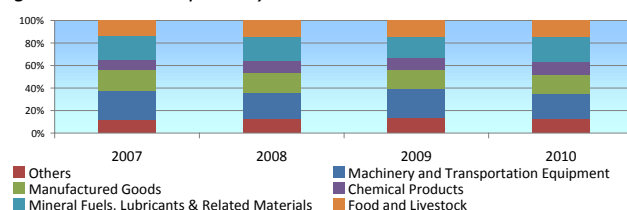


Sources : Author's calculation based on Jordanian Department of Statistics [www.dos.gov.jo](http://www.dos.gov.jo)

Unlike exports, imports declined as a share to GDP to 58.3% in 2010 from 60% last year, way below pre-crisis levels of close to 80% of GDP in 2007. It is important to note that Jordan is heavily dependent on imports (particularly of oil and machinery, accounting for 45% of total imports), which are equivalent to 2.5 times exports (Figure 4).

As export growth was able to outpace import growth, the trade deficit slightly shrank from 26% of GDP in

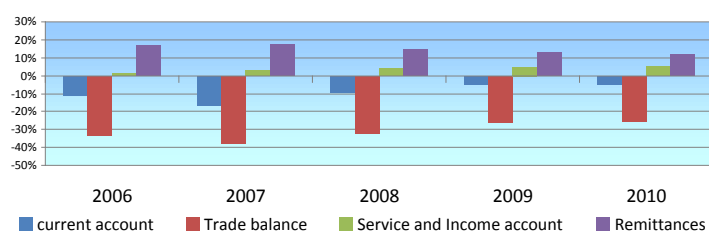
Figure 4. Jordan Imports by Sector 2007 - 2010



Source: Author's calculation based on Jordanian Department of Statistics



Figure 5 External Finances (% of GDP), 2006-2010



Source : Author's calculations based on Central Bank of Jordan data

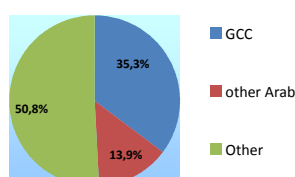
2009 to 25% in 2010. Among services exports, tourism receipts, which account for more than one quarter of exports of goods and services, has been particularly buoyant (13% of GDP) in 2010 and are approaching pre-crisis levels (13.5% in 2007). Remittances, which represent a bit more than a third of foreign exchange earnings are still low (12% of GDP in 2010, compared to 17.5% in 2007), thus resulting in a slight widening of the current account to 5% from 4.7% of GDP.

In 2011, exports are expected to grow but at a slower pace (11% vs 15.2% in 2010) as external demand recovers in Asia and increased re-export trade with Iraq make up for sluggish demand in the US. Meanwhile, the import bill will continue to grow as commodity prices (of both oil and food) increase. However, the current account is expected to narrow from 4.3% of GDP in 2010 to 2.9% in 2011, on the back of export growth, thus compensating any short-term decline in tourism numbers caused by regional unrest.

## 1.2 FDI inflows have not recovered

Following reforms to improve the business climate, Jordan attracting large inflows of FDI before the 2008 crisis (15% of GDP in 2007), especially from GCC countries (a bit less than a third of total FDI inflows) (figure 6). In fact, Kuwait is Jordan's largest single foreign

Figure 6. Geographical composition of FDI, (%) 2010



Sources : Arab Investment and Export Credit Corporation

investor, with an estimated US\$5bn invested in banking, telecommunications, retail and real estate. Owing to slower regional and global growth since the 2008-09 global economic downturn, FDI inflows declined to 6.3% of GDP in 2010, down from 10% in 2009. In contrast, portfolio investment increased to 3% of GDP after an

outflow of a 2.6% of GDP in 2009. In fact, the stock market index closed the year 2010 with a decrease of around 6%. The downward trend has continued until July 2011, with a cumulative decline of 12% since the beginning of the year.

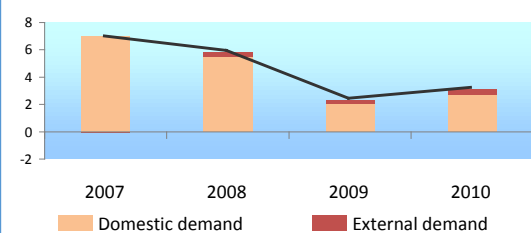
Even though given the domestic political turbulence seems well-contained so far, global and regional developments will hamper FDI's already slow recovery in 2011. Gulf investments are expected to ease in following the financial difficulty of several of the larger Gulf Arab real estate firms. More generally, efforts by the government to draw in greater private sector investment in new infrastructure developments will be hindered by the slow recovery of the global economy, and fears of regional instability, potentially delaying a number of power and transport projects. More positively, if the region stabilizes and as the world economic climate improves, Jordan's attractiveness to foreign investors will be boosted by the recent reduction of corporation tax rates and the launch of a more flexible new foreign investment law. In addition, its advantageous geographical location could potentially offer a larger role as a base for companies looking to invest in Iraq and as a conduit for imports into the country. Moreover, free-trade agreements with the US and Canada and an Association Agreement with the EU add to the country's attractiveness as a base for exports (EIU, 2011).

## 2. Crisis impact on main Macroeconomic Balances

### 2.1 The recovery was weak in 2010

Following a decade of strong growth (6.5% between 2000 and 2007), the Jordanian economy

Figure 7. Contribution to GDP growth, (%) 2007-2010



Sources: Author's calculations based on EIU data

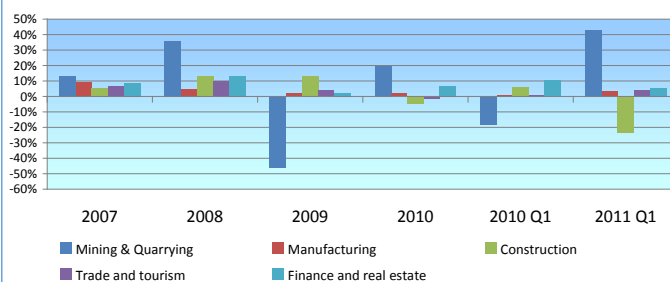
slowed down considerably to 2.3% in 2009, due to the global economic downturn, and anemically recovered to only 3.1% in 2010 (figure 7). The recovery was mostly due to a recovery in investment (up by 2%, from a fall of 0.5% last year) and exports (up by 1.1% compared to a contraction of 2% last year). Imports also picked-up by 0.3% compared to a drop of 2.1% in 2009. All other components of aggregate demand have not expanded. Finally, it is worthwhile to note that domestic demand still accounts for most of the growth with a contribution of around 88% of GDP growth (figure 7).

Most economic sectors posted positive growth rates in 2010, except for construction and trade and tourism with respectively contracted by 5% and 2%. In particular, the recovery was strong in mining and quarrying (up by 19% compared to a decline of 46% in 2009), following an increase in global demand of phosphate and other minerals. Other fast growing sectors included financial services (up by 7%) and transportation, storage and telecommunications (up by 5%). The manufacturing sector witnessed only a limited upturn (up by 2%, the same growth as last year and still significantly lower than 9.2% in 2007) (figure 8). As a result, its share to GDP declined from

19 % in 2007 to 16.9% in 2010. In tandem, industrial production fell by 3% in 2010 (compared to only -1.1% in 2009). This occurred despite a phenomenal increase in the production of extractive industries (up by 40%) which only partly offset the drop in manufacturing output (by 5.5%). In the first quarter of 2011, GDP grew by 2.3%, the same level as last year, driven mainly by mining and quarrying (up by 43%), finance, insurance, real estate and business services (5.6%), and wholesale, retail trade and restaurants (4.1%). According to CBJ (2011), this sluggish performance is the result of regional instability.

The recovery in Jordan is dependent on the recovery of its regional neighbors. In particular, the political unrest in Syria has broad economic implications for Jordan as the two are significant trading partners and valuable transit traffic for Saudi Arabia and the Gulf (EIU, 2011). Other large trading partners include the Gulf Cooperation Council (GCC) economies, particularly Saudi Arabia. These countries account for the largest share of Jordanian trade, remittances, grants, FDI, and tourism receipts. The IMF (2010) shows that Jordan's output growth has the strongest correlation with the growth in GCC non-oil output compared with other oil-importing economies in the region. Moreover, they provide empirical evidence that Jordan's growth cycle movements are closely linked to those of Saudi Arabia. A one percentage point (ppt) increase to Saudi Arabian output increases growth in Jordan by about 0.8 ppt. Moreover, shocks to the cyclical component of Saudi Arabia's output have a large, long-lasting, and significant impact on Jordan's growth path.

Figure 8 : GDP growth by economic activity, (%) 2007-2011



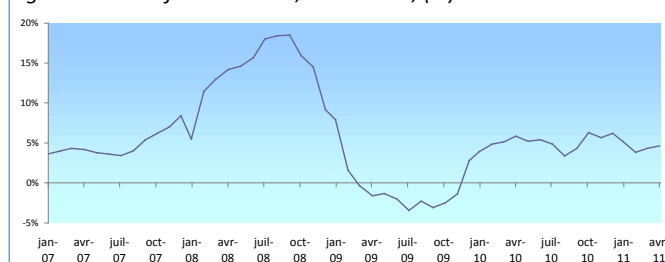
Source: Author's calculation based on Central Bank of Jordan's data

## 2.2 Unemployment has not eased

Jordan's unemployment rate remained in the double-digit over the past 10 years, stubbornly persisting close to 13 % since 2007 (figure 9). In general, unemployment in Jordan has several characteristics. In 2010, unemployment had only marginally recovered

from the effects of the crisis, to 12.5% in 2010, down from 12.9% a year ago. This was driven by a decrease in female unemployment (from 24% to 22%). Meanwhile, male unemployment has remained unchanged (around 10.4%). In Q1-2011, unemployment has declined to 12.2% despite an increase in male unemployment to 10.8%.

Figure 10. CPI inflation trends, 2007-2011, (%)



Source : Author's calculation based on Central Bank of Jordan's data

## 2.3 Inflation is on the rise but remains moderate

After having declined steadily through 2009 to slightly negative rates, in tandem with lower world commodity prices, inflation picked-up again in 2010 averaging around 5% and has been hovering around this level since the start of 2011 (figure 10). These recent increases have been largely due to rising international food and energy prices. For 2011, headline inflation is projected to increase in line with imported commodity (energy and food) prices from 5% in 2010 to 6.4%. A more formal anti-inflationary strategy is expected in the second half of 2013, in tandem with the start of rate rises by the Federal Reserve (the US central bank).

## III. Macroeconomic responses

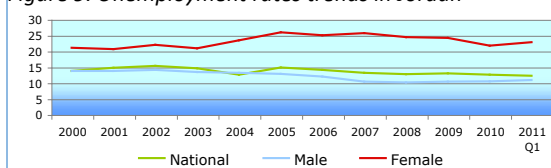
### 1. Meeting popular demands adds strain to public finances

Like many emerging market countries, Jordan's already difficult fiscal position worsened in 2009, following sharp decline in external grants and to a lesser extent an increase in capital spending. However, in 2010, the deficit narrowed to 5.6% of GDP from 9% in 2009. The deficit excluding grants was larger but also exhi-

bited the same trend, declining to 7.7% from 11% of GDP. This is explained by a fall in both expenditure to 30.4% of GDP in 2010 from 35.7% of GDP in 2009, and revenues, to 24.8% from 26.7% of GDP. Most of the decline in expenditure was due to a reduction in capital spending by (to 5 from 8.5% of GDP) and most of the decline in revenues was due to a decrease in tax revenues (to 16% from 17% of GDP). Grants did not increase; accounting for 2% of GDP, down from 4.6% of GDP in 2008. In the first half of 2011, the deficit (including grants) increased by around 55%, following an expansion in current expenditure (by 13%), which more than offset the cut in capital spending (down by 19.7%). On a more positive tone, foreign grants almost doubled, though revenue growth only increased by 5.5%. Jordan has already accepted a US\$1bn grant from Saudi Arabia in July and edged closer to joining the Gulf Cooperation Council (GCC).

Like in Egypt, the Jordanian government's desire to keep a tight rein on spending in 2011 has been undermined by new spending commitments made as a result of the January protests. The King has granted a JD100 bonus in August to former civil and military employees, as well as day labourers, employees of state-run, independent institutions, public universities and municipalities, pensioners receiving payments from the Social Security Corporation and families receiving financial support from the National Aid Fund. Consequently, current expenditures are expected to rise again. Meanwhile, recent moves to lower taxes on 150 basic items will only serve to decrease revenue further. However, buoyed by foreign grants recovery (particularly from Saudi Arabia), the deficit (including grants) is forecasted to widen

Figure 9. Unemployment rates trends in Jordan



Source : Department of Statistics, Jordan

only slightly to 6.2% of GDP in 2011, higher than the government forecast of 5.5% of GDP. However, this means that the government will not meet its 2011 target of achieving a primary fiscal surplus (which would imply an overall deficit of under 3% of GDP).

Although government borrowing rose in the first half of the year, the government seems on track to keep its total debt level below 60% of GDP, a debt ceiling recommended by the IMF. Net public debt increased to 58.5% of projected GDP in 2011, down from 61.1% of GDP at the end of 2010. The public-sector debt burden is forecasted to increase as wider fiscal deficits force the government to issue rising levels of Treasury bills.

## **2. Monetary policy is tightened to curb rising inflation**

After an accommodative monetary policy stance between November 2008 and February 2010, the Central Bank of Jordan (CBJ) raised its policy rates by 25 basis points in May 2011 and reduced banks' reserve requirements, following rising inflation. Yet, the spreads between commercial bank lending rates and its policy rate remain wide, as commercial banks have so far not responded to government demands to reduce their lending rates in line with CBJ cuts. Further interest rates spikes are not expected in 2011 while the recovery is still fragile, and also to encourage commercial bank lending (which finally picked up by 6.8% in 2010 and further to 13% in June 2011 vs. only 2.2% in 2009).

According to IMF (2010), the Jordanian peg to the US\$, maintained since the 1990s, plays a key role in both anchoring inflation expectations and in maintain financial stability. Even though the recent strength of the US\$ has led to some real appreciation of the Jordanian dinar, IMF (2010) provides evidence that Jordan's real effective exchange rate remains broadly in line with medium-term fundamentals. However, should the dollar depreciates ( a likely scenario after the US lost its AAA credit rating with Standard and Poor's last August 2011),

this would have expenditure-switching effects for Jordan (imports from non-US sources would become more expensive and exports less so).

The increase in short-term inflows allowed official foreign reserves to reach a record high of US\$12.2 billion by end-2010, which decreased to US\$ 10.7 in June 2011. According to IMF (2010), current levels of foreign reserves are sufficient to buffer against severe potential capital and current account shocks as well as offset any pressure on the currency stemming from short-term liquidity problems or negative political developments. This comfortable reserve position - relative to both potential stocks and to other economies in the region - ranks Jordan higher than most comparator countries in the region based on both traditional reserve adequacy measures and some benchmarks for optimal reserve holdings. It should also allow more flexibility for the future conduct of monetary policy.

## **3. Financial sector has weathered relatively well the 2008 financial crisis**

Following some efforts to protect the banking sector from the fallout from the global financial crisis, like extending a government guarantee of all bank deposits until end-2010 (IMF, 2010), domestic credit picked-up in 2010 to 6.8% in 2010, compared to 2.2% a year before, driven by a revival in private sector credit growth (up by 7.2% compared to 1.3% last year). This has led the government to remove the guarantees in January 2011. So far, credit growth remains buoyant at 9.7% though still far from pre-crisis levels of 26% in 2008.

Also, the banking sector remains liquid (with loan/deposit ratio near 75%) (IMF, 2010). Banks remain profitable and well capitalized. Naceur et al. (2011) report some banking sector indicators for Jordan. The return on assets and return on equity are around 2% and 10% respectively, slightly lower than the average for the MENA region. However, Jordan's banking sector concentration ratio (the share of the 3 largest

banks' assets to the total banking sector assets) is high (86%). Moreover, IMF (2010) reports that the ratio of non-performing loans to outstanding loans is only 6.6%. Yet, they highlight that banks could be exposed to higher non-performing loans and provisioning requirements over the medium term, as Jordan's growth path is likely to remain below potential in the near-term.

Following regional and domestic unrest, Moody's downgraded Jordan's Ba2 foreign-currency government bond rating outlook, last February 2011, from «stable» to “negative”. The government's local-currency bond rating was also downgraded with a negative outlook to Ba2 from Baa3, as well as the country's foreign- and local-currency ceilings. These downgrades reflect concerns about both Jordan's public finances, following the decision to raise pay and pensions and lower fuel and food prices, and external finances as a deterioration in the balance of payments could lead to a decline in foreign-currency reserves. Standard & Poor's soon followed with a cut in both Jordan's foreign- and local currency ratings to the junk grade of BB+/B, for the same worries. The outlook on the long-term foreign currency and local currency ratings was also cut to negative from stable.

#### IV. Youth unemployment

Like most of its Mediterranean neighbors, the population in Jordan is young: out of 6 million inhabitants in Jordan in 2010, 1.7 million are aged 15-29 (28%), 2.1 million are aged 15-34 (35%), and 1.8 million (30%) are between the age of 30 and above, according to the Department of statistics. This young population puts increasing pressure on the labor market. Yet, youth face the highest unemployment rate, particularly those who are educated, pushing thus many of them to migrate to find better jobs.

##### 1. Youth unemployment is the highest

Despite representing a significant part of the population, youth in the age group 15-24 including first

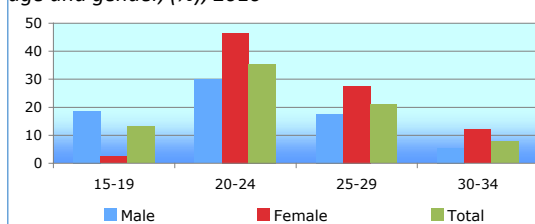
time entrants in the labor market, accounted for close to half of the unemployed (Amer, 2011).

Moreover, youth face the highest unemployment rates. According to data from the Jordanian Labor Market Panel Survey (JLMPS) (2010), youth unemployment (15-29 years) is around 18%, which is somewhat lower than in countries like Egypt or Turkey. As figure 12 shows, the unemployment rate for young men is 15% and it is more than double for young women, close to 32%. Unemployment is highest for the age cohort of 15-19 (27.3%) then decreases with age. However, the peak of female youth unemployment is for a higher age group, 20-24. Also, Amer (2011) observes that female unemployment rate is much higher than that of men for all age groups. It is more than twice higher than that of men for those aged between 15 and 34 (26% as compared to 11.6%). And even though female unemployment decreases with age after increasing first between those aged 15-19 and those between 20 and 24, it remains high among the 30-34 years old (12.2%).

##### 2. Higher unemployment among the educated

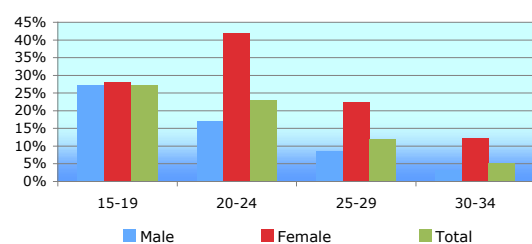
Like the rest of Mediterranean economies, a main characteristic of unemployment in Jordan is that young educated have difficulty in obtaining a job: 34.1% of the unemployed hold a bachelor degree or above, according to the department of Statistics. The problem of educated unemployment is more severe for females, as the share of unemployed females holding a bachelor degree or above is 61.5%, compared to 21.2% for males (Figure 13). However, those with less than a secondary education are those who account for most of the unemployed: 45%.

Figure 11. Share of youth unemployment in Jordan by age and gender, (%), 2010



Sources : Amer (2011)

Figure 12. Unemployment rate by age and gender, (%) 2010



Sources : JLMPS 2010

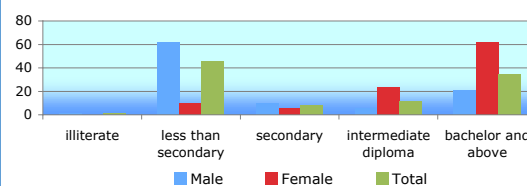
Unemployment of the 15-34 years is highest for those with a university degree and above (21%) (figure 14). Amer (2011) shows that the female unemployment rate (for 15-34 years) increases continuously with educational attainment, peaking to 29 % among university graduates. The same trend is observed for men with a peak to 13.8% among university graduates. The high unemployment for the educated reflects a mismatch between the quality of jobs offered and the expectations of highly educated individuals (Kanaan and Hanania, 2009).

### 3. The Jordanian labor market between immigration and emigration

The focus of government's efforts in recent years has been to create 46,000 new jobs per year and reduce unemployment to 6.8% by 2017. Between 2000 and 2005, the economy did create between 24,000 and 44,000 jobs per year but this did not reduce unemployment among nationals with remain around 14% (Rad, 2011). This reflects two paradoxical features in the Jordanian economy.

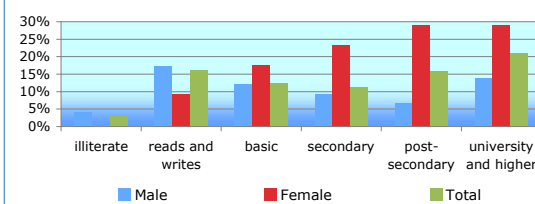
On the one hand, there is mismatch between the quality of jobs offered and the expectations of highly educated individuals, which lead the most skilled and highly educated Jordanians to remain "voluntarily unemployed" or migrate to oil-rich countries, particularly where they can get high quality jobs and high salaries (Rad, 2011). This can explain why about half of the employed in Jordan have less than secondary qualifications.

Figure 13. Share of unemployed by education and gender, 2010



Sources : Department of Statistics (DOS), the Hashemite Kingdom of Jordan

Figure 14. Youth unemployment by education, 15-34 years, 2011



In general, Jordan is a major labor-exporter and Jordanian migrants were around 734,000 in 2010 (around 12% of the Jordanian population). Around a quarter of Jordanian migrants go to the GCC and just over half go to other Arab economies (World Bank, 2011). Those households who receive remittances are less reluctant to get employed because they have a higher «reservation wage» making them less willing to accept low-quality jobs (Kanaan and Hanania, 2009).

On the other hand, job is also a labor-importer. In 2010, it received around 2.9 million migrants and around 20% of the country's labor force was composed of foreign workers in 2009 (Rad, 2011 and World Bank, 2011). However, since the newly created jobs are of low quality (low wages, and hard work conditions), they appeal to the non-Jordanian workers, like Egyptians, who represent 71% of the foreign workers in Jordan (Kanaan & Hanania, 2009). Rad (2011) also explain that around 63% of newly created jobs between 2001 and 2005 were filled by non-Jordanians.

This feature in Jordan's labor market suggests that there is demand for labor but that it is not supplied by nationals. Rad (2011) worryingly concludes that the increasing economic growth alone would not

be sufficient to reduce unemployment and that efforts need to be deployed to generate decent jobs that match the qualifications of the Jordanian's credentials.

## V. Conclusion

Compared to most of its southern Mediterranean neighbors, Jordan seems to be enjoying more political stability. While the country could not escape some political turbulence in the beginning of the year, the quick reaction of its leader calmed the protests. So far, reforms have fallen short of opposition demands. And while the King's regime is not toppled, it could be at risk of falling if it does not deliver on promises for political reform.

Economic growth has been recovering slowly from the effects of the 2008 crisis, in tandem with a growth revival in the GCC economies, due to large trade and financial linkages. Unlike Egypt and Tunisia, Jordan's political turmoil has not had led to drastic economic consequences. Nevertheless, regional instability, particularly from Syria, is weighing on Jordan's near-term growth prospects.

Unemployment, which has persisted around 13% despite growth over the past decade, remains one of Jordan's longstanding challenges. Unemployment of the youth (around a third of the population) is around 18%, thus exerting pressures on the labor market. Dealing with youth unemployment challenge is crucial, especially that that they have recently triggered social discontent and political upheaval. The following policy recommendations could help improve the insertion of the youth in the labor market:

✓ Higher education systems need to be restructured and school to work transition programs are required to help new labor market entrants to adjust to market needs,

✓ The Jordanian government has adopted a National Strategy for Employment in order to replace foreign workers with Jordanians but employment policies should encourage disadvantaged

youth to accept lower-paid jobs, currently taken by foreigners,

✓ In parallel, there is a pressing need to create decent productive jobs that can match young Jordanians' qualifications. In fact, the Jordanian youth is relatively well and more and more educated (a large proportion has secondary, post-secondary and university degrees) (Amer, 2011).

✓ Finally, jobs created should not be generated by the government sector, as this short term remedy will only be reflected in higher fiscal burdens in the medium term.

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## LEBANON: Weak growth because of domestic political turmoil

Up until last year the Lebanese economy was maintaining a high rate of growth despite the international crisis and domestic political instability. After growing by 8.5% in 2009, GDP grew by 7.2% in 2010, in part due to capital influx during the elections period which boosted GDP. But, while revenue effects resulting from the international crisis were small in size, the domestic political unrest throughout 2011 and the regional climate of uncertainty are expected to limit growth to only 1.3%.

As already noted in previous reports, the Lebanese case is a special one since the economy is largely stimulated by reconstruction efforts. The economy bases its development on the service sector, primarily on tourism, but has seen little progress in the industry sector. Meanwhile Lebanon is less productive than other MP's and an industrial policy that allocates Lebanese resources in a more optimal way would be greatly needed. Finally, the reconstruction cost has generated considerable public deficits that ask for a budgetary reform.

The challenges mentioned above could probably have been dealt with more efficiently had Lebanon not faced continuous political instability since its independence. Factors such as concentration of power by ethnic elites and the structure of the party system has perpetuated instability. Meanwhile, foreign intervention has often made matters more complicated while the current climate of regional uncertainty certainly threatens the domestic political balance. This comes at a time when the political divide has already contributed to a degradation of governance indicators. Furthermore, more than 1 out of 4 Lebanese lives in poverty which means that social conditions are in need of improvement in a time when regional turmoil can be easily propagated through social uprisings.

Regarding Lebanon's macroeconomic position the following elements should be noted :

✓ An estimated increase in exports by 3% following national data. In May 2011 exports had recorded a 1.62% year-on-year real increase.

✓ A 17.9% increase in goods imports, a great source of concern following the rise in international prices.

✓ Thus, a trade balance in deficit, expected to reach -15.2bn US\$, to 37.5% of GDP up from 31.2% of GDP in 2010.

✓ A service balance marking an unprecedented fall to 2.76% of GDP from 5.75% in 2010, primarily due to an expected fall in tourism with tourist arrivals in the first six months of the year down by almost 20% compared to the same period of 2010.

✓ The total trading volume in the Beirut Stock Exchange decrease by 58% in the first five months of 2011 compared to the same period last year. Meanwhile, aggregate turnover amounted to 306m US\$, a 78% fall compared to the first five months of 2010.

✓ Foreign currency reserves, expected to amount to 48.063bn US\$ in 2011, a 7.9% rise compared to 2010.

✓ Debt stock is expected to rise by 15.14% at 35.062bn US\$ in 2011. Debt service payments are expected to reach 5.3bnUS\$, a 4% compared to last year.

✓ The Lebanese pound is expected to remain pegged to the US\$ within a band of L£1,501-1,514: US\$1. If as expected the US\$ strengthens against the euro in 2011-12 then the Lebanese pound shall strengthen as well vis-a-vis the European currency.

### I. The current situation and its implications

#### 1. A political model that sustains instability

##### 1.1 Political instability derived from both internal and external causes

In 1943, Lebanon formed its first independent democratic government and amended the cons-

titution ending the mandate of french-imposed authority. But, since its independence Lebanon has constantly faced political instability that affects its population's well being.

According to Zakaria (2011), both internal and external factors contributed to the political instability in the country, with external factors exacerbating the internal ones. Internal factors would consist of economic and political marginalization (concentration of power by ethnic elites and no power given to the population), the structure of the party system (ideology, inclusive and exclusive representation, and elite cartels), as well as the militarization of communities. One should emphasize on the fact that, « parties aligned with religious doctrine, particularly...tend to fail to develop a perceptible party structure and carry out the regular functions of a modern western political party ». According to the author this is the case of Lebanon where the two main political parties have greatly contributed to political instability and violent conflict following their Islamic doctrine.

Meanwhile, there are also external factors to political deficits which include foreign intervention (by countries such as Syria, Iran, Israel, Saudi Arabia, and the United States), the Iranian Islamic Revolution and the after shocks of the Arab-Israeli conflicts etc). The Arab-Israeli conflict could have been a contributing factor to instability since the increase of Palestinian migration into Lebanon had « a backlash on the delicate balance (agreement) between Maronite Christians and Muslims in the country » (Zakaria, 2011).

## **1.2 A political situation that is still irritable**

Though Lebanon has a regime closer to democracy and one that is far from the cases of MP's such as Egypt, Tunisia or Syria, the domestic political state of affairs is still a tense one and is expected to remain so in the short-run despite recent efforts.

In recent years, the political scene witnessed a stalemate, after the departure of president Lahoud in November 2007, which lasted for roughly six months before the election of General Suleiman as president. Beforehand, there were several incidents that led people believe that a new civil war could take place, that is before the newly elected president stood neutrally allowing to alleviate pressures from the political divide and keeping the army out of any political developments (BBC, 2011).

Recently, after a five-month struggle, prime minister Mikati managed to appoint a government, primarily composed of members of "March 8th", a faction supported by Iran and Syria that had removed from office "March 14th", a body supported by the US, Saudi Arabia and France in early 2011 (EIU, 2011). It appears Syria still has political influence in Lebanon, despite withdrawing military authority in 2005 (BBC, 2011). In that respect, political stability greatly depends upon the ongoing support of Walid Jumblatt (at the head of the Progressive Socialist Party) who appears to be in favor of maintaining ties with Syria, but not as much with the regime of Bashar al-Assad (EIU, 2011).

Lebanon's constant instability, of which the 2011 administration fall appears to be one of its recent materializations, is the cause and consequence of the limitations of the modern Lebanese state. As noted by Colombo (2011) "the absence of a state budget between 1993 and 2009, the lack of regular cabinet meetings, and the fact that the parliament can be closed at will by its speaker...are all indicative of the profound weakness and poor functioning of the fractured Lebanese state".

Overall, the political tensions are expected to persevere and the Lebanese government seems to be currently facing « a test for existence », with the recent split of views over the electricity bill, a dispute between the two key sides of Gen. Aoun and Walid Jumblatt, presently threatening the majority alliance and being a source of tensions (TheDailyStar, 2011).

### 1.3 Governance has all but improved

Indicators of governance can provide valuable insights and explain how Lebanon is in a relatively unstable political situation. As shown by figure 1, most of the country's governance scores have remained negative in 2009 and deteriorations have occurred in almost all measures.

In recent years, the war on Lebanon but also interminable political divide has led to a deterioration of the Political Stability No Violence indicator which in 2009 was very close to a level of "bad governance". Meanwhile, the government effectiveness indicator, which mirrors how the quality of services provided by public authorities is perceived has decreased, suggesting lessened credibility and a lack of effectiveness in policy implementation.

Furthermore, control of corruption appears to have deteriorated as well. In its 2010 edition, the Corruption Perceptions Index (CPI) of Transparency International ranks Lebanon 127th out of 178 countries which means the country remains among the most corrupt economies in the region and keeps worsening since 2007 (CPI of 2.5 in 2010 versus CPI of 3.6 in 2007). The causes behind this phenomenon include the lack of awareness on the causes and consequences of corruption, non-effective (or the lack of) anti-corruption institutions and an insufficient legal

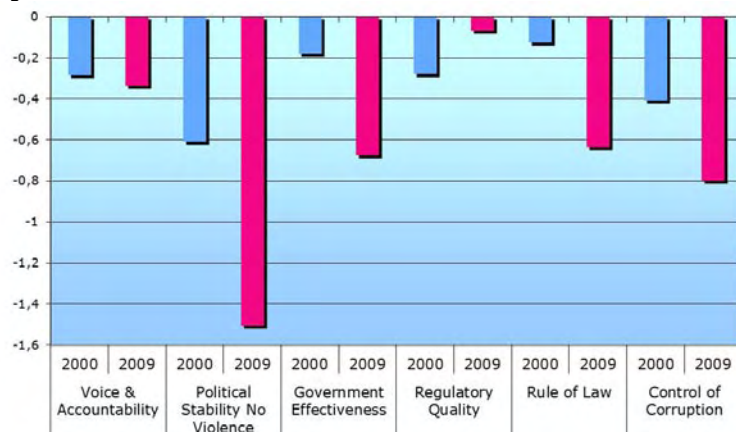
framework and legal implementation mechanisms. One should also note that after the war all past efforts conducted to combat the phenomenon have been rendered practically useless, giving place to division as well as « competition for state resources » (The Lebanese Transparency Association).

### 1.4 A growth model with potential to decrease inequalities but poverty is still high

In figure 2, it appears that the Lebanese regime of economic growth is close to the « tip-over point » of the Kuznets regional curve. This means that for the time being growth does not reduce inequalities, but the country can hope to achieving that in the near future. Thus, contrary to the majority of MP's, an increase in GDP per capita could potentially reduce inequalities domestically in the short-run since the distribution of wealth would mainly favor poorer deciles of the population.

But, despite being in a better position than other MPs the challenge is still considerable, a study by the International Poverty Centre (2008) suggests that roughly 28% of the population is poor while 8% is extremely poor. Most importantly, regional disparities are massive, while poverty is insignificant in Beirut it appears to be high in the North governorate. The study finds that the poor are primarily unemployed and unskilled workers

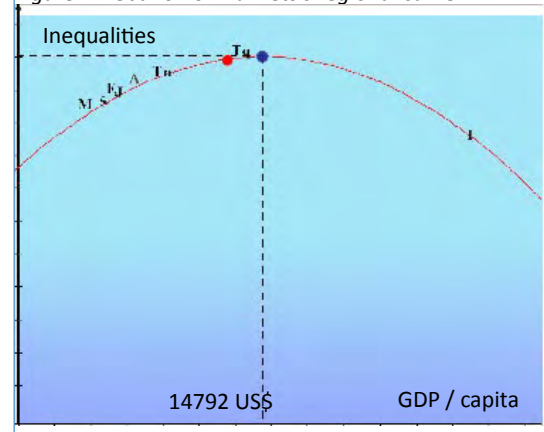
Figure 1. Israel's Governance Indicators



Source : Worldwide Governance Indicators 2010, World Bank.

Note : Values vary from -2.5 (bad governance) to 2.5 (good governance)

Figure 2. Lebanon on Kuznets's regional curve



Sources : FEMISE calculations based on EHII inequality database and WDI 2010

Table 1. Poverty Measures by Governorate, 2004-5						
Governorate	Extremely Poor			Entire Poor Population		
	P0	P1	P2	P0	P1	P2
Beirut	0,67	0,07	0,01	5,85	0,95	0,24
Nabatieh	2,18	0,21	0,05	19,19	3,97	1,26
Mount Lebanon	3,79	0,69	0,21	19,56	4,45	1,52
Bekaa	10,81	1,89	0,53	29,36	8,05	3,06
South	11,64	2	0,53	42,21	11,35	4,22
North	17,75	3,65	1,08	52,57	18,54	8,63
Total	7,97	1,5	0,43	28,55	8,15	3,32
Source : International Poverty Centre (2008)						
Note : The poverty gap index (P1 index) measures the gap between the average income of poor individuals and the poverty line. The poverty severity index (P2 index) measures inequality among the extremely poor.						

in agriculture and construction. It also finds that the projected cost of halving extreme poverty is very modest « a mere fraction of the cost of the country's large external debt obligations ». But the cost would rise considerably if future growth were to be « anti-poor ».

As noted by the study, future macroeconomic policies need to be revised to mobilize resources in order to increase public expenditures on social safety nets and public investment in social services.

Table 2. Trade and BoP Indicators, US\$m					
	May 10	March 11	April 11	May 11	% change
Exports	371	354	375	377	1,62
Imports	1369	1631	1501	1578	15,27
Trade Balance	-998	-1277	-1126	-1201	20,34
Balance of Payments	-195	270	-199	-199	2,05
Source : Byblos Bank					

## 2.Short-term prospects

### 2.1 Real sector

The Lebanese real economy is expected to be hit to some extent in 2011. More specifically one expects:

- √ An estimated increase in exports by 3% following national data,
- √ A 17.9% increase in goods imports,
- √ A trade balance in deficit, expected to reach - 15.2bn US\$, to 37.5% of GDP up from 31.2% of GDP in 2010,
- √ A service balance marking an unprecedented fall to an estimated 1.14bn US\$ in 2011, that is to

2.76% of GDP from 5.75% in 2010,

√ A current account deficit that could reach -28.5% of GDP in 2011 from -22.4% in 2010.

The Lebanese export sector does not appear to have marked any considerable fall caused by the regional turmoil. In May 2011 exports had recorded a 1.62% year-on-year real increase. According to

EIU, goods exports are expected to fall by 1% throughout 2011 to reach 5.41bn US\$. However, recent figures show that industrial exports reached 1.7bn US\$ in the first six months of 2011, being equal to an increase of 3% from 1.66bn

US\$ in the same period in 2010 (Byblos Bank, 2011). Industrial exports reached 314.3m US\$ in June 2011, up 3.9% from 302.5m US\$ in May 2011 but lower than June 2010 by 0.5%. Pearls & precious or semi-precious stones accounted for 22.1% of total industrial exports in the first half of the year, followed by base metals & articles of base metals (18.1%) and machinery and mechanical appliances (16%). Meanwhile, Arab countries accounted for 37.3% of total industrial exports in June distantly followed by European countries with 18.9%.

The great concern is on the side of imports, following the rise in international prices, they

are expected to record a considerable rise after continuously increasing. In May 2011 they had already met a 15.3% year-on-year increase while EIU estimates for the entire year point to a 17.9% rise in goods imports. According to the Ministry of Industry industrial imports reached 123.1m US\$ in the first half of the year an 8.8% year-on-year rise. This was partly explained by a 30.9% year-on-year increase of imports of industrial equipment and machinery in June 2011.

Additional pressures to the trade balance should thus be expected and consequently an impact on the current account. The trade deficit witnessed an year-on-year increase close to 20.34% between May 2010 and May 2011. Projections for 2011 suggest the deficit could climb as high as -15.2bn US\$, that is to 37.5% of Lebanese GDP.

Meanwhile, the service balance is expected to record an unprecedented fall to an estimated 1.14bn US\$ in 2011, that is to 2.76% of GDP from 5.75% in 2010. Following the regional turmoil, the tourism industry could be affected if passengers decide to cancel their trip to Lebanon, in May 2011 the total number of airport passengers being close to the levels of 2010 that is to 466.640, a slight decrease of 0.02%. But, recent data from the Ministry of Tourism suggest tourist arrivals in the first six months of the year were at 774000, down by almost 20% compared to the same period of 2010. It appears, the impact not only affected the hotel industry, but also other sectors of the domestic economy such as real

estate, construction, transport, retail and other services sectors (EIU).

Consequently, the current account deficit could reach -28.5% of GDP in 2011 from -22.4% in 2010.

## 2.2 Financial sector

### 2.2.1. Stock Market affected by regional and international events

The total trading volume in the Beirut Stock Exchange reached 50.4 million shares in the first five months of 2011 which corresponds to a decrease of 58% from the same period last year. Meanwhile, aggregate turnover amounted to 306m US\$, a 78% fall compared to the first five months of 2010. Regional developments have thus had a considerable impact, market capitalization decreased by 8.9% from end-May 2010 to roughly 11.7bn US\$, of which more than 70% was in banking stocks and 25% in real estate (Iloubnan.info, 2011).

Recently, the Lebanese stock market is drawing little attention at a time where investors focus on E.U and U.S. market developments. On August 19th 2011, the Beirut Stock Index would close at 1,299.69 points, with a market capitalization of 11.22 billion US\$ versus 13.06bn US\$ in August 2010. The large losses across international equity markets due to rising fears of a new global recession have thus affected the Lebanese financial world (TheDailyStar, 2011b).

### 2.2.2 Foreign Reserves on the rise and Debt still among the highest

The high level of the Central Bank's foreign-exchange reserves (31.5bn US\$ in March 2011) can be deemed as positive in a period of internal and external instability. Foreign currency reserves have been continuously on the rise. According to EIU, total international reserves are expected to amount to 48.063bn US\$ in 2011, a 7.9% rise compared to 2010.

Figure 3. Debt Indicators in Lebanon, US\$ million



Source: EIU:

Regarding Lebanon's debt indicators, preliminary figures for 2011 suggest debt stock to rise by 15.14% at 35.062bn US\$ in 2011. Debt service payments are expected to reach 5.3bnUS\$, a 4% compared to last year. As noted by EIU (2011), foreign debt is mostly held by local banks while debt servicing is in effect a form of government support to the banks. In that respect, the country which has little chance to face contagion from international debt crises despite a large structural deficit and among the highest debt/GDP ratios.

### 2.2.3 A domestic currency to remain pegged to the US\$

Finally, the Lebanese pound is expected to remain pegged to the US\$ within a band of L£1,501-1,514:US\$1. If as expected the US\$ strengthens against the euro in 2011-12 then the Lebanese pound shall strengthen as well vis-a-vis the Euro. As noted by EIU, the Banque du Liban's commitment to defending the peg finds support in « its ability to influence interest rates, high levels of assets and strong support from local commercial banks ». Hence, in the possible case of capital outflows, the Lebanese economy would need to fall back on its foreign currency reserves and use a share to support the domestic currency.

One should note that a survey of 100 senior executives in the Lebanese industrial sector identified exchange-rate fluctuations in the past

as one of the determinants for the limited industrial productivity and competitiveness of the Lebanese industry. More precisely, 56% of respondents considered exchange-rate fluctuations as the most important cause for the deterioration of competitiveness since it brought a higher cost for imported raw materials. On the opposite side, only a share of 12% considered exchange-rate fluctuations to improve « competitive positioning » in export markets (Byblos Bank, 2011).

## II. Economic Policy and Macro expectations

### 1. Main developments

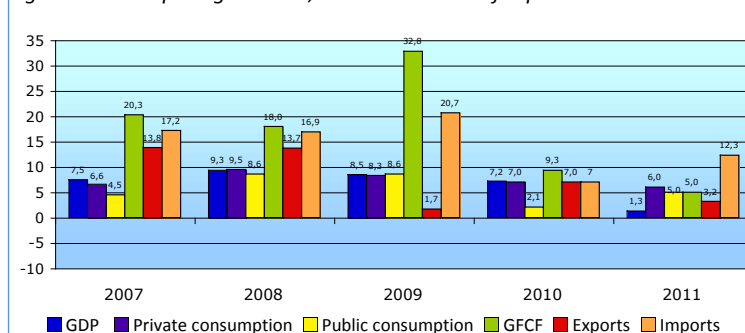
#### 1.1 Economic activity to be impacted

The economy expanded at an impressive of 7.2% in 2010, though lower than 2009's 8.5%, but higher than most neighbouring mediterranean economies. The slight moderation in GDP growth was driven by a sharp fall in gross fixed capital formation growth to 9% in 2010 down from above 30% and while imports also declined (to 7% from 21%), exports rebounded to 7% from almost 2% last year.

Growth seems to have eased in early 2011 following rising the domestic political unrest that gripped the country during the first half of the year, in addition to the effects of the regional uprisings across the Arab world, particularly from Syria. The domestic

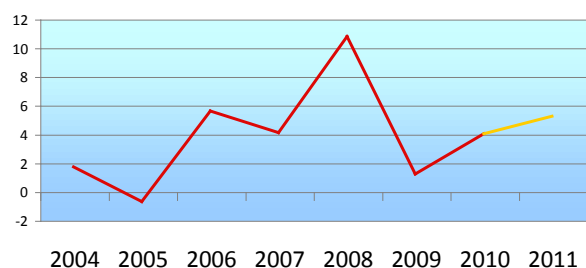
developments have weighed on consumption and investment and the regional unrest weakened Lebanon's export performance. Lebanon's economy is largely dependent on tourism, banking and construction all of which have already weakened in the first half of 2011. For the first two months of 2011, tourist arrivals were down by 13% over the same period of 2010 and property sales (a

Figure 4. Decomposing demand, annual variation of expenditure to GDP



Source: EIU:

Figure 5. CPI Inflation (av., %)



Source: EIU

measure of construction sector activity) declined by 18.7%.

Taking into account regional and domestic developments, economic activity is expected to slip in 2011 to 1.3% in 2011, far below the rate of 7.2% in 2010, placing Lebanon among the slowest-growing economies in the Mediterranean region. The services sector is expected to continue to suffer from regional knock-on effects.

## 1.2 Inflation is on the rise but remains moderate

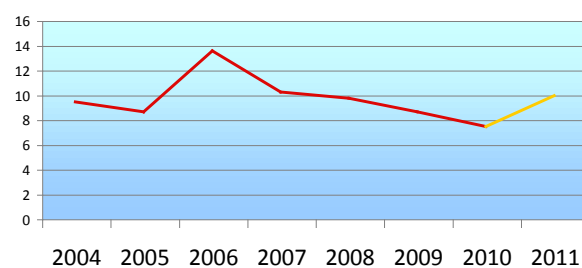
After dropping sharply in 2009 in tandem with lower world commodity prices, inflation picked-up again to around 4% in 2010. It has continued its upward in 2011 on the back of rising international food and energy prices, on which Lebanon is entirely dependent in terms of imports. In fact, CPI inflation is currently (August 2011) around 5.5% with energy and food prices rising respectively by 14 and 6%. However, other CPI items posted high spikes including clothing and footwear (up by 8.8%), transportation, health and education (up by around 7%). In 2011, headline inflation is projected to increase in line with imported commodity prices to 5% (see Figure 5).

## 2. Macroeconomic responses

### 2.1 Public finances

Lebanon's fiscal deficit improved for the first time since 2006, narrowing in 2010 to 7.4% of GDP from 8.6% in 2009 and from much higher levels over the period 2006-2008 (deficit was on average

Figure 6. Budget deficit (% of GDP)



Source: EIU

11%). This was mainly due to a cut in spending to 28.8% of GDP from 33% of GDP, which more than offset the decline in revenues to 21.4% from 24.4% of GDP. For the first 6 months of 2011, the deficit remain unchanged from last year, around 2.5% of GDP. However, ad hoc spending of ministries is expected to continue for the remainder of the year, adding to the deficit. The latter is thus forced to increased to 9.9% of GDP.

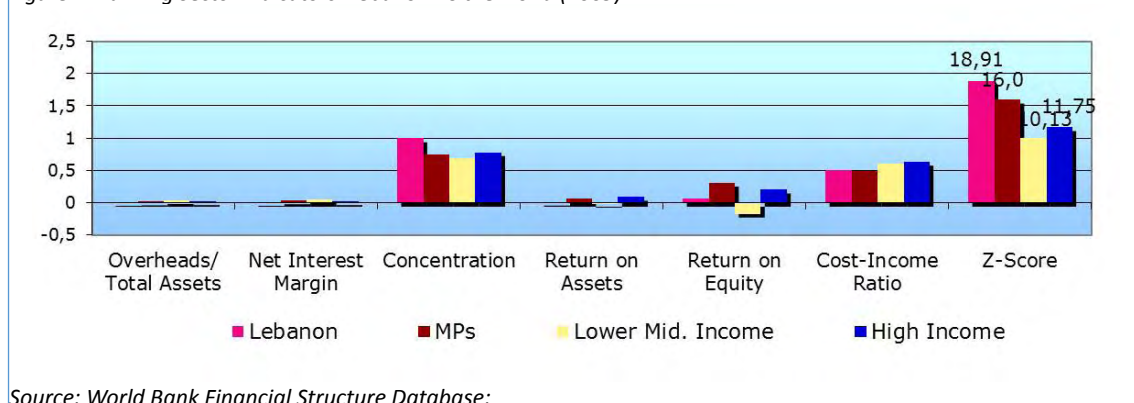
Lebanon's public debt has also declined to 133.8% of GDP from 148% last year. Much of the government's foreign debt is held by local banks, and debt servicing is in effect a form of government support to the banks—which means that Lebanon is unlikely to face contagion from debt crises elsewhere, despite having a large structural deficit and one of the world's highest debt/GDP ratios. In turn, the banks' heavy exposure to the government, and the high interest rates on offer, encourages them to keep buying government debt.

### 2.2 Monetary Policy and Banking

The monetary policy framework, centered around the exchange rate peg to the US\$, has helped to bolster confidence in the Lebanese financial system. In recent years, it has benefited from a strong leadership of the current governor. At the same time, capital inflows have led to substantial reserves accumulation to around US\$ 44.5 billion in 2010 up from US\$ 39 billion in 2009. Yet, as the Banque du Liban had to sterilize these capital inflows to maintain the peg, mainly



Figure 7. Banking Sector Indicators: Lebanon VS the world (2009)



Source: World Bank Financial Structure Database:

through the issuance of high-yielding domestic-currency certificate deposits at some cost which weighs significantly on the BdL's net income position (IMF, 2010).

Interest rates (for 3-month t-bills) have remained from last year (around 3.8%) but deposit growth has been slowing down, posting negative growth of around -1% in July and June 2011, after average growth of 29% last year. Declining interest rates have maintained healthy levels of private sector credit growth (around 17% in June 2011, lower than last year's 22%).

The Banque du Liban aims to keep deposit rates stable in the near term in order to ensure adequate liquidity. The premium of pound deposit rates over equivalent dollar rates will continue to support inflows and an ongoing de-dollarisation of deposits.

The latest data from the World Bank Financial Structure Database indicate that the Lebanese banking system is more solid than the regional average (Z-score of 18.91 versus 16 for the region) but the concentration ratio (share of the 3 largest banks' assets to total banking assets) is higher compared to the rest of the world (value of 1 in Lebanon versus 0.745 in the region) which means a need to increase banking competition. IMF (2010) has also observed that effective banking regulation and supervision, coupled with conservative bank funding and asset structures, have shielded the domestic financial sector from

the global turmoil. At the same time, conservative prudential regulations on leverage and limited bank exposure to real estate have protected banks from potential effervescence in the real estate market. In fact, bank regulation and supervision have particularly focused on preventing excessive risk taking in this regard. The BdL and the Banking Control Commission have indeed reinforced cross-border supervision and measures aimed at strengthening the oversight of Lebanese

### III. Conclusion : The Road Ahead

As highlighted by Fakhoury Mühlbacher (2009), the process of democratization in Lebanon will remain incomplete and frail to reversal if disagreements over main issues lead to deep and continuous confrontation and ambivalence about democratic institutions. Thus, it would be safer to apprehend the transition to democracy as « a precarious process whose further consolidation could be tested in the course of time » following a number of criteria. The latter would include adopting a fair electoral law, introducing substantial civil and political liberties, the possibility for full decision-making by those elected, a gradual reform of state institutions and separation of powers, rules of democracy being applied to all including the « elites » and finally the accession of the youth to the political process. As also noted by Colombo (2011), the Lebanese are used to dealing with a faulty administration while they also know that they have to coexist since there appears to be no alternative to the plurality of

the domestic society and “no immediate way out of the confessional political system that was established with the National Pact”.

All these years there were numerous factors that did not allow for advancement in democratic transition. But, with the emergence of the Arab-Spring Lebanon should grasp the opportunity : in its internal politics it should finally deal with « synchronizing its democratic and consociational faces, and more precisely clearing up lingering internal Disagreements » (Fakhoury Mühlbacher 2009). Meanwhile, authorities should provide incentives to promote private investment in strategic sectors of the economy. The tourism sector should be helped in this crucial period and be restructured for coming years in order to reduce the widening current-account deficit. If domestic parties also decide to opt for a stance of « internal cooperation » then the potential risk of capital flight will be reduced along with the probability for a political shock. But, while the Arab-Spring can initiate a new stage of development in the region, it could also translate into an additional load on the Lebanese state due to increased fears of the emergence of conservative regimes and the relations with Israel (Colombo, 2011). The main challenge will be to “maintain the country open, politically and economically, while shielding it from the destabilising effects of this openness to external influences”.

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## MOROCCO : A more democratic regime in course

In a period of political instability across the Mediterranean region, Morocco stands as a case of its own. Despite recent protests, the country has been ahead most of its neighbours in terms of democratic reforms, efficiently marrying them with its domestic growth regime. The latter has been based on domestic consumption and investment on infrastructure projects which have rendered Morocco a resilient economy with great economic potential. To Morocco's credit is the fact that it has coupled democratic reforms with a growth model that progressively relies on the knowledge economy, that has fostered more employment creation than in neighbouring MP's while at the same time inflation has become considerably manageable.

Nonetheless, the country has not been left unaffected by recent events especially that efforts for more democracy have stagnated recently. Additionally, sources of growth are still not diversified enough and youth unemployment is still high. There is no better time than the present for the authorities to deal with these issues, especially that they have the luxury of time to do so. Indeed, while some demonstrations have already taken place, both the economy and political climates have been less affected than in other economies of the region.

Some factors allow for optimism in the Moroccan case: First, despite the regional context, the Moroccan economy is expected to regain its growth momentum in the next 2-3 years with strengthening domestic demand and an anticipated rebound in external demand, provided the crisis does not worsen in European economies. Second, authorities seem to be determined to initiate measures that upgrade the domestic infrastructure, both for physical and human capital, thus providing much needed stimulus to economic growth and employment. The only major sources of concern will be those of potential inefficiency and fewer fiscal resources in the short-run, following the increase in the budget deficit.

For 2011 a rate of growth close to the 3.8% mark is expected picking-up considerably starting from 2012. With that in mind, one notes the following evolutions in the Moroccan economy:

✓ The social crisis in the region has not had any considerable negative impact on the Moroccan economy. Preliminary data for early 2011 suggests that external demand for Morocco will keep improving and exports are anticipated to rise by 13.5% in 2011.

✓ But, there is an expected 20.6% rise in imports for 2011 which means that the trade deficit is expected to worsen by an estimated 30.2% to 18.8bn US\$ in 2011 and the deficit would rise to a high of 18.9% of GDP.

✓ Tourism was feared to be affected by both the Arab-Spring and this year's cafe-bombing. But, tourist arrivals until the end of April were approximately 10% higher than in 2010. Meanwhile, the Moroccan tourism minister had highlighted that tourism receipts would increase faster since Gulf states would participate through a 14.5 bn US\$ fund to develop new resorts. In the end, it appears that in the January-July period tourism receipts rose by 8.5% to 33.1 billion dirhams.

✓ After a 10% rebound in 2010, FDI is anticipated by some to fall by 10.1% to 1.95bn US\$ (EIU), close to its 2009 levels. But even so, compared to several neighbouring MPs, Morocco is viewed as having more opportunities for investors and the advanced partnership with the EU means that investments are more likely to be long-term ones.

✓ Events in early 2011 have harmed the financial market and protests could halt the recovery since capital markets are nervous in such situations. In 2011, Casablanca bourse's two benchmark indexes, the MADEX and the MASI, have fallen respectfully by 9.01% and 9.07% in mid-July 2011.

✓ The import cover ratio remained above the 7 months mark. Early projections for 2011 suggested a slight rise in reserves following initial positive forecasts on tourism, however, the regional turbulence could bring a revision of the import-co-

ver ratio though it will probably remain above levels of 2008.

√ Two remarks could be made regarding youth unemployment. First, youth cannot wait for a job that both matches their qualifications and wage expectations. Second, they are more educated than the rest of job seekers and have higher expectations which unfortunately lead to a demand-supply mismatch. Therefore, this can explain that unemployment among the highly educated is still twice the overall unemployment rate.

√ Domestic authorities need to take into account (build on?) the productivity gains achieved in services and try to channel them towards other sectors of the economy within a consistent strategy. Moreover, there is a great need to provide the necessary incentives to orient the youth towards productive employment. A 1% increase in the public-private lifetime earnings gap is the equivalent of queuing up to 5.3 months for a job in the public sector. This means that an adjustment of public remunerations in Morocco would help avoiding a higher unemployment rate.

√ Finally, Morocco has one of the most rigid labor regulations in the Maghreb countries on both the hiring and firing side. Social partners and all interested parties should provide a new labor regulation framework, one that does not create impediments and inequalities in entering the formal labor market.

## I. The political situation and its implications

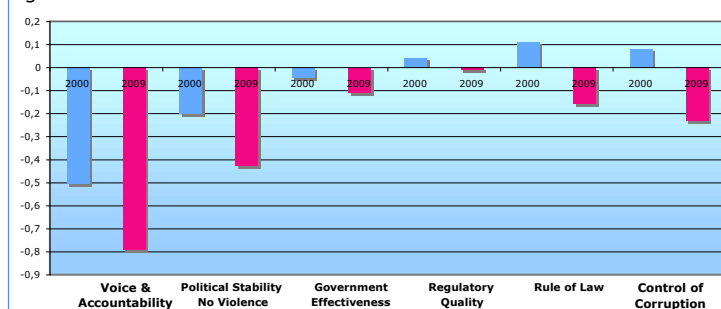
### A country ahead in terms of democracy compared to other MPs, but in need of better governance

Contrary to neighbouring MPs which currently face great political uncertainty, Morocco has already started a path to democratic openness and appears to be currently ahead of its neighbours. Democracy promotion has been ongoing for years and a series of reforms that were adopted in recent decades have made Morocco one of the most politically liberal countries of the Southern Mediterranean. While those reforms have sometimes been delayed the country did proceed to : a) implementing the premises for constitutional reforms (1996) by creating a House of Representatives elected by direct elections , the prohibition of torture and the inclusion of opposition in the government, b) personal status code reforms (Mudawana) to empower Moroccan women in marriage, divorce and civil rights issues and c) reforms on the freedom of press, on minorities rights and on decentralization.

Nonetheless, one could argue that Morocco is a monarchy where the executive, judiciary, legislative powers are still concentrated. Also, the recent upheavals in Egypt and Tunisia have not gone unnoticed by the domestic population, in early 2011 thousands of people protested throughout the country demanding, among others, for the monarchy to renounce part of its power and reform

the constitution. When looking at estimates of governance for the Moroccan case it clearly appears that in a decade the country has also receded in all indicators with conditions worsening considerably in Voice & Accountability, Political Stability and Corruption, a fact that was voiced by current protestors. Hence, the February 20 Movement for more democracy and a constitutional monar-

Figure 1. Morocco's Governance Indicators



Source : Worldwide Governance Indicators 2010, World Bank.

Note : Values vary from -2.5 (bad governance) to 2.5 (good governance)

chy might not appear unfounded and could reflect valid concerns (New York Times, 2011). Also, one could say that efforts for more democracy had stagnated. The party system has been inefficient, the monarchy elite is perceived as overly privileged and the electoral process has been met with little enthusiasm. Moreover, cases of human rights abuses have been noted and the freedom of press is seen as far from its optimum (MoroccoBoard 2010).

But then, Morocco's king ordered a drastic reform of the constitution through a referendum on July 1st, voted «overwhelmingly» by the population (hindustantimes, 2011). Thus, more powers will be given to the Parliament, human rights will be established as core principles and minorities and women will obtain more rights. Thus, the Moroccan political model appears to evolve and fortunately before the domestic situation became unsustainable. To its advantage is that, despite the existence of inequalities, its economic growth has allowed for partial reduction of unemployment. The rate of the latter has fallen below the 10% mark in recent years, below the Mediterranean average, and is not expected to massively rise in the coming years as in neighbouring MPs. The figure below suggests that the country has already passed the crucial turning point in its trajectory from an authoritarian to a democratic society. Hence, the authorities have all to gain by embracing more « pro-democracy » reforms as they have done in the past since the possibility for domestic instability is reduced. While the country still has to evolve towards « full-democracy » it can still claim that its stability is due to its progressive democratic openness and the long-term gains to be achieved are already closer than in neighbouring MPs.

Two paths are now possible for Morocco: the current regime can keep embracing democratic reforms since its long-term benefits are closer. Or it can stagnate, with a more democratic regime compared to most of its neighbours, but still too close to the possibi-

lity of upheaval which would lead to instability. The approach followed in recent months suggests Morocco is following the first path.

If successful, the Moroccan experience could even serve as an example to other countries in the Southern shore of the Mediterranean due to the fact that it consists of a marriage of democracy and Islamic concepts such as « shura » (consultation in governing between leaders and the community), « ummah » (a diverse international Muslim community that favours human rights) and ijma (consensus).

## II. Economic Cost of Recent Developments

### 1. Real sector that has not worsened but trade deficit remains high

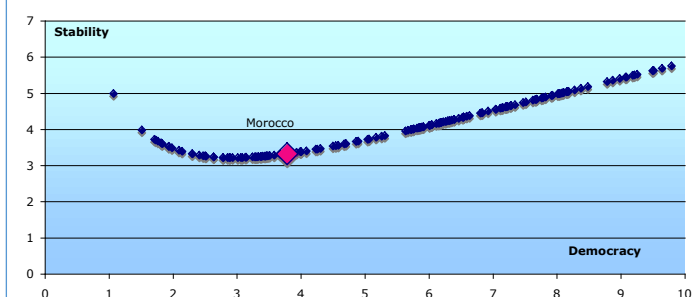
The social crisis in the region has not had any considerable negative impact on the Moroccan economy. While demonstrations have occurred in the capital and the recent bombing could be perceived as a threat to the country's stability, the economy has been less affected than in other economies of the regions, as shown by the evolution of the following main aggregates:

- ✓ An estimated increase in **goods exports** of 13.5% in 2011.

- ✓ A 20.6% rise in the **imports** bill in 2011 which would bring it to an anticipated 40.8bn US\$.

- ✓ Thus, the **trade deficit** is expected to rise by 30.2% to 18.8bn US\$ in 2011,

Figure 2. Morocco on the world J-Curve (2010)



Source : FEMISE calculations based on EIU Political Instability Indicator, Index of Democracy.

v The service balance is expected to fall by -5.6% in 2011 but tourism rose by 8.5% to 33.1 billion dirhams in the first 7 months of 2011.

The domestic economy is more open than the Mediterranean average, hence Moroccan trade benefited from the rebound in external demand especially from EU partners. This translated into a 38.26% rise in goods exports for 2010 at 19.42 bn US\$. A large share of **exports** traditionally originates from phosphates, which recorded an impressive 36.7% year-on-year increase in the first seven months of 2011. As for textile products they recorded an 8.7% rise in the same period. Meanwhile, all other export sectors saw a rise in their value with a marked increase by the electricity cables sector which rose by 21.9% . Thus, Morocco achieved a positive export-performance in the first seven months of 2011, total goods exports grew by 19% (*Bank Al-Maghrib*) and their annual rate of growth could reach 13.5% (EIU).

But, the continuous rise in exports is not expected to suffice in covering a tremendous increase on the **import-side**. One must note that, throughout 2010, commodity prices brought a 65.1% increase in food imports. It clearly reflects the serious implications of international food price increases, in the first seven

months of 2011 food imports increased by an additional 50% compared to the same period in 2010. Meanwhile, imports in energy increased by 39.1%, imports of semi-finished products increased by 20.6% while consumer goods imports also rose by 8.4%. Hence, there is an expected 20.6% rise in imports for 2011 which would bring the bill to an anticipated 40.87bn US\$.

As these trends are likely to continue over the next year, the **trade deficit**, which is expected to rise by an estimated 30.2% to 18.8bn US\$ in 2011. This means that if forecasts are verified, then the deficit would rise to about 18.9% of GDP.

Tourism was feared to be affected by both the Arab-Spring and this year's cafe-bombing. Tourist arrivals until the end of April were approximately 10% higher than in 2010 but after the attacks about 15000 people (3% of the total) had cancelled their visits. But contrary to other MPs, Morocco depends less on package tourists and relies more on independent tourists. Meanwhile, the average tourist spends about more than three times (800 US\$) than a tourist in neighbouring Tunisia. Meanwhile, the Moroccan tourism minister had highlighted that tourism receipts would increase faster since Gulf states would participate

Table 1. Trade by sector grouping, million dirhams

	January-July 2010	January-July 2011	year-on-year variation (%)
<b>Goods exports</b>	<b>83 355,00</b>	<b>99 160,30</b>	<b>18,96</b>
Phosphates and derivatives	19 134,60	26 160,40	36,72
Exports other than Phosphates and derivatives	64 220,40	72 999,90	13,67
Textiles and clothing	10 852,30	11 792,30	8,66
Electricity cables	7 297,30	8 893,30	21,87
Fabric, knitting	3 951,40	4 316,70	9,24
Electronic components	2 893,90	3 069,70	6,07
<b>Goods imports</b>	<b>171 307,50</b>	<b>205 553,60</b>	<b>19,99</b>
Energy products	37 281,90	51 871,50	39,13
Imports other than Energy products	134 025,60	153 682,10	14,67
Semi products	36 122,20	43 550,20	20,56
Food products	15 568,50	23 358,10	50,03
Equipment goods	40 609	38 933,00	-4,13
Consumption goods	32 741,20	35 490,00	8,40

Source: Bank Al-Maghrib

through a 14.5 bn US\$ fund to develop new resorts. In the end, it appears that in the January-July period tourism receipts rose by 8.5% to 33.1 billion dirhams. Meanwhile, migrant remittances increased by 8.2% to 33.3 billion dirhams (MoroccoWorldNews, 2011).

## 2. Financial Sector

Morocco is an economy with a financial system at an intermediate development stage, with a capital account not completely open and overall a step-by-step approach to liberalization of finance.

### 2.1 Uncertain impact on FDI

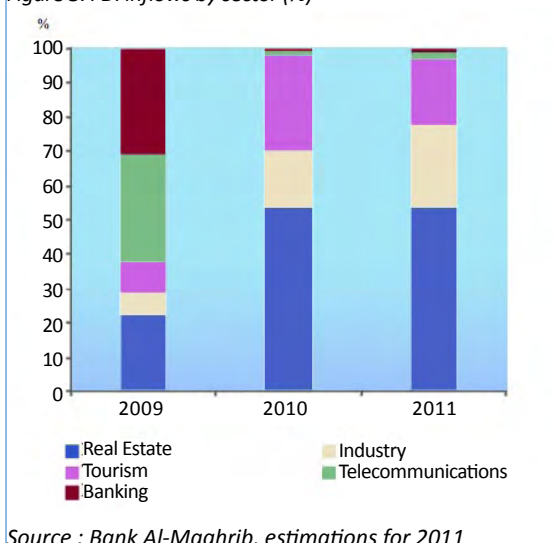
After a 10% rebound in 2010, FDI is anticipated by some to fall by 10.1% to 1.95bn US\$ (EIU), close to its 2009 levels. But even if this decrease occurs, it should be seen as a stabilization instead of a fallback. Indeed, compared to several neighbouring MPs, Morocco is viewed as having more opportunities for investors, the domestic environment being a hub for the European, Mediterranean, and African Markets. Domestic reforms led to sustainable investment growth (FDI was multiplied by 6 since the early 90s) and along with infrastructure investments they have lead to an appealing business environment. Last but not least, the advanced partnership with the EU and the fact that Morocco remains the

sole Arab country with agreements with the US means that investments are more likely to be long-term ones. Despite the regional instability, Morocco is expected to keep developing its reforms and growth to attract foreign firms.

### 2.2 Stock Markets' upward trend interrupted

Recent events have proven harmful to an otherwise well-performing market. In the last quarter of 2010, the MASI index grew by 6.4% compared to the previous quarter, to a 21.2% annual performance. The market was expected to keep following an upward trend throughout 2011, in February it had already appreciated by 1.7% with a 1.2% market performance since the beginning of the year. But, among other reasons, the bombing that targeted foreign tourists appeared to have interrupted that trend. As for the MADEX Free Float Index, it used to be close to the 10,500 mark in early March before falling by 3.5% and finally reaching a value of 9,694.51 after the April attack. In mid-July 2011, the MADEX and the MASI indexes have fallen respectfully by 9.01% and 9.07% (Yacout.Info, 2011). Whether Moroccan indices will fully recover remains to be seen. Recent protests might halt the recovery since capital markets are nervous in such situations. In all cases, the initial euphoria of early 2011 appears to have dissappeared, hence, it could take some time for market activity to get out of its current state.

Figure 3. FDI inflows by sector (%)

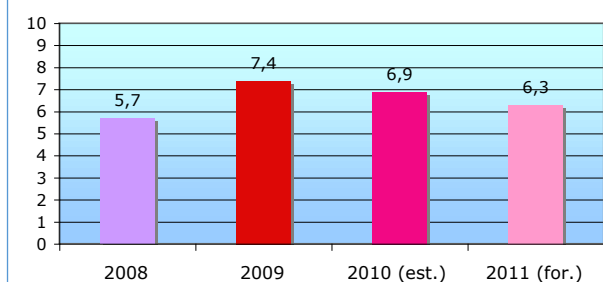


### 2.3 Foreign Reserves and Debt Indicators expected to remain stable

Foreign currency reserves had reached 7.4 months of imports in 2009, and the import bill was reduced which alleviated pressures on foreign exchange. Imports rose in 2010, thus the import cover ratio reached the 6.9 months mark. Net external reserves progressively grew in 2010 and in early 2011 their outstanding amount increased by an annual rate of 6.7% following the rise in tourism receipts. But the massive rise in imports for 2011 has lowered expectations for the import ratio to 6.3 months of imports, des-



Figure 4. Foreign exchange reserves (in months of imports)

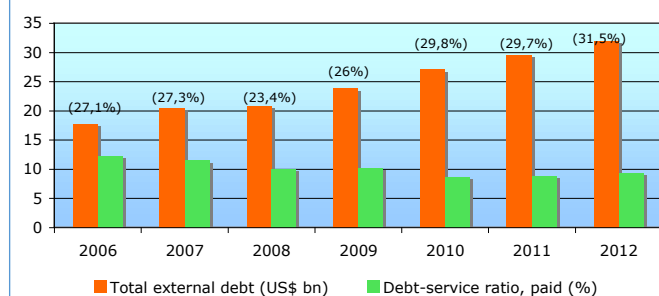


Source : COFACE

pite positive forecasts on tourism. Fortunately, despite the regional turbulence the ratio will remain above its pre-crisis levels of 2008.

As for Moroccan debt, external debt for 2010 increased to 27.1bn US\$ which corresponds to an increase in percent of GDP from 26% in 2009 to 29.8% in 2010. In 2011, total external debt could reach 29.6bn US\$ which is roughly equal to last years level in terms of GDP (29.7%).

Figure 5. Debt Indicators in Morocco, external debt as % on GDP in parenthesis



Source : EIU

As for the debt service ratio, it stood at 8.7% in 2010, down from 10.2% in 2009, well below its pre-crisis levels. Forecasts point towards an increase in 2011 to 8.9% before stabilizing. The overall levels of debt increased since September 2010, a time when Morocco resorted to the international market, and one should note that political tensions in the region could result in upward pressures on risk premiums. Even so, the current growth regime and the determination of authorities control the fiscal deficit should maintain the public debt below 70% of GDP in the coming years.

### III. Economic Policy and Macro expectations

#### 1. Main developments

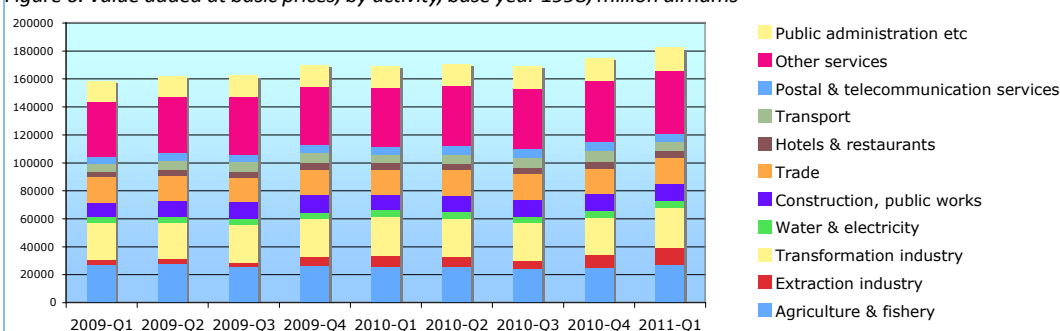
##### 1.1 Economic growth partly hindered in the post-crisis context

In 2010, following the still frail external demand, Morocco achieved a 3.7% rate of growth, below initial forecasts and lower than the regional average of 4.9%. Once again, this stresses how the country needs to diversify its sources of growth, the deceleration in GDP growth being correlated with the 5.13% fall in the agriculture & fishery sector for 2010. It was a year where agricultural harvest faced unfavorable weather conditions, the 2009/10 cereal harvest falling by more than 25%, coming on the heels of a spectacular 2009 where the agricultural sector had grown by approximately 30%.

The non-agricultural economy needs to grow and authorities should focus on higher value-added sectors and foster more productivity. Currently, Moroccan growth also relies on other services and commerce, the former grew year-on-year by 6.1% in the first quarter of 2011 while the latter met a 5.8% rise in the same period. Other sectors such as extraction (+39.5%), hotels & restaurants (+9.2%), postal, telecommunication services (+5.8%) and the construction sector (+3.2%) also grew. The trade sector is also expected to benefit from the upward path followed by nonagricultural activities. Furthermore, the transportation sector is expected to grow following the 7.1% growth in the fourth quarter of 2010 and 7.2% in the first quarter of 2011. More specifically, air traffic grew by 15.1% in end 2010 and kept its pace at 15.3% in January 2011 (Bank Al-Maghrib).

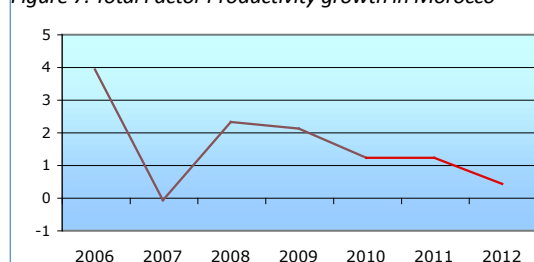
Expectations for 2011 suggest a rate of growth close to the 3.8% mark, above the regional average anticipated at 2.6% in 2011, before rising above 4% starting from 2013 (EIU). The export-led industry is expected to be fueled by the new

Figure 6. Value added at basic prices, by activity, base year 1998, million dirhams



Source : Bank Al-Maghrib

Figure 7. Total Factor Productivity growth in Morocco



Source : EIU, estimates for 2011, 2012

Renault car-assembly plant while the port of Tangiers is expected to contribute to services-induced growth. Even so, the 2011 rate of growth will still be well below the 2000-2008 Moroccan average (close to 5.5%) and even further than the level needed to reduce inequalities and foster employment. In that respect there is imminent need for Morocco to fully embrace a productivity-led regime.

#### Box. The beneficiaries of Moroccan employment creation

During the last decade, the annual average employment creation amounted to 156,000 job positions, bringing the volume of employment from 8.845 million in 2000 to 10.405 million in 2010.

The beneficiaries of the new creations are mainly:

✓ Men, with 118 000 jobs created annually versus only 38 000 for women,

✓ Adults aged 40 to 59, benefit from 112 000 new jobs annually, meanwhile, those aged 15 to 29 annually lose 9000 jobs;

✓ The services sector created 84 000 jobs annually during the last decade followed by the construction sector (48000 and 63000 annually in the two years since 2008);

✓ Urban regions, have profited from 1.08 million new jobs versus only 480 000 for rural regions;

✓ Regions that are main contributors to production value and GDP include Casablanca (contribution of 21.3% to GDP and 28 000 jobs annually created).

Source : Haut-commissariat au Plan

In last year's report, FEMISE stressed how the Moroccan economy gradually gained in efficiency to reach a positive productivity growth rate through the first half of the 2000's. But, as shown by figure 7, total factor productivity growth in recent years has been relatively inconsistent, estimates show that after being close to 4% in 2006 it turned negative -0.1% in 2007, bounced back to a 2.2% average in 2008-2009, before falling again at 1.2% in 2010 and 2011. Morocco needs to strengthen its growth regime, favoring a firm structure that maximizes productive potential, allows for better transfers of technology and builds upon a skilled labour force. The country can achieve these goals by developing higher value-added products straying away from its agricultural dependence.

#### 1.2 An unemployment rate that has stabilized well below the Mediterranean average

The unemployment rate in Morocco was at the 9.1% mark in 2010, lower than the regional average of 10%. Efforts have been conducted but, as we will discuss in a latter section, more needs to be done regarding the youth where most of the unemployed are concentrated. The rate of unemployment in recent years has

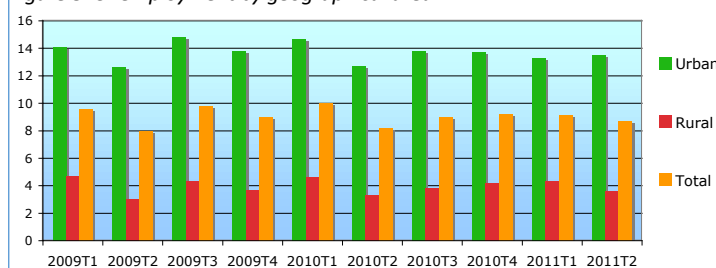
seen a spectacular decrease. It fell from a 14.4% average in the 2000-2007 period to 9.6% in 2008, 9.1% in 2009 and remained at that level in 2010. Urban areas suffer from the highest rates, though unemployment fell drastically, from 21.4% in 2000 to 13.5% in end-June 2011, following several employment creation initiatives.

As for rural unemployment, it attained 3.6% in mid 2011, however one should note that underemployment, a frequent phenomenon in such areas, is usually higher than in the urban land. The highest rates of unemployment are in the regions of l'Oriental (18% in 2010), Rabat-Salé-Zemmour-Zaer (12.2%) and the three regions of southern Morocco (11.4%). Meanwhile, Marrakech-Tensift-Al Haouz (5.8% in 2010), Taza-Al Hoceima-Taounate (6.1%), Fès-Boulemane (6.1%) and Tadla-Azilal (6.2%) are among the least affected regions.

Contrary to other countries in the region, the gender issue in employment does not appear to be as marked as in neighbouring MPs. In mid-2011 the unemployment rate among women reached a rate of 9.7% versus 8.4% for men a fact that mirrors the efforts that have been conducted in creating a society of equality among both sexes, one that could serve as an example at the regional level.

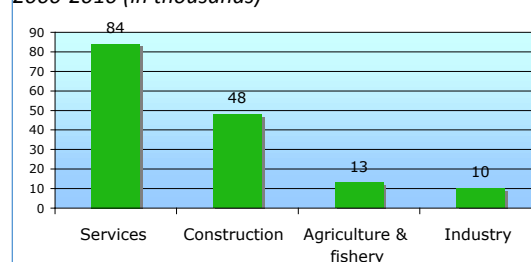
In the end, unemployment is expected to remain close to last year's levels in 2011, slightly increasing to 9.2%. However, the unemployment issue, while not as dramatic as in neighbouring MPs, is still a very serious one. According to domestic authorities, to maintain the unemployment and activity rates at its 2010 level Morocco should create an additional 17000 jobs per year in the next two deca-

Figure 8. Unemployment by geographical area



Source : Haut Commissariat au Plan

Figure 9. Average annual employment creation by sector, 2000-2010 (in thousands)

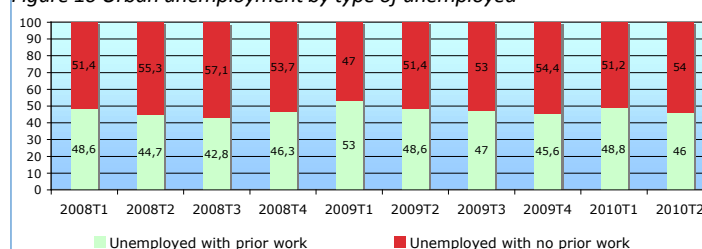


Source : Haut Commissariat au Plan

des. But, if Morocco's activity rate were to attain its level of 1999 then the domestic authorities would need to create about 92000 additional jobs per year.

All indications point to the fact that the country needs a new model for growth, one that integrates the economy in the global context, in sectors such as renewable energy and manufacturing in which Morocco can have a comparative advantage. The gains in infrastructure would allow for the creation of decent jobs and most importantly for better income distribution among the workforce. But, a valuation of human resources is needed and education and training need to be used more efficiently in the coming years since currently, as we will later see in detail, Moroccan

Figure 10 Urban unemployment by type of unemployed



Source : Haut Commissariat au Plan

students are below average regarding knowledge skills.

## 2. Macro reaction : Decelerating growth and increased fiscal pressures but expected return to trends starting 2012

### 2.1 Economic activity that will still rely on private and public consumption

In recent years, public consumption has contributed in sustaining Moroccan growth. Right after the 2008 crisis it registered a real increase by 12.1% in 2009, it fell in 2010 by 0.9% while it is expected to grow in 2011 (by an estimated 5%). Public works following the international turmoil have been used as a means to sustain growth and employment creation in sectors such as tourism, allowing for the rise in the GDP to be near 3.7% in 2010.

Even so, private consumption grew a lot less than in prior years (only 2.2% in 2010 and is expected to grow by 4.5% in 2011). However, there are reasons for optimism for the near future following the rise in nonagricultural activities but also the recent increase in remittances.

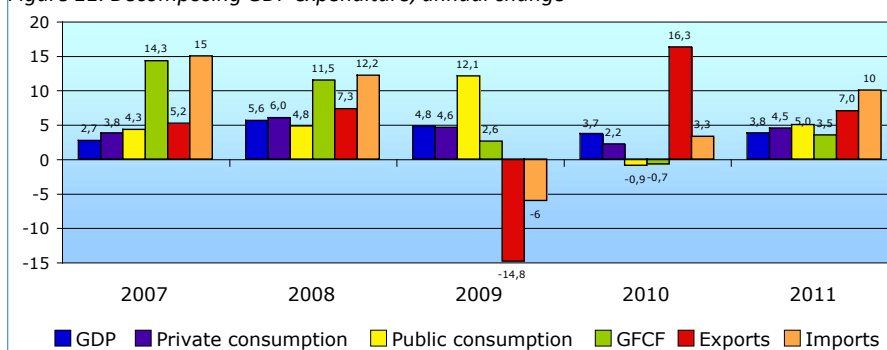
peaks since external demand from the EU will not have not fully recovered.

### 2.2 A fiscal balance close to the regional average, that still allows for some maneuvering

After the international crisis, increased fiscal spending brought the once balanced public finances (+0.4% in 2008) to a deficit of 2.2% in 2009, and 4.7% in 2010 and now an estimated -6% in 2011 following plans to increase subsidies on basic commodities by almost 100%.

Even so, contrary to high deficits in neighbouring Egypt and Tunisia, Morocco still has possibilities for aligning its a fiscal position with the Mediterranean average. While there are no plans for any tax increases in the new budget, authorities expect revenues to increase along with growth. As for the subsidy system, plans to reform it, will be delayed

Figure 11. Decomposing GDP expenditure, annual change



Source : EIU

Investment growth, while important, will have difficulties matching the pre-crisis rate of growth (14.3% in 2007 and 11.5% in 2008) and the current regional political climate might partially affect the attractiveness of Morocco as an investment destination bringing in investment growth to an estimated 3.5% in 2011, still above the levels of 2010. Public investment is expected to increase and be essentially ventilated in the phosphate, renewable energy and basic infrastructure sectors (Bank Al-Maghrib).

Finally, export performance will probably keep improving though it will hardly parallel its previous

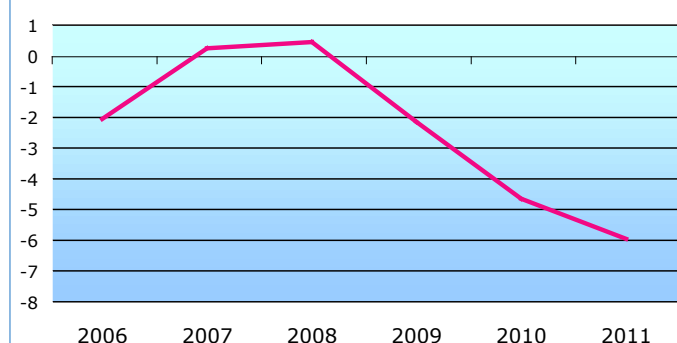
in order to ensure that political stability is not threatened following regional turmoil.

### 2.3 Monetary Policy that is always flexible

It has been more than 2 years since the last time Bank al-Maghrib changed its policy rate, currently at 3.25%. Inflation forecasts remain low, in line with the Banks' objective of price stability, which explains why the key rate has been left unchanged.

The Moroccan banking system appears to be more solid than the regional average (Z-score of 22.0 ver-

Figure 12. Budget Balance, % of GDP



Source : EIU

sus 16 for MPs), the country has a ratio of return on equity similar to that of high income countries but the concentration ratio (share of the 3 largest banks' assets to total banking assets) is higher compared to the rest of the world (1 in Morocco versus 0.745 in the region) which can mean that there is a need to increase competition. Monetary authorities efficiently dealt with liquidity concerns in the domestic banking system, in end-2010 the liquidity shortage of Moroccan banks was narrowed to 13.9 billion dirhams from 23.4 billion dirhams in the third quarter. This was achieved primarily through Treasury operations which provided a much needed liquidity injection of 12 billion dirhams. In the first two months of 2011 liquidity further improved and went to 10.1 billion dirhams due to interventions to counter pressures on the weighted average rate. Bank Al-Maghrib intervened through 7-day advances, with an average daily amount of 9.3 billion dirhams, meanwhile, the central bank provided additional liquidity through an overnight advance of 3.6 billion dirhams. However, in Q2-2011 the deficit of banking treasury had increased to 21.6

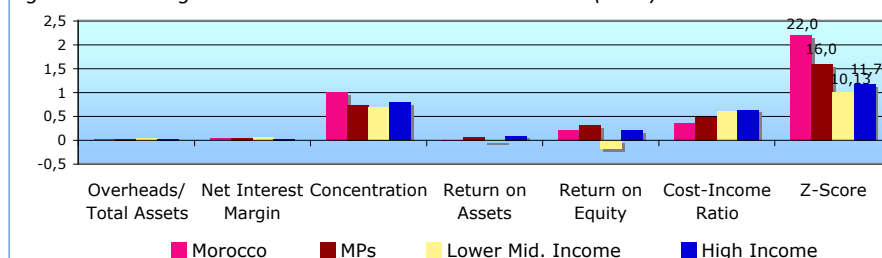
billion dirhams, with autonomous factors exerting a restrictive impact on banking liquidity equal to 11.9 bn dirhams.

As for the exchange-rate regime, the managed float vis-a-vis a basket of currencies (mainly comprised of euro) was maintained to keep inflation at low levels. In end-2010, the dirham depreciated by 0.92% against the euro. As for 2011, the dirham is expected to follow the trends of the Euro and allow for Moroccan competitiveness to be maintained. Overall, the flexible nature of the Moroccan monetary policy allows it to not contradict or impede growth.

**IV. The youth issue**

Economic growth increased from less than 2% in the late 1990s to 5.1% in the 2000-2007 era and 5.6% in 2008. Even so, employment creation did not reach its full potential and Moroccan youth unemployment remains an important issue, unemployment in Morocco for the 15–29 demographic age group is around 17.6 percent in 2008. While

Figure 13. Banking Sector Indicators : Morocco VS the world (2008)



Source : Ben Naceur et al (2011)

this rate is below what is observed in neighbouring countries such as Tunisia, youth unemployment represents 62% of the total unemployed.

**1. Insufficient employment creation, high urban joblessness rate**

As depicted, in terms of unemployment the 15-24 age group is the most affected (16.2% in the first quarter of 2006, now 17.4% in mid2011), followed by the the 25-34 age cohort (14.1% in

Table 2. Exchange rate

	August 2009	August 2010	August 2011
Dh:US\$ (av)	7,9	8,57	7,86
Dh:€ (av)	11,26	1,07	11,27

Source: EIU

the first quarter of 2006, now 12.8% in mid2011) while those in the 35-44 age range come as a distant third (stable at 5.1%).

In Morocco, two remarks could be made regarding youth unemployment. First, youth can not wait for a job that both matches their qualifications and wage expectations. Second, they are more educated than the rest of job seekers and have higher expectations which unfortunately lead to a demand-supply mismatch. Therefore, this can explain that although unemployment among the highly educated fell from 29% in 2001 to about 20% in 2008 (see Achy, 2010), it was still twice the overall unemployment rate.

As noted by Achy (2010), the labor force expansion has been puzzlingly slow, each percentage point of economic growth only brought 0.34% growth in employment which is lower than what is observed in Tunisia for instance (0.55% growth in employment). The author suggests that the explanatory factor is to be found in the fact that average labor productivity in Morocco increased by a phenomenal annual rate of 3%, but, productivity gains only benefited few private sectors agents mostly of the service economy (transport & telecoms, banking and insurance etc) that took advantage from technology transfers. In the rest of the economy the situation is characterized by an uneven performance especially in agriculture which is a sector responsible for about 40% of jobs.

Thus, domestic authorities need to take into account the productivity gains achieved in services and try to channel them towards other sectors of the economy within a consistent strategy. But the latter should not only focus on sectors, it should take into account territorial characteristics of the youth issue as well. It appears that youth unemployment is mostly an urban phenomenon and while the unemployment rate for the youth in urban areas has declined in recent years, it still remains considerably high. Again, the 15-24 age group is the most affected despite recent efforts (37.8% in

#### **Box. Understanding the evolution of the Moroccan labor-market and its relation towards the youth**

✓ The demography of the population is slowly evolving, the total population stood at 30.9 million s in 2006, rising to an estimated 32.3 millions in 2010 and anticipated to reach 34.5 millions in 2015.

✓ Moroccan GDP grows at an uneven pace, for example it grew by 5.1% in 2004, by 3% in 2005, b 7.8% in 2006 and 2.7% in 2007, a trend that is partly related to agricultural dependence and fluctuating weather conditions. Implications for employment are that such growth trends cannot fully meet increasing labor demand.

✓ Unemployment has the following characteristics in Morocco: it is mostly urban, mostly youth-oriented and especially affects the educated.

✓ The labor-market is subdivided into a formal and an informal market. The first is regulated by the government, the second has no specific rules and is unproductive and non-responsive to investment in human capital.

✓ In the domestic market, a workers dismissal can only occur for disciplinary reasons, not for economic ones.

✓ Work experience is greatly appreciated by employers, contrary to prior training, something that naturally penalizes the youth.

✓ The Moroccan youth tends to find an employment through their own social networks (family, acquaintances etc). Meanwhile, family is a great financial resort for the unemployed since no formal unemployment insurance exists.

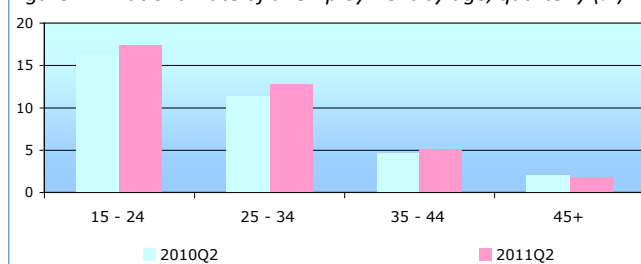
✓ unemployment has brought considerable depreciation to the human capital and migration phenomena to more developed partners.

✓ Domestic authorities have tried to tackle the issue of unemployment in the qualified youth population (programme Action-Emploi, CJNA, ANAPEC, etc) with varying degrees of success.

Source : Schonholzer J. (2008), EIU (2011)

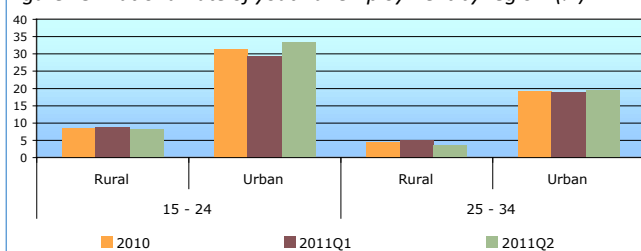
2006, 33.4% in Q2 2011), followed by the the 25-34 age range (30.2% in 2006, 19.5% in mid2011). Meanwhile, unemployment in rural areas has been below the average rate, at 8.1% for the 15-24 age cohort and 3.7% for those aged 25-34.

Figure 14. National rate of unemployment by age, quarterly (%)



Source : Haut Commissariat au Plan

Figure 15. National rate of youth unemployment by region (%)



Source : Haut Commissariat au Plan

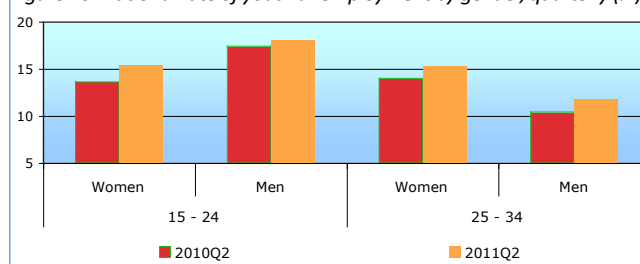
As for gender issues, they appear to play a less significant role within the youth, that is compared to other countries at a similar development stage. Young women aged between 15-24 are less affected than men, even though one should note that unemployment has recently risen faster within the young female population (13.2% for women versus 17.2% for men in early 2006, 15.5% for women versus 18.1% for men in Q2 2011). In the 25-34 age range however, women are more affected, unemployment being at the 15.3% range in mid2011 versus 11.8% for men.

On the whole, unemployment appears to be mostly youth-oriented, of urban nature and also affects the most educated. The latter point merits special attention and will be studied in the following section.

## 2. The youth issue and education

It is a fact that, as in other MPs, there is a high level of unemployment across the educated population in Morocco. There are reasons to believe that this is not only due to insufficient employment creation in qualified fields, but, also due to the poor quality of the education system.

Figure 16. National rate of youth unemployment by gender, quarterly (%)



Source : Haut Commissariat au Plan

An international assessment of the math and science knowledge of fourth grade students shows that Moroccan students are below average in both math and sciences (scores under 400 signify only basic knowledge is acquired). Furthermore, as Achy (2010) notes, only 6.7% of post-secondary students in Morocco are enrolled in engineering versus 15% on average in developing countries. Indeed, Moroccan students tend to be oriented towards social sciences and law creating the unwanted undersupply of skills necessary for the private sector to flourish.

As noted by FEMISE (2008), access to education was long constrained in the 1990s, among others, by the predominance of sociological perceptions in limiting literacy and schooling. Now, basic education is still compulsory and provided at zero cost by the government and contrary to neighbouring MPs. Paradoxically, more than a-quarter of the national budget is attributed to education while the adult illiteracy rate, especially among girls, remains among the highest (Achy, 2010). In addition, access to vocational training strengthens the unequal access to education. By perpetuating significant weaknesses in terms of literacy and by accumulating the negative effects of low levels of enrollment in secondary and tertiary education, Morocco did not properly enforce the education-training sector. Meanwhile, increasing migration of skilled workers were determined by the globalized nature of certain segments of the labor market. Later on, professional training did contribute to both the improvement of the qualification rate while facilitating the education-economy linkages, but, with mixed results and a lot of issues still in need of



strengthening among which those related to youth unemployment.

One needs to look at potential determinants of employment access for the Moroccan youth who graduated from the vocational training system, according to Schonholzer (2008), two elements are of crucial importance in the Moroccan case. First, the age of the graduates is found to be negatively correlated to job access, hence, younger graduates appear to have a higher probability of getting a job which is something that may appear contrary to pre-concieved ideas. It could be that the jobs obtained are under-paid and require little qualification but the study does not dig into more detailed analysis. Second, employment appears to be linked to the profession of the graduates' father. This can be interpreted in many ways, it could mean that family connections can act as a facilitator in finding a job, it could also mean that the children of senior executives have been raised in a safer financial environment, one that values education and obtaining a qualified job.

It is overall clear that there is a great need for an educational and vocational training reform in Morocco from which employment would benefit. But at the same time, there is a need to provide the necessary incentives to orient the youth towards productive employment. In a relevant article, Boudarbat (2008) finds that earnings and unemployment durations have a considerable impact on employment selection. The

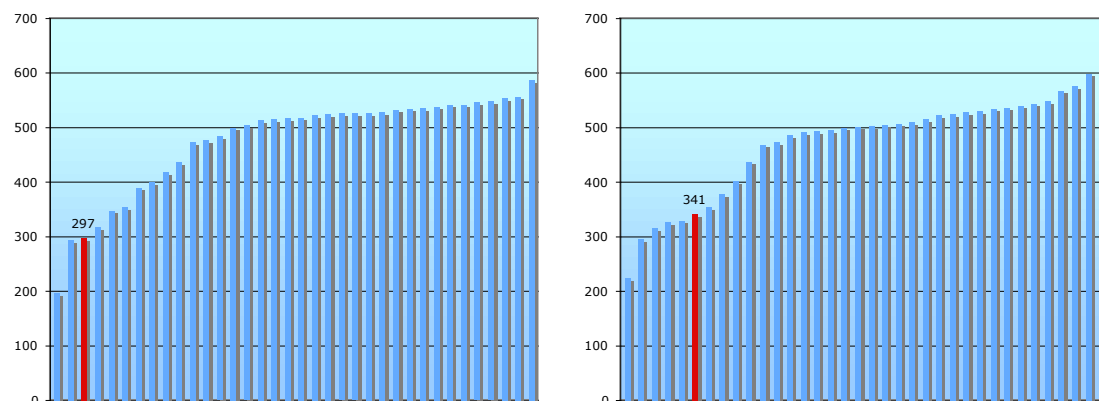
author finds that the wage premium of the public sector (initial hourly wages gap) is close to 42.5%, hence, a 1% increase in the public-private lifetime earnings gap is the equivalent of queuing up to 5.3 months for a job in the public sector. This means that an adjustment of public remunerations in Morocco would be in order to avoid a higher unemployment rate.

### 3. What policies for the youth ?

After recent protests, authorities proceeded to the recruitment of over 4,000 PhD students within the public sector. Even so, this could be only characterized as a temporary solution. Short term emergency programs can allow for the integration of the unemployed Moroccan youth, in sectors such as public works and construction, but the most important are the long term ones, in other words policies that foster an employment-intensive growth regime. Focusing on ICT related sectors should be the way to progressively inverse the tendency that wants students to go to less « growth-carrier » sectors.

The Bank al-Maghreb Governor recently stated (Magharebia, 2011) that Morocco should open up both the public and private sectors to the youth, providing the necessary skills all the while reforming the vocational training system. This seems logic as suggested by previous sections, a reform in the educational and training systems is of great importance in the Moroccan case since the quality of the education provided

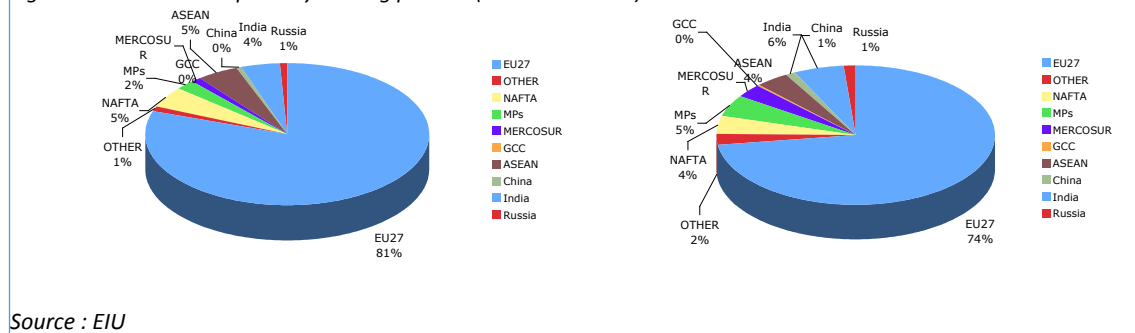
Figure 17. Average science and mathematics scale scores of 4th-grade students, Morocco VS the World: 2007



Source : IES, National Center for Education Statistics, U.S. Department of Education



Figure 18. Moroccan exports by trading partner (2000 AND 2009)



is low and creates an education-employment mismatch. Currently, less than 20% of formal manufacturing firms provide training to their employees, versus 50% in the developing world (Achy, 2010).

One should also not forget that limited jobs in the private sector greatly contributed to youth unemployment. Hence, as also suggested by Boudarbat (2008), more investment in human capital is needed. It appears that authorities plan on going towards that path. The ministry of finance announced that measures to train young people while providing them income during training. Furthermore, negotiations with businesses are expected to start on the recruitment of graduates at the end of their training (targeting 150000 new jobs in 2011, 30000 more than in 2010).

Finally, there is a labor market regulation issue to be dealt with. Currently, Morocco has one of the most rigid labor regulations in the Maghreb world and that is on both the hiring and firing side. But all these regulations do not concern the agricultural workers or those of the informal sector, who represent the majority of workers (70% of wage earners in Morocco do not have an employment contract according to Achy, 2010). Hence, social partners and all interested parties should provide a new labor regulation framework, one that ease entry to and reduce inequality the formal labor market.

#### IV. Concluding Remarks

The country is steps ahead of its Mediterranean neighbours since it has married democratic reforms with

its growth model. Moreover, despite the regional context, the economy is expected to regain its growth momentum, expecting a rate of growth close to the 3% mark in 2011 before growth picks up considerably later on. Finally, the rate of unemployment has fallen below the Mediterranean average and is not expected to rise in the coming years.

But, if the regional socio-economic crisis has taught us anything it is that countries that were labelled stable are often more fragile than what they seem. Hence, in the Moroccan case authorities should take all necessary measures to avoid a contagion of sorts inspired from the Egyptian and Tunisian events.

#### With that in mind :

√ First, as already noted by FEMISE in earlier reports, the country should embrace a model that allows distributional shifts in favor of the poorest quintiles which appear to have benefited the least from growth.

√ Second, it should follow an educational and vocational training reform to further combat youth unemployment all the while providing greater incentives to orient the youth towards productive sectors that will carry future growth.

√ Third, authorities should sustain investment in the tourism sector to counterweigh a possible impact from recent happenings through various infrastructural projects that also sustain employment. They should also allow for FDI projects to emerge throughout the territory and avoid concentration of foreign capital in limited

urban regions. Currently, Casablanca represents more than a third of announced FDI projects but Tangiers and Rabat have been gaining wait, respectively with 12% and 8% of FDI announcements in 2010 (ANIMA).

✓ Last but not least, the trade deficit risks to escalate massively which means the country should rethink its openness strategy to allow for further diversification. The truth of the matter is that the EU still represents about three quarters of Moroccan trade and there is still great potential to diversify. For instance, trade with the NAFTA region only represents 4% of Moroccan exports (down from 5% in 2000) while trade relations with big markets such as China and Russia roughly represent a total of 2%. Further trade diversification would mitigate the fall in EU demand and partially shield Morocco from external shocks.

#### Notes:

1. The J-curve approximation is obtained plotting the «political instability index» (EIU) to the «index of democracy 2010» (EIU).

We obtain a quadratic equation that represents a simplified relationship between the two indexes and takes the form of :

$$Y = 5.2547 - 8.7419 * \ln X + 9.3128 * \ln X^2$$

where X is the EIU democracy indicator of 2010 and Y the inversed political instability index (political stability)

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## SYRIA: Is there potential for an Arab Spring?

### Introduction

While most Mediterranean countries witnessed a relative rebound from depressed growth rates in 2009, this did not happen in Syria, following a poor harvest which affected the growth of its agriculture sector. Encouraged by uprisings in Egypt and Tunisia, and fuelled by discontent with severe political repression, demonstrations broke out in Syria as of last March. To date, the government has offered limited political reforms to the opposition and has resorted to violence to crackdown on the protestors.

Clearly, the political unrest has led to disruptions in usual business activities but there have not been sufficient data releases to support this. Nevertheless, forecasts for the year 2011 are as follows:

- ✓ GDP growth is forecasted decline to -2% (IMF estimate), following political turmoil,
- ✓ Exports and imports (volume) are expected to contract respectively by 2.6% and 11.8% according to IMF,
- ✓ The current account deficit is expected to quadruple to 4% of GDP from around 1% in 2010,
- ✓ Inflation is expected to increase from 4.4% in 2010 to 6-7%, following the rise in international commodity prices,
- ✓ The fiscal deficit is expected to double to 8% of GDP, following revenue losses,
- ✓ Heavy withdrawals in private deposits (by about US\$1.4 billion) lead the central bank of Syria to impose some foreign exchange controls,
- ✓ The official exchange rate has remained surprisingly stable but the black market has reappeared with a premium of almost 15%.

### I. The limitations of the political economy model

Syria has been governed by the Baath party since 1963 which, for most of that time has, in turn, been dominated by the Assad family and

associated members of its Alawi sect. Syria enjoys limited options for political participation and restrictions to civil liberties. Some reforms were initiated since the mid-1980s but they never dealt with domestic politics, despite presidential promises to do so (Aita, 2006 and Colombo, 2011).

Unlike many neighboring countries, Syria had already witnessed some political unrest in the early 2000s, emanating mainly from the civil society with demands of freedom of expression, and in 2005, calling for political change. All such movements were met with strong repression (Colombo, 2011).

Syria seemed to be somewhat initially insulated from the wave of popular uprisings in the Arab World initiated in the beginning of 2011, largely because the government imposed a very tight control on freedom of expression, especially through internet websites and social media platforms (Colombo, 2011). The initial reaction of the Syrian president to the first uprising in Tunisia was to express sympathy, then like Jordan and Morocco, to offer some concessions and superficial reforms as a means to preempt an escalation of the domestic situation in Syria. These included lifting the ban on Facebook last February, in addition to offering some political reforms comprising the abolition of the 1963 emergency law, scrapping the Supreme State Security Court and passing a law entitling people to hold demonstrations, subject to their obtaining a license from the Ministry of Interior.

However, the wave of anti-government unrest eventually hit the country since March 2011. Colombo (2011) explains that while uprisings in neighbouring economies had a role in triggering the same incidents in Syria, others factors of “unsustainability” may have played a role like widespread corruption, the increasing gap between the ruling elite and the population. According to EIU (2011), President Assad has continued to offer some political reforms, though

limited, such as appointing a new government and approving new election and political parties' laws that respectively regulate elections through a new independent commission and allows the founding of independent political parties. The president is also making promises for new parliamentary elections in February 2012 and on local government reforms.

Yet, as these actions were deemed insufficient, Syrians have gathered a stronger momentum following stronger mobilization through text messages and postings on social media platforms, and were able to break their historical fear of the security forces. In reply, the regime has led a most aggressive crackdown against protestors, with a death toll estimated at 2200, many more wounded, and an estimated 8,000 arrested, since the uprising until August 2011. Moreover, it was reported that roughly 10,000 refugees from Northern Syria had crossed into Turkey, fleeing the army last June (EIU, 2011).

### 1. Political instability will be endured, if Syria were to « break free »

The J-curve below suggests that countries that have authoritarian regimes are generally stable and when opening-up their regimes to democracy, they enter a short phase of instability before reaping the benefits of a more democratic economy and institutions. Figure 1 shows that Syria's position on the left hand side of the curve, which is before the turning point, thus making

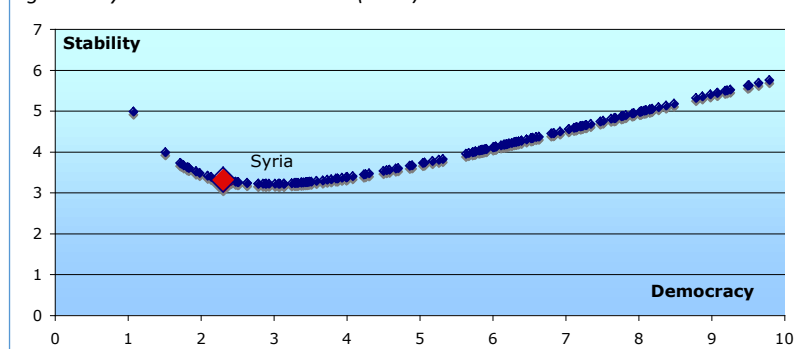
it closer to an "authoritarian regime" than to an open one.

Moreover, Syria's position on the J-curve also suggests that there is enormous potential for democratization efforts. This would of course be dependent on how the situation develops and this is very difficult to predict. Colombo (2011) explains that Syria has a peculiar situation that would not necessarily mean that events will unfold in the same manner they did in Egypt and Tunisia and this is due to several factors. First, Syrian protests have erupted in defined "pockets" rather than as nation-wide protests like those witnessed in Egypt and Tunisia. Second, the protestors do not form a clearly defined group. Third and more importantly, the regime has resorted to violence to suppress the protests and is still stubbornly clinging to power with the hope of leading the process of change. Of course, this could not have happened without the support of the army which has completely aligned their strategies with those of the regime, a crucial difference with Tunisia and Egypt. Other factors to be taken into account is the large mobilisation of pro-regime supporters, even though they are believed to be created by the regime itself. Also, Colombo (2011) explains that two factors interplay in favour and against the president, his past popularity and achievements which had large domestic and foreign appeal, vs. his ability to live up to popular expectations.

Should the protestors succeed in toppling the regime, the country would start its democratic

transition which would be associated with some short-term instability, like what is witnessed in Tunisia and Egypt. Alternatively, if the regime succeeds in repressing the protests, then there is a risk that the country adopts a protectionist stance in an effort to preserve the political status-quo. In

Figure 1. Syria on the world J-Curve (2010)



Source : FEMISE calculations based on EIU Political Instability Indicator, Index of Democracy.

this scenario, it is unlikely that there will be significant reforms towards genuine democratization in Syria. And even though some reforms may be undertaken, they will be superficial especially if they are carried out by the old guard.

## 2. Issues of governance, “false reforms”

Indicators of governance can provide valuable insights, though their reliability should be treated cautiously. As shown by figure 2, all governance indicators were negative between 2000 and 2009, like Egypt, indicating a bad performance. Moreover, they have all deteriorated except for government effectiveness and regulatory quality. Indicators of Voice and Accountability, political stability, rule of law and corruption have all worsened in one decade. Syria has a score of 2.5 in Transparency International’s Corruption Perceptions Index for 2010 and ranks 127th out of 178 countries and ranks last among MPs (Transparency International, 2010).

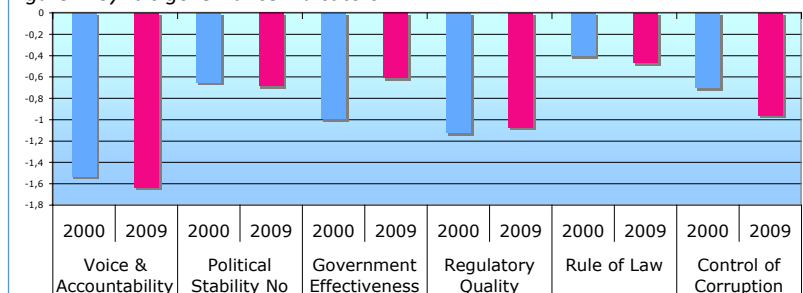
## II. Crisis, response and short-term prospects

### 1. Oil sanctions put pressures on trade and perhaps the regime

Syrian external finances are expected to come under significant pressure in 2011. In particular, the forecasts are as follows:

√ An estimated contraction in both exports and imports (volume) by respectively 2.6% and 11.8% according to IMF data,

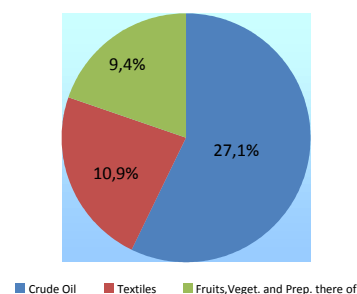
Figure 2. Syria’s governance indicators



Source: Worldwide Governance Indicators 2010, World Bank.

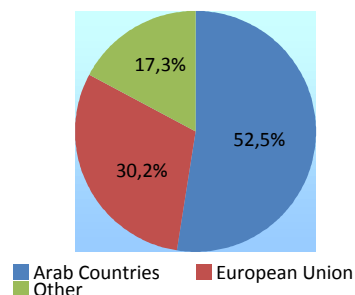
Note: Values vary from -2.5 (bad governance) to 2.5 (good governance)

Figure 3. Export composition, 2009, percent



Source: Central Bank of Syria

Figure 4. Geographical composition of exports, 2009, percent



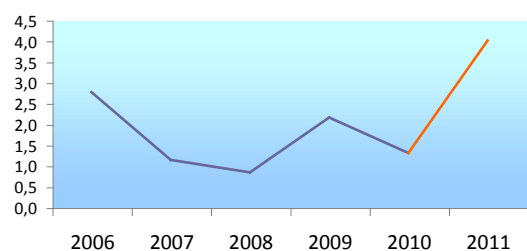
Source: Central Bank of Syria

√ The current account deficit is expected to quadruple to 4% of GDP from around 1% in the year 2010.

There are no official figures released for 2010 but IMF estimates show a recovery in merchandise exports (volume) which grew by 20% compared to a contraction by almost 19% last year. Meanwhile, merchandise import growth (volume) remained positive at 5% but significantly slower than last year’s pace of 24.5%. This led to an improvement of the current account deficit to 1.3% of GDP from 2.2% of GDP a year ago.

In the aftermath of domestic developments, exports are assumed to have taken a strong hit following some business disruptions. The recent sanctions on oil exports can be particularly harmful to Syria’s external finances. According to 2009 data from the Central

Figure. 5. Current account deficit, percent of GDP



Sources : EIU

Bank of Syria, crude oil exports accounted for around 27% of total exports (figure 3). Moreover, a bit less than a third of Syrian exports and as much as 95% of oil exports are destined to Europe (figure 4).

Despite an increase in international oil prices, Syrian exports are expected to decline by around -2.6%, as a result of the EU sanctions which could be partly mitigated by finding alternative buyers, probably at a discounted price, but also as non-oil exports decline as a result of political unrest. Imports will also decline (by 11%) as political uncertainty depresses consumer confidence and better harvests make Syria more self-sufficient in food. The impact of changes in oil prices on the trade balance is limited, because Syria's imports of refined products are about equal in value to its exports of crude oil. Tourism receipts are expected to plummet during 2011-12 following the recent public unrest. The current-account deficit is expected to nearly quadruple to 4% of GDP (figure 5).

## 2. Considerable impact on financial inflows

Following rising political tensions, Syria has witnessed an FDI decline by approximately two-thirds in early 2011 (ANIMA). Plans for future investment in Syria are also being halted. For instance, the auction for a license to operate the third mobile-phone network in Syria has been postponed indefinitely. Despite government's continued efforts in inviting bids for licenses to explore for oil and gas, further drops could be expected as the situation fails to stabilize quickly.

Political concerns have been reflected in the continued falls in the Damascus Securities Exchange (DSE) index, which on July 20th dropped to 990 below 1000 for the first time since its launch, and from a peak of a high point of 1,752 in mid-December 2010. The market made some gains in the following days. By late August, the index had lost almost 50% of its value. Trading days have been cut from four per week to three in response to the losses.

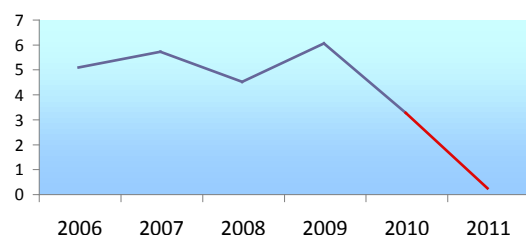
## III. Main macro-balances

### 1. Syria's weak rebound in 2010 is further undermined by political situation

While most Mediterranean countries witnessed a relative rebound from depressed growth rates in 2009, this did not happen in Syria. Central Bank provisional figures show that real GDP growth was 3.2% in 2010, down from 6% in 2009. This modest performance is believed to be the result of a contraction in the agriculture sector (8.7% of GDP in 2009), of 4% in 2010 after 12% growth in 2009, after a poor harvest in 2010. In addition, increased food imports also mitigated the positive growth effects related to increased oil production and buoyant tourism.

So far, major oil companies have reported that production has been unaffected by the unrest, although there are reports of sabotage against some pipelines, which might cause some delays in delivery. Nevertheless, the political situation and the ensuing disruptions in business activity is expected to have a toll on growth which is forecasted to drop to 0.2% in 2011 (figure 6), although IMF estimates are much more pessimistic, forecasting a contraction in growth by around 2%. Political instability is also likely to deter investment in most areas, except for the oil and gas sector. On the sectoral side, after a poor harvest in 2010, there are signs that the agricultural sector will recover in 2011-12. Services will decline in line with a major decrease in tourist arrivals, especially from Western states.

Figure 6. GDP growth, percent



Source : EIU

The government has taken some measures with the purpose of alleviating the economic impact of political events. Right before Ramadan, tariff rates on a number of intermediate goods imported by local industries, as well as on foodstuffs, were lowered. The government has also announced that it is considering lowering the age of retirement for public-sector employees to 52 from 60 (with a full pension of 75% of final earnings guaranteed provided the employee has worked for 30 years), as a means to open up job opportunities for young people.

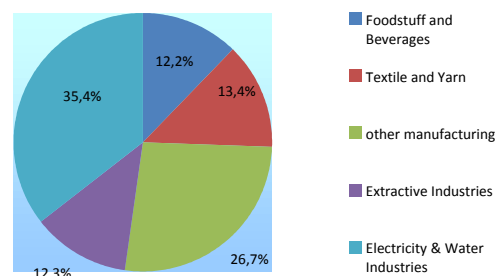
## 2. Unemployment

On a related note, unemployment has remained around 8% in 2010, the same level as in 2009. Unemployment could increase sharply especially if business disruptions occur in the manufacturing sector (around 52% of total employment) (figure 7).

## 3. Inflation is on the rise but remains moderate

After having declined steadily through 2009 to slightly negative rates, in tandem with lower world commodity prices, inflation increased again averaging around 4.4% in 2010 (from 2.8% in 2009). In particular, inflation has picked-up in end-2010, peaking at 7.2% in January 2011. It has been very volatile since then, fluctuating between 3 and 5%, (figure 8). Rising prices since June have been largely due to rising food prices (up by 11.6% in July 2011 compared to 0.3% in July 2010) and to some extent the increase in

Figure 7. Employment by sector, 2009, percent



Sources : Central Bank of Syria

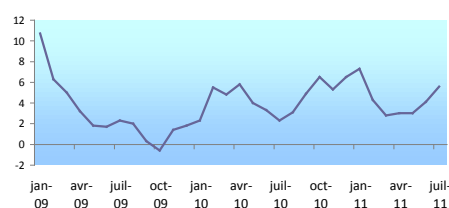
liquidity resulting from the hike in state employees' salaries and tax cuts promised during March. It is claimed that actual price increases were not as high as expected reflecting (i) an improved wheat harvest, which has limited Syria's exposure to rising international prices, (ii) the government's decision to lower diesel prices by 20% on April 1st. For 2011, headline inflation is projected to increase in line with international commodity prices to around 6-7%.

## IV. Macroeconomic responses

### 1. The fiscal deficit nearly doubles

The fiscal deficit is estimated to have slightly widened in 2010, to 4.4% of GDP from 4% in 2009, following increased expenditure to 26.5% from 25.7% of GDP and only slight improvement in fiscal revenues (estimated around 22.1% of GDP in 2010). Recent spending pledges and the loss of expected revenue from the auction of the third mobile-phone license are likely to result in a deterioration of the fiscal deficit to a bit less than a double, to 8% of GDP. The revenue losses could be in part attributed to the reduction in aid received from the EU, which has lately suspended aid to

Figure 8. CPI inflation, percent



Source : Central Bank of Syria



Syria. The EU has provided more than €1.1 billion in finance to Syria, in particular to energy projects in the amount of €615 million loans provided by the EIB for the construction of power stations and transmission and distribution systems

## 2. Capital flight and heavy deposit withdrawals pushed the Central Bank to impose foreign exchange controls

The political unrest seems to be having some adverse effects on Syria's financial sector. Heavy deposit withdrawals from banks were reported since last March. Overall bank deposits have fallen by 8.7% by end of April, recording an outflow equivalent to US\$2.6 billion. The public-sector banks, which account for 73% of Syria's total commercial bank assets, have declined by 7.1%, or a total of US\$ 1.3 billion. However, the biggest fall was in private sector demand deposits, which fell by about US\$ 1.4 billion, recording a fall of 15% between January and June 2011. Foreign currency deposits fell by about US\$ 300 million from just under US\$ 4 billion at end-January. It would seem that the bulk of the withdrawals occurred in the initial period of unrest.

This has led the Central Bank of Syria to adopt some measures as of last May that include: (i) increasing interest rates both on Syrian pound deposits (by 300 basis points), and on foreign exchange rate deposits to 2-3% over the benchmark Libor rate for US dollars and 1-2% over Libor for euros, (ii) lowering the statutory reserve ratio to 5% from 10%, with a possibility of reducing it to zero if the portion of deposits is devoted to financing projects, (iii) some foreign exchange controls. Such controls include restricting the sale of foreign exchange to Syrian residents (only US\$1,000 in a month and only

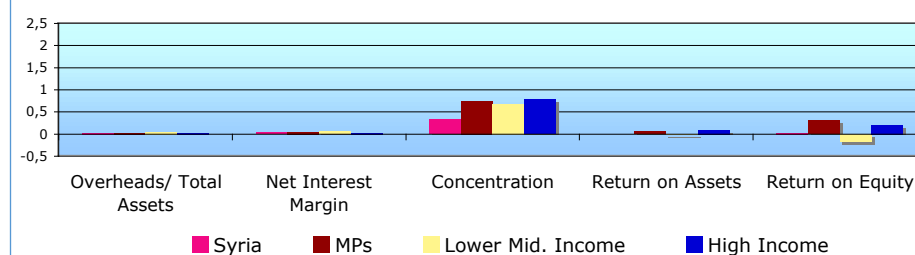
three times a year), or to those who need to finance imports with the requirement that the seller registers each sale so that the authorities can check that the funds have been used for the purpose stated. Syrians will still be entitled to withdraw foreign exchange, but it will be more difficult to convert Syrian pound holdings into hard currency. Also, travelers are entitled to buy foreign exchange freely, but only twice a year and on presenting valid travel documents and stating the intended date of departure. Finally, Syrians can make a one-off purchase up to US\$120,000 per year on condition that it is left in a term deposit account. The funds will earn interest, but this will be deducted in the event that the funds are withdrawn before the minimum term of three months.

Despite these developments, the official exchange rate has remained surprisingly stable at about Syrian Lira/US\$ 47.6. However, the black market erupted again where the exchange rate has weakened to Syrian Lira/US\$ 52. As a result of measures adopted by the CBS, the gap between rates had started to narrow. The government has also stated that foreign exchange reserves remain at a comfortable level of about US\$18bn, sufficient to cover more than one year's imports. This would also allow the Central Bank to defend the currency.

## 3. Banking sector

Data from the World Bank Financial Structure Database indicate that the concentration ratio (sha-

Figure 9. Banking Sector Indicators: Syria vs. the world (2009)



Source : World Bank Financial Structure Database

re of the 3 largest banks' assets to total banking assets) is lower compared to the rest of the world (value of 0.33 in Syria versus 0.745 in the region) which means that banking competition might not be low. But, return on equity (0.03) is lower compared to the rest of the region (0.314) and high income economies (0.208). The net interest margin of Syrian banks is also lower than the Mediterranean average (0.038 vs. 0.041) (figure 9).

Recently, Syrian banks have increased their capital in order to comply with the requirements of a law passed at the start of 2010 allowing the foreign shareholding in private banks to rise to 60% from 49%, and at the same time raising the minimum capital for conventional banks to US\$200 million from US\$30 million and for Islamic banks to US\$300 million from US\$100 million.

## V. Conclusion:

Compared to most of its southern Mediterranean neighbors, Syria's political and security situation is the most unstable. The protestors have not been successful in putting sufficient pressure on the ruler either to step down or to respond to their demands. The security situation is alarming, given the regime's aggressive stance towards the protestors. It is very difficult to make accurate predictions about the near-term developments but it is clear that the political unrest has led to some business disruptions that have undermined the already weak recovery witnessed in 2010. It will most certainly weigh on Syria's near-term growth prospects.

## Notes:

1. The J-curve approximation is obtained plotting the «political instability index» (EIU) to the «index of democracy 2010» (EIU).

We obtain a quadratic equation that represents a simplified relationship between the two indexes and takes the form of :

$$Y = 5.2547 - 8.7419 \cdot \ln X + 9.3128 \cdot \ln X^2$$

where X is the EIU democracy indicator of 2010 and Y the inversed political instability index (political stability)

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## TUNISIA : Entering a phase of transition towards « democratic capitalism »

Until recently, one would think that Tunisia managed to cushion the effects of the international crisis at only a small price, that of an increased fiscal deficit and lower economic growth. Now, recent events underscore how the damage was much deeper, the sensitivity of the domestic population to a decrease in living standards, one that may seem bearable in richer economies, was a determinant to social upheaval given the low living conditions in several regions and provinces. Hence, after a series of consecutive demonstrations throughout the territory, Tunisia entered a profound social crisis that resulted in a drastic change in the political regime. But at the same time, political change towards more democracy offers great hope for the future.

However, this renewed hope risks of being unfulfilled if Tunisia does not quickly acquire an image of stability, one that is based on both favorable expectations of economic agents and a growth regime that is also more inclusive. One should not forget that economic policy in Tunisia was globally effective in the 2000's since total factor productivity allowed increasing the country's competitiveness, the real economy was solid due to the economic upgrade programme and FDI had picked up.

Indeed, while the old-political model might have tackled the issue of economic development, it proved to be largely below expectations from a social point of view, dilating the social space. As in most MP's, but perhaps even more than elsewhere, the Tunisian youth has been plagued by massive unemployment. Thus, university graduates would either choose to migrate or, for the less fortunate, find underpaid and underqualified jobs that did not match their skills.

Up until early 2010, the challenge for Tunisia was to manage the fall in international demand due to

the economic crisis and maintain investment all the while coping with budget limitations. But now the challenge is much more profound, the country also needs to show that it is determined to make the necessary steps towards social peace, by addressing the core issue of youth unemployment, by balancing its reforms, by improving its government administration and by following a path to democracy. These elements are all pre-requisites to the country regaining its status of a reform economy in the Mediterranean, one that is straying away from its past insufficiencies all the while embracing and deepening its economic success.

Regarding the latest developments in Tunisia, at the moment this report was written, one would note the following:

✓ Economic growth is currently expected to be negative (-0.7%) in 2011 (versus an estimated 3% initially). Riots roughly cost 3 billion dinars to the economy (1.6 billion Euros), equivalent to 4% of GDP. About 2 billion dinars were lost because of the stop in domestic economic activity and 1 billion from the exports being halted.

✓ Tourism, representing 6.5% of GDP has already been greatly hit and could further increase unemployment (13% in 2010, estimated at a massive 16.6% in 2011). Thousands of tourists flew out of Tunisia during late 2010 and tour operators have asked for an emergency plan. Tourism decline and deterioration of the trade balance should bring a n important 7.9% current account deficit (versus a 2.2% deficit in 2010).

✓ FDI for 2011 looks worrisome, in the first two months of 2011 it had reached 275.1 million dinars, a 21.7% year-on-year fall, foreign investment is anticipated to degrade by 35.3% to 1.1bn US\$ in 2011. However, transport (especially by road), the technological infrastructure and industrial zones are all in need of immediate development which could create small-scale projects in areas that have been neglected and allow restoring much needed confidence to rebound from the shock.

✓ The climate of instability brought international rating agencies to downgrade Tunisia. For instance, Moody's Investors Service downgraded the global local currency (GLC) and foreign currency (FC) deposit ratings of five Tunisian banks.

✓ Before the Tunisian social crisis, the domestic stock-market enjoyed relatively healthy fundamentals and was even viewed as the best performing market in the entire MENA region. In mid-April 2011, the Tunisian Bourse would show total losses of 17.16% versus an 11.2% gain in the same period of 2010.

✓ The import-cover ratio fell to approximately 5 months of imports in end 2010. Thus, Tunisia had fallen to reserves levels of 2006, a fact that should be monitored in the coming years. Recent estimations point to further degradation to only 3 months of imports.

✓ Initial plans to reduce subsidies and increase taxes seem inappropriate. The new government will need to increase social transfers and subsidies to prevent more riots. But, Tunisia has a large budget deficit (estimated at 4.6% of GDP in 2010). The budget deficit will increase to about 9.1% of GDP in 2011 and will need to be contained in the years that follow.

✓ Inflation attained 4.4% in 2010, as food prices increased, it should fall to 4% in 2011. The Central Bank will probably maintain a tight monetary policy ensuring that inflation remains largely under control. In the short term, the central bank will focus on maintaining economic growth, particularly growth in exports, in light of weak expansion in the EU. Full currency liberalisation will probably be delayed for some years.

✓ An extended outfall on unemployment is probable in 2011, until now 33 foreign companies ceased operations resulting in the loss of 2400 job positions. Meanwhile, the majority of job-seekers still appear to be comprised of women.

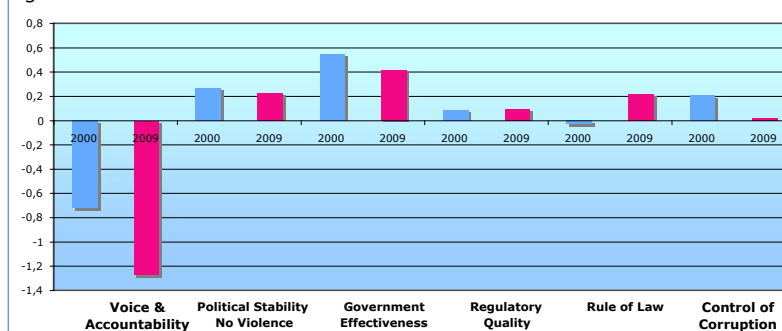
✓ Moreover, while Tunisia enjoyed good macroeconomic performances it did not manage to efficiently reduce youth unemployment. The unprecedented unemployment of young graduates is probably the biggest challenge to overcome. Young people are more affected by unemployment than the rest, which produces "discouraged workers" effects as well as social exclusion. A double crisis-induced effect weighs on the youth: first, a decrease in labour demand means that new entrants are more affected and second, employment destruction is currently more youth-oriented. Tunisian professional integration programs could be more efficient for those with a degree in a field that is prone to unemployment such as social sciences and other disciplines.

## I. The political situation and its implications

### The political model in a crucial transitory phase

Tunisia is in a state of unparalleled political uncertainty. Following the largest uprising Tunisia ever faced, ex-president Ben Ali fled the country, social protests and violence continued for several weeks while the third interim government is now making efforts to organise democratic elections that should lead to a better representation of all political currents. We should note, in particular, the impressive issuance of a law imposing that the voting lists are composed of 50% of women. It remains that a long path is still ahead of the new authorities for the institutions of the old monarchy to be rebuilt.

Figure 1. Tunisia's Governance Indicators



Source : Worldwide Governance Indicators 2010, World Bank.

Note : Values vary from -2.5 (bad governance) to 2.5 (good governance)

One should take into account the amplitude of the current task. To deal with this question indicators of governance can provide valuable insights, mainly as to the evolution of the Tunisian political regime, albeit always with some reservations as to the pertinence of an index that « quantifies » governance. It appears that in a decade Tunisia has improved in terms of rule of law and very slightly on regulatory quality. However, the country has witnessed its Voice & Accountability, Political Stability, Government Effectiveness and Corruption indicators considerably worsen. Thus, while the country made considerable steps in terms of economic growth since the Barcelona Process, it appears the political scene followed the opposite trajectory.

The current situation highlights the fact that the Tunisian political model failed, it did so more particularly with regards to two elements, that is the rising cost of living and insufficient employment creation. This highlights the fact that being the most competitive economy in the continent does not suffice when the fruits of growth are not accompanied by more jobs, reduction in inequalities and less corruption.

The figure below explains the instability crisis faced by Tunisia as it moves from an authoritarian to an open society. As explained by Bremmer (2006) « there is a counterintuitive relationship between a nation's stability and its openness, both to the influences of the outside world and within its borders ». Certain states are stable because they are closed, the influence on the population from the

outside such as the improvement in the ability to communicate (ex. through social networks) can undermine the domestic regime and lead to social upheaval and instability. However, a country that is « stable because it is open » will enjoy higher levels of stability and long term gains that easily outweigh the short term cost of transition.

However, for a « closed » country to become stable because of its openness a transitional period of instability has to be travelled as shown by the J-curve. This is where Tunisia stands right now, democracy and political stability indicators position the country on the bottom of the curve, at a transitional period in which more openness has brought more instability. But Tunisia is also very close to the turning point where more openness in terms of democracy could progressively lead to greater stability.

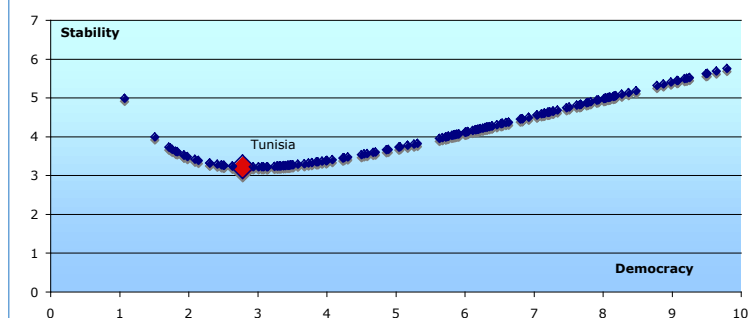
Thus the issue is the following: the Tunisian political regime can follow a route of reform towards democracy and its long-term benefits, but, going through an extended period of short-term instability. Or it can follow the opposite route, seeking to fall-back to stability in the short-run, but to the detriment of democratic openness. The measures followed since the fall of Ben Ali hint at the first path.

In a short period of time, the transitional government(s) removed former ministers and detained close associates linked to the previous regime. Former political prisoners were released and exiled leaders can now return to Tunisia.

Meanwhile, interim authorities have shown political flexibility and less rigidity than in neighbouring MPs in crisis which stresses Tunisia's uniqueness.

Cautious optimism can thus be applied for the political future. The Tunisian society could evolve towards real democratization with civil liberties and not just a regime that is slightly less authoritarian.

Figure 2. Tunisia on the world J-Curve (2010)



Source : FEMISE calculations based on EIU Political Instability Indicator, Index of Democracy. [1]

## II. The implications of recent developments

### 1. Real sector

The social crisis has had a clear impact on the Tunisian economy. Riots have already cost 3 billion dinars to the economy (1.6 billion Euros), equivalent to 4% of GDP. Transmission of the crisis can be felt at varying degrees through the main aggregates summarized below:

√ About 2 billion dinars were lost because of the stop of domestic economic activity and 1 billion because of the stop in exports, consequently in 2011 **exports** are expected to increase by only 7.2% to 17.9bn US\$,

√ A 10.7% rise in the **imports** bill is also expected bringing it to an anticipated 22.7bn US\$ in 2011,

√ Thus, the **trade deficit** expected to rise by 23.7% in 2011, going from -3.8bn US\$ in 2010 to 4.7bn US\$ in 2011,

√ **Tourism**, representing 6.5% of GDP was greatly hit; thousands of tourists flew out of Tunisia while tour operators have asked for an emergency plan to re-launch the sector. As a result the service balance is expected to fall by 28% to 1.8bn US\$ in 2011,

Tunisia was the first Mediterranean economy to enter an Association Agreement with the EU and had proceeded to important tariff dismantling while trade became an important growth engine. But, in 2009 exports declined following the international crisis and overdependence to developed partners

demand. In 2010 **exports** picked up by 16% but the recent happenings in Tunisia are all but positive for Tunisian trade, about 1 billion dinars were instantly lost in the first weeks of protests because of the stop in exports. In January 2011 Tunisia registered a year-on-year fall in equipment, agriculture, and other intermediate and other consumer products by respectively 7.75%, 11.3%, 5.42% and 7.04%. But, exports showed relative resilience during the international crisis and there was hope that this scenario could repeat itself in 2011 even partially. Thus, despite such initial negative trends, most sectors have shown a year-on-year increase as of mid-2011. In the first six months of the year Tunisia registered an important year-on-year increase in energy (11.5%), other intermediate products (24.7%) and other consumption products (20.1%). As a result, revenues from exports rose by 10.2% year on year in the first seven months of 2011. Meanwhile, demand from the EU remains strong in spite of the euro zone debt crisis (EIU). Thus, export earnings are expected to increase by 7.2% to 17.9bn US\$,

Meanwhile, **imports** in 2010 increased by 13.3% as demand picked-up from the low it had reached the prior year. That being said, recent figures point to another import increase (of 10.7%), imports are expected to reach an anticipated 22.7bn US\$ in 2011 led by the rising bill of agricultural and food imports. The overall merchandise trade performance in 2010 caused the **trade deficit** to widen bringing it to -3.8bn US\$. But in 2011, the rather timid export performance that is currently forecasted

Table 1. Exports by product group

	Exports				
	six-months			Variations	
				2009-10	2010-11
	2009	2010	2011		
Agro-food industry	588,8	500,5	535,1	-15,0%	6,9%
Energy	1168,5	1610,8	1795,9	37,9%	11,5%
Mining & phosphates	783,6	875,3	721,5	11,7%	-17,6%
Other intermediate	1875,1	2479,1	3092	32,2%	24,7%
Equipment	1418	1883,2	1962,3	32,8%	4,2%
Other consumption	3683,7	3999,7	4803	8,6%	20,1%

Source: Institut National de la Statistique

Table 2. Imports by product group

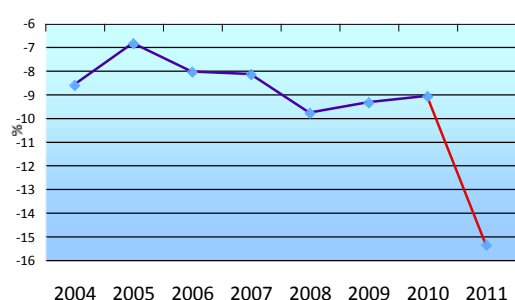
Imports					
	six-months			Variations	
	2009	2010	2011	2009-10	2010-11
Agro-food industry	658,5	812,6	1112,8	23,4%	36,9%
Energy	1034,6	1801,4	2181,3	74,1%	21,1%
Mining & phosphates	257,7	297,6	306,7	15,5%	3,1%
Other intermediate	4984,1	6232,9	6890,5	25,1%	10,6%
Equipment	3615,4	4927,9	4330	36,3%	-12,1%
Other consumption	1496,1	1719,4	1685,8	14,9%	-2,0%

Source: Institut National de la Statistique

brings the estimated figure to -4.7bn US\$ (roughly -10% of GDP). If such deficit is reached it will mark a negative performance record for the Tunisian economy since such depths have not been attained domestically since instigation of the Barcelona process.

Finally, the **service balance** increased in 2010, however, it is expected to shrink by 28% to 1.8bn US\$. Tourism is the main responsible for that negative performance, thousands of tourists flew out of Tunisia during protests while the interim tourism minister announced that revenues and visits had fallen by roughly 40% in January 2011, furthermore, the number of tourists dropped by an additional 40% from January to mid-April compared to 2010. **Tourism** is naturally of crucial importance to the domestic economy, not only

Figure 3 Trade Balance (% of GDP)



Source : EIU

does the sector employ 400,000 Tunisians and contributes by 2.5bn US\$ to GDP, it is also the country's first foreign currency earner. While security has been improved in Tunisia, it remains to be seen if foreigners wish to return or if the sector continues to suffer. Unfortunately, the tourism issue in the Tunisian south appears troubling. The island of Djerba, a famous destination for tourists, sees half of its hotels shut which is surprising considering peak season is approaching. The incidents in Libya have naturally made things worse since there is geographical proximity with the Tunisian south. Furthermore, among the seven million tourists that come to Tunisia annually more than 20% are from Libya which can greatly affect inflows in the short-run at

least. Indeed, recent news suggest that the tourism sector has plummeted by more than 50%. A 2 billion US\$ loss in tourism revenues and trade has been announced, in great part due to the war in Libya (The Big Issue, 2011). An expected « destination-substitution effect » to countries with a similar climate (ex. Greece, Turkey) could harm Tunisian tourism even more in the coming years. This makes the request of Tunisian tour operators for an emergency plan to re-launch the sector all the more relevant and imperative.

## 2. Financial Shock

Tunisia is an economy with a financial market at an intermediate development stage, though with an advanced level of financial liberalization. Thus, any shock, exogenous or domestic, would have a moderate impact on the financial sector, though higher than in neighbouring partners.

### 2.1 Foreign investment declining

Meanwhile, FDI estimates for 2011 look worrisome. Foreign investment fell by roughly 39.6% in 2009, it timidly started to pick-up in 2010 but is now anticipated to further degrade by 35.3% to 1.1bn US\$ in 2011. In the first two months of 2011 foreign direct investment had reached 275.1 million dinars, in other terms this corresponds to a 21.7% year-on-year fall. Energy and services represented together more than half of investment inflows, respectively 120 million dinars and 44.2 million dinars. Thus, the country will have to face a double challenge, first to try averting further delays in current investment projects and second to attract foreign investors by providing a reliable, transparent business environment that is free of corruption. Whether authorities manage to deal with this issue efficiently will largely depend on what will be done in the coming months. Transport (especially by road), the technological infrastructure and industrial zones are all in need of immediate development which could create small-scale projects in areas that have been neglected. Currently, it is to the country's benefit that only 33 foreign companies have ceased



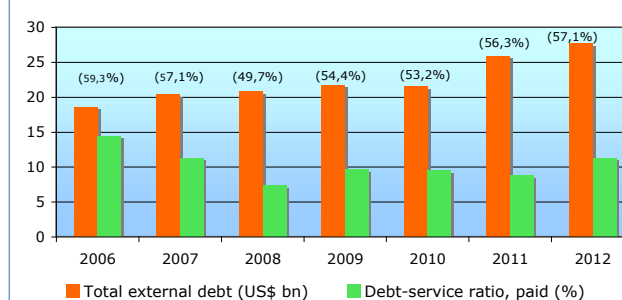
operations out of a total of 6 185, while most have normally resumed their operations. All this could allow restoring much needed confidence domestically but could also show the world that Tunisia can quickly rebound from the shock.

## 2.2 Stock Market

Before the Tunisian social crisis, the domestic stock-market enjoyed relatively healthy fundamentals with no indications on speculative activity. The stock-exchange was even viewed as the best performing market in 2009 in the entire MENA region with a very attractive asset price-dividend ratio. But, starting from the last quarter of 2010, the situation started to worsen and the stock-market index (Tunindex) marked a 9.82% decline in October 2010. This was surprising since the main firms that are part of the Bourse showcased 50% gains during the last quarter. It is possible that this trend reversal was initiated by the announcement of a new bill that would impose taxation on stock-benefits. Whatever the case, the events of the « black October » (Octobre noir) were shortly followed by the greater social crisis, hence, political instability and the consequent fall in investors' confidence further accentuated the trend reversal. In mid-January, the Tunisian stock-market entered a two-week suspension since the downfall of the previous political regime led to a 12% in only one week. After reopening, for limited hours a day, activity remained timid with an additional 2% fall of the stock-index during re-opening. In late February, it was announced that the stock market would suspend all trading operations to protect savings invested in equities.

In mid-April, the Tunisian Bourse would show some signs of recovering, albeit in the week of April 18th to April 22nd total losses would amount to 17.16% versus an 11.2% gain in the same period of 2010. It remains to be seen if the recent election of a new President of the Board of Directors of the « Bourse des Valeurs Mobilières de Tunisie » will provide for greater stability. But, it must be said that since end May 2011, the stockmarket index Tunindex has been on the rise, reaching a value of 470 in mid-September.

Figure 4. Debt Indicators in Tunisia, % on GDP in parenthesis



Source : EIU

## 2.3 Foreign Reserves and Debt Indicators

Remarkably, foreign currency reserves had increased by more than 50% in 2009, reaching almost 7 months of imports in 2009, since tourism revenues had compensated for the fall in trade income and lower import value had reduced pressure.

But, as noticed earlier, imports in 2010 increased by more than 13% which explains why the import-cover ratio fell to approximately 5 months in end 2010. Thus, Tunisia had fallen to reserves levels of 2006 and is now estimated to have further degraded to the 3-month threshold, a fact that should be monitored closely in the coming years. The probable fall in the import bill for 2011 might help cushion this recent downward trend though optimism should be cautious.

Regarding Tunisian debt indicators, revised figures for 2010 pinpoint external debt at 21.5bn US\$ which corresponds to a slight decline in absolute terms from the 21.7bn US\$ in 2009 but an increase in percentage of GDP from 54.4% in 2009 to 55.5% in 2010. While Tunisia did not manage to sustain its debt to the pre-crisis level of 2008 (close to 50%) it still maintained it below the 60% threshold of the mid 2000's. While external debt stock has been increasing since the crisis, it is expected to stabilize in 2011 before registering a decrease starting from 2012.

As for the debt service ratio, it stood at 9.5% in 2010, down from 9.6% in 2008, with forecasts pointing towards increases starting from 2012. It remains to be seen how authorities can follow a policy that allows improving fiscal and current-account balances, redu-

cing the debt-service ratio in a context of instability and lessened confidence from international markets.

### III. Economic Policy and Macro forecasts

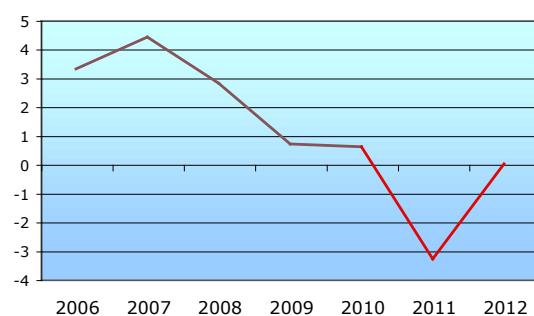
#### 1. Main developments

##### 1.1 Growth : A regime that could benefit from adjustments

Last year, despite a decline in international demand, Tunisia achieved a 3.7% rate of growth. Nonetheless, to carry-on future growth, it is deemed necessary to make additional efforts in diversifying national exports by developing high added-value products and services all the while seeking new trade partners. However, recent events could halt such policy initiatives. Some estimations point towards a negative growth rate of -0.7% in 2011 (EIU).

To a large extent domestic GDP is fueled by services. Tradable services represent more than 40% of GDP and during the first quarter of 2011 the sector fell by approximately 3.8%. Transport and wholesale traders respectively fell by 16.3% and 2.2% during the same period. Past diversification efforts could partially shield Tunisia from the outfall of the current crisis. Even so, its capacity to rebound still depends on external demand and thus, the expected fall in tourism revenues

Figure 5. Total Factor Productivity growth in Tunisia (Source : EIU, estimates for 2011, 2012)



Source : EIU

could seriously impact growth and bring it to negative levels in 2011.

In last year's report, FEMISE underscored how Tunisia was following a fruitful growth regime based on productivity. However, in the aftermath of the economic crisis total factor productivity in the country slowed down, while recent events appear to have influenced on the productive efficiency of the economic fabric (TFP for 2011 estimated at -0.2%).

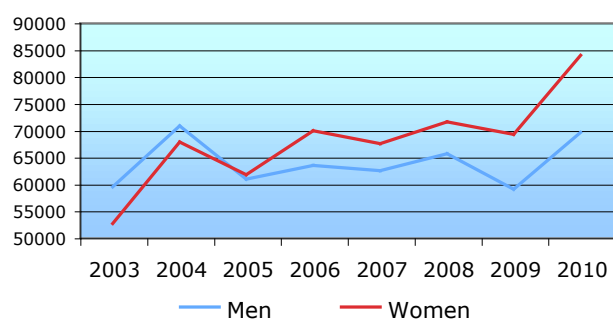
The truth of the matter is that Tunisia has one of the more robust growth regimes in the region. It also has higher chances than most of its regional counterparts to develop higher value-added products to maintain its competitiveness level. But, in a period where there has been an outcry for better redistribution and opportunities, a transition period for the growth regime

Table 3. GDP by sector grouping (by quarter, current prices)

	Q1 2011	Q1 2010	Variation (%)
<b>Agriculture &amp; fishery</b>	1262,1	1140,9	10,62
<b>Manufacturing</b>	2440	2471,5	-1,27
of which <i>Textiles, apparel, leather</i>	460,5	448,5	2,68
<i>Mechanic, electrical industries</i>	800,8	694,9	15,24
<b>Non-Manufacturing</b>	2034,1	2012,2	1,09
<b>Tradable Services</b>	6090,6	6331,6	-3,81
of which <i>Wholesale trade</i>	1145,8	1172,1	-2,24
<i>Transport</i>	1003,6	1199,8	-16,35
<b>Total of Value Added</b>	14127,1	14082,4	0,32

Source: Institut National de la Statistique

Figure 6. Evolution of new job-seekers, by gender



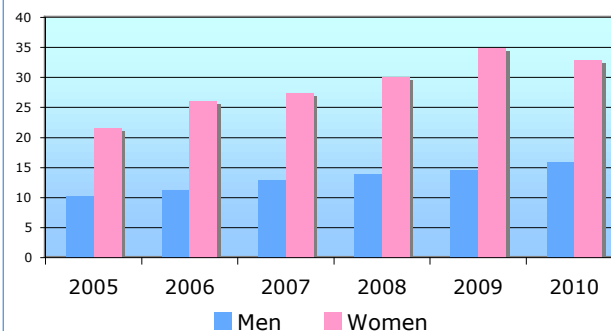
Source : Tunisian Republic, Ministry of Vocational Training and Employment

will have to be expected. The transition towards a more « democratic capitalism » could then lead to a, hopefully permanent, economic rebound.

### 1.2 Employment : The new decade's priority

The unemployment rate in Tunisia was at the 13% mark in 2010 and risks to escalate in 2011. On average, during the first six months of 2011 employment demand increased by an annualized 24.5% while supply decreased by 5.3% (Table 3). Unemployment, as we will later discuss, it is considerably higher among the youth. During the first six months of 2011 employment demand among first time job seekers had increased year-on-year by 27.2%. On many occasions, FEMISE has noted that the country is rich in qualified human capital. The largest share of employment supply is located in the manufacturing sector, followed distantly by other services, agriculture and tourism.

Figure 7. Unemployment of higher education graduates by gender



Source : Tunisian Republic, Ministry of Vocational Training and Employment

Again, a transition phase is needed. In simple terms, the domestic economy not only needs to diversify its growth sources but it also needs to diversify its creation of job positions across the economic fabric. Developing new export oriented sectors must also go hand in hand with the emergence of new jobs, the creation of new products should be accompanied by new positions for the qualified, especially the youth. While the previous government seemed to pursue some efforts for more flexible labour allocation, the current phase of instability might halt the process.

Let it be noted that since the mid 2000's, the majority of job-seekers has been comprised of women and this is a tendency that appears to be accentuated in recent years. The rate of unemployment is also persistently higher in the case of women, an issue that must be dealt with by the new authorities. The importance of the issue is immediately

Table 4. Labour market in Tunisia

	2011		Variation			2010		
	June	January	Monthly Average (S1)	June 2011 - June 2010 (%)	S1 2011 - S1 2010 (%)	June	January	Monthly Average (S1)
Employment demand (total)	54968	74390	50361	3,10	24,51	53315	47888	40448
of which: first time job seekers	50508	69716	45320	3,68	27,22	48713	43097	35623
Governorates with highest employment demand								
Tunis	4952	5916	3809	19,87	25,42	4131	3249	3037
Sfax	4136	5012	4206	-21,55	42,87	5272	4875	2944
Gafsa	3492	4554	3069	-1,16	77,81	3533	3618	1726
Employment supply (total)	9662	9302	14683	-28,28	-5,31	13472	15268	15507
Employment agency placings	4963	4096	10302	-51,41	-3,63	10213	10172	10690
of which: first time job seekers	3907	3105	7334	-46,35	1,03	7283	6678	7259

Source: Institut National de la Statistique

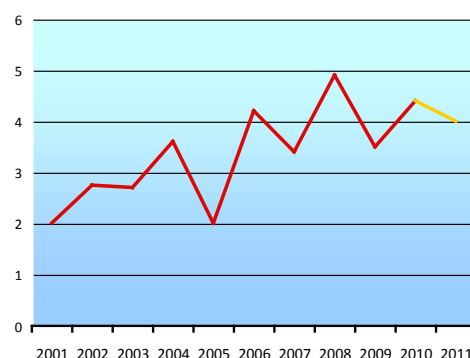
apparent in the case of unemployment among higher education graduates ; women in 2009 faced a rate close to 35% (32.9% in 2010) more than double than the one faced by men.

While some measures that could reduce the gender gap in unemployment have been taken (ex. monthly 80-dinar allowance to 40,000 youths from both sexes as part of professional integration of secondary-education graduates), their applicability, sufficiency and effectiveness remain to be seen. Meanwhile, an extended outfall on unemployment is probable. For instance, in early 2011, 33 foreign companies had ceased operations in Tunisia which resulted in the loss of 2 400 job positions. If the tourism industry and export-oriented sectors do not manage to quickly pick-up then the jobless rate could further escalate (estimated rate of 16% in 2011 according to EIU).

### 1.3 Inflation on the rise, yet still manageable

The average rate of inflation in Tunisia is on the rise for a second consecutive year. Consumer and producer price inflation both marked an increase in 2010 (the former from 3.5% to 4.4%, the latter from at 2.2% to 3.1%) which can be explained by higher international prices and especially a rise in oil-prices (brent increasing from 61.9 US\$/b to 79.6 US\$/b). Though higher, consumer price inflation remains close to the Mediterranean average. Meanwhile, the prices of

Figure 8. Inflation (%)



Source : EIU

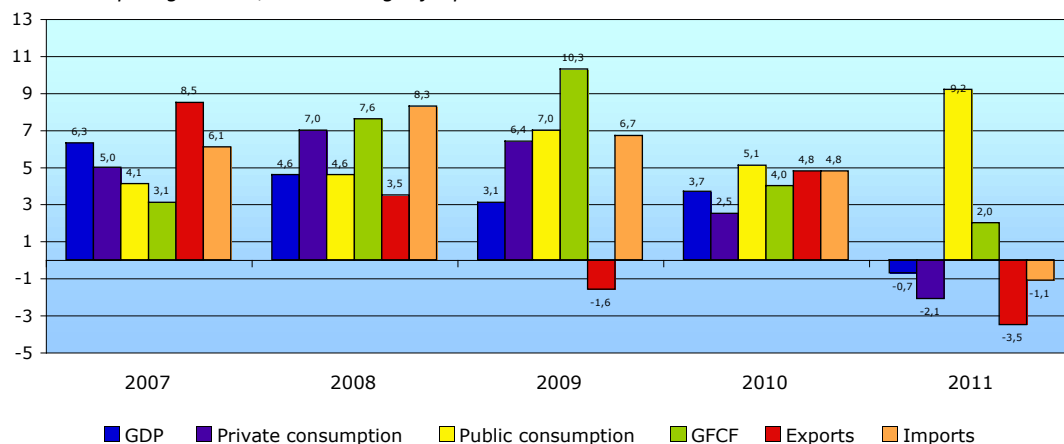
basic products and oil might finally not escalate any further in the coming year, bringing the inflation rate in Tunisia at an estimated 4% in 2011.

Let it be noted that the rise in nominal wages is expected to slowdown (from 4% in 2010 to 3.6% in 2011 and 3.5% the year after). Wages will thus increase at a slower rate than inflation. Up until now, limited increases in wages have been made to stimulate the competitiveness of the domestic labour force, however, minimum wage will probably be determined by authorities above inflation to avoid a worsening social condition.

## 2. Macroeconomic policy responses

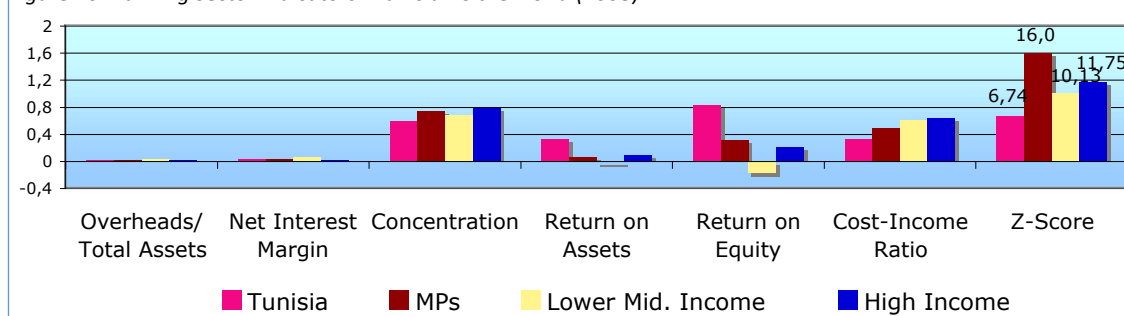
Currently, the country is entering a phase of increased pressures on the budget deficit because of the limited revenues as a result of the slowdown in economic activity and lower reserves.

Figure 9. Decomposing demand, annual change of expenditure to GDP



Source : EIU

Figure 10. Banking Sector Indicators : Tunisia VS the world (2008)



Source : World Bank Financial Structure Database

## 2.1 Economic activity to be put to test

The 3.7% rate of growth in 2010 was attained, despite the 2008 crisis fallout, with the help of investment and public consumption, which in terms of expenditure on GDP grew respectively by 4% and 5.1%. Meanwhile exports in 2010 bounced back from their 2009 slump (4.8% expenditure on GDP growth in 2010).

It was expected that Tunisian growth would be able to attain its pre-2008 levels after exports would pick-up following a more dynamic international demand. But, as of late 2010, the socio-political climate has affected the Tunisian growth engine. The halt in exports following riots and the transition period that the country is enduring are expected to bring an estimated fall in export expenditures by 3.5% in 2011. This is unfortunate since private consumption was already becoming less relevant with an anticipated -2.1% fall of its expenditure on GDP for 2011. Thus, the transitional government must do whatever it takes to boost investment, currently expected to showcase a 2% expenditure growth. The authorities should follow strategic development investments to allow for convergence of conditions throughout the territory. If they succeed in doing so all the while maintaining stability, then, private investors from both Tunisia and foreign partners should progressively follow allowing to fuel growth.

## 2.2 A fiscal deficit expected to heavily widen

Following the international crisis, the Tunisian budget was greatly solicited especially to boost

employment, consumption and investment. Meanwhile, receipts declined in light of poorer export performance explaining how the fiscal deficit rose from 0.8% in 2008 to 3% in 2009 to 4.6% in 2010. As of 2011, the transitional government has announced an emergency plan for the Tunisian economy, targeting investment and employment creation. But, naturally, such plan is costly and comes at a time where oil-prices are increasing, reserves are already lower and economic growth prospects are dim.

Simply put, until last year Tunisia still had some room for budgetary maneuvering compared to the rest of the region, now the country appears to be in a worst fiscal position than the Mediterranean average. On the revenue side of the fiscal balance perspectives are not bright, income from privatisations will logically diminish while borrowing from international markets would imply a much higher cost due to risk premiums rising for the Mediterranean as a whole.

To sum up, the Tunisian government will likely have to proceed to development spending and provide for some social alleviation to the population in a very difficult context, one that is expected to propel the fiscal deficit to an estimated 9.1% in 2011.

## 2.3 Monetary Policy to protect Banking sector

Until recently, the Tunisian Central Bank was pursuing a gradual transition towards inflation targeting

to allow, in the longer run, total convertibility of the dinar. Furthermore, efforts to render the exchange rate system more flexible were undertaken. But, in the current context, the immediate priority of the Central Bank would probably be to ensure liquidity remains ample in the banking system, especially in light of recent downgrading from international investor agencies. Let it be noted that Moody's Investors Service downgraded the global local currency (GLC) and foreign currency (FC) deposit ratings of five Tunisian banks in early 2011 following concerns about the probable impact of the social unrest on the economy and credit.

When looking at indicators of banking performance, one immediately notes how return on assets in Tunisia are above the regional average which is itself above the one observed in both lower middle income and high income OECD economies. Furthermore, the concentration ratio (share of the 3 largest banks' assets to total banking assets) shows a lower concentration in Tunisia compared to the rest of the world (0.59 in Tunisia versus 0.75 in the region) which is not necessarily a bad thing as noted by Ben Naceur et al (2011) since high concentration can be an indicator of lack of competitiveness. Last but not least, the z-score index of bank stability (ratio of return on assets plus capital-to-asset ratio to the standard deviation of return on assets) is lower in Tunisia than in the entire region which means that, as in the case of Egypt, the domestic banking system is less stable.

As already suggested by FEMISE, in spite of the new banking law the banking system is still not well prepared to deal with an evolving interest rate. One must also note that the recent happenings in Libya shall affect the remittance channel (an important share of remittances to Tunisia originates from Libya), hence, the monetary policy's priority of maintaining liquidity in banks is all the more important.

As noted by EIU, the key interest rate has cut from 4% to 3.5% and the Central Bank is likely to maintain a loose monetary policy to boost the economy.

#### IV. The youth issue, main challenge of the new era

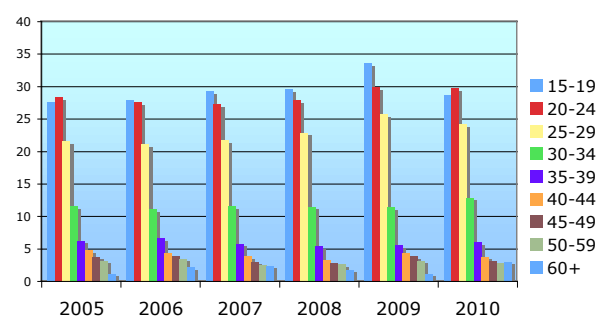
Tunisian youth unemployment has multiple causes. Low private investment, but also the demographic boom and the rise in university graduates are both responsible for sky-rocketing labor market participation. Moreover, the youth find short term jobs due to the nature of contracts (CDD) proposed to them.

The unprecedented unemployment rate of young graduates is probably the biggest challenge to overcome. However, solutions within the prior development plan have been scarce and protests, which led to the departure of the old regime, were greatly related to this issue.

##### 1. Understanding the problem of youth unemployment

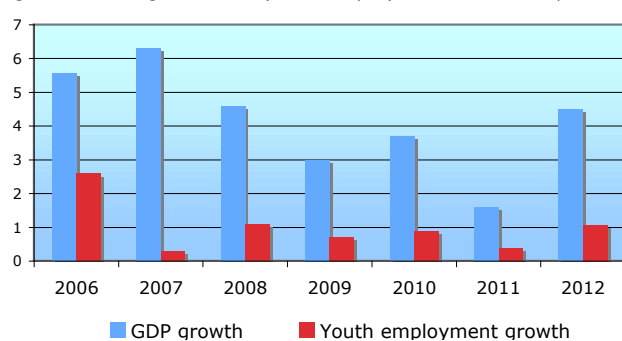
In 2009, unemployment in Tunisia reached considerable heights and especially in younger segments of the population. While the average rate was close to 13%, in the case of the 15-19, 20-24 and 25-29 demographic the already high unemployment rates respectively grew to 33.6%, 29.9% and 25.7%. While some efforts to alleviate youth unemployment were undertaken in 2010, unemployment still remains massive for the Tunisian youth. The recent social tensions prove how the issue needs to be tackled in an efficient manner before the situation escalates even more.

Figure 11. Evolution of unemployment by age, in % of age population



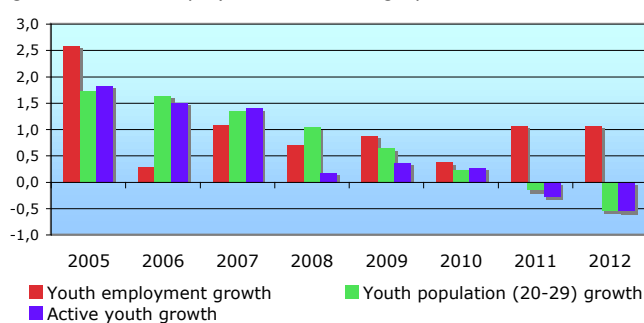
Source : Tunisian Republic, Ministry of Vocational Training and Employment

Figure 12. GDP growth and youth employment relationship



Source : Stampini and Verdier-Chouchane, 2011

Figure 13. Youth employment and demographics



Source : Stampini and Verdier-Chouchane, 2011

The truth of the matter is that Tunisia enjoyed good macroeconomic performances but did not manage to efficiently reduce youth unemployment. Thus one would ask the following : What is the relationship between growth and youth employment creation? Which sectors could reduce it?

A working paper by Stampini and Verdier-Chouchane (2011) provides valuable insights into these issues and helps understand what the dynamics of the youth labor market are in Tunisia. In the 2000-2007 period GDP in Tunisia grew by an annual average of 4.9% and by 5.7% and 6.3% in 2006 and 2007. In the same two years, employment for young Tunisians grew by 2.6% and 0.3%. Thus, the GDP elasticity of employment calculated by the authors (0.47 in 2006 and 0.05 in 2007) shows that not only is the domestic economy progressively less « youth-driven » but also that the current growth regime contributes to employment creation for the youth in a volatile manner.

#### Box. Active Labor Market programs in Tunisia

Despite its relative inefficiency in fighting unemployment, one must note that Tunisia has put in place a series of measures to stimulate employment. These active policies represent approximately 1.5% of total GDP and can be categorized into :

*Introductory courses to the Professional Life*, put in place to help Tunisian graduate job seekers find their first job by providing basic professional skills. Training mainly occurs in the private sector, assessed after a 6 month period with possibility for extension. The targeted youth perceives 150 TD monthly, social security benefits, while the minimum integration rate is fixed at 50% (average in 3 years).

*Graduates Contract of insertion*, targeting graduate job seekers, who have been unemployed for more than 3 years since graduation, to acquire those skills that fulfill the requirements of a private firm ready to offer an opening. Training takes place in the private sector, though it can also occur in the public sector, targeted youth perceives 150 TD allowance monthly, social security cover for 7 years after recruitment, while the government grants the firm an integration allowance of 1000 TD a year after recruitment.

*Contract of adaptation and professional insertion*, targeting non-graduate job seekers, unqualified to work in a given sector or firm, providing professional skills to individuals with the purpose of providing the necessary workforce to a firm in-demand. The targeted youth perceives 80 TD monthly, social security benefits are covered during the contract by the government, while the firm undertakes to recruit the beneficiaries and perceive an integration allowance of 1000 TD a year after recruitment.

*Contract of reintegrating working life*, targeting permanent workers who lost their jobs for economic, technical or other reasons. This measure is hence related to the youth, though not solely, its objective being to provide new skills identified by a private firm beforehand. The government grants a monthly allowance of 200 TD, co-



vers training costs and social security cover while the host firm must recruit the beneficiaries.

Program of backing the promoters of the small businesses, put in place to help small businesses promoters set their project idea, study and business plan, provide help in business administration and in various technical fields. The government covers the costs of training in setting up businesses and costs of technical assistance for project promoters. Possibility of training in public or private firms is given to provide the necessary skills to set up a business.

Solidarity employment contract, targeting all job seekers, seeking to integrate them within specific actions that are part of local and regional employment initiatives. Yearly target contracts are concluded with the Regions according to given programs.

Program of voluntary public service, put in place to allow higher education graduates that are also first-job seekers have access to voluntary and part - time community service jobs. The program is supervised by associations/ professional organizations under concluded agreements with the Ministry of Vocational Training and Employment. The targeted youth perceives 150 TD monthly while the « National Fund for Employment 21-21 » can support a party not exceeding 60% of expenditure for urban public transport.

Source : Tunisian Republic, Ministry of Vocational Training and Employment

Furthermore, it appears that employment creation for the youth during the last two years has been particularly low, estimated at 0,71% and 0.88% in 2009 and 2010 respectively, while growth was above the 3% mark. In that respect, the economic literature suggests that the economic crisis of late 2008 could be responsible for worsening conditions for the youth.

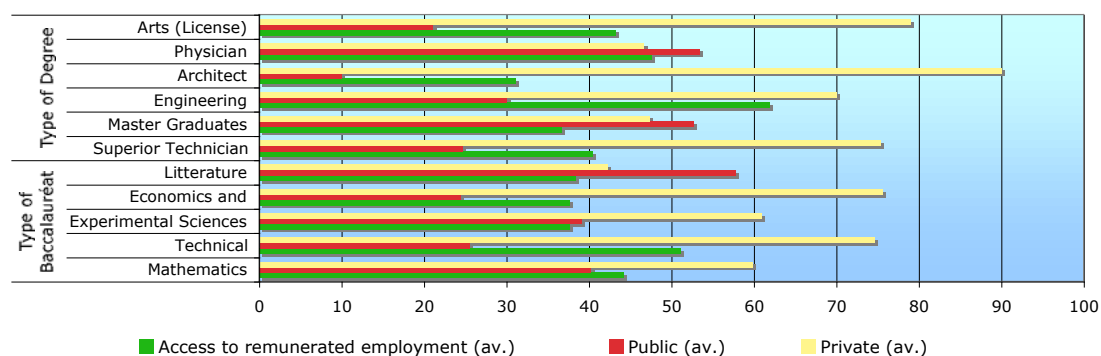
In a recent article, Choudry et al (2010) suggest that young people are far more affected by unemployment than the rest, which can produce “discouraged workers” effects as well as social exclusion from labour market. It is found that the impact of the financial crisis is positive and significant on youth unemployment (with a 2-year lag), suggesting that financial crises causes additional unemployment for the youth. Furthermore, a double crisis-induced effect weighs on the youth. First, a decrease in labour demand means that new entrants in the job market that have by definition a high “experience gap” are more affected. Second, employment destruction is more youth-oriented because of the temporary nature of their job contracts.

## 2. Deconstructing the issue of youth employment

A recent study (Ben Halima, Kocoglu and Ben Halima, 2010) of professional insertion in Tunisia provides great insights regarding the youth issue.

First, it appears that graduates with a Masters degree (36.7%) and architects (31%) face the greatest difficulties in finding employment. Meanwhile, young indivi-

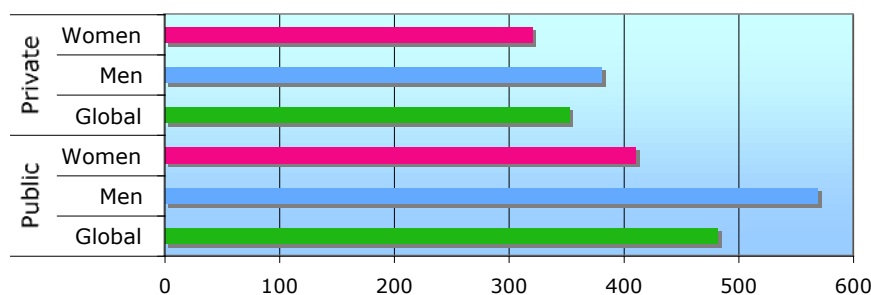
Figure 14. Employment access in Tunisia, by degree and sector



Source : Ben Halima et al (2010)



Figure 15. Average wages by gender, public-private



Source : Ben Halima et al (2010)

duals with an engineering degree (61.8%), physicians (47.6%) are those with greater job-access. They are followed by those with a license in Fine Arts (43.2%) and technicians (40.4%) who constitute an intermediate category.

Furthermore, whether one belongs to the private or public sector matters. It appears engineers are more prevalent in the private sector (69%) than in the public sector (30%) which contradicts some pre-conceived ideas and could be explained by early privatization efforts. Finally, the private sector appears to attract technicians (75%) and architects (90%). In contrast, more than half of physicians (53%) and master degrees (52%) are in the public sector.

Undeniably, one of the characteristics of the Tunisian labor market is that wages in the public sector are much higher than in the private sector which may act

as a barrier to youth-orientation towards more productive employment.

As seen in figure 16, Tunisians working in the public sector receive an average monthly wage of 482TD versus 35TD for the private sector.

Additionally, men in the public sector perceive 569 DT about 50% more than the average wage for men in the private sector. It should also be noted that while women are underpaid compared to men in both sectors, it appears however that women in the private sector are better paid than men in the public sector.

Interestingly, Ben Halima et al (2010) find that entering the public sector depends on a series of parameters. The decision to be employed in the public sector is a decreasing function of age while gender appears to play no significant role. Those with a bachelor degree in experimental science or literature appear to have easier access to the public sector which is not the case of those with a bachelor degree in mathematics. Meanwhile, senior technicians and graduates in Fine Arts have more difficulties to be employed in

Table 5. Percentage of Unemployed after benefiting from a professional integration program, by education

	Post-participation unemployment rate	Index of relative effectiveness
Less than secondary	15,68	0,76
Secondary (BAC)	23,64	0,79
Vocational Training	18,95	0,46
Masters in Social Sciences	29,22	0,68
Economics, Management and Law	21,18	0,45
Hard Sciences	32,59	0,8
Other disciplines	18,91	0,51
Degree in Engineering	9,09	0,37
Degree in Medicine or Pharmacy	15,53	0,53
PhD	7,13	0,27

Source : Stampini and Verdier-Chouchane (2011)

Note : The index of relative effectiveness is equal to the rate of unemployment among beneficiaries to the rate of unemployment among non-beneficiaries.

the public sector as well. Last but not least, firm size plays a role in determining wages. Working in a small firm (1 to 9 employees) appears to decrease wages in both sectors by a significant margin. In the end, public sector wages are mostly higher due to master degrees that are ensured to have a higher wage, while others are either jobless or in the private sector with a lesser paid employment. For all other degrees, the private sector appears to « pay more » though not significantly.

### 3. Gauging the effectiveness of labor-market programs

As for the incidence of labor market programs in Tunisia, it appears that employees with a CDD (determined duration contract), SIVP (stages d'Initiation à la Vie Professionnelle) and contract within the CFNE (cadre du fond national de l'emploi ) respectively earn 26%, 36% and 49% less compared to permanent employees (CDI) in the public sector (Ben Halima et al, 2010). As for employees with no contract they would earn 56% less than permanent employees. Similar results are observed in the private sector, though at a lesser extent. Moreover, training « stages » appear to have a positive effect on wages in the private sector.

But one would ask the following : are professional integration programs really efficient in Tunisia ? The issue is raised by Stampini and Verdier-Chouchane (2011) who provide valuable insights. As seen in the Table, the index of relative effectiveness of professional integration programs all have a value below 1 which suggest that the rate of unemployment among beneficiaries is lower than the rate of unemployment among non-beneficiaries of such initiative. Nonetheless, success is relative across education levels.

The best results (value closer to 0) are to be found values (indicating best performance) for individuals with vocational training (0,46), graduates in economics , management and law (0,45) and also in engineering (0,37) and PhD's (0,27). On the contrary, while existent, results are less encouraging for those with only

secondary education (0,79), less than secondary education (0,76) and masters in social sciences (0,68). The comment to be made is that Tunisian professional integration programs could be more efficient for those with a degree in a field that is inclined to unemployment such as social sciences and other disciplines. Also, a profound reflexion must be made at the level of education as to orienting the youth towards disciplines that present a greater employment potential for the coming decades.

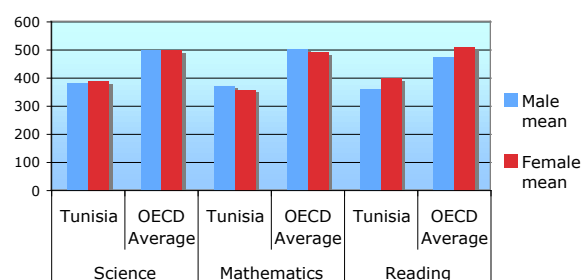
Furthermore, the authors projections allow for some optimism : if Tunisia manages to fall back to a growth rate of 4.5% after 2011, something that was entirely feasible prior to 2008, the youth unemployment rate could drop significantly. That is, provided economic reforms for a sustainable growth regime are implemented continuously.

### IV. Conclusions

The country has entered a period of profound political change that will have considerable implications at the economic level as well. This suggests a series of concluding remarks.

First, a gradual transition towards a more democratic capitalism should be followed. This implies political reforms that provide coverage for domestic needs, better institutions, opportunities for all and a reduction of inequalities. The first step that the authorities ought to do is provide compensations for those who have suffered the immediate economic repercussions of the social crisis. Short-run initiatives appear to be on that track, the interim government adopted economic

Figure 16. PISA 2009 domestic performance VS OECD average



Source : OECD (2010), PISA 2009 Results: Executive Summary

measures for businesses that suffered damages like, for instance, taking charge of half of the employer's contribution in compulsory social security in wages for employees working reduced hours because of slower activity. Similarly, the authorities will take charge of two percentage points of lending rates? under restructured loans and credits for reparations.

The plan for economic and social recovery adopted in April 2011 should also provide initiatives for employment creation and investment. It is expected to provide tax exemptions for investors in regional development areas, company exemption of taxes on wages without any time limit for projects in industry, handicraft and services (tourism as well), and other incentives to finance investment through markets. Furthermore, export-oriented companies should be supported to cope with underlying troubles in exporting their services and products, allowing them to sell a portion of their goods or services on the local market.

Additionally, among the most « obvious » sectors that are hit is tourism and the sector will need immediate revitalizing. Tourism employs 400,000 Tunisians and contributes by 2.5bn US\$ to GDP while being the first foreign currency earner. In that respect, the Tourism Ministry launched the 'I Love Tunisia' campaign to attract foreigners after recent events, meanwhile French agency «Eco Tour» is expected to also launch a marketing plan for Tunisia tourism. It remains to be seen if such measures will be successful and cover for the expected loss of tourists coming from Libya.

Finally and perhaps most importantly, Tunisia must cope once and for all with the issue of youth. But the youth issue naturally transits mainly from education and in that respect Tunisia should focus on ameliorating the quality of its educational system. The country presently ranks 56th out of 65 countries on the PISA-OECD criterion and comes last when compared to the rank of neighbouring MPs that are part of the sample. A framework that allows for better orientation of Tunisian students to the sectors in need should be

envisaged, progressively reducing the ratio of literary studies that are synonyms of higher unemployment. A collaborative effort through Public-Private Partnerships (commonly known as PPP's) should ensure that the labor markets demands and qualifications obtained from the education system are in harmony. The issue should be tackled with comprehensive policies to allow the emergence of a dynamic and competitive private sector and the knowledge economy. Gender issues should be dealt while development policies should take regional differences across the territory into account, thus creating jobs in a manner that reduces geographical disparities.

#### Notes:

1. The J-curve approximation is obtained plotting the «political instability index» (EIU) to the «index of democracy 2010» (EIU).

We obtain a quadratic equation that represents a simplified relationship between the two indexes and takes the form of :

$$Y = 5.2547 - 8.7419 * \ln X + 9.3128 * \ln X^2$$

where X is the EIU democracy indicator of 2010 and Y the inversed political instability index (political stability)

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## TURKEY : Democratic regime with some vulnerabilities

Compared to most of its southern Mediterranean neighbors, Turkey is ahead in terms of democracy. Naturally, as turmoil spread in the Arab world, it has not been much affected. Not only that, but it had been among the first countries to support the popular uprising in Egypt and Tunisia and is currently seen by many as a democratic model for other Islamic countries.

Yet, while Turkey currently stands to gain from past democratization and economic reform efforts, some observers (Rodrik, 2010) have pointed that there is a risk that it regresses back to less political openness. This is because of some recent concerns about the ruling political party trying to weaken the military's hold on the state. And more worryingly, it led a crackdown on journalists in 2010 to silence voices of opposition, particularly those from the old secular guard. Nevertheless, a positive development is the outcome of the June 2011 parliamentary elections. The ruling party was not able to secure the minimum number of seats in parliament required to change the constitution which means that it will have to seek the support the opposition.

Turkey's economy, which performance was not very impressive until the early-2000s, was able to weather the strong outfall of the 2008 crisis without facing another full-fledged financial crisis (Macovei, 2009). It is true that the impact of the crisis was more severe than other emerging economies but it was short-lived and the Turkish economy showed strong signs of recovery in 2010 (IMF, 2010a). This was largely due to a structural transformation of the economy and improved economic management (a successful disinflation program, fiscal discipline and financial sector supervision) in the wake of a home-grown financial crisis in 2001. These efforts strengthened Turkey's fundamentals and increased its resilience to external shocks which allowed mitigating the impact of the 2008 financial crisis.

After an impressive economic recovery in 2010, forecasts for 2011 are as follows:

- ✓ Growth which had surged to 9% in 2010, is expected to moderate to 5.7% in 2011, reflecting a continued revival in external demand but a less accommodating monetary policy,
- ✓ In tandem with the growth recovery, unemployment is expected to decline slightly from the current rate of 11% but would require high long-term growth rates to decline below the persistent rate of 10%,
- ✓ The current account, dormant during the crisis, is expected to soar to 9.8% of GDP, reflecting Turkey's growing external financing needs,
- ✓ FDI inflows are expected to remain below pre-crisis levels (to 1.7% of GDP).
- ✓ Inflation is expected to exceed the initial central bank target of 5.5%, as a result of stronger domestic demand, rising commodity prices and a weaker currency,
- ✓ After a better than expected performance in 2010, the fiscal deficit is forecasted to continue to decline from 3.6 in 2010 to 1.5% of GDP in 2011, following a restructuring of income tax and social security premium arrears,
- ✓ Finally, job creation is a long-standing challenge for Turkey which is exacerbated for the youth who have been the most vulnerable to employment losses in the aftermath of the 2008 crisis. They also have the highest unemployment rate (23%) particularly among the graduates. When employed, they have low earnings from informal jobs. So far, past policies have not sufficiently remedied labor market regulations which are considered to be too restrictive and discourage job creation.

### I. The limitations of the political economy model

Contrary to most neighboring MPs which currently face heightened political uncertainty, Turkey is ahead in its democratization efforts. It has been governed by a secular democratic state since 1923, has a multiparty democratic regime since 1945, free elections since the 1950s. In recent years, more reforms were introduced. Constitutional

changes introduced in 2007 allowed for the direct election of the president (to be held for the first time in 2014) and also reduced the presidential term to five years, for a maximum of two terms. The current ruling party won the general parliamentary elections held in June 2011, securing a third consecutive term in government. Yet, the party was not able to secure the minimum number of seats in parliament (acquiring 326 out of 550 seats) required to change the current 1982 military-inspired constitution which means that it will have to seek the support the opposition to do so. Amendments need to be supported by at least two-thirds of the assembly (367 MPs). Alternatively, a three-fifths majority (over 330 MPs) is enough to pass amendments in parliament and then put them to a referendum. The need to build a broader consensus will make introducing constitutional reforms more difficult.

### 1. A country past the transition but with some risks

Turkey's position on the J-curve confirms that it is ahead of many MPs (like Egypt, Tunisia and Morocco). It has crossed the turning point, or the inevitable transition period of instability (figure 1). Past achievements seem to keep Turkey relatively safe from the current political turmoil and have also allowed Turkey to play a prominent role in supporting the demands of the 'Arab Street' for political change. Turkey has even invited Arab leaders, such as the Syrian President, to come and learn from their democratic experience. Furthermore, its se-

cular democratic model; reflective of economic dynamism, foreign policy creativity as well as Islamic moderation; could serve as an example for other Euromed countries.

Yet, it is important to note that in terms of democracy, Turkey is relatively far from other Mediterranean neighbors (Israel) and is even further from fully-democratic countries like Norway. Clearly, a deepening of its democratization process would enable it to catch-up with them. Alternatively, if it does not, there is a risk it will lag behind other Mediterranean countries who get engaged in genuine democratization. Finally, some observers (Rodrik, 2010) have pointed that there is a risk that Turkey regresses back to less political openness. While the ruling party has been making promises for increased political freedom and democratization, a new constitution as well as judicial efficiency, there has been recent concerns about attempts to weaken the opposition either from the military (through a 2010 constitutional reform package increasing civilian oversight of the military) or the media. In fact, the government led a crackdown on journalists in 2010 to silence voices of opposition, particularly those from the old secular guard.

### 2. Governance in political measures still need to be improved

Turkey's record in governance is better than most Mediterranean economies but more importantly, figure 2 shows that there was an improvement

between 2000 and 2009. The most notable improvement can be seen in government effectiveness, control of corruption and rule of law. In particular, Turkey made significant progress in the fight against corruption in the context of the implementation of the OECD anti-bribery convention since 2003. Accordingly, several legislative and regulatory provisions

Figure 1. Turkey on the world J-Curve (2010)

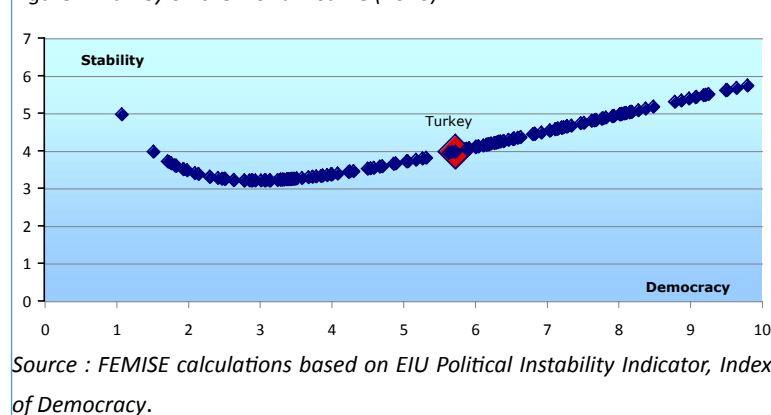
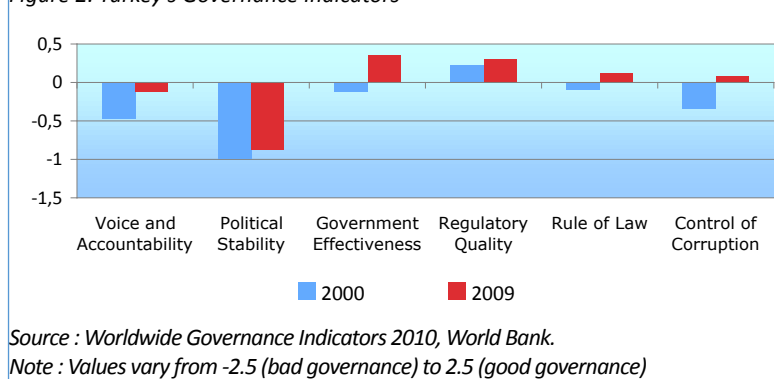


Figure 2. Turkey's Governance Indicators



have been adopted and there was an increase in law enforcement (OECD, 2010). Currently, Turkey has a score of 4.4 in Transparency International's Corruption Perceptions Index for 2010 and ranks 56th out of 178 countries but ranks first among Eastern and Central European countries (Transparency International, 2010). Nevertheless, scores for political stability and voice and accountability measures are negative. This poor performance reflects the recent above-mentioned concerns.

### 3. Human development and poverty

Contrary to the Egyptian case, Turkey's improved macroeconomic performance was accompanied by better human development, poverty reduction and increasing equality.

Between 2000 and 2010, Turkey's human development index rose by 1.3% annually, which gives the country a rank of 83 out of 169 countries in 2010. This places Turkey very close the regional average, ranking very closely with other MPs like Tunisia and Jordan but lagging behind more developed MPs like Israel (UNDP, 2010).

Moreover, Aran et al. (2010) showed that there was a dramatic decline in poverty from 28% in 2003 to 18% in 2006. This occurred following impressive poverty reduction in urban areas where the poverty headcount declined by almost 14 percentage points to 9.4%. Meanwhile, poverty in rural areas remains high, estimated around 33%. Furthermore, inequality measures also improved

considerably in urban areas. Ferreira, Gignoux and Aran (2010) find that inequality of opportunities accounts for at least 26% (31%) of total inequality in predicted consumption (the wealth index), for ever-married women aged 30-49 in Turkey. In contrast with the Egyptian case, the pattern of economic growth was pro-poor in

Turkey between 2003 and 2006. In fact, Aran et al. (2010) show that both growth and distribution greatly contributed to urban poverty reduction, accounting respectively for 7 and 3.8 percentage points decrease. The occurrence of fast growth in sectors like commerce/tourism, manufacturing and construction with a large distribution of the poor in 2003 (33%) has helped reduced the share of the employed poor in 2006 (25%).

### II. External finances have recovered but are vulnerable to a sudden stop in short-term capital inflows

Current external balances have recovered in 2010. The 2011 outlook based on IMF projections is as follows:

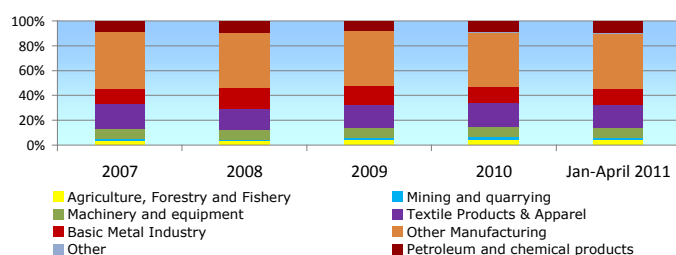
- ✓ Merchandise **exports** (in volume) is expected to maintain positive growth rates close to 7%,
- ✓ Merchandise **imports** growth is forecasted to slowdown to 9%,
- ✓ The **current account**, dormant during the crisis, is expected to soar to 8% of GDP, reflecting Turkey's growing external financing needs,
- ✓ Finally, **FDI** inflows are expected to increase to 1.7% of GDP but should remain below pre-crisis levels.

#### 1. A recovery in trade growth highlights Turkey's dependence on imported energy

Export volumes recovered from negative growth in 2009 (-22%) to a positive pace of 6.3% in 2010 and rose by 18% y-o-y in the first half of 2011. Manufacturing accounts for the largest share in exports (above 90%), particularly exports of textiles (figure 3). They



Figure 3. Exports by sector grouping, 2007-2011 (%)



Sources : Author's calculations based on data from Turkish Statistical Institute.

recovered in 2010, growing by 10.6% after contracting by 24% in 2009. Textiles exports posted an impressive growth of 12.6% in 2010 after negative growth last year. Most manufacturing exports posted positive growth in Q1-2011 (that is still low below pre-crisis levels) with the exception of basic metals. Oil exports represent less than 10 % of Turkish exports, thus limiting the gains Turkey can make from the current price boom.

It is also important to highlight that the assembly-type feature of Turkey's exports, especially in transport vehicles, implies that these industries have a low domestic content (or alternatively a rising import content) destined to satisfy domestic and external demand. These industries may be footloose, as experience in Central and Eastern Europe shows, and thus willing to uproot to more competitive countries.

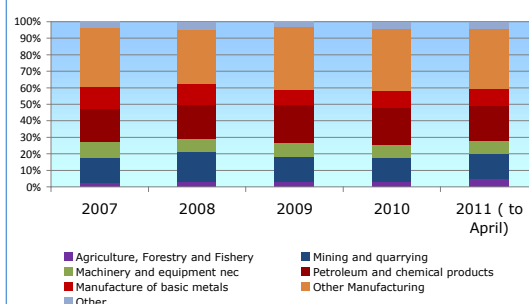
The strength of domestic demand and higher oil prices led to soaring imports (up by 21% in 2010 and by 45% in the first half of 2011), reflecting a strong dependence on imported energy. In fact, oil (both crude and refined) constitute about more than a third of total imports (figure 4). Most other import groups posted double digit growth; the highest was for basic metals manufactures up by 40%.

Consequently, the trade deficit rose, from 4% of GDP in 2009 to 6% in 2010. In the first half of 2011, it surged to 6.3 from 2.9% of GDP. Further international price increases are likely to accentuate this trend. In tandem with the rising trade deficit, the current account deficit, dormant during the 2008 crisis when external financing was scarce, edged

up rapidly. In 2010, it more than doubled to 6.6% of GDP from 2.3% in 2009 and to 6% of GDP in the first half of 2011 up from 2.8% last year (figure 5).

As EU demand for Turkish export is expected to remain subdued, the pace of (volume) export growth will be maintained at the same level close to 7%. To boost export growth, Turkey could increase export market penetration in other markets. Meanwhile, high growth and rising commodity prices are likely to maintain import growth but at lower levels (9%) and exert pressure on Turkey's current account deficit which is forecast to rise

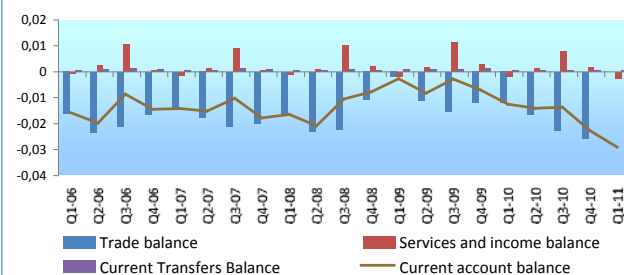
Figure 4. Imports by sector grouping, 2007-2011 (%)



Source : Author's calculations based on data from Turkish Statistical Institute.

to close to 9% of GDP in 2011. The current account is expected to ease only moderately starting 2012 but the deficit will still be worryingly large. The current account now financed by short-term capital inflows remains vulnerable to a sudden stop in these inflows, if global financial conditions deteriorate again. This could cause severe problems, including an abrupt fall in the value of the lira leading, as it has done in the past, to higher inflation and a sharp tightening

Figure 5. External finances (% of GDP)



Source : Author's calculations based on data from Central Bank of the Republic of Turkey (CBRT).

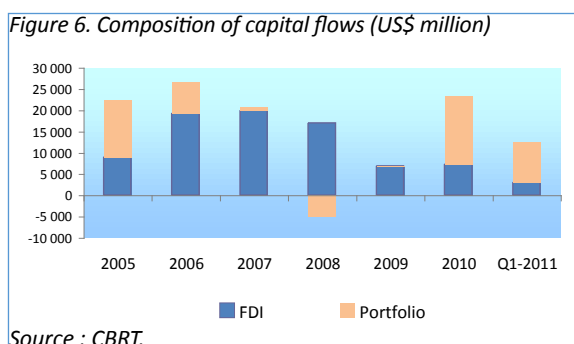
of monetary policy followed by a rapid slowdown in economic activity, with possible private-sector debt servicing difficulties.

## 2. Financial sector: capital inflows have resumed but their quality has deteriorated

Capital inflows, which have been the main financing item of the current account, have resumed after some interruption in the aftermath of the crisis in 2008. Yet, their composition has shifted from FDI and longer-term debt towards portfolio and short-term flows (covering 40% of the current account deficit), mostly intermediated by the banking sector (figure 7).

Portfolio investments soared to 3% of GDP in 2010 from almost nothing in 2009; and from 1.3% of GDP in the first quarter of 2011 from 0.4% of GDP last year. This increase came at the back of the issuance of a yen-dominated international bond (in the equivalent of US\$ 2.3 billion), of which foreign investors purchased US\$2.1 billion in the domestic government bond market, and banks and companies increased their use of foreign loans by about US\$ 5.5 billion. The predominance of short-term capital inflows increases exposure to capital flow reversal. According to IMF (2010b), push and pull factors drive these short-term capital inflows and will continue to do so in the future. Pull factors include high interest rate differentials, favorable growth prospects and healthy public finances while push factors include inadequate competitiveness and a rising current account.

Benefiting from the return of short-term inflows, the Istanbul stock exchange has been on a rising trend since mid-2009 and closed 2010 with a 25% growth,



thus outpacing many comparable emerging markets. Since the beginning of 2011, the stock market had a good performance on the back of a generally positive sentiment regarding the global economy and satisfactory company results. However, renewed concern about the sustainability of the global economic recovery and debt problems in some EU member states as well as expectations that further measures would be taken to curb Turkey's current-account deficit have increased market nervousness recently. According to IMF (2010a), the sensitivity of Turkish financial markets to global risk appetite – measured by Turkish sovereign CDS spreads – appears to have recently declined. In other words, domestic markets have become less responsive to global risk sentiment, reflecting the strength of the recovery, the resilience during the 2008 crisis, and strong fundamentals.

Meanwhile, FDI inflows remain well below pre-crisis levels (1.4% of GDP in 2010 compared to above 3% in 2007 and 2008, and in the first quarter of 2011, they increased to 0.4 from 0.2% of GDP) and below levels in main competitors in central and eastern Europe. FDI are expected to increase only slightly to 1.6% of GDP in 2011. Reforms to the business environment can help attract more FDI to more sustainably finance the widening current account.

## III. Main macroeconomic balances

While the southern Mediterranean region is witnessing unprecedented political turmoil with implications on economic activity, the Turkish economy is on a fast-track recovery from the effects of the 2008 global financial crisis. This recovery is projected to continue, where robust private demand and buoyant credit growth are lifting economic activity amid still-accommodative macroeconomic policies.

### 1. The real sector shows a strong recovery in 2010, with some cooling down in 2011

The political crisis in the region has not had adverse effects on the Turkish economy. It is true that the

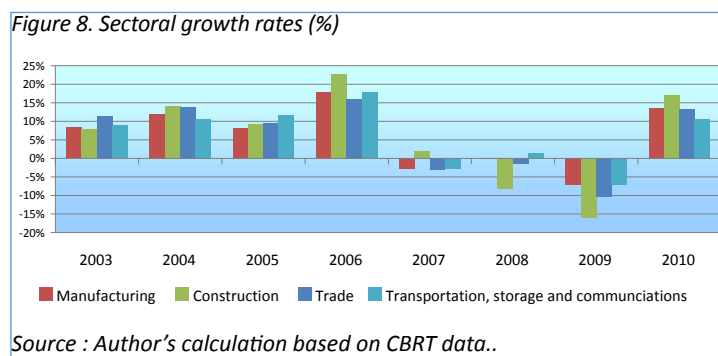
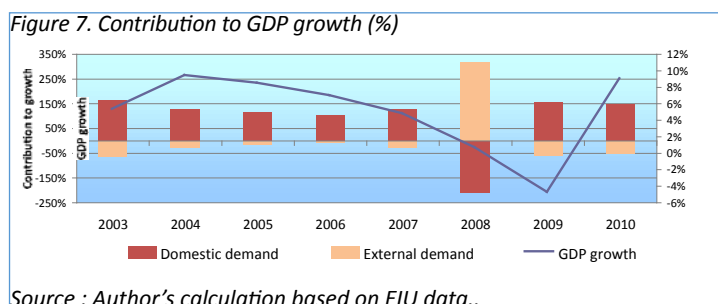
impact of the crisis was more severe than other emerging economies because of Turkey's high degree of trade and financial integration with the world economy (IMF, 2010a). Yet, the domestic recession was short-lived with a better-than-expected GDP growth of 8.9% in 2010, following a sharp contraction of 4.8% in 2009 (figure 8). The recovery continued in the first and second quarters of 2011 with GDP growing at 11% and 8.8% respectively. The recent growth surge reflects some base effects but also strong domestic demand growth driven by low real interest rates, strong capital inflows and a rapid acceleration in bank credit growth. The growth boost was largely driven by the private sector, with consumer spending up by 6.6% in 2010 (compared to a contraction of 2.3% last year) and a recovery of private investment growth (to 30%), which is above pre-crisis performance. As a share to GDP, private investment also increased to 21.5% in 2010 up from 19.9% in 2008 and lower levels in 2009.

On the supply side, the industry, construction, trade and transportation sectors all grew at double digit rates (figure 9). In the first quarter, most major sectors continued to post strong growth rates (trade, up by 17%, construction up by 14.8% and manufacturing up by 12.3%). The pace of growth in economic activity has been slower in the second quarter of 2011, with falling industrial production growth since February 2011. TFP had taken a hard hit in 2009, falling by 5.8% but has recovered in 2010 to 3.3% (figure 10).

Recent analysis showed that past reform efforts - including a highly capitalized and better-regula-

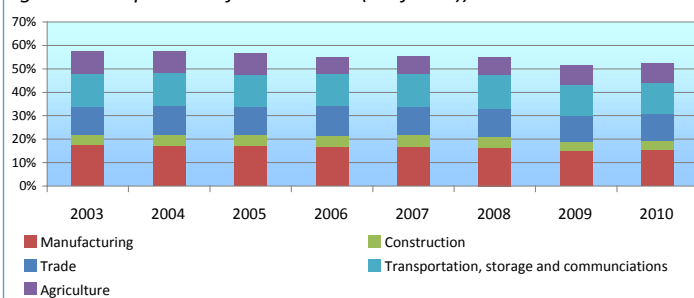
ted banking sector and well-managed monetary, fiscal, and public debt policies - have rendered the economy more resilient and helped it weather the strong outfall of the 2008 crisis without facing another full-fledged financial crisis (Macovei, 2009 and IMF, 2010a). Moreover, Alp and Elekdag (2011) provide evidence that without such key reforms - in particular the adoption of an inflation targeting framework underpinned by a flexible exchange rate regime - the global financial crisis would have been associated with a much deeper economic contraction. Using model-based counterfactual simulations, they estimate that without the counter-cyclical and discretionary interest rates cuts implemented by the CBRT, growth in 2009 would have further decreased to -6.2 %. Moreover, if a fixed exchange rate regime would have been in place, growth in 2009 would have been -8 %.

Taking into account the speed of recovery in Europe, political certainty (after the June elections), robust domestic demand, but also a less accommodating monetary policy, GDP growth is expected to moderate to 5.7% in 2011 and to lower rates in 2012 (EIU, 2011b). Growing external financing and a dependence on short-term inflows to finance them are pressing concerns that could affect this outlook.



In the longer-term, growth should stabilize around its potential rates 4.5-5.5% on the back of a well-diversified economy (figure 11), the return of long-term capital inflows, sound balance sheets, the external anchor of EU accession, and the past track

Figure 9. Composition of value added (% of GDP)



Source : Author's calculation based on CBRT data..

record of solid economic management and structural reform. These positive factors are downplayed by weak external competitiveness and labor market inefficiencies. Reforms to enhance energy efficiency and invest in alternative energy sources are necessary to reduce Turkey's imported energy dependence and thus its exposure to oil price volatility.

## 2. The strengthening economy had a positive effect on unemployment

In tandem with the economic recovery, employment went up by 6.2% in 2010 and 7.2% in February 2011, up from 0.4% in 2009 and is forecasted to decline slightly in the short-term. This improvement reflects several efforts adopted the previous year to boost employment including a 5 percentage point cut in employers' social security premiums, increased funding for active labor market policies, as well as more general stimulus measures such as expanding short-time unemployment benefits and temporary tax cuts on purchases of cars and other durables. As a result, unemployment declined to 12% in 2010 from 14.1% a year ago and is expected to decline further to 11% in 2011. Gender differences are not striking (13% for

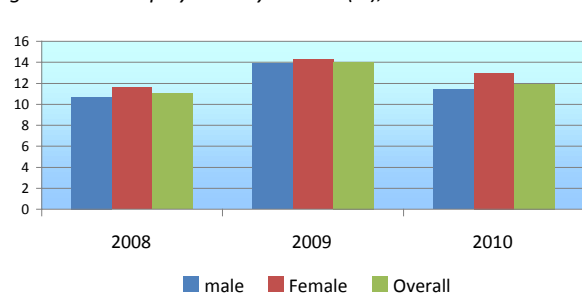
females and 11.4% for males) (figure 12). Youth unemployment dropped to 21.7% in 2010 from 25% in 2009.

Regional disparities are present with urban unemployment (14%) being almost double rural unemployment (7%). The latter has recovered quicker than urban unemployment which still remains above pre-crisis levels (figure 13).

## 3. Inflation has remained under control but is expected to increase in the short-term

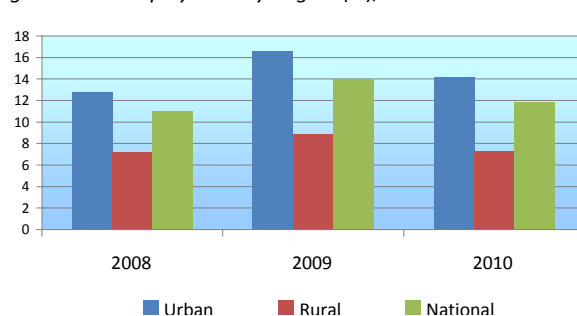
Having adopted a downward trend since between September 2010 (9%) to March 2011 (a low of 4%), inflation soared to 7.2% in May but declined to an average of 6.5% in the following months. Food prices (accounting for over one quarter of the CPI basket) which declined between October 2010 (18%) and April 2011 (2.7%) also surged in May 2011 (to 13%) but also subsided recently (figure 14). Inflationary pressures were owed to a combination of factors including base effects, stronger domestic demand, rising commodity prices and a weaker currency. These factors are likely to interact and continue to push inflation up significantly in the coming months. The Central Bank of the Republic of Turkey (CBRT) is aware of these "temporary" pressures and taking into account a provincial increase in customs duty (on many textile products) implemented in July, it has revised upwards its 2011 mid-point forecast to 6.9% from 5.5% (though the new forecast is still within the band of uncertainty of  $\pm 2$  percentage points). In line with the CBRT's medium-term

Figure 10. Unemployment by Gender (%), 2008-2010



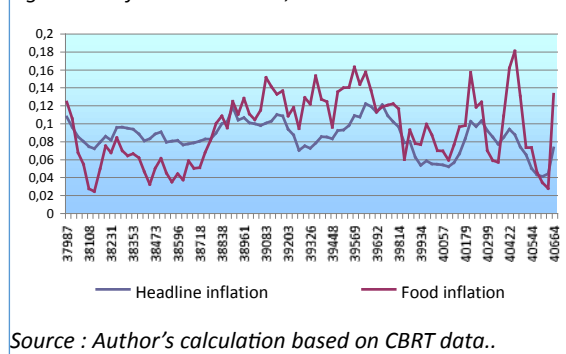
Source : Turkish Statistical Institute.

Figure 11. Unemployment by Region (%), 2008-2010



Source : Turkish Statistical Institute.

Figure 12. Inflation measures, 2004-2-11



objective of price stability, and also as economic activity moderates and short-term interest rates rise, inflationary pressures should subside. The ultimate long-term target is to bring inflation rate to levels complying with the Maastricht convergence criteria.

#### IV. Macroeconomic response

##### 1. Fiscal policy performed better than expected

The government's budget performed better than expected in 2010, with the deficit narrowing to 3.6% of GDP from 5.5% in 2009 (and an initial 2010 forecast of 4.7%). This was in part due to the robust recovery in domestic demand, which supported an increase of revenues to 23 from 22.6% of GDP. More importantly, public expenditure was brought down significantly to 26.6 from 28% of GDP. In the first half 2011, strong demand led to a small budget surplus, benefiting from a restructuring of income tax and social security premium arrears, which led to higher tax revenues and falling interest expenditures. The deficit is projected to decline to further decline to 1.5% of GDP in 2011, below the fiscal target of 2.8%. This decline comes at the back of expected increased tax revenues following the announcement of a new tax amnesty that is expected to generate additional revenue of around 1% of GDP.

The public debt stock fell significantly in the second half of 2010, thereby fully mitigating early year increases, and amounted to about 43% of GDP by the end of 2010 from 46% of GDP in 2009. The pu-

blic debt to GDP ratio is anticipated to fall gradually from 42.3% of GDP in 2010 to 36.8% by 2013.

In order to capitalize on Turkey's past accomplishments in fiscal consolidation, and also to limit government discretion in adopting ad-hoc measures to achieve fiscal targets, the EU recommends that a strong fiscal anchor and an acceleration of key structural reforms would be highly beneficial (EC, 2011a). In the short term, the main challenge will be to continue to meet the fiscal targets set out in the Medium Term Program, to be announced soon. This will not only bring down the public debt, but will also signal policy credibility to investors, important for longer run stability. The government has put forward draft legislation of a fiscal rule, which would help in this regard (IMF, 2010a).

##### 2. Monetary policy in dilemma: curbing inflation versus management of capital inflows?

Concerns about Turkey's soaring current account deficit in 2010 have complicated the conduct of monetary policy for the CBRT. In response to this trend, the CBRT has adopted a policy mix since October 2010 to prevent the economy from overheating as well as maintain financial stability. The CBRT has combined sharp increases in banks' required reserve ratios with moderate reductions in short-term interest rates.

On the one hand, the CBRT raised commercial bank reserve requirement ratios (which have been reduced in end-2008 to alleviate the impact of global financial crisis on the domestic economy). For Turkish lira liabilities, the reserve ratios were raised by 1 percentage point to 6% between October and November 2010. In December 2010, new reserve ratios were announced, varying according to maturity. They were revised again in January and March 2011, nearly doubling for short maturities. Currently, the ratios range from 5% for deposits of one year or more to 16% for demand deposits. For foreign exchange liabilities, requirements were reduced by 2 percentage

points to 11%. The hikes on short-term liabilities should achieve the following: (i) curb the growth of bank credit, which has soared to 45% in December 2010 from single digits in 2009 (figure 16) and continues to be high above the authorities target of 25%, boosted by a surge in capital inflows and low interest rates, (ii) encourage banks to increase the average maturity of their funding. About 90% of bank deposits have a maturity of less than three months, (iii) Contribute to tighter monetary without resorting to sharp rises in the interest rates.

On the other hand, the CBRT adopted a more loosened policy stance despite above-target inflation expectations and domestic demand growth. In fact, the one-week repo (repurchase) lending rate was cut by a total of 1.25 basis points in December 2010 January and August 2011 to 5.75%. These cuts are an attempt to deter short-term capital inflows, which are largely attracted by the yield differential between domestic and international rates, and which until late 2010 were driving up the value of the lira, increasing import penetration and thereby contributing to the rise of the current-account deficit. However, the CBRT sharply increased its overnight borrowing rate to 5% from 1.5% in an attempt to protect the local currency.

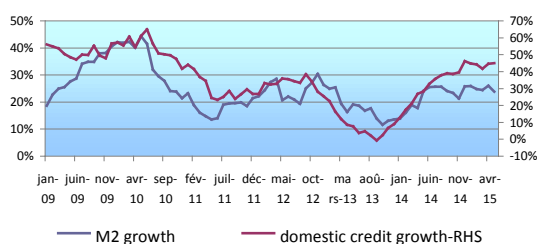
The CBRT expects that higher reserve requirements would offset the effect of interest rate reductions on credit growth, although the latter showed no sign of slowing. And while the CBRT believes the need for further reserve requirement increases has diminished as the increases already made will have a

delayed effect, it might be compelled to start raising interest rates if inflation does not decelerate and also to mitigate the widening of the current account, the latter also requiring tighter monetary policy. Also, as credit growth has remained high, the banking regulation and supervision authority adopted various macro-prudential measures last June 2011 including increasing provisions and changing the risk-weighting attached to short-term loans, to restrict consumer loans other than vehicle and housing loans, particularly those with maturity of over one year, as a means to slow down lending growth.

The Turkish lira started weakening since early 2011 (down by 10%), reversing the appreciation gains made in 2010, as a result of strong short-term capital inflows since April 2010 (up by 9% y-o-y). The depreciation was largely in response to the CBRT policy of reducing interest rates (on foreign currency) and generally seeking to discourage short-term capital inflows. Concern about the depreciation has led the CBRT to suspend the daily foreign-exchange buying auctions and reduced reserve requirements for foreign-exchange deposits. Despite strong global liquidity, which has so far ensured strong capital inflows into lira-denominated assets, there is some concern that Turkey's rapidly deteriorating external imbalances will put downward pressure on the lira exchange rate. Pressures are likely to be exacerbated if global risk aversion increases sharply, making it difficult for Turkey to meet its large external financing needs.

Official foreign exchange reserves rose to roughly US\$ 86 billion (6.6 months of merchandise imports) in 2010 up from US\$ 75 billion in 2009 (5.8 months of merchandise imports). Accumulation of reserves continued throughout 2011 increasing to US\$ 94 billion in June 2011 following continued strong capital inflows a strengthening euro (against the dollar), which boosts the dollar value of euro-denominated reserves. The gross external debt stock amounted to 40% of GDP by end 2010, almost unchanged from a year earlier.

Figure 13. Domestic liquidity, % change, 2005-2011



Source : Author's calculation based on CBRT data..



About two thirds is held by the private sector. Reflecting in part lower credit demand, corporate' external indebtedness declined.

### 3. The banking sector

In 2010, Turkey's banking sector performance improved. In tandem with the recovery, loan and asset growth grew solidly, by respectively 30% and 20%. The capital adequacy ratio stood at 19% at end 2010, versus 20.5% a year earlier. The non-performing loans ratio fell gradually from 5.3% end-2009 to 3.7% by December and 3.4% by early March 2011. Banking sector profits increased by 8.5% but declined by 13.5% y-o-y in Q1-2011 following the hikes in reserve requirements. However, the sector should continue to be profitable in 2011, as it may take advantage of the robust economic expansion in Turkey's economy and of increasing private sector leverage (EC, 2011b).

## V. The Challenge of Youth Unemployment

Like Egypt, Turkey is undergoing a rapid demographic transition, which has generated a youth bulge (between the ages of 15-29) accounting for around a third of the Turkish population and the labor force in 2010. This implies a rapid increase in the working age population which is projected to grow till 2040, meaning that the challenge of job creation will remain pertinent. The large working age population is an opportunity to generate growth, but if these people are not employed, the future bulge in the retired population will have to be supported from lower levels of per capita income (World Bank, 2006).

Turkey's labor market is characterized by low employment rates, reflecting relatively high unemployment and declining labor force participation rates. These problems are exacerbated for the youth who face the following employment challenges: (i) the alarmingly slow pace of employment generation, (ii) they have the highest unemployment rate, (iii) unemployment is particularly

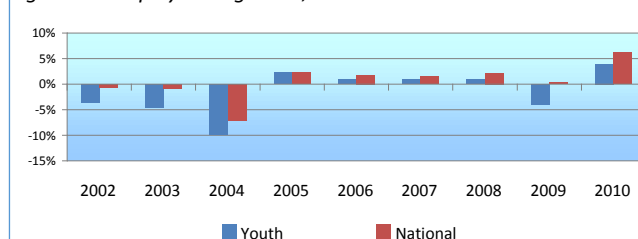
high for higher education graduates, (iv) labor market regulations that are not job-creating friendly.

### 1. Youth employment generation has been alarmingly low

As mentioned earlier, Turkey's impressive economic growth between 2002 and 2007 failed to translate in a strong pace of employment generation. The 2008 crisis only worsened this trend which the recovery in 2010 contributed to partly reverse. In fact, overall employment cumulatively increased by only 5.8% between 2002 and 2010 with employment losses occurring until 2005. In general, Turkey suffers from "jobs deficit" that presents a particular challenge on the road toward EU accession. The European Council meeting in Lisbon in 2000 adopted an employment rate target of 70% to be met by 2010 (World Bank, 2006). Currently, the employment rate is 43%, one of the lowest in world. According to World Bank (2006), most countries have employment rates above 50%.

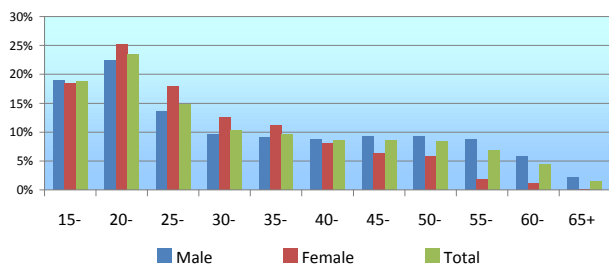
The situation for the youth is more worrying since their employment declined by almost 10% during 2002-2007 the same period and when it experienced positive growth, this rate was consistently below the national average, except for 2005 when it witnessed the same expansion. In the aftermath the 2008 crisis, the youth was the most vulnerable group to employment losses as it was the only group where employment sharply declined by 4% in 2009. The recovery of youth employment is also occurring at the lowest pace among other age groups.

Figure 14. Employment growth, 2002-2010



Source : Author's calculation

Figure 15. Youth Unemployment (15-24 years), 2002-2010



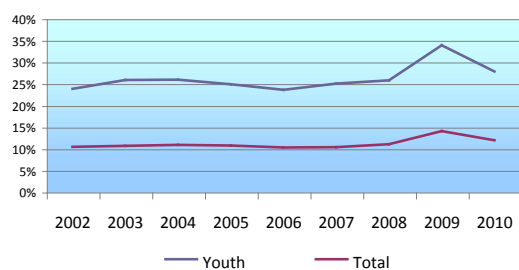
Source : Author's calculation

## 2. Youth have the highest unemployment

Youth unemployment which declined from 27.6% in the aftermath of the crisis in 2009 to 22.6% in 2010 remains the highest - almost double the national average - , compared to other age groups (figure 18). The age group of 20-24 years, the age of completion of university degrees and, therefore, first labor market entry, suffers from the highest unemployment rate of 28%. While labor participation rate suffer from a wide gender gap, (71% for men and 27.6% for women), gender differences are not striking for young males and females.

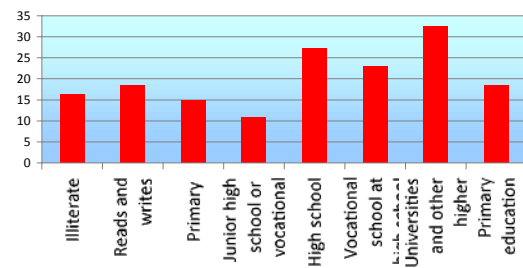
Figure 16 also shows unemployment of youth (15-24 years) has been more than double total unemployment. While the latter has persisted at around 10%, youth unemployment has also been stuck but at a significantly higher level, 25% with a peak to 34% in 2009. Youth unemployment appears to be an urban phenomenon, particularly for the youngest group. Urban unemployment is around 23% almost double the rural unemployment rate (12.4%). Yet, urban youth unemployment has been declining in recent years; the opposite trend can be seen in rural unemployment.

Figure 16. Youth Unemployment (15-24 years), 2002-2010



Source : Author's calculation

Figure 17. Youth unemployment (15-24) by education level, 2011



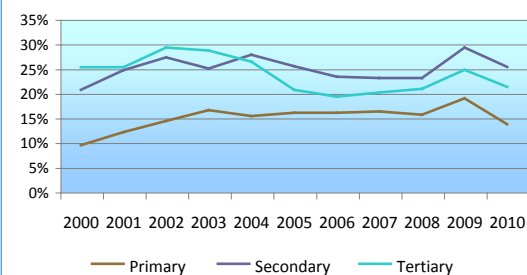
Source : Author's calculation

## 3. Youth unemployment and education

Educated young people (15-24 years) have difficulty finding jobs. In fact, in 2010, job seekers with an intermediate degree and above accounted for above 89% of unemployed, of which graduates with a university degree and above represent around 56%. Unemployment rates are generally high for all education categories, being the lowest (10%) for those with a junior high school degree. Unemployment rates for those with a lower education status are above 15% and they are highest for university graduates (33%) and those with a high school degree (27%) (figure 17). On a more positive tone, unemployment for all levels of education has been declining over time, except for the crisis-induced spike in 2009 (figure 18).

Both demand and supply factors could be responsible for the unemployment of the educated. The economy may not be generating jobs that can absorb educated young, but also the educated young may not be well-suited to the job market. In fact, World Bank (2007) highlights that the quality of education and the skills learnt by Turkish students remain below those in comparator countries. Also, few firms provide training to their workers.

Figure 18. Youth unemployment (15-24) by education level, 00-10



Source : Author's calculation



#### 4. Youth, informality and labor market institutions

Informality is widespread among young individuals where it was estimated close to 80% for the 15-19 age cohorts and at 50% for the 20-25 age groups (World Bank, 2010). Young workers are on average less productive and their level of productivity may be less certain to their employers, since they have a shorter track record and thus may not justify the costs of a formal job offer. Young workers may also place lower value on social security and other benefits of formality, and be more willing to accept offers of unregistered work. A previous study, World Bank (2006) had already shown that young workers (15–24 years) had the worst earnings record, experiencing a real decline of 10 % between 1989 and 2002. This group benefited the least from the wage gains between 1989 and 2004 (only 12.3 growth) and was hurt the most from the wage declines between 1994 and 2002 (19 % loss). As a result, mean youth earnings in 2002 were just half (50 %) of the average for all workers, down from 63 % in 1989.

The widespread of youth informality is just a reflection of overall informality in the Turkish economy, estimated at 33% of GDP, a size that is not considered excessively large, given its per-capita income level and comparable to countries of similar income levels (World Bank, 2010). A positive outcome noted is that informality rates decreased from 52% in 2001 to 48% in 2006 following a decline in agriculture sector informality (to 87% of total employment in 2006 from 90% in 2001), strong urbanization and rapid migration from rural to urban areas which both led to a decline in rural informality to 66 from 75%. Nevertheless, as labor shifted to urban areas, informality in nonagricultural sectors increased from 29 % overall to 34 % in 2001-06. Meanwhile, wage earners have an informality rate of 18 %, but constitute over half of the labor force and two thirds of the non-agriculture labor force.

Nevertheless, informality and slow job creation seem a repercussion of unfriendly labor market

institutions. In fact, many studies have pointed to the high-minimum wage, excessively rigid or protective labor market regulations as well as high non-wage labor costs to be the main factors that foster informal employment or lead to weak employment creation (IMF, 2010a; World Bank, 2010 and 2006). First, Turkey's minimum wage in the formal sector is binding (it has tripled since 2002) and higher than in most EU member countries (IMF, 2010 and OECD, 2008). Second, Turkey has one of the most protective employment protection rules among 28 OECD countries. This is primarily due to the existence within the protection regulations of limitations on temporary employment, fixed term contracts as well as regular employees. The most significant factor increasing the strictness of regular employment protection is the high level of severance indemnity payment compared with most countries. While a worker with 20 years tenure in Turkey gets 20 times his or her monthly wage as severance payment, the average payment is 6.2 times in the OECD and 9.8 times in upper middle income countries. Moreover the severance pay in Turkey is not limited to dismissals. Severance pay is paid to male workers for compulsory military service, female workers who leave within one year after marriage, and workers qualifying for old-age pension.

Finally, high non-wage labor costs add to the cost of complying with regulations. The combined employee employer contribution rate on payroll taxes is 36.5 % (pensions, health insurance, work injuries, workman's compensation and unemployment insurance): well above the middle-income country average of 25 %, and the OECD-20 (developed countries) average of 27.4 %. Unemployment insurance premium (4% of which 2% employer's share, 1% employee's share, and 1% state contribution) also contributes to the non-wage cost of labor. Eligibility criteria for unemployment benefits are strict when compared with OECD countries. Both labor market regulations and the tax wedge created by high social security contributions establish disincentives for formal sector job creation.

## VI. Conclusion

Compared to most of its southern Mediterranean neighbors, Turkey is ahead in terms of democracy. Yet, while it stands to gain from past democratization and economic reform efforts, there may be a risk of regression less political openness because of concerns about reducing the opposition power.

Turkey was able to weather the strong outfall of the 2008 crisis without facing another full-fledged financial crisis. Its short-term outlook is rather optimistic except for a large and increasing current account which is financed by short-term capital inflows and thus remains vulnerable to a sudden stop in these inflows, if global financial conditions deteriorate again.

Unemployment, which has persisted around 10% despite growth between 2002 and 2007, remains one of Turkey's medium-term challenges. It is forecasted to decline only slightly and it has been argued that high long-term growth rates are required to permanently reduce it. In addition, it is crucial to address labor market inefficiencies that have led to an expansion of informal jobs or discouraged job creation altogether. These inefficiencies include the high minimum wage compared to almost all new EU member countries, the generous severance pay scheme (one month per year of tenure) and restrictive regulations on short-term contracts. To foster employment, the following recommendations are suggested:

First, a reduction in informality could increase wages and productivity in the economy. Irrespective of firm size, formal firms pay higher than their informal counterparts. The wage differential is much higher in services (about 55 %) than in manufacturing (about 35 %). Second, increasing the flexibility of the labor market and easing restrictive employment protection rules could increase the incentives for job creation. Third, there is a need to align the workers' skills with the needs of the private sector by improving the quality of education and increasing training provided by employers.

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## TECHNICAL ANNEX.

### a. The theory behind new gravity models: the Anderson and van Wincoop (2003) approach

In recent years, the most popular specification of the gravity model can be found in Anderson and van Wincoop (2003). These authors develop a consistent general theoretical framework with special emphasis on trade costs from which the gravity equation can be derived.

$$X_{ijt} = \left( \frac{Y_{it}^\alpha Y_{jt}^\gamma}{Y_{wt}^\mu} \right) \left( \frac{T_{ijt}}{P_{it} P_{jt}} \right)^{1-\sigma} \quad (1)$$

$X_{ijt}$  corresponds to country  $i$ 's exports to country  $j$  at year  $t$ . The first term in brackets includes the mass variables, namely country  $i$ 's GDP ( $Y_{it}$ ), country  $j$ 's GDP ( $Y_{jt}$ ) as well as world GDP ( $Y_{wt}$ ). The second term in brackets reflects trade costs. They include the bilateral trade cost ( $T_{ijt}$ ) as well as implicit prices ( $P_{it}$  and  $P_{jt}$ ) which measure multilateral trade costs (Anderson and van Wincoop, 2003).

In the same way, implicit prices can be written as [7] :

$$P_{jt}^{(1-\sigma)} = \sum_i P_{it}^{\sigma-1} \theta_i t_{ijt}^{1-\sigma}, \forall j \quad (2)$$

$$P_{it}^{(1-\sigma)} = \sum_j P_{jt}^{\sigma-1} \theta_j t_{ijt}^{1-\sigma}, \forall i \quad (3)$$

With  $\theta_i$  and  $\theta_j$  denoting country  $i$  and  $j$ 's income shares.

Since prices depend on the trade barriers applied to all countries, they reflect multilateral trade resistance, i.e. the trade barriers that an exporter faces with all importing countries, not only its bilateral partner  $j$ . As a result, a rise in the trade costs vis-à-vis all its partners leads country  $i$  to trade more with its bilateral partner  $j$ .

The log-linearization of equation (1) leads to the new gravity equation where exports depend on GDP, distance as well as bilateral and multilateral trade costs.

### b. The calculation of ad-valorem equivalents for NTBs: the Kee et al. (2009) approach.

The Kee et al. (2009) approach, also referred to by KNO (2009) makes it possible to calculate ad-valorem equivalents of NTBs. Two stages must be implemented. The first includes an estimation of the quantity impact of NTMs on imports. In a second stage, this impact is transformed into price effects, using import demand elasticities calculated in Kee et al. (2008).

In the first stage, the basic equation to be estimated is the following:

$$\log(m_{n,c}) = \alpha_n + \sum_k \alpha_{n,k} C_c^k + \beta_{n,c}^{ntb} ntm_{n,c} + \varepsilon_{n,c} \log(1 + t_{n,c}) + \mu_{n,c} \quad (4)$$

Where  $m_{n,c}$  is the import value of good (or industry)  $n$  in country  $c$  from  $i$ ,  $C_{n,c}$  denotes a vector of country characteristics variables in country  $c$ . They include relative factor endowment and the sum of GDP (of the reporter and the partner country) which captures economic size. The geographic distance between MED countries and their Mediterranean partners is also included.  $ntm_{n,c}$  is a dummy variable which reflects the existence of bilateral NTMs.  $t_{n,c}$  is the bilateral tariff on good  $n$  in country  $c$  and  $\varepsilon_{n,c}$  corresponds to the import demand elasticity.

The initial model is subsequently modified as follows. First, import-demand elasticities estimated in Kee et al. (2008) are substituted into (4). Second, the tariff term is moved to the left-hand side to address the endogeneity of tariffs. This introduces a new error term  $\kappa_{n,c}$ . Third, a White correction is introduced in order to tackle heteroskedasticity of the error term. Fourth, product specific effects are also introduced so as to capture the variation of  $\beta$ s across tariff lines. Fifth, appropriate instrumental variables are included to address the endogeneity problem related to NTMs. Indeed, as shown in Lee and Swagel (1997), such endogeneity may lead to a downward bias on the estimated impact of NTMs

on imports, which would result in underestimating AVEs. Sixth, a two-step estimation procedure is implemented to estimate the  $\beta$  coefficients, following a Heckman two-stage procedure.

After these transformations, the final estimated equation becomes:

$$\log(m_{n,c}) - \varepsilon_{n,c} \log(1 + t_{n,c}) = \alpha_n + \sum_k \alpha_{n,k} C_c^k + \left( -e^{\beta_{n,c}^{ntb} + \sum_k \beta_{n,k}^{ntb} C_c^k} \right) ntm_{n,c} + \kappa_{n,c} \quad (5)$$

Estimating equation (5) with the two-step Heckman procedure (TSHP) described later. The last step consists of calculating the AVEs after transformation of the quantity impact derived from equation (5) into price-equivalents. This leads to:

$$AVE = \frac{\partial \log P^d}{\partial NTM} \quad (6)$$

Where  $P^d$  denotes the domestic price. This equation defines AVEs as the effects of NTMs on prices. The introduction of the price variable is necessary since, like ad-valorem tariffs, NTM effects must be calculated on prices and not on quantities. After differentiation of equation (4), it is easy to obtain:

$$AVE_{n,c}^{ntb} = \frac{e^{\beta_{n,c}^{ntb}} - 1}{\varepsilon_{n,c}} \quad (7)$$

### c. The choice of the appropriate estimator.

The selection of the appropriate estimators is guided by the potential econometric biases which may reduce the relevance of the calculation of export potentials. The first potential bias concerns heterogeneity which is commonly found in panel data models. This problem can be addressed through the inclusion of country and time specific effects, which capture heterogeneity across countries and time. It also addresses the problem of the remaining omitted variables (Egger, 2004). These specific effects can be considered as fixed or random de-

pending on the final specification of the model. In this regard, the calculation of Wald tests enables us to check that they are very significant.

A second problem concerns time invariant variables, whose parameter cannot be estimated through fixed-effects (FE) estimators, as well as endogeneity. This problem can be solved through the use of the fixed-effects vector decomposition (FEVD) estimator developed by Plümper and Troeger (2007). This three stage fixed-effects model makes it possible to produce efficient and less biased parameters of time-invariant variables compared to random effects models, while dealing with the endogeneity problem [8]. However, the use of this estimator has been recently questioned in the literature (Greene, 2010).

An alternative estimator also makes it possible to simultaneously address the problem of endogeneity and the time-invariant variables. This is the Hausman and Taylor estimator, described in Egger (2004). This is a 2SLS random effect model which makes it possible to deal with potential correlation between the unobserved bilateral effects and some of the regressors. Moreover, it provides an estimation of time-invariant parameters and is suitable for out-of-sample prediction (see additional details in the technical annex).

A final potential bias concerns zero observations for the bilateral export variable. Zero flows are commonly found in gravity model. The simplest way to deal with this problem consists in estimating equation (1) with a transformed export variable:

$$\ln X_{ijt}^* = \ln(X_{ijt} + 1)$$

Indeed, when  $X_{ijt}=0$ ,  $X_{ijt}^*=1$  and as  $X_{ijt}$  increases,  $\ln X_{ijt}^* \rightarrow \ln X_{ijt}$ . This technique has been increasingly used in the recent literature, especially since Chen (2004). However, it does not specifically address the question of why some firms export while some others don't (selection bias). An alternative interesting method is the

Two-Stage Heckman Procedure (TSHP). It relies on the idea that zero trade flows in the dataset do not occur randomly but are the outcome of a selection procedure. As a result, the TSHP estimator provides a correction for this selection bias [9].

The last bias is specific to the dynamic version of the model. It relates to the potential correlation between the error term and the lagged dependent variable. Due to the likely existence of simultaneity bias, the most appropriate method of estimation appears to be GMM. We used here the Arellano, Bond and Bover's (ABB) Estimator (Arellano and Bond, 1998 ; Arellano and Bover, 1995). Basically, the initial structure of the model is similar to the HT models described in the technical annex.

To sum up, in order to address the econometric biases described above, the following estimators has been implemented: Hausman and Tay-

lor, TSHP as well as ABB for the dynamic model. The estimators are also controlled for cross-sectional heteroskedasticity and serial correlation of the error term by using respectively the Huber-White Sandwich estimator and the AR1 Cocrane-Orcutt transformation. Finally, multicollinearity is controlled through the variance inflation factor (vif) statistics, which must be below [10].

#### d. The detailed econometric results (Tables A1 and A2)

	HT	TSHP	Heterosc. (HW)	AR(1)	Dynamic ABB	
					short run	long run
GDP reporter	0.8186***	0.7522***	0.8103***	0.8286***	0.1231***	0.8632***
GDP partner	0.7719***	0.5594***	0.7706***	0.7829***	0.1101***	0.7721***
tariffs	-0.2624***	-0.1044***	-0.2529***	-0.1570***	-0.0186***	-0.1304***
NTBs	-0.0396***	-0.0227**	-0.0382***	-0.0224**	-0.0104***	-0.0529***
logistics	2.7629***	2.1222***	2.7718***	1.5238**	0.2893***	2.029***
common language	0.3356***	0.3629***	0.3334***	0.5614***	0.0782***	0.5483***
colony	0.5165***	0.3255**	0.5124***	0.6508***	0.0949***	0.6655***
migration	0.2744***	0.2130***	0.2705***	0.2712***	0.0327***	0.2293***
FDI stocks	0.0274***	0.1702***	0.0254***	0.0189***	0.0007**	0.0491**
services	0.1778***	0.1919***	0.1777***	0.4722***	0.0573***	0.4018***
regional agreements	1.7549***	1.3119***	1.7601***	2.0822***	0.3085***	2.1633***
Governance: rule of law	0.2025***	0.1925***	0.2042***	0.1734***	0.0337**	0.2363***
lagged exports	-	-	-	-	0.8574***	-
Intercept	-31.0560***	-22.9977***	-31.0025***	-32.9113***	-4.5888***	-32.1795***
selection variable	-	0.2577***	-	-	-	-
Adjusted R-squared	0.7292	-	-	-	-	-
VIF	2.47	-	-	-	-	-
Hausman	24.8	-	-	-	-	-

Note: HT: Hausman and Taylor; TSHP: Two-step Heckman Procedure; Heterosc: Heteroskedastic Huber-Sandwich; AR(1): Autoregressive model (lag 1); Dynamic ABB: Arellano, Bond and Bover estimator.

Table A2: Results with various proxies							
	HT1	HT2	HT3	HT4	HT5	HT6	HT7
	Regional		Trade costs		Governance FDI stocks		Sample restricted
	Agreements	Distance	logistics	MAOTRI	and institut. or flows		to MP countries
GDP reporter	0.7750***	0.8041***	0.8365***	0.7653***	0.8186***	0.8186***	1.3293***
GDP partner	0.7937***	0.7692***	0.7696***	0.7713***	0.7719***	0.7719***	0.8122***
tariffs	-0.2488***	-0.1706***	-0.2584***		-0.2624***	-0.2624***	-0.3096***
NTBs	-0.0444***	-0.0469***	-0.0386***		-0.0396***	-0.0396***	-0.0316***
Distance		-0.0001***					
logistics: all	2.3451***	2.3451***		2.6324***	2.7629***	2.7629***	3.4194***
logistics: customs			0.6831***				
logistics: infrastructure			0.5673***				
logistics: shipment			0.6216***				
logistics: competence			0.6388***				
logistics: track			0.7677***				
logistics: timeliness			0.1496***				
MAOTRI				-5.7572***			
common language	0.2620***	0.3391***	0.3160***	0.4089***	0.3356***	0.3356***	0.7110***
colony	0.7125***	0.2857***	0.5159***	0.3414***	0.5165***	0.5165***	0.4967***
migration	0.2566***	0.2772***	0.2774***	0.2800***	0.2744***	0.2744***	0.3472***
FDI: stocks (%GDP)	0.0302***	0.0234***	0.0274***	0.0562***	0.0274***	0.0274***	0.0266***
FDI: stocks (US\$)						0.0030*	
FDI: flows (%GDP)						0.0496***	
FDI: flows (US\$)						0.0551***	
services	0.2654***	0.3091***	0.1933***	0.2455***	0.1778***	0.1778***	0.2751***
regional agreements: All		- 0.6737***	1.7620***	1.6579***	1.7549***	1.7549***	
regional agreements: EU	2.1510***						
regional agreements: Euromed	0.3696***						
regional agreements: Nafta	0.9095***						
regional agreements: Mercosur	3.0979***						
regional agreements: Asean	1.9566***						
regional agreements: Gafta	2.4279***						
Governance: rule of law	0.1393***	0.5260***	0.1735***	0.1551***	0.2025***	0.2025***	1.1049***
Governance: political stability					0.5224***		
Governance: government effectiveness					0.6299***		
Governance: regulatory quality					0.5059***		
Governance: voice					0.1929***		
Governance: control of corruption					0.2072***		
Intercept	-30.6389***	-27.7076***	-30.4138***	-29.8901***	-31.0560***	-31.0560***	-42.3378***
Adjusted R-squared	0.7536	0.7228	0.7294	0.7362	0.7292	0.7293	0.6555
Note: HT1 to HT7 means that the Hausman and Taylor estimator has been used for each sensitivity analysis							