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FEMIP

The crisis and ways out of it in the Mediterranean countries

Study carried out by 





Foreword

The southern and eastern Mediterranean countries did not avoid the global economic crisis, but the fact that they were well placed to respond to it and bounce back quickly kept them on a promising growth path.

That is the main lesson to be learned from the study undertaken, at the request of the EIB, by the experts of the Forum Euroméditerranéen des Instituts de Sciences Économiques (FEMISE) under the direction of Professor Jean-Louis Reiffers and Ahmed Galal.

The FEMISE network, which brings together more than 80 economic research institutes from both the European Union and Mediterranean partner countries, mobilised its resources to produce this new, very high quality and completely independent study, which provides a vital contribution to the analysis of both the authorities and those involved in development in the Mediterranean.

As this study shows, the crisis spread and its impact was felt in a very different way in the northern and southern parts of the Mediterranean. Today, at a time when the relative ranking of economies in the world is changing, the Mediterranean partner countries are facing an opportunity that is also a challenge: the opportunity to consolidate their development, provided that they come up with new drivers of growth; and the challenge of modernising their economies and creating some 60 million new jobs.

For 40 years, the European Investment Bank has been working in the Mediterranean to help meet this challenge. Under the mandate entrusted to it by the

Council of the European Union in 2002, it established an instrument dedicated to the region's socio-economic development, the Facility for Euro-Mediterranean Investment and Partnership (FEMIP). Through its financing operations and its concerted action with each of its partner countries, FEMIP is ready, now even more so than in the past, to help the partner countries emerge from the crisis and therefore promote growth in the Mediterranean of tomorrow.

Philippe de Fontaine Vive

European Investment Bank
Vice-President

A stylized, handwritten signature in blue ink, consisting of several fluid, connected strokes.



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The crisis and ways out of it in the FEMIP Mediterranean partner countries

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EXECUTIVE SUMMARY

The FEMIP Mediterranean countries (FMCs) have reacted well to the crisis. They were protected from a severe financial crisis by the fact that their financial integration – both regionally and globally – is limited. But the shock of the crisis was nevertheless felt. It was transmitted by real effects via four main channels: exports, transfers of income, tourism and direct investment. This shock led to a reduction in growth (by 2 to 2.5 percentage points on average), had an impact on employment (with fewer jobs being created and unemployment rates rising again) and on the public budgets as a result of support measures being introduced (with deficits of 7% of GDP on average).

The current general context of the crisis points up two important facts that will leave their mark on the years to come. First, the FMCs are undergoing an external demand crisis, which raises the question of balancing their supply and, at the same time, the difficulty of managing the gap between strong domestic demand and flagging external demand pressures – which automatically imposes a strain on the current account balance.

Second, we have witnessed a widespread return to more proactive policies (particularly in the developed countries), with the introduction of major programmes aimed at modifying the content of growth and developing new activities involving, in particular, the environment and the knowledge economy. These are being augmented by more defensive action, such as the establishment of standards and the implementation of measures aimed at making the areas in question more attractive, or even at limiting offshoring. At the international level, we have also seen progress being made towards new forms of regional consolidation that are clearly intended to put the countries concerned in a better position as they emerge from the crisis (see the Asean+3 fund).

The aim of this report is to provide the FMCs with the wherewithal to maintain their financial and macroeconomic equilibria, while preparing the way out of the crisis and enabling the FMCs to continue along the path of convergence with the EU 27.

Five questions are addressed in this report:

1. How far had the FMCs got with opening up their economies internationally – in commercial and financial terms – when the crisis erupted?
2. By what channels was the crisis transmitted to the FMCs?
3. How were the effects of the crisis felt in terms of the macroeconomic equilibria, the ability of those affected to withstand it and their expectations?
4. How, in the aftermath of the crisis, is a growth path leading to convergence to be achieved?
5. How are the active structural policies that are being implemented to be optimised to increase growth and create new comparative advantages?

I. Progress has been made in opening up the economies to trade but further potential exists

The crisis occurred at a time when the FMCs had made considerable progress in opening up their economies to trade in goods and services and to foreign investment. They were more circumspect, however, when it came to opening up their capital accounts.

A start was made on opening up the FMCs' economies to trade in goods and services in the mid-1990s, triggered by a regional agreement (the Barcelona Process), and this led to better integration into the global economy (not only in relations with Europe, whose relative share is decreasing). Customs tariffs have come down by more than 5 percentage points since 1995, while the FMCs have at the same time been signing numerous trade agreements, including among themselves. As a result, trade as a share of GDP has increased by more than 20 percentage points. This development applies not only to merchandise trade, as the opening up of services has followed the same trend.

Fifteen years after the launch of the Euromed agreements, the after-effects of the Barcelona partnership have been measured. Most of the studies agree on the positive, albeit modest effects, which were to some extent limited by the fact that the agreements have not yet been fully implemented in all the countries in question. There is therefore potential to be exploited by extending the free trade area to the whole of the region – more through the possibility of giving the FMCs' companies the benefit of economies of scale than through the gains in the allocation of resources made possible by the dismantling of customs barriers. Nevertheless, this additional opening up, which must extend to services and agricultural products, can no longer be regarded as virtually the sole factor in revitalising the FMCs' economies, as in the past. It must be supported by structural policies for each individual economy and the region as a whole.

Other crucial long-term strategic challenges still have to be taken into account at the regional level. The situation regarding trade with Europe is very much to the advantage of the EU. In the future, a better balance must be achieved in the system of interdependence, which presupposes, on the part of the FMCs, a significant increase in their competitiveness, a big move upmarket with their product offerings, together with greater diversification, to be achieved through growth in the size of companies, which better integration between FMCs (in particular) would facilitate. To this should be added proper management of exchange rates and, on the European side, the elimination of distortions, especially with regard to agriculture and standards, and even action to raise the level of FMC products to bring them up to the required standards.

Insofar as capital movements are concerned, progress has been more limited. To avoid the risk of massive outflows in the event of a crisis of confidence, no FMC has introduced full convertibility of the capital account (the four most advanced countries in the region are Egypt, Israel, Jordan and Lebanon). It should be acknowledged that this has been a positive point in the context of the present crisis. But what is an advantage at a time of crisis becomes a disadvantage over the medium term, as it deprives private companies and governments alike of the ability to raise finance on the world capital markets. However, these restrictions are gradually disappearing, particularly for non-residents and, in this context of gradual liberalisation – which is leading to an increase in cross-border capital flows – the question of exchange rates is becoming more important.

The FMCs' balances of payments are currently being kept on an even keel via two flows of "real" income (revenue from tourism and remittances) and three capital transactions (direct investment, portfolio investment and short-term capital flows), which offset the trade imbalance. The first two real flows make up around half of the deficit. Over the past decade FDI (foreign direct investment) inflows have been roughly on a par with the revenue from tourism and remittances.

In fact the part played by international finance is therefore very limited since, in total (bank credit included), it accounts for only a quarter of the trade deficit. This situation will have to change if the FMCs are to take advantage of the international capital markets but first a number of conditions will have to be met, and in the correct order: (i) there must be a move towards a more flexible exchange rate and futures markets must be developed in order to enable exchange risks to be hedged, without falling into the "casino" finance trap; (ii) one must contrive to engineer favourable exchange rate

expectations, which will enable interest rates to be kept relatively low. This presupposes tight monetary policies (with inflation targeting and the freedom to set interest rates), fiscal policies aimed at balancing the budget and politically and socially stable societies; and (iii) a sound, deregulated banking system must be established, with a modern supervisory system.

Multilateral cooperation can play a part in this process of gradual liberalisation, in accordance with two strategies. For the FMCs that have adopted a flexible exchange rate with a high degree of freedom of capital movements, what is urgently needed is a fund – like that established in the case of Asean – that will enable the volatility caused by foreign exchange speculation to be limited. For the FMCs that still want some kind of fixed exchange rate system and for restrictions on financial transactions to be maintained, what is needed instead is a development bank, which will make up for the deficit in national savings and focus on projects that will be able to change the conditions on which growth is predicated. The two solutions are of course not mutually exclusive, resources permitting.

II. A significant real shock but limited in financial terms

Owing to the way in which they are integrated into world trade and the restrictions on capital movements, the FMCs were not affected by the crisis as badly as Europe and the other regions of the world that are more integrated into the international capital market. For the EU and these other countries, the sequence of events was depreciation of financial assets, which led, as a result of various mechanisms (loss of value of financial assets, the crisis on the interbank market, the banking and stock market crisis, the credit crunch, the economic crisis), to a slump in domestic demand. For the FMCs, it was a decline in external demand and the transfers of revenue from trading partners, which was immediately reflected in the real economy, with the risk that it would subsequently spread to the financial sector as a result of the reduction in reserves and weakening of bank portfolios.

The real shock was felt all the more as it hit economies that had been weakened by the sharp rise in the prices of foodstuffs and petroleum products between 2007 and 2008 (a situation that occurred again in 2010 in the case of basic foodstuffs). The external and fiscal deficits were exacerbated and the consequences were serious for the people concerned and the social climate.

The crisis then spread via income effects as a result of the trading partners' weak domestic demand and led to: (i) a fall of nearly 30% (USD 70bn) in goods exports, while imports declined by only 18.6% (USD 50bn); (ii) a worsening of the trade deficit, approaching USD 22bn; (iii) a decline in revenue from tourism of less than 5%, despite the fact that tourist numbers were up by more than 6%; (iv) a reduction in transfers of income of nearly USD 2bn; (v) a decrease in FDI of around 31.2%. All in all, this caused a deterioration in the current account balances of some USD 35bn (a deficit of 2% of GDP in 2009, following a 2.7% surplus in 2008).

At the beginning of 2010 there were signs of a slight increase in these flows, thanks to a weak recovery among the partner countries, but without an improvement in the balances, as the pick up in migrants' remittances, revenue from tourism and foreign direct investment appears to have gone hand in hand with a stronger recovery in imports, which will affect the trade balance.

In financial terms, the effects of the crisis were limited. First, the volume of capital outflows was weak. Second, the local economies' poor access to financial markets limited the macroeconomic effect of the depreciation of stock market and bond market assets, especially as stock markets had rebounded by the second quarter of 2009. Third, the volume of cross-border lending remained weak and the reduction in debt in the middle of the crisis made it possible to maintain a correct level of foreign exchange reserves, which ultimately remained fairly close to the pre-crisis level. This does not, however, rule out deterioration at a later stage: there is therefore still a risk of a liquidity shortfall and a significant reduction in reserves. In this connection, a substantial increase in the price of imported inputs (oil, agri-foodstuffs) remains a risk factor to be taken into account. Fourth, there was no significant growth in external debt, which has even remained below the level at the beginning of the decade.

III. Effects of the crisis on the macroeconomic equilibria, the ability of those affected to withstand it and their expectations

Macroeconomic developments

Growth therefore suffered as a result of the lack of net external revenue, which initially had the effect of causing unemployment rates to rise again and the number of jobs being created to level off. At the same time, there was a significant decline in inflation rates. Finally, despite the extent of the crisis, the macroeconomic policies that were being followed proved capable of preserving the fundamentals and favourable expectations.

In order to counter the decline in external demand, domestic demand was mobilised, mainly through public and private consumption. The general response of the FMCs was to support domestic demand via the budget. These countries therefore benefited from advantageous pre-crisis conditions (a favourable budgetary context or a satisfactory level of foreign exchange reserves) to introduce countercyclical recovery policies, though to a far lesser extent than in the developed countries. However, these fiscal stimuli (which had a far greater effect than the automatic stabilisers) meant that most FMCs were exposed to the prospect of large primary deficits in 2010 and probably 2011. The scope for subsequently supporting the economy via the budget is therefore limited, particularly if the FMCs are to encourage long-term public investment and their sovereign debt is to continue to be viewed favourably by the rating agencies.

The FMCs are going to be faced with three types of problem in 2010 and 2011: (i) lower growth, bigger budget deficits and rising unemployment; (ii) reduced capital inflows; and (iii) lower exports, larger current account deficits and increasing difficulties in servicing debt denominated in foreign currencies. The countries with fixed exchange rates, limited room for manoeuvre on the budgetary front and poorly developed financial markets (Jordan, Lebanon, Syria) will be most affected. Those such as Algeria, Egypt, Morocco and Tunisia, which have more flexible exchange rates, have greater leeway to pursue countercyclical monetary policies, as long as there is not complete freedom of movement of capital. This tends to show that the right policy mix is greater exchange rate flexibility, but with a cautious movement towards convertibility of the capital account. With the current state of local financial systems, credible inflation targeting would make it possible to improve the effectiveness of monetary policies and create the favourable expectations that are required for progress to be made in opening up the financial markets.

Banking systems

The FMCs' banking system also withstood the effects of the crisis relatively well because of good profitability before and the support from the authorities after the event. The banks therefore remain solvent and even profitable. Though the return on own funds and assets fell in 2009, the level of non-performing loans also declined in most FMCs. Banks nevertheless remained reluctant to increase lending to the private sector and failed to participate sufficiently in the recovery. While the situation remains healthy, local financing of the private sector must, however, be encouraged in order to benefit from the rebound.

Expectations conducive to recovery

Two main conclusions may be drawn from the way in which the spreads on external debt have evolved internationally throughout the crisis, especially in the FMCs. The first stems from the high volatility in their value, as well as in that of CDSs. This is likely to cause debt to run out of control if a country resorts to borrowing while the crisis is at its height. For the FMCs, this suggests that strict management of the fundamentals is required and confirms the need to be cautious when it comes to opening up to the international capital markets, essential though this is. The second conclusion is that the FMCs have – thanks to what has been done in terms of fiscal management, progress in monetary policy and the move towards independent central banks – clearly inspired a certain amount of confidence among international financiers, as is shown by their main ratings.

IV. Emerging from the crisis and future growth

As countries emerge from the crisis, there is likely to be a change in the relative ranking of economies. This is an opportunity for the FMCs, provided that they develop new catalysts for growth.

These catalysts for growth must help to increase the current rate of growth, not only to enable the FMCs to converge with the other countries in the region (which would require annual GDP growth of 7% on average), but also to enable the increase in the economically active population over the next 20 years to be managed (the potential workforce in the 15 to 65 age range is set to increase by more than 60 million by 2030).

Observations over a long period show that GDP growth in the FMCs has been due primarily to demographic growth and capital accumulation and only to a very limited extent to growth in productivity (total factor productivity, or TFP).

With regard to per capita GDP growth, which is the most widely used welfare indicator, the following points must be made: (i) the contribution to that growth from human capital accumulation (via education and training) has been positive but relatively modest, with big discrepancies between countries over time; (ii) physical capital accumulation appears to have been the main driver of per capita GDP growth in most FMCs (Egypt, Morocco, Palestine and Turkey in particular), irrespective of the periods studied, which distinguishes the FMCs from other developing regions; (iii) the contribution of TFP has always been relatively limited. It should be noted that in the 1980s and 1990s, the contribution of TFP was at best zero, or even negative (except in the case of Tunisia and Israel). It is only in recent years that there has been a more general move towards an increase in total productivity, which coincided with the period when the FMCs were becoming considerably more attractive for foreign direct investment (their share of FDI has doubled since the late 1990s).

Thus there is little doubt that success in emerging from the crisis, assuming that the FMCs do not abandon their strategy of opening up their economies internationally, will depend very much on (a) their ability to remain attractive to foreign investors, to take greater advantage of the spillover effects of the investment (which is a clear sign of an improvement in the business climate) and (b) on the progress that they can make in establishing a system of productivity-based growth. In the latter case, this involves a more general approach in terms of the vitality of the economies as a whole, and, in particular, the establishment of a knowledge economy.

FDI

The crisis led to a huge fall in FDI flows worldwide in 2008 (amounting to around USD 1 000bn). The recovery in 2009 proved to be weak and, according to forecasts (UNCTAD 2010), the 2007 level will not be achieved again until 2012. A global consensus is emerging on the conditions that make a country attractive to FDI, viz. the size of the domestic (or regional) market, which must be closely linked to the global market via foreign trade; a favourable business environment; and the nature of the relations with the providers of foreign aid, particularly in the regional context.

A number of observations will serve to clarify this point. The first is the net change in the destination of the flows that has occurred recently: the share of flows between developed countries has fallen from 70% in 2007 to 50%. This is one of the reasons why some people say that the emerging countries are going to become the “new engines of the world economy”. The increase in the emerging countries’ share can be attributed to institutional progress, greater openness and the growth prospects of new activities that are attracting greenfield investments. The second observation is that the emerging countries have also increased the amounts they are investing abroad themselves, by 25% in 2009, mainly because of the appearance of multinational firms in the major emerging countries (the BRICs). The third observation relates to the significant change in the type of foreign direct investment, which suggests that mergers and acquisitions will become less important compared with long-term investment in new activities, which is likely to encourage the development of comparative advantages in the host countries.

With regard to the FMCs, the trend has been to progressively open up to FDI throughout the past two decades, reflecting the region’s specific progress in making itself more attractive: thus its share of the world market has doubled (1.5% of FDI on average between 1995 and 2005, compared with 3% today). In 2008 FDI accounted for a significant share of total investment in Jordan (52%), Lebanon (48%), Egypt (26%), Israel (26%), Tunisia (25%) and Syria (20%). It is lower in Morocco (8 to 10%) and extremely low in Algeria (4.6%). This also highlights the role of the Euro-Mediterranean partnership, which has undoubtedly made the countries in the region more attractive and will inevitably have a greater impact in the future in terms of spillover effects.

The crisis naturally led to a big fall in flows, although to a lesser extent than elsewhere in the world. In 2010, flows recovered, with a significant increase in projects. This will not necessarily be reflected in the amounts invested, which appear to be stagnating, suggesting that the average value of the projects is declining. The trend therefore indicates that investors are not abandoning their projects in the region, but are taking fewer risks, with more modest projects. A geographical shift in investors has also been noted, with the arrival of the emerging countries (30% of projects), in particular China. However, Europe is still the main source (30 to 40% of projects), with smaller but more diversified projects.

From the point of view of emerging from the crisis, the question arises of the part that will be played by FDI in future growth. It will be all the greater if the FDI leads to widespread transfers of technology, involves products with a higher value on the world market and not only bottom of the range products, and draws on the local fabric of SMEs through relations based on subcontracting. This attractiveness will be positively affected by the development of a South-South regional dimension, which would enable the investor to take into account immediately an integrated market of more than 200 million consumers. The UfM framework would be ideally suited for establishing a regional agreement on foreign investment along the lines of the Asean Comprehensive Investment Agreement (ACIA). This agreement maintains states’ sovereignty with regard to fiscal matters and grants, guarantees freedom to use any currency and repatriate capital, and provides for national treatment, free movement of the related jobs, the existence of an independent body to deal with disputes and joint promotion of the region. The final aspect on which progress must be made is the effective use of public-private partnerships for projects, in line with national and regional development strategies.

Powering growth through total factor productivity

The system followed by the FMCs to achieve growth has hitherto clearly still been based on capital accumulation. This system may prove to be not very robust when the level of accumulation is inadequate relative to the dynamics of the active population, when it results in capital being substituted to a large extent for labour or when extensive accumulation causes productivity to fall. And yet it is productivity that is the crucial factor in the long run in determining per capita income.

In the short term, it should also be pointed out that an increase in productivity without a reduction in employment (which is possible with TFP compared with labour productivity obtained by substituting capital for labour) considerably relaxes the macroeconomic constraints. This fact is crucial when emerging from a crisis, when domestic saving is still going to be affected by public deficits. Moreover, academic research has shown that the phenomenon is self-sustaining: this objective of growth in total factor productivity should therefore be retained by putting in place national structural policies, like the partnership operations carried out under the UfM.

What form does this phenomenon take? Broadly speaking, it is determined by two things: first, more effective factor allocation, based on the fact that factors go where they will be most productive; and, second, shifting the technological frontier (each factor is most productive in the place where it is located). The first point is based on mobility, the ability to start up and shut down businesses (entry and exit). The second point is based on (a) innovation (product, process, organisation), which moves the production frontier and (b) training, which continuously increases the quality of the factors used. Some FMCs have obtained convincing results from this point of view (Tunisia, Morocco, Jordan, Lebanon), while others clearly still follow a system for achieving growth based on capital accumulation (Algeria, Syria).

In all cases it takes a long time for the results to appear. Academic research has highlighted a number of factors that lead to an increase in TFP, although their relative importance remains to be determined. Four crucial points may be mentioned here.

The first concerns the level of demand, in order to be able to achieve over the long term the level of potential growth. Here it is the issue of chronic unemployment that must be addressed, particularly graduate unemployment, which stimulates the dynamics of the demand for labour but also the quality of the supply and the balance between the two. Furthermore, where austerity plans are implemented to restore the fundamentals, capacity utilisation rates decline, leading automatically to a fall in TFP. Hence the importance of not allowing fiscal deficits in the FMCs to deteriorate unduly.

The second is related to the size of the reference market. Where businesses are faced with an expanded market, they achieve economies of scale and benefit from increasing returns if they are able to grow. This presupposes both continuation of the process of opening up and the availability of long-term finance (equity and bank credit).

The third concerns the role of the system of relationships between businesses. Two aspects emerge: the need to introduce competition into the market for goods, which will encourage the effective allocation of resources, and the development of externalities and spillover effects between large companies and SMEs. In this case the liberalisation of economies and active policies focusing on clusters, technology parks and other development policies have a part to play.

The fourth point concerns penetration of the knowledge-based economy. This involves a general approach, encompassing institutional reforms, development of the ICT sector, improvements in education and training, and innovation – areas where the FMCs are, in a number of respects, lagging behind. These four crucial points must be targeted as part of structural policies, to be effectively introduced by the FMCs.

V. Structural measures to be optimised

The current crisis is probably going to influence the future of the system of global interdependence and the sources of economic growth. Thus we have witnessed a strong resurgence of structural policies, particularly in the developed countries, aimed at developing new products and processes, laying down standards, reducing the extent of offshoring and investing in infrastructure on a massive scale. Finally, the current period has made people realise that, insofar as structural policies are concerned, there is no contradiction between a market-based approach combined with greater openness and public action in areas considered to be a priority. The general practice, if not the declared policy, is now that public structural initiatives are preferable to protectionist measures and can, in a way, be substituted for them. In addition, with regard to the Euromed region, the effects of the main instrument for creating momentum, viz. the free trade area, have to a large extent been felt. Although it needs to be further extended (to cover agricultural products and services), it can no longer be at the heart of regional action to the exclusion of virtually everything else.

The FMCs have correctly identified these trends and launched new structural action plans that go beyond simply “upgrading” to embrace an approach focused on “emergence”, reflecting a declared determination to participate in the new model for global growth. For Femise, this is a fundamental matter: the difficulties associated with the crisis, the weaknesses referred to with regard to the FMCs must not under any circumstances call into question these policies, which must, on the contrary, be supported by the Euromed authorities (UfM as well as FEMIP), and serve to remedy the main vulnerabilities of the FMCs and put these countries on track to emerge from the crisis on a high note.

The first point to be emphasised is that this resurgence of structural policies is taking place in a specific context, based on economic pragmatism, with care being taken to avoid pitting the State and the market against each other. It must be stressed, first, that the liberalisation policies recommended in the past few decades have not by themselves enabled satisfactory convergence to be achieved between developed and emerging countries, particularly in the case of the FMCs. Secondly, the general response to the crisis has been based more on public initiatives coordinated at the national and regional level than on significant advances in the mechanisms for coordinating and regulating the global economy. Finally, the crisis – and above all the aftermath of the crisis – may change the relative ranking of economies, with certain cards being dealt again. For the FMCs, this is an opportunity to be seized.

The rationale behind these policies can be based on issues such as factor allocation, shifting of technological frontiers and competition, and is vindicated by the success of the public strategies adopted to promote their development by the Asian countries, for instance. In the modern world, every country must choose an initial policy mix consisting of liberalisation to reduce distortions and intervention to transform structures, reduce vulnerabilities and improve the distribution of the benefits of growth, then a second mix consisting of stability of the macroeconomic equilibria, which can be temporarily disrupted, and financial intervention, to create the conditions for stronger growth, it being understood that no policy of intervention that risks sacrificing the fundamentals is conceivable in the long run. However, the contradictions are mitigated if properly controlled momentum is created. The issue is therefore not public intervention per se, but how to intervene so as to develop new comparative advantages without giving rise to rent-seeking behaviour, but with the prospect ultimately of a sustainable economic equation without state intervention. Clearly this is a matter that is considerably more complex than simply listing the application of a series of measures universally recommended by international experts.

The FMCs have a long history of structural policies. But these policies have not always been as successful as was expected. There are a number of possible explanations for this. The policies followed up until the 1990s were based first on the appropriation by the public sector of the means of production, protection of the domestic economy from the outside world, vertical operations and underlying objectives of redistribution, removed from the main objective of production. By studying this “traditional” action of the State in the FMCs, we can thus see that it differed from the points that effective policies were found to have in common: corporate autonomy, vertical integration and limited and/or temporary infra-sectoral specialisation to encourage diversification, tough budgetary

constraints, a business environment where the market for goods is competitive and precludes the development of monopoly powers and locational advantages.

This approach changed from around 2005 onwards. If we look at the FMCs' recent development plans, it is clear that the emphasis has been placed on incentives and horizontal integration, with action focused on human capital, infrastructure (particularly ICT) and the financing of local businesses. But a tendency remains that is still deeply rooted in the "upgrading" strategy, the sectoral approach and the protection of traditional industries. The content, in terms of support offered, is often based on the principle of industrial hubs and tax advantages, inadequately linked to the achievement of specific objectives and with vague time limits. International comparisons in terms of "benchmarks" make it possible to both measure the progress achieved so far and identify those areas where decisive action is needed. We can thus see that the success of the structural policies that have been implemented will depend very much on the progress made with the fundamentals, such as the quality of the workforce, the business climate and the quality of the public administration, with each country having its own specific characteristics. Given that the impetus provided by opening up the FMCs' economies internationally will inevitably be diminished by the crisis, new engines of growth will have to be introduced if the FMCs are eventually also to become the region's new locomotives.

VI. Recommendations

The impact that the international crisis had in the FMCs was far less severe than might have been expected. The FMCs were protected from a major financial crisis. They did, however, feel the shock through income effects as a result of their growing integration into international trade, which exposed them to the economic slowdown affecting their main partners: Europe and the Gulf countries. In 2010 and 2011, a weak recovery has been taking shape but the public budgets have been called upon to play their part and it is not desirable that disproportionate intervention should increase the imbalance in the public accounts.

The short to medium-term approach must focus on two courses of action: to maintain domestic demand at an adequate level; and to obtain a more favourable position with regard to trade. In a context of lower interest rates and declining inflation worldwide, a more expansionary monetary policy is possible, in particular by encouraging lending to the private sector. The local banking industry must play its part by making more credit available and improving the way in which it is allocated. This will involve arranging major training programmes for bank staff and more extensive guarantee facilities. It is necessary to increase the economies' access to the financial markets, in particular by developing funds focusing on very small businesses and also the bond markets, which would reduce the dependence on capital inflows, while at the same time compensating for the reduced room for manoeuvre on the budgetary front. Exchange rate flexibility should also be increased, which will enable monetary policy and fiscal support policy to be made compatible with one another, while avoiding an excessively sluggish recovery. Finally, if global FDI flows continue to stagnate until 2012 at least, the competition to attract this investment will intensify and the FMCs will have to continue to make progress on the institutional reform front, so as to improve the business environment.

These issues are now well under control in most FMCs today and steady progress is being made at rates that are consistent with each country's economic and social constraints.

But it is also important that the long-term strategy should be consistent, as this will be crucial in order to move the FMCs higher up the global hierarchy, encourage convergence with their European partners and enable them to become the driving force for emerging from the crisis.

Femise considers that the long-term economic strategy must be based, first, on continuing with the international opening-up process, by targeting in particular the wider Euro-Mediterranean region and, second, on developing active structural policies to create the conditions for changing the growth regime and creating new comparative advantages.

It is this economic strategy that must be supported by the policies implemented across the region.

The economic strategy

On the economic front account will therefore be taken of the need to extend the regional market and of consistency insofar as structural policies are concerned.

Extension of the regional market

With regard to the first issue, the main recommendations are:

- ✓ The EU must open up more to agricultural trade with the FMCs and develop mechanisms that will enable the FMCs to meet the standards in place in order to have access to its market.
- ✓ The FMCs must complete the dismantling of their customs barriers in respect of European products and among themselves, which will increase the volume of trade and improve welfare. They must also reduce their non-tariff barriers, especially among themselves.
- ✓ A system of diagonal cumulation of the rules of origin should be finalised pursuant to the 2003 Palermo Declaration. The question of moving towards a system of full cumulation must be addressed.
- ✓ Further liberalisation of the factor services (banking, insurance, transport) is necessary.
- ✓ Progress with horizontal integration between the southern countries is also desirable. This will improve the efficiency of production processes in this region, mainly via market desegmentation and the creation of economies of scale. This must take the form of: (i) a reduction in trade costs, which are particularly high; (ii) a reduction in distortions via better fiscal convergence, especially with regard to foreign investors; (iii) the development of cross-border infrastructure and administrative cooperation; (iv) an improvement in financial and monetary cooperation, particularly with regard to exchange rates.

Structural policies

With regard to the second issue of optimising structural policies, the recommendations focus on three crucial questions in order to avoid the failings inherent in these policies if they are applied without proper precautions.

The first question concerns ***the overall strategy***. This must involve both positioning on the regional market and world market and continuously improving social cohesion by reducing the number of poor, encouraging the emergence of a middle class and achieving a regional balance.

The second question concerns ***the focus and ways of introducing*** the structural policies. It is possible to define certain key aspects from this point of view:

- ✓ The focus on exports must be seen in a dynamic way, without concentrating on the static comparative advantages, but at the same time encouraging the development of new activities with an international focus from the outset. Here the role of greenfield FDI and international cooperation may be crucial.
- ✓ The measures must aim to develop the profitability of firms and total factor productivity at the level of individual industries or the economy. This implies, specifically, creating a business environment that will enable the private sector to emerge at the international level, and, more generally, adopting a training-based growth model. This also implies secondary objectives relating to the employability of a skilled workforce, international competitiveness and moving upmarket with the products.

✓ The measures must be designed to target the economic agents concerned and prevent rent-seeking behaviour from occurring. The question of targeting means moderating the “new industries” versus “old industries” aspect and favouring an approach based on activities rather than sectors.

✓ The measures must provide, right from the design stage, for the framework for evaluating the measures taken, a framework based on indicators of quantifiable and measurable results rather than the latest economic beliefs.

✓ The measures must avoid reducing private investment and crowding it out with public investment. With this in mind, care will be taken to involve the private sector in public investment.

Finally, the third question relates to *the areas of activity* that should be favoured. These may be aimed at:

✓ correcting the initial conditions (infrastructure, education and training in particular) that play a key role in terms of the level of transaction costs and sustainable growth in productivity;

✓ improving the current conditions under which businesses operate, but also under which they enter and exit from markets;

✓ encouraging the development of localised cross-border production networks;

✓ promoting skills and the employability of human capital across the region by means of networks of institutes offering training in identified areas, with mutual recognition of qualifications;

✓ developing research and innovation and, more generally, implementing arrangements that will enable a knowledge economy to be established.

Policy ramifications for the instruments of Euro-Mediterranean cooperation

The way in which the regional management – of the UfM as well as the new neighbourhood policy – will consider the above aspects will be crucial for the outcome. The following points should be emphasised:

1. The first question concerns the transfer equation (which reflects the system of interdependence in the region) and the amount of the transfer between the EU and the Mediterranean partner countries, to which particular attention must be paid. Up until 2008 the FMCs managed to make up their trade deficit (of which the EU accounted for about two thirds) thanks to the surplus on services (tourism) and current transfers (remittances in particular). But in 2008 and 2009, there was a current account deficit, as tourism and remittances were no longer sufficient to compensate for the trade deficit. This led some FMCs to mobilise reserves and resort to exceptional financing in order to put the balance of payments on an even keel. Furthermore, the trade deficit will inevitably increase in view of the differences between them in terms of pressure from domestic demand following the crisis. With regard to balancing flows, the projections for FDI inflows and the variability of earnings from tourism and, in particular, remittances from immigrants (especially because of unemployment in the host countries and the general context surrounding migration) mean that it is uncertain whether the transfer equation can be balanced.

2. The second policy question concerns the completion of the free trade area for goods, which must remain a core objective. This presupposes progress on agricultural products and standards, which means thinking about the support policies.

3. The third question concerns trade in services, which is the main source of future growth to be expected from the free trade area. However, trade in services implies bringing societies closer together and means having to go further insofar as mobility of people is concerned. This is a key issue in the region, which implies, first, making progress in terms of the conditions that will make it

possible (mutual recognition of skills and qualifications) and, secondly, explicitly raising the question of the detailed arrangements on a regional scale. This point applies to the North-South as well as the South-South.

4. The fourth question concerns the projects Union and, more generally co-development, which requires a common approach in terms of strategy, the procedures for establishing public-private partnerships and evaluation.

Femise considers the project-based approach to be justified, provided that the decisions are taken in the light of long-term economic profitability criteria, combined with criteria relating to the major issues facing the FMCs (changes in the content of growth as a result of the development of new activities, the development of momentum for productivity, improvements in the regional balance and narrowing the gap in living conditions).

Here the approaches to be followed are as important as the policies themselves. This implies public-private partnerships (the leverage provided by this type of partnership is welcome at a time when financial resources are limited) and a coherent strategic framework, which could involve four distinct types of contribution: (i) innovative projects that prepare for the future by helping to create new forms of specialisation and comparative advantages; (ii) projects that consolidate regional integration; (iii) projects that increase the quality of traditional lines of production and improve their access to the global market; (iv) projects that create externalities that underpin the external business environment. Here a new development bank could have an important role to play, not only through the resources that it would be able to mobilise but through its expertise in identifying and selecting projects.

5. If progress is not possible in terms of free transfers or on the development bank front, the FMCs must accelerate their integration into the international capital markets and their movement towards greater exchange rate flexibility. In that case the risk is that there will be a considerable increase in volatility. The establishment of a stabilisation fund supported by the ECB in order to prevent reserves crises, along the lines of what has been done by Asean, might then be the appropriate response.

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List of acronyms and abbreviations

A

AA: Association agreement
ACIA: Asean Comprehensive Investment Agreement
AFD: Agence française de développement (French development agency)
AMIR: Achievements of Market-Friendly Initiatives and Results
ANDPME: Algerian SME Development Agency
ASEAN: Association of Southeast Asian Nations

C

CA: Cooperation agreement
CDS: Credit default swap
CEECs: Central and Eastern European Countries
CNMN: Moroccan economic modernisation committee
COMESA: Common Market for Eastern and Southern Africa

E

EEPC: Egyptian Export Promotion Center
EIB: European Investment Bank
EIU: Economist Intelligence Unit
EJADA: Euro-Jordanian Action for the Development of Enterprise
EJEP: Euro-Jordanian Export Programme
ELCIM: Euro-Lebanese Centre for Industrial Modernisation
ENP: European Neighbourhood Policy
EPC (CEPEX): Tunisian Export Promotion Center
EU: European Union

F

FAMEX: Export Market Access Fund (Tunisia)
FDI: Foreign direct investment
FEMIP: Facility for Euro-Mediterranean Investment and Partnership
FEMISE: Euro-Mediterranean Forum of Institutes of Economic Sciences
FMCs: FEMIP Euromed partnership countries, excluding Turkey (Algeria, Morocco, Tunisia, Lebanon, Egypt, Israel, Jordan, Palestine, Syria)
FODEC: Tunisian fund for the development of competitiveness
FOMAN: Moroccan national economic modernisation fund
FPCI: Algerian fund to promote industrial competitiveness
FTA: Free trade area

G

GAFTA: Greater Arab Free Trade Area
GDP: Gross domestic product
GFEAE: Tunisian pre-shipment export finance guarantees
GMP: Global Mediterranean Policy

I

ICT: Information and communication technologies
IMF: International Monetary Fund
IMP: Industrial Modernisation Programme

J

JEDCO: Jordan Enterprise Development Corporation
JUMP: Jordan's Upgrading and Modernization Programme

M

M&As: Mergers and acquisitions
MCs: Group of countries comprising the FMCs including Turkey

MEDA: Euro-Mediterranean partnership programme

MENA: Middle East and North Africa

MFA: Multifibre Arrangement

N

NTB: Non-tariff barrier

P

PCAM: Tunisian support programme for business competitiveness and to facilitate market access

PTA: Preferential trade agreement

Q

QIZ: Qualified Industrial Zone

R

R&D: Research and development

ROA: Return on assets

ROE: Return on equity

S

S&P: Standard & Poor's rating agency

SC (COFIL): Steering committee (Tunisia)

SMEs: Small and medium-sized enterprises

SMIs: Small and medium-sized industries

SNAT: Algerian national regional development master plan

SOTG: Tunisian guarantee company

T

TFP: Total factor productivity

TNC: Transnational corporation

U

UfM: Union for the Mediterranean

UNCTAD: United Nations Conference on Trade and Development

UNDP: United Nations Development Programme

UNIDO: United Nations Industrial Development Organization

UTICA: Tunisian Union for Industry, Commerce and Handicrafts

V

VER: Voluntary export restraint

W

WB: World Bank

WTO: World Trade Organization

Y

YOZMA: Israeli venture capital fund

The crisis and ways out of it in the FEMIP Mediterranean partner countries

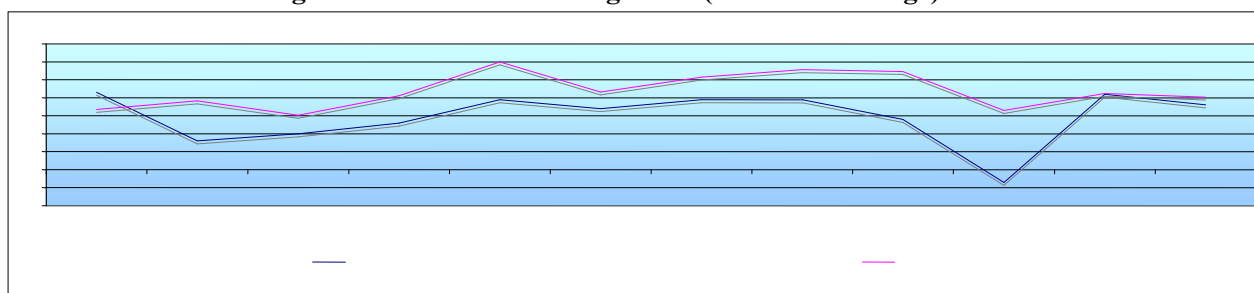
Ahmed Galal and Jean-Louis Reiffers, FEMISE coordinators

INTRODUCTION

The European Union's Mediterranean partner countries (Algeria, Morocco, Tunisia, Lebanon, Egypt, Israel, Jordan, the Palestinian Authority, and Syria, but excluding Turkey), which we shall refer to subsequently as FMCs (FEMIP Mediterranean partner countries), reacted well, on the whole, to the global crisis¹. In general, the crisis gave rise to real effects. These were compounded by extreme volatility in commodity prices, especially hydrocarbons and agrifoodstuffs. All countries were affected, but to differing degrees. Favourable climatic conditions and strong State support helped to cushion the impact on the population, which was not well received.

However, the shock of the crisis was nonetheless felt, triggering a fall in average real GDP growth (3.7% in 2009, compared to 5.5% in 2008 and 4.6% in the period 2000-2007). This reduction had an impact on jobs (pushing up the unemployment rate) and on national budgets, where support measures were needed (measures which increased the budget deficit as a percentage of GDP: -4.4% on average over the period 2000-2007; -3.5% in 2008; -7.3% in 2009).

Figure 1. FMCs: real GDP growth (annual % change)



Source: Economist Intelligence Unit (EIU), International Monetary Fund (IMF).

While certain developed countries and a number of large emerging markets are now showing signs of a rebound, the effects of the crisis on the FMCs have not yet manifested themselves in full. The economic and social consequences of the crisis on employment, for instance, could be long-lasting, especially since a double-dip recession in some developed economies remains a possibility.

When this report was written, the macroeconomic equilibria had generally held up well, thanks to appropriate monetary and fiscal policies, which were successful in cementing the progress made over the previous 10 years and in responding to the needs of the moment. Additionally, financial systems have so far remained robust, with the majority of them even managing to forge ahead with the process

¹ In the past two decades, monetary, fiscal and foreign exchange crises have occurred in a number of emerging countries: (1) the 1994 Mexican crisis, triggered by a devaluation of the peso to correct the overvalued real exchange rate, which had been the cause of flagging economic growth. The devaluation resulted in a contraction of the economy and was followed by a debt crisis; (2) the 1997 Asian crisis, which was brought about by poor financial governance, continued adherence to fixed exchange rate systems, the rapid liberalisation of the capital account, and weaknesses in Asian financial systems; (3) the Russian crisis of 1998, in which the rouble devaluation of some 260% in December 1998 led to a significant increase in external debt and the cost of servicing it, as well as a collapse in the Treasury bond market and a commercial banking crisis which paralysed the payment system, a deterioration in the budget deficit caused by the reduction of the tax base, and the impossibility of further borrowing to finance that deficit; (4) the 1999 Brazilian and 2001 Argentinian crises. Years of financing deficits by printing new money drove Brazil and Argentina to hyperinflation, and Argentina to default on its external debt; and (5) the Turkish crisis of 2001. Turkey also experienced hyperinflation as a result of financing its deficit, but managed to avoid defaulting on its external debt obligations.

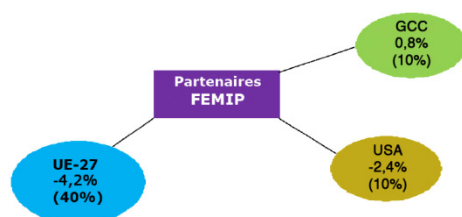
of consolidation. These remarks suggest that the FMCs are relatively well-placed in the short term compared to a number of the economies in their immediate environment, including European ones.

The central theme of this report is to consider how able these countries will be to manage the short-term effects of the crisis and resume a process of convergence with the EU through more buoyant long-term growth.

The crucial issue raised by developments in the international environment is external demand, whether in relation to trade, services, transfers of income or investment. Here, two factors are at work: firstly, the predictable level of that demand, which is a new phenomenon to be considered owing to the generally depressed state of domestic demand in the FMCs' main trading partner countries, and secondly the adequacy of supply from those same countries.

In the pre-crisis period, external demand was not a problem since the FMCs' traditional markets were experiencing strong growth. That no longer applies, and the FMCs are having to cope with the growth differential between their own domestic demand and foreign demand. The result is increased pressure on current account balances, which may give rise to problems with reserves, the exchange rate, bank portfolios and financial security. While all countries are having to face this situation in one way or another, those which have advanced furthest in opening up their economies internationally are feeling it most acutely.

Figure 2. Growth in the main FMC partner countries, 2009



Key: FEMIP partners
EU-27

Source: International Monetary Fund (IMF), Regional Economic Outlook Report, and World Economic Outlook (WEO). Figures in brackets reflect the FEMIP countries' share of total trade; those not in brackets show the IMF's forecast rate of real GDP growth for 2009.

On top of this quantitative trend, there is a qualitative issue that is becoming critical in the current context. Although, thankfully, we have not seen any significant re-emergence of protectionism, it is nonetheless clear that, in response to the crisis, most developed economies are turning to increasingly proactive policies.

The consequence for FMCs is that they are being forced to further diversify their markets and products, achieve a quantum leap in the quality of the goods that are currently being produced, and envisage a gradual shift in the make-up of growth in which the production of more sophisticated goods and services will play a greater part. To achieve that, active structural policies are also required, failing which there is a risk of missing out on the opportunities provided by the new activities that will drive global growth over the next decade. The challenge for FMCs is therefore to make further progress with opening up their economies internationally and with the reforms on which that depends, a strategy that has now been followed for over 15 years, while at the same time generating new comparative advantages through appropriate policies. The opinion of Femise is that the FMCs can successfully rise to this challenge, provided these policies form part of an overall strategy and are carefully calibrated.

This trend clearly raises issues for the UfM, which can no longer remain primarily focused upon establishing a free trade area and providing aid for upgrading the FMCs' economies and support for institutional reform. Although the effort of opening up internationally must continue, and the related institutional reforms must be followed through, the free trade area effect will diminish in 2010. It is

therefore no doubt necessary to provide more support for the proactive structural policies being implemented in the FMCs in policy areas such as industry and agriculture, development and infrastructure, and employment and training.

To deal with these questions, this report will be organised into six chapters.

- ✓ The first chapter will cover the background against which the crisis developed, namely one of more internationally open economies.
- ✓ In the second, we shall consider the channels through which the global crisis was transmitted to the FMCs.
- ✓ In a third chapter, we shall look at the types of macroeconomic response that have been provided and the consequences of those responses for the soundness of those parts of the economy affected and their expectations.
- ✓ A fourth chapter will look at two unquestionable vectors for future growth: foreign direct investment and productivity growth.
- ✓ In a fifth chapter, the proactive structural policies chosen will be discussed.
- ✓ The sixth chapter will present conclusions and recommendations.

CHAPTER I. BACKGROUND TO MORE OPEN ECONOMIES²

When the crisis broke, the FMCs had already made significant progress in opening up their economies in the areas of trade in goods and services, and investment. However, numerous restrictions on capital movements still remained, and the development of non-bank financial intermediaries was limited; hence, the only way for the crisis to develop was through the real economy, rather than through financial channels passing on the effects of asset devaluation.

I. Greater openness to trade, but further potential still available

I. 1 A slow but continuous process

The Euro-Mediterranean partnership came into being almost 50 years ago with the signature of the first association agreements with Turkey in the early 1960s. Morocco and Tunisia signed their own agreements with the EC in 1969. Despite their limited scope, these initial agreements paved the way for gradual extension of the Euromed partnership. In fact, the Global Mediterranean Policy (GMP) was launched in 1972 to enable the preferential treatment granted by the EU to the FMCs (FEMIP Mediterranean partner countries) to be extended and harmonised. As a consequence, cooperation agreements were gradually signed with all the FMCs up to the late 1970s. These agreements provided for a major liberalisation of trade as regards exports of manufactured goods from the FMCs, as well as an increase in tariff concessions for agricultural produce. Financial cooperation was also introduced through loans on favourable terms from the European Investment Bank (EIB) for MEDA instruments.

The subsequent stage coincided with the accession of Spain and Portugal to the EU. This led to the signature of adaptation agreements with the FMCs in 1988, which provided for the complete abolition of tariff barriers within the EU for all goods imported from FMCs, including certain agricultural products.

The implementation of the Barcelona Agreement in 1995 represented a crucial step for the Euromed partnership. It further reinforced Euromed economic cooperation with the prospect of setting up a Euro-Mediterranean free trade area by 2010. The agreement also renewed the financial instruments, including a stepping up of preferential loans from the EIB under FEMIP.

In 2004, the opening up of the EU to the Central and Eastern European Countries enabled the Barcelona process to be reinforced through the development of the new European neighbourhood policy (ENP). The aim of this policy is, fundamentally, to reinforce regional integration between the new neighbouring countries to the east and south of the EU through a gradual implementation of the Community “acquis” and of the four freedoms within the area.

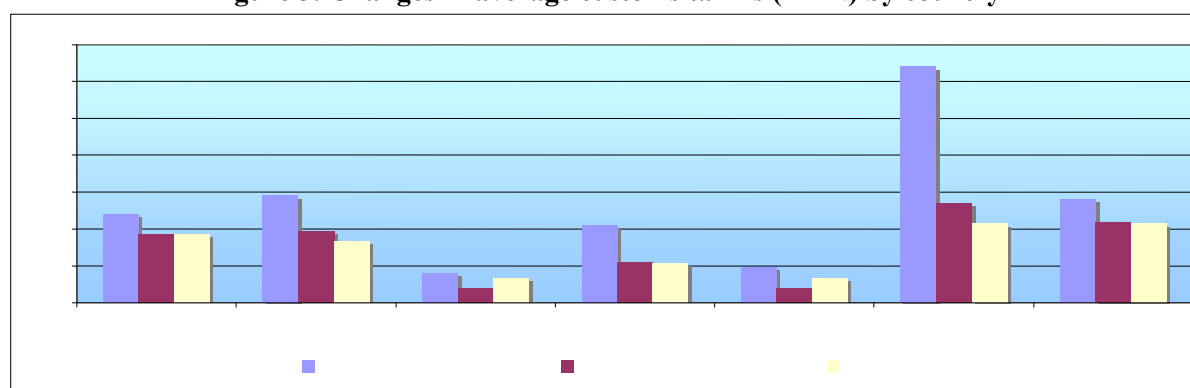
The final stage was the Union for the Mediterranean (UfM). Although this agreement does not actually reinforce the process of economic integration, it does create new opportunities to develop common regional projects (energy, cleaning up pollution, infrastructure, etc.), while at the same time trying to establish governance within the Euromed area by developing a co-presidency and secretariat.

² This section uses information from Roux, N. (2010) "The Euro-Mediterranean Partnership: 15 Years After Barcelona", working paper.

I. 2 Progress made in opening up the economies to trade

The FMCs have made considerable progress in terms of opening up their economies to international trade: average customs tariffs stood at 13.6% in 2008, a level which represents a 5-point reduction since 1995 and brings the area significantly more into line with other major regions. Association agreements with the EU are largely responsible for this trend, as all the FMCs now have customs duties with the EU of below 18% for agricultural and 5% for non-agricultural products. The FMCs with the lowest tariffs are Israel, Lebanon and Jordan, while those that have made most progress in this direction are Morocco, Jordan and Egypt. However, Lebanon, Jordan and Syria are more focused on the Gulf States and the rest of the world. Israel is a special case as it is significantly more involved with the EU for imports than for exports which, in simple terms, means that it is importing from the EU to export to the entire global market.

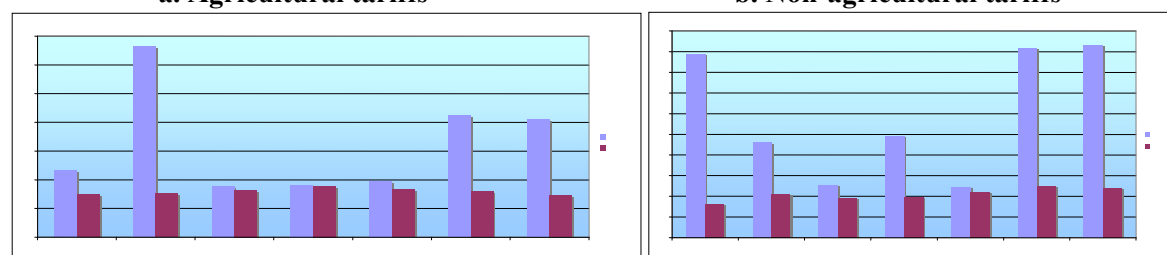
Figure 3. Changes in average customs tariffs (MFN) by country



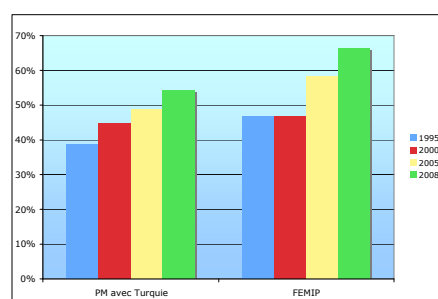
Source: World Trade Organization, Tariff Profiles, 2005 FEMISE report on the Euromed partnership.

At the same time the EU has significantly scaled down its own tariff protection against exports from the FMCs, with the result that its market has been opened up to those countries to a greater extent than to the rest of the world. However, it should not be forgotten that this outcome on tariffs takes no account of a whole arsenal of non-tariff barriers such as quotas, agricultural calendars, standards, etc. Clearly, therefore, the association agreements have been a decisive factor in the policy of opening up followed by the Mediterranean countries since the mid-1990s.

Figure 4. Customs tariffs (imposed by the EU and the world)
a. Agricultural tariffs **b. Non-agricultural tariffs**



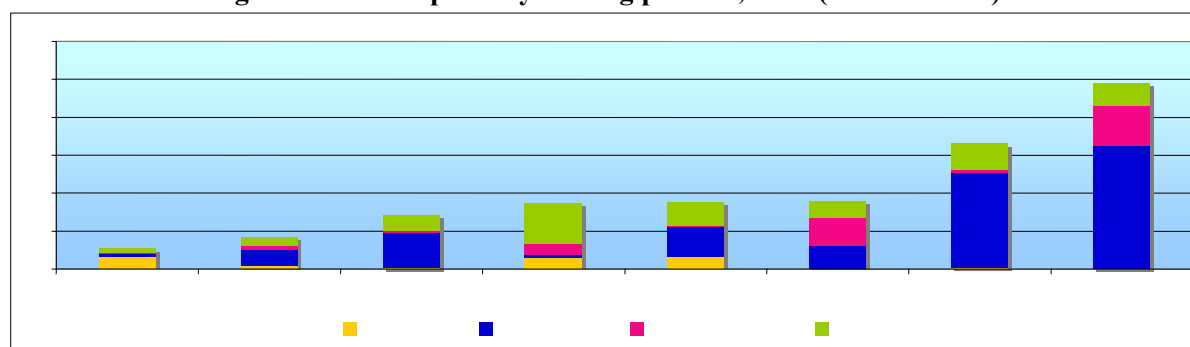
Source: World Trade Organization, Tariff Profiles.

Figure 5. Changes in the average level of FMC openness, as % of GDP (FEMISE calculations)

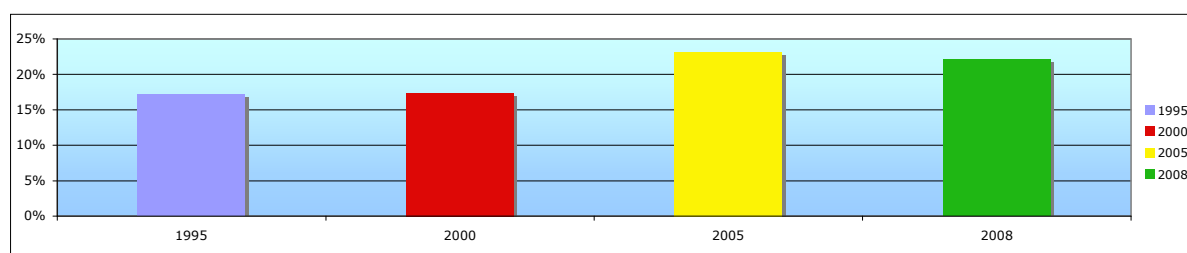
Key: MCs with Turkey

Although opening up has been the result of a regional process (which must include the Agadir and GAFTA agreements), it still has some way to go, and the extent to which the FMCs are actually involved in trade with the EU has declined in relative terms, with the rest of the world benefiting (except for Tunisia for exports). That means that the creation of the free trade area with the EU has improved FMC integration with the global economy as a whole. In the case of countries such as Syria, Egypt and Jordan, this phenomenon has been dramatic.

If we take **first** the result on trade in goods, this desire to open up the economy has been reflected in a significant increase in foreign trade as a percentage of GDP ($X + M/GDP$). One important point is that, although there are obvious differences between the Mediterranean economies, with two oil-exporting countries (Algeria and Syria), three countries with close trade links with the EU (Algeria, Morocco and Tunisia), and four countries more closely involved with the Gulf states and the rest of the world (Egypt, Lebanon, Palestine and Israel), all have seen increases in the extent to which their economies have been opened up (from 47% in 2000 to 66% in 2008).

Figure 6. FMC exports by trading partner, 2009 (as % of GDP)

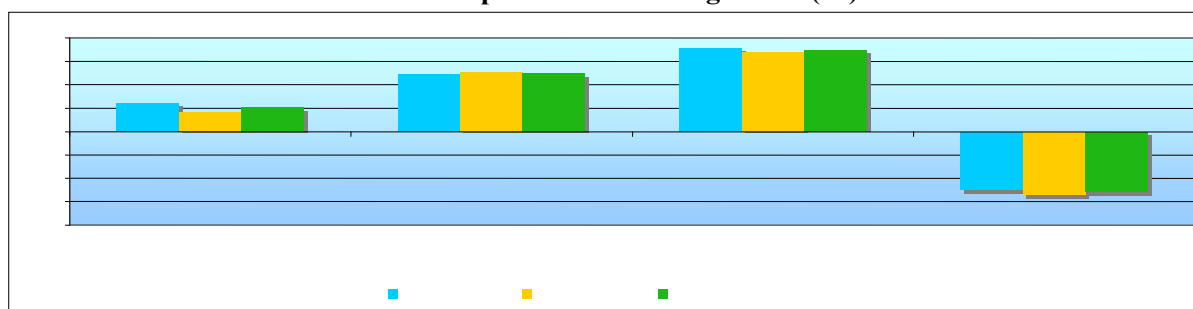
Source: Regional Economic Outlook Report, WEO, Euromonitor.

Figure 7. Level of openness of the FMCs' services sector (%), $(X + M)/GDP$ 

Source: Femise calculations. Rate calculated for 6 FMCs (Algeria, Egypt, Israel, Jordan, Morocco and Tunisia).

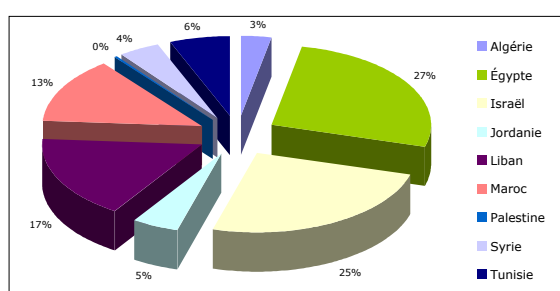
Secondly, services have also followed the general trend, with the share of trade in services rising over the same period from 17.4% in 2000 to 22% in 2008. The opening up of the economy in the services sector is a clearer reflection of the strategy followed. Services imply greater political cooperation and, in the case of certain types of service, a closer social rapprochement. Whereas for "factor" services such as transport, finance and insurance, this need for rapprochement is not so pressing, for activities related to consultancy, distribution, education and training it is much more marked. And the FMCs have argued that, without a significant improvement in the mobility of people within the region, further progress will be difficult.

Figure 8. FMC average annual growth rates for trade in services at current prices and exchange rates (%)



Source: Femise calculations. Rate calculated for 6 FMCs (Algeria, Egypt, Israel, Jordan, Morocco and Tunisia).

Figure 9. FMC exports of services in 2008 (Source: UNCTAD)



These comments explain the disparity of the various situations from this point of view. While the Lebanese economy is by far the most open to services (103%), Algeria and Syria have the lowest rates. The overall rate of openness in 2008 fell slightly from the 2005 level. However, there is nothing to suggest that the opening up process may have peaked. Certain countries have even become

Key: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine, Syria, Tunisia

more open recently (Jordan, Lebanon, Morocco and Tunisia). These are also the countries with the highest rate of GDP growth in 2009 (together with Egypt, which is still one of the most open economies). We should therefore emphasise, as many other studies have confirmed, that the FMCs whose economies have been most open in terms of services are generally those that have been able to maintain high growth rates (with the exception of Israel, whose economy is significantly more developed).

I. 3 Potential for significant gains, as yet unfulfilled

The prospect of gains held out by academic research

The potential economic gains expected from implementing these agreements can be identified using the framework of new commercial theory (Helpman and Krugman, 1989), including the new theory of regional integration (Pomfret, 2003, and Baldwin and Venables, 2005). Table 1 summarises the effects in welfare terms of signing up for a preferential trade agreement. These effects include, firstly, traditional gains arising from a situation of perfect competition (gains due to comparative advantages and factor allocation). They also include gains resulting from the removal of non-tariff barriers (NTB) and improvements in the terms of trade. The additional gains are based on a situation of imperfect competition, i.e. the role of product differentiation ("taste for variety" assumptions), and on economies of scale. Theoretically, dynamic gains may also be expected, including effects on domestic investment, FDI and growth. Finally, a last series of effects is dependent upon potential distortions in regional agreements, such as taxes and subsidies.

Despite all these potential gains, economists, businesses and political strategists have sometimes questioned, or even criticised, the content and real effects of the EU-FMC agreements. For example, it has been suggested that, notwithstanding the large-scale liberalisation of trade in the EU's manufactured goods, the Union has retained a very high level of protectionism in agricultural products, which has considerably reduced the access of products from the FMCs to the EU's market. Additionally, the use of voluntary export restraints (VERs) in the textile and clothing sectors until the late 1990s also limited market access for the FMCs' exports. In more general terms, the application of

NTBs in the FMCs and EU Member States is often viewed as a major obstacle to a genuine process of trade liberalisation. The absence of any liberalisation of services and of FDI is a further handicap. In other words, the lack of any thorough integration into the Euromed area can be considered as detrimental to that area in terms of economic gains.

Table 1. Welfare effects of entering into a preferential trade agreement (PTA)

	Welfare effects	Comments
Perfect competition effects		
<i>trade volume effect</i>	+/-	positive if there is net trade creation; otherwise negative
<i>cost of trade effect</i>	+	positive effects of reducing NTBs
<i>terms of trade effect</i>	+/-	positive effects if prices are reduced; otherwise negative
Imperfect competition effects		
<i>production effect</i>	+	positive if prices exceed average costs
<i>economies of scale</i>	+	
<i>product diversity</i>	+	positive effects thanks to the increase in diversity of available products
Dynamic effects		
<i>investment</i>	+/-	positive in the long-term, negative in the short
<i>growth</i>	+	positive effects in the case of technical progress and production efficiency
<i>FDI</i>	+	
Distortion effects		
<i>high wages/salaries</i>	+/-	negative in the domestic country; positive in the partner country
<i>taxes</i>	0/-	only negative if the PTA leads to higher taxes; otherwise no effect

Source: FEMISE presentation on new trade theory.

Other aspects criticised are the lack of economic integration among the FMCs (despite the signature of GAFTA), problems related to the type of specialisation in the MENA countries (over-dependent on low value-added products), problems linked to distortions between countries in terms of taxes and subsidies, problems linked to rules of origin and, more generally, to governance, the quality of infrastructure, market segmentation, etc. All these aspects are suspected of having limited the scope and hence the effects of the Euromed agreements.

Ex post results indicate potential to pursue greater openness, but this is not the only instrument available

Ex post analyses are usually based on gravity models. Notwithstanding the large body of literature devoted to assessing the effects of the initial EU-MENA agreements, only a handful of studies have focused on the Barcelona process.

Based on the pre-Barcelona agreements, the majority of studies generally show positive albeit limited effects. Péridy (2005) shows, for instance, that gross trade creation resulting from the EU-MC preferential agreement amounted to around 20-25% (depending on the specifications of the models) over the period 1980 to 2000. He also shows a gradual decline in trade creation over time. In fact, by running the model for all consecutive 5-year periods since 1980, he shows that gross trade creation has gradually declined from 27% to 12%. Three reasons are put forward to explain this result: (i) the EU's restrictive agricultural trade policy vis-à-vis exports from FMCs; (ii) the gradual elimination of the Multifibre Arrangement (MFA), which reduced the preferential margin previously enjoyed by FMCs as compared to Asian countries; (iii) the signature of preferential agreements with the Central and Eastern European Countries, which exacerbated the erosion of favourable treatment on tariffs. The author concludes that the Barcelona process should, in future, halt the erosion of this favourable treatment, unless the access of Mediterranean agricultural products to the market remains permanently restricted.

However, other studies regard the effects of the initial agreements as even more limited. For example, Al-Atrash and Youssef (2000) see no evidence of positive effects of the EU-FMC trade agreements in the period preceding Barcelona, although it has to be said that the period examined is very short (1995-1997). Antonucci and Manzocchi (2006) focus particularly on the specific case of Turkey in the period 1967-2001. They only identify limited positive effects of the association and cooperation agreements with the EU.

All recent studies evaluating the Barcelona Agreement suggest positive albeit limited effects. For instance, Michalek (2007) and Hagemeyer and Cieslik (2009) conclude that there are significant positive effects on FMC imports, but that the effects on exports are minor or even negative. The authors explain this result by the asymmetry of the Barcelona Agreement, which provides for gradual tariff reductions in the FMCs in relation to the EU's exports of manufactured goods. However, since the EU had already removed its tariffs on exports from FMCs, the Agreement has had no effect on those exports. Additionally, the existence of EU trade barriers for agricultural products is detrimental to exports from the FMCs, as they have a comparative advantage for those products.

These authors also stress the possible damaging effects of this type of star-shaped vertical model for the liberalisation of trade between the EU and FMCs unless it is accompanied by true horizontal liberalisation of trade between the MENA countries, as suggested by new economic geography models (Puga and Venables, 1997). This conclusion is supported in Bagoulla and Péridy (2010b), who show that more extensive vertical integration with the EU could lead to the establishment of industries in the southern economies by facilitating their access to larger markets. However, to make a success of that experiment, the FMCs would need to make greater progress with their own integration process.

A more recent study presented by Nicet-Chenaf and Wachs (2009) analyses the impact of the Barcelona Agreement by looking at the fixed bilateral effects on the countries in a gravity model. The results show significant positive effects on both exports and imports. That appears to suggest strong commercial ties between the EU and the FMCs. However, it is difficult to be certain whether those links are purely the result of the Euromed agreements or are due to other variables not considered.

De Wulf and Maliszewska (eds.) (2009) show that the effects of the Barcelona process vary from one FMC to another. A positive effect is identified in the case of Tunisia and Egypt, but it is less significant for Morocco and Jordan, and even negative for Lebanon and Algeria. However, as the authors indicate, it is perhaps simply too early to pinpoint any trade effect whatsoever of the EU-Med free trade agreements, since Lebanon and Algeria have only implemented them very recently (in 2006 and 2005 respectively).

Lastly, Bagoulla and Péridy (2010a) look at the direct effect of the Barcelona Agreement on growth and convergence. The results show, somewhat ambiguously, that the Barcelona process has failed to stimulate growth and convergence within the FMCs. This result is confirmed regardless of the indicator or the specifications of the model used in this research. However, there is evidence that the indirect effect of the Barcelona Agreement, as measured by the increase in EIB loans, is positive.

I.4 The challenges of future specialisation

Three points, to which a number of long-term strategic challenges correspond, will be discussed briefly in this section (for further details, see the FEMISE 2010 Annual Report, still to be published):

- ✓ The trade position with the EU
- ✓ The breakdown and geographical development of trade
- ✓ The quality of specialisation

Looking, firstly, at the trade position with the EU, the FMCs have had a permanent deficit with the Union averaging some US\$ 40 billion since the early 2000s. As a proportion of its trade, the EU as a whole obtains its best commercial results with these countries. This obviously poses the question of the logic of the system of interdependence between countries in the region, and the nature and amount of the transfers required from the EU to avoid unbalancing its partners' balances of payments and fuelling a reserves crisis.

Over time, this system of interdependence will need to be better balanced in terms of the trade in goods. That presupposes, firstly, that the FMCs become more competitive in the European market and that all types of distortion (standards, new competitors in a privileged situation post-enlargement, the fact that the EU market is not open to the FMCs' agricultural products, etc.) are progressively eliminated. However, given the FMCs' substantial trade imbalance with the rest of the world as well, it also presupposes a significant move upmarket with their product offerings, the ability to develop economies of scale, favourable equilibrium exchange rates and improved product diversification. In the short term, though, the system is only sustainable if it is balanced by tourism, remittances from migrants, direct and portfolio investment, bank loans and free public transfers. In the longer run, changes will undoubtedly be necessary to generate economies of scale (in particular the development of South-South trade), and to increase competitiveness through productivity and product diversification.

Secondly, an examination of the geographical breakdown of trade shows that there are two distinct groups of countries: those for which the EU is the preferred market (Algeria, Tunisia and Morocco), and those with a greater focus on the rest of the world (Egypt, Jordan, Israel, Lebanon, Syria, and the Palestinian territories). Whereas countries in the former group conduct over half of their trade with the EU, for those in the second group the figure is closer to 30%. Developments over recent years have shown a general tendency to look increasingly towards the rest of the world (and hence to reduce the EU's share), which could be interpreted as a positive trend if it implied that the preference granted in the European market had enabled the FMCs to become better integrated commercially in the global market.

Table 2. EU's share as a percentage of MCs' trade

	Exports			Imports		
	1995	2005	2009	1995	2005	2009
Western Med	69%	62%	58%	64%	57%	55%
Eastern Med	47%	34%	29%	46%	26%	29%
Israel	34%	29%	26%	53%	39%	37%
Turkey	57%	57%	47%	51%	45%	40%
MC 10	53%	51%	44%	53%	43%	41%

Source: FEMISE calculations based on Comtrade figures.

Thirdly, if we look at the issue of specialisation, this reveals a decisive long-term challenge. Increased quality of specialisation would show that goods produced in the FMCs were moving higher in the value chain, and that their products were more competitive and less sensitive to changes in prices and incomes (the elasticity of external demand to changes in price and income differentials is weaker).

An examination of the most recent pre-crisis trends shows undoubted progress. A study of three types of significant indicators of the nature of FMCs' penetration of international trade (share in exports of

manufactured goods, the level of their technology, and the share of intra-sectoral trade) shows that the majority of Mediterranean countries have significantly improved the quality of their specialisation in the international arena.

Over the period 1995 to 2009, all the MCs (including Turkey) significantly increased the relative share of manufactured goods in their exports. However, the level of this general indicator is heavily influenced by the two strongest economies in the region, namely Turkey and Israel, which respectively account for 36% and 28% of the MCs' exports to the rest of the world (RoW) and 42% and 11% of their exports to the EU. An analysis by country shows that (i) the commercial proximity of western Mediterranean countries such as Tunisia and Morocco to the EU has stimulated their industrialisation, while (ii) the eastern Mediterranean countries have improved their level of specialisation in manufactured goods thanks to their trade with the rest of the world.

Table 3. Performance indicators for the MCs (including Turkey)

	Share of exports of manufactured goods		Share of high/medium-technology exports		Share of intra-sectoral trade	
	1995	2009	1995	2009	1995-2000	2001-2009
<i>World</i>	59%	62%	24%	32%	37.8%	48.8%
<i>EU</i>	58%	61.5%	19%	31%	27.9%	37.5%
<i>RoW</i>	57%	62%	30%	35%	39.1%	46.7%

Source: FEMISE calculations based on Comtrade figures.

Moreover, the increased share of high and medium-technology products in the MCs' exports of manufactured goods (24% to 32% between 1995 and 2009 for the MCs as a whole, and 28% to 40% for the MCs excluding Algeria and Syria) shows that this specialisation in industrial goods has taken place in parallel with a general move upmarket.

Although the share of high and medium-technology goods is on the whole largest with non-European partners (35%) the most significant progress has been made with the EU over the past 15 years. Additionally, for the MCs excluding Algeria and Syria, the share of high and medium-technology products is the same (41% to 42%) regardless of the partner.

It should be noted that the most rapid progress has been made in the area of medium-technology products (from 9.4% in 1995 to 17.5% in 2009), especially with the EU (from 8.8% to 21%). That automatically gave rise to a reduction in the share of labour-intensive and resource-intensive products.

The indicator of intra-sectoral trade is a significant reflection of the level of these countries' participation in international industrial activity and of their ability to offer differentiated products. In general, there has been a significant improvement in the share of intra-sectoral trade between the two periods 1995-2000 and 2001-2009, with a larger increase in this type of trade with countries in the rest of the world.

While the general trend is for an improvement in the share of intra-sectoral trade (with the exception of Syria and Algeria, which have the lowest levels), the most significant levels of intra-sectoral trade are with partners in the rest of the world. However, it is worth noting that the two countries closest to the EU (Tunisia and Morocco) are developing this type of trade more intensively with their European partners.

Finally, over the past 15 years the MCs have, on the whole, slightly improved their performance in terms of expanding the range of products exported and aligning the structure of their exports more closely with the global average.

It is clear that they need to extend this progress further in future, and that the crisis must not be allowed to derail their efforts to develop economies of scale and achieve vertical differentiation of their activities by incorporating them into the international division of production processes (within large transnational firms) and horizontal differentiation by developing variety. Within a general context of increasingly rapid product renewal (each year 10% of goods traded internationally are new

products) and for those same products to have a higher technological content, innovation and the creation of a knowledge-based economy have also become essential.

II. On the road to convertibility of the capital account, and midway to exchange rate flexibility

To date, the FMCs have still not introduced full convertibility of their capital accounts (the countries closest to achieving it are Egypt, Israel and Jordan). The reason for this is the fear of seeing massive capital outflows when any crisis of confidence occurs. These shocks can be the result of political events, to which the region is highly exposed, or of a sharp reduction in the value of domestic or foreign assets held by the country's citizens.

Restrictions on capital movements have had the advantage of sheltering the FMCs from the turbulence afflicting the international financial markets. Accordingly, the low level of international integration of their financial systems and the undeveloped nature of non-bank finance have kept the FMCs relatively insulated from the crisis. But what is an advantage at a time of an asset crisis becomes a disadvantage over the medium term as, if the crisis is prolonged, the bond market loses the ability to supply private companies and governments alike with the finance they need. Thus, depriving oneself of the potential of international financial markets does have a cost.

Table 4. Degree of capital account openness (Chinn-Ito Index)³

	1990	1995	2000	2008
<i>Algeria</i>	-1.14	-1.14	-1.14	-1.14
<i>Egypt</i>	-1.83	-0.58	1.80	2.50
<i>Israel</i>	-1.14	-0.09	1.43	2.50
<i>Jordan</i>	-1.14	0.12	2.23	2.50
<i>Lebanon</i>	2.50	2.50	1.43	1.17
<i>Morocco</i>	-1.14	-0.09	-1.14	-1.14
<i>Syria</i>	-1.83	-1.83	-1.83	-1.83
<i>Tunisia</i>	-1.14	-0.09	-1.14	-1.14
<i>Turkey</i>	-0.09	-0.09	-1.14	0.12

Source: Chinn and Ito (2008).

In addition to this observation, which explains that, gradually and with extreme caution, the FMCs are following a strategy of integration into the international financial system, there is also the fact that capital movements are normally liberalised for non-residents and the subsidiaries of foreign firms established in the country. Thus, a slow but continuous liberalisation of capital flows can be observed at the borders.

In this context, countries with fixed exchange rates (Lebanon, Jordan and Syria) will be more exposed than those with variable exchange rates pegged to a basket of currencies (Algeria, Morocco and Tunisia) or floating exchange rates (Egypt and Israel). Furthermore, when the mobility of capital across national borders increases, and the nominal exchange rate remains fixed, monetary policy is

³ The Chinn-Ito index measures the degree of openness of a country's capital account. It is based on the binary dummy variables that codify the impact of restrictions on cross-border financial transactions recorded in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). The index covers four types of restriction: (i) the existence of multiple exchange rates (k1), (ii) restrictions on current account transactions (k2), (iii) restrictions on capital account transactions (k3), and (iv) the requirement to surrender export proceeds (k4). K3 in isolation is a poor indicator of capital account openness, being a binary variable which does not permit the extent of restrictions on the capital account to be represented accurately. For this reason, it is accompanied by the other three variables. The authors assume a correlation between the existence of restrictions on cross-border transactions and the degree of regulation to which the capital account is subject in each country. The most "closed" countries are given a negative index of up to -1.83. The most open countries have a positive one, which can go up to 2.50.

more effective in defending an exchange rate target.⁴ In an extreme case, free movement of capital and fixed exchange rates rule out the possibility of having an independent monetary policy, because interest rates will be required to cover the interest rate of the currency used as a peg without taking account of the fact that the foreign interest rate may not be appropriate for the situation of the domestic economy.

⁴ The relationship between fixed exchange rates, perfect capital mobility and independence of monetary policy is referred to as the "impossible trinity" because all three cannot coexist; this feature is considered as the principal cause of the crisis in the European Monetary System (EMS) in 1992, and of the Argentine currency crisis, the 1998 Russian crisis and the 2001 Turkish crisis.

Box 1. Exchange rate systems, using the IMF's classification

	US\$	Euro	Basket	Other
<i>Conventional fixed peg arrangement</i>	Jordan		Morocco	
	Lebanon		Tunisia	
<i>Pegged exchange rates within horizontal bands</i>			Syria	
<i>Managed float with no predetermined path</i>			Algeria	Egypt

To look at this issue in greater depth, we propose to examine briefly three points:

- ✓ The current situation as regards capital movements
- ✓ Possible ways forward
- ✓ The two options open for multilateral cooperation

Firstly, looking at the balance of payments of the FMCs as a whole, it is clear that the trade deficit is balanced by five types of inflow, two of which correspond to real transactions and three to capital transactions. The two real flows are tourism and income remittances from migrants. These two sources of revenue cover almost half of the FMCs' trade deficit.

The three financial flows are direct investment, portfolio investment and short-term capital flows, and bank credit. Over the past few years, net direct inward investment has roughly equalled migrants' remittances. Portfolio investment and short-term capital flows account for only 8% on average and some 20% of FDI in those countries where they are the largest component (Jordan and Israel). The remainder is covered by borrowing or drawing on the reserves of central banks. Hence, the role of international finance in the region is extremely limited.

Secondly, it is clear that this situation must change if the FMCs are to be in a position to take advantage of international capital markets. To do that however, a number of preconditions are necessary, and must be met in a careful sequence. The first is probably to move towards more flexible exchange rates, and to develop the futures markets in order to be able to hedge real transactions against foreign exchange risks (see Sami Mouley, Rafik Baccouche et al., 2010). This will be a difficult undertaking, because no one in the Mediterranean is prepared to tolerate development of the "casino finance" that led to the global crisis. And experience has shown that it is difficult to have instruments that enable bets to be placed on underlying assets (options, futures, and short selling) without limiting this facility to risk hedging operations alone. The second is to generate favourable exchange rate expectations, thereby allowing interest rates to fall to relatively low levels. That presupposes a tight monetary policy (with an inflation target and liberalisation of interest rates) and prudent management of fiscal policy, as well as politically and socially stable societies. Lastly, it will require a banking system that is deregulated, and sound in terms of non-performing loans, capital ratios and profitability. It also requires modern stock exchanges, a development that could be helped by regional agreements. This last point is obviously linked to attractiveness to foreign portfolio investors and the readiness of the society to tolerate stock market gains (which have been restricted in certain countries).

If we consider the history of the region, it is clear that liberalisation of the money markets (through interest rates and central bank intervention via open market operations) is the first step towards financial reform. This was introduced relatively early in Tunisia (commencing in January 1987 and ending in November 1996) and in the early 1990s in the other countries. However, while the pace of reform was slow in Tunisia (10 years), it was rapid (2 years) in Egypt.

Table 5. Portfolio investment as a percentage of FDI in the period 2004-2007

	Portfolio investment, US\$ m (inflows)	FDI, US\$ m (inflows)	Ratio
<i>Algeria</i>	N/A	5420	N/A
<i>Egypt</i>	1055.1	29154	3.6%
<i>Israel</i>	4697.1	30584	15.4%
<i>Jordan</i>	1818.2	8315	21.9%
<i>Lebanon</i>	343.1	10835	3.2%
<i>Morocco</i>	0.5	7976	0.0%
<i>Palestine</i>	5.3	143	3.7%
<i>Syria</i>	N/A	2676	N/A
<i>Tunisia</i>	23.3	6349	0.4%
<i>Turkey</i>	11031.0	54868	20.1%
FEMIP	7942.6	96032	8.3%
FEMIP (incl. Turkey)	18973.6	150900	12.6%

NB: Figures not available for Algeria and Syria.

Source: IMF International Financial Statistics, UNCTAD, World Investment Report, various issues.

The second component of financial reform is external financial liberalisation. Prior to the 1990s, most countries in the region typically had their banking systems dominated by the public sector. Following the WTO agreements on the deregulation of financial services, several countries scaled down restrictions on the establishment of foreign banks.

The liberalisation of capital movements is the final stage in the process of external financial liberalisation. The majority of countries, except for Egypt, Jordan and Israel, have adopted a cautious approach that entailed reinforcing their economic fundamentals in order to obviate or minimise the risk of volatile capital movements. Egypt, by liberalising external finance relatively quickly, suffered a number of problems arising from the dollarisation of the economy and imbalances in the foreign exchange market. In other countries, such as Tunisia, concern was more focused on FDI, which is still subject to restrictions.

According to S. Mouley and Rafik Baccouche (2010), the aim must be to increase openness and inward financial flows without exposing the economy to uncontrollable risks, to give preference to FDI rather than portfolio investment, with the emphasis on contributions in kind, which are frequently favoured by transnational corporations. These conclusions, which also mirror several earlier studies and now represent the consensus, are consistent with the (successful) strategy followed by Chile which, by using reserve requirements, only gradually relaxed the constraints on short-term flows. Similarly, this approach is also consistent with a desire to safeguard the country's strategic and sovereign interests, because sensitive sectors can currently receive special tax treatment, which in turn can be compatible with the free rein of market forces. Lastly, it reflects a gradualist approach enabling monetary policy to be perfected down to the use of inflation targets, coupled with exchange rate flexibility and total freedom of capital movements, as well as the pursuit of increased financial sophistication and a more resilient banking system.

Thirdly, turning to the role of multilateral cooperation, two strategies are possible, or a mix of the two depending on the extent of the progress the countries have made with convertibility of their capital account. Countries which, like Egypt, have adopted flexible exchange rates and liberalised the capital account, need a fund to regulate exchange rate volatility resulting from speculative movements. This ability to regulate, which has been introduced in the ASEAN economies, provides reassurance to the markets and helps limit dramatic exchange rate depreciation, which fuels exaggerated spikes in import prices. For countries that still want to retain a system of more or less fixed exchange rates with significant restrictions on capital movements, and which finance their balance of payments deficits by transfers, what is needed instead is a development bank. This takes us to the heart of the debate around which the Mediterranean Bank project will probably be centred.

To summarise the argument so far, it appears that the vast majority of FMCs are still midway along a path that will no doubt lead them to introduce greater freedom of capital movements, at least within the context of regional monetary and financial integration, together with more flexible exchange rates and inflation targets. That will lead to the development of futures markets, and to increased inward and outward portfolio investment flows, and will require substantial changes to be made to monetary and financial policy tools. In the case under consideration, emerging economies where this process had been completed were hit harder by the crisis, but also displayed greater resilience in recovering from it.

CHAPTER II. TRANSMISSION CHANNELS FOR THE CRISIS

In the industrialised countries, the shock originated in the financial sector, with the now-familiar sequence of events: the subprime crisis and a broader loss of value across all asset classes; the crisis in the interbank market; the bank and stock market crisis; the credit crunch; and the economic crisis, triggered by depressed domestic demand. The starting point was therefore an asset crisis, which could not have applied in the FMCs given the restrictions on the capital account and the limited development of non-bank financial intermediation.

In the most internationally open emerging markets, the crisis spread through the simultaneous impact of financial deregulation and the revenue effects caused by the gap between domestic and external demand. As we have pointed out, however, it is clear that the countries that were most open in terms of trade and capital movements, with convertible capital accounts and banks well represented in the international financial system, were the most seriously affected (see, in particular, Pelin Berkmen, Gaston Gelos et al., 2009).

In the FMCs, the vectors for transmitting the crisis were therefore real, with the risk of contamination of the financial sector through a reduction in central bank reserves and a deterioration in bank portfolios.

I. A significant real shock

At first, the FMCs as a whole suffered two real shocks. The first, the rapid rise in food and oil prices, now appears to have been absorbed. The increase in the prices of foodstuffs drew attention to the level of poverty in certain countries. Thus, it was calculated that for the entire MENA region, the prices of foodstuffs rose by 25% in 2008, while these products accounted for 60% of the shopping basket of poor rural households. The clear result was increased poverty in the households concerned in all countries (in Egypt, for instance, the rise in food prices was 30% and triggered a 12% increase in poverty — World Bank 2009a). This increase has now been absorbed, with a fall in prices and the introduction of regulations in the countries concerned. The surge in oil prices (which more than doubled between 2004 and 2008) benefited the region's two exporters, namely Syria and Algeria. When prices fell (-46% in 2009), all the other FMCs felt the benefit of cheap energy, whereas it was the turn of the exporters to feel the pinch.

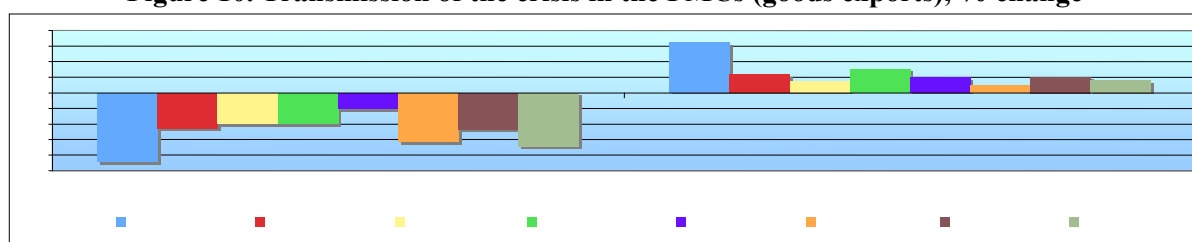
The second shock, whose effects were longer-lasting, was reflected in income effects and was felt by all FMCs. These income effects, linked to the weakness in domestic demand in their trading partners, had the following general results:

- ✓ A sharp fall in goods exports of some 30.6% (US\$ 71.6 billion). The decline in exports was only partially offset by the import effect, with imports of goods falling by 18.6% (US\$ 50 billion).
- ✓ A worsening of the trade balance in goods of almost US\$ 21.6 billion (-60.4%).
- ✓ A worsening of the trade balance in services of almost US\$ 3.63 billion, or 14.1% (FMCs excluding Syria, Lebanon and Palestine).
- ✓ A fall in revenue from tourism of 4.3%, despite a 6.5% increase in volume.
- ✓ A reduction in remittances of 6.1%, representing US\$2 billion.
- ✓ A deterioration in current account balances of US\$ 15.3 billion (US\$ 29.5 billion if Turkey is included) and a deficit of 2% of GDP in 2009.
- ✓ A decrease in FDI of 31.2% (US\$ 11.8 billion). The reduction was € 20.26 billion in the 10 MCs (including Turkey), or 38.5% (ANIMA). A 29.7% fall in capital projects also occurred, representing 219 fewer projects in 2009 (MC10, ANIMA).

The results for the first few months of 2010 and such estimates as it has been possible to make all suggest that these flows will increase moderately, although with no significant improvement in the external balances. It appears likely that the slight recovery in partner countries will result in increased

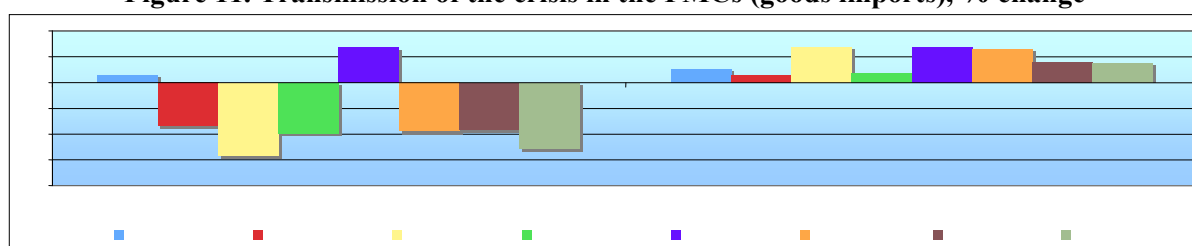
remittances, revenues from tourism and foreign direct investment. However, in the majority of cases, the recovery in imports will outpace the upturn in exports, with a consequent adverse effect on the trade balance.

Figure 10. Transmission of the crisis in the FMCs (goods exports), % change



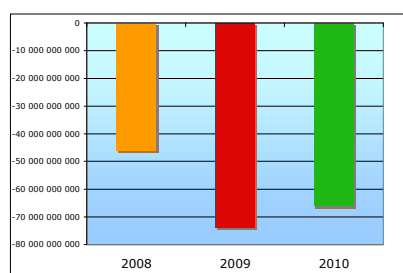
Source: FEMISE calculations, EIU estimates for 2010.

Figure 11. Transmission of the crisis in the FMCs (goods imports), % change



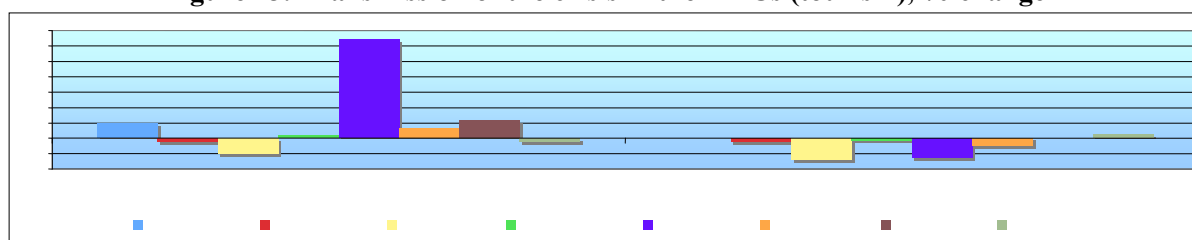
Source: FEMISE calculations, EIU estimates for 2010.

Figure 12. Trade balance (goods) in the FMCs, in US\$ (Source: FEMISE estimates)

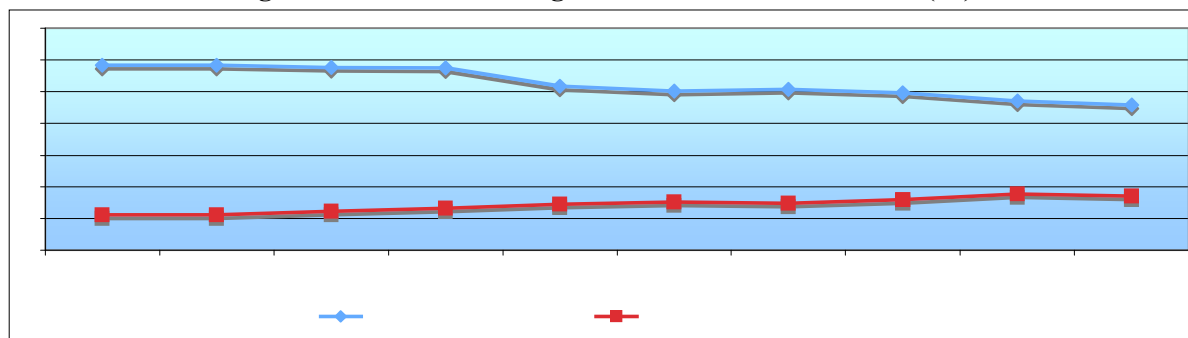


Examining the figures in greater detail reveals that all countries except Lebanon saw a **fall in both exports and imports**. Generally, however, the decline in imports was smaller, which had the effect of increasing the trade deficit. Countries whose exports were worst affected were Algeria, Morocco and Tunisia. Conversely, Israel, Egypt, Morocco and Jordan made up for the fall in exports with a larger reduction in imports. Lebanon is a special case as it enjoyed a sharp recovery in all sectors, indicative of the economy's extreme sensitivity to any improvement in the political climate.

Figure 13. Transmission of the crisis in the FMCs (tourism), % change

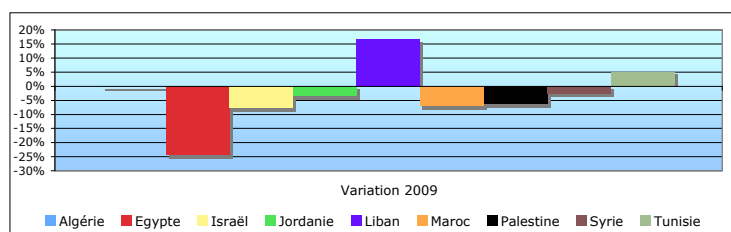


Source: FEMISE calculations.

Figure 14. Breakdown of global tourism market shares (%)

Source: META.

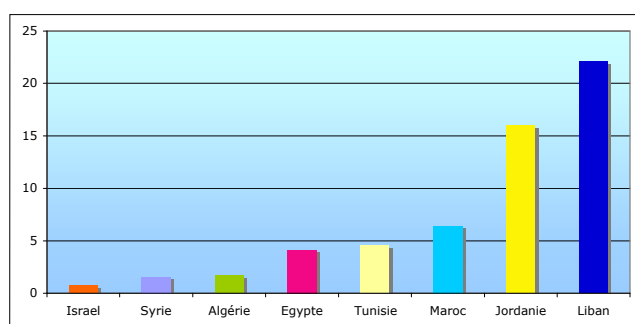
Contrary to expectations, **tourism** held up well as falling prices were offset by tourist numbers. The region's gravitational effect came fully into play, with short-haul tourism, particularly European, being substituted for long-haul destinations. This phenomenon clearly applied in the case of Egypt, Jordan and Tunisia. Conversely, Israel and Morocco were more seriously affected.

Figure 15. Transmission of the crisis (remittances), % change (Source: WB, Simon Neaime)

Key: Change 2009 Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine, Syria, Tunisia

Income transfers (remittances), which constitute an important resource for countries such as Lebanon, Jordan, Morocco, Tunisia and Egypt (see Figure 15) fell in all FMCs except Lebanon and Tunisia. This affected in particular remittances from the Gulf to Egypt, and from the EU to Morocco. This phenomenon is likely to last, particularly for

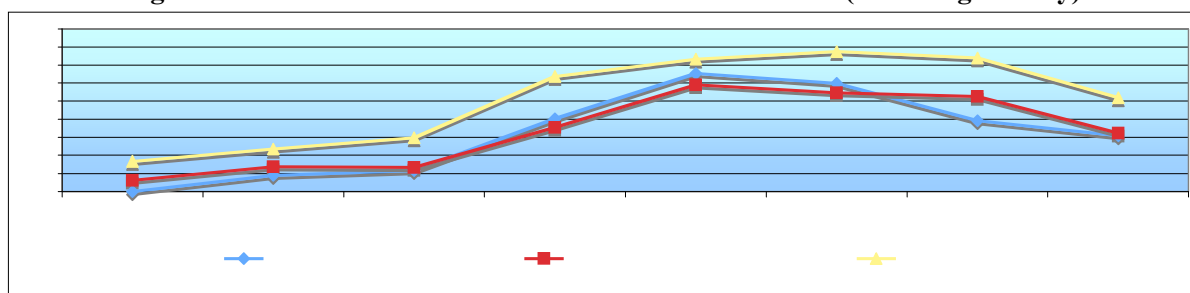
countries which have numerous emigrant workers in Europe. Here, everything will depend on the strength of the recovery in Europe and on trends in unemployment among migrant workers. On the other hand, the rebound in the Gulf States suggests that there should be a more marked recovery in Syria, Lebanon, Jordan and Egypt.

Figure 16. Remittances in 2009 by FMC (as % of GDP)
(Source: IMF, Euromonitor International)

Key: Israel, , Syria, Algeria, Egypt, Tunisia, Morocco, Jordan, Lebanon

fully if the FMCs can maintain an adequate level of domestic demand and create a large and robust South-South market offering economies of scale, and are able to persevere for some considerable time with their efforts to modernise their institutions.

As regards **foreign direct investment**, one of the main drivers of growth in the 2000s, the decline was significant (-31.2%) and the recovery modest. This is clearly one of the areas of greatest concern. The preferred growth strategy, in fact, has been to make countries more attractive to foreign investors through various incentives and by modernising their institutions. The crisis brought tensions to the surface in the countries of origin, which sought to limit offshoring; those tensions can only dissipate

Figure 17. Transmission of the crisis and FDI in the MCs (including Turkey)

Source: ANIMA, UNCTAD.

II. A relatively mild financial shock

The knock-on effects of the global economic and financial crisis and its impact on financial markets vary, as we have said, depending on the extent of the FMC's integration into the capital markets of the EU and US. Overall, however, these effects are relatively mild in the FMCs today.

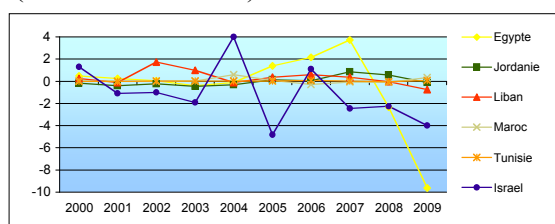
Countries such as Egypt and Morocco with higher exposure to US and European banks and to the equity and bond markets were the first to experience this phenomenon. These countries potentially faced four problems: a fall in asset prices, higher borrowing costs, capital outflows and a reduction in current foreign currency revenue (due in particular to the decline in exports).

The other FMCs, such as Tunisia and Israel, have become more resilient thanks to their greater ability to safeguard their foreign exchange reserves and control their budget deficits. Elsewhere, the current crisis has also halted the rate of progress seen in the past 10 years in terms of the debt service burden in certain countries, and has introduced the risk of fresh problems in managing debt coupled with the exchange rate. This risk could become a reality in the event of a dangerous combination of fixed exchange rates, external shocks, increased debt service costs and a pressing need to increase both external and domestic borrowing as a way of supporting growth.

The principal vector for transmitting the effects of the crisis in a large number of developing countries is the **repatriation of capital by investors** from the developed economies. This disengagement could lead to stock market crashes, problems in the bond market, a negative trend in cross-border bank transactions, and a massive reduction in foreign exchange reserves. Ultimately that could lead to the crowding-out of private borrowers (as the public exchequer mobilises the available savings) and to higher interest rates (as in the case of Asia), which would further impede any resumption of growth. Here we shall look at:

- ✓ Portfolio investment outflows
- ✓ Equity and bond market developments
- ✓ Cross-border movements and foreign exchange reserves
- ✓ External public debt.

Figure 18. Portfolio investment (net) in the FMCs, in US\$ billion.
(Source: IMF WEO)

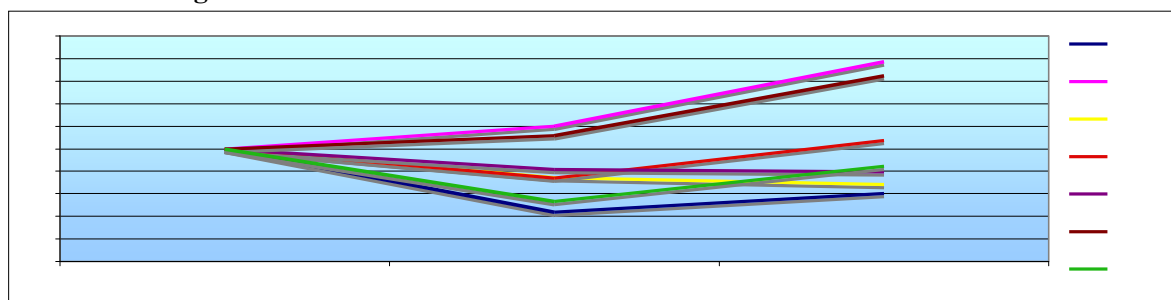


Key: Egypt, Jordan, Lebanon, Morocco, Tunisia, Israel

If we look, **firstly**, at portfolio investment, the region's economies were relatively untouched. Those most affected were Egypt and Israel (Egypt, for instance, one of the most exposed countries, saw a loss of more than 50% of its financial account resources in 2009 as compared to 2008). However, although the level of capital repatriation by foreign firms was very significant (over 150% in Egypt in the first half of 2009, and 60% in Tunisia), the final impact of these movements was minor.

Secondly, the relatively undeveloped state of the region's economy and the fact that the process of opening it up to the outside world was still in its infancy explain **why the 2009 fall in equity prices** gave less cause for concern than elsewhere. Although equity markets fell sharply, this was something of a short-term reaction to the onset of the crisis in the second half of 2008, which lasted until the first quarter of 2009. Thereafter, this trend gave way to a steady recovery in stock prices (except in Morocco and Jordan, where the process of reverting to pre-crisis levels has proved more difficult). The ultimate effect is marginal since market capitalisation and the diversification of market participants are still limited. However, this reaction should serve as a stimulus to increase the depth of the market by diversifying the number of participants and increasing the free float of shares traded, in order to expand its role in financing the economy.

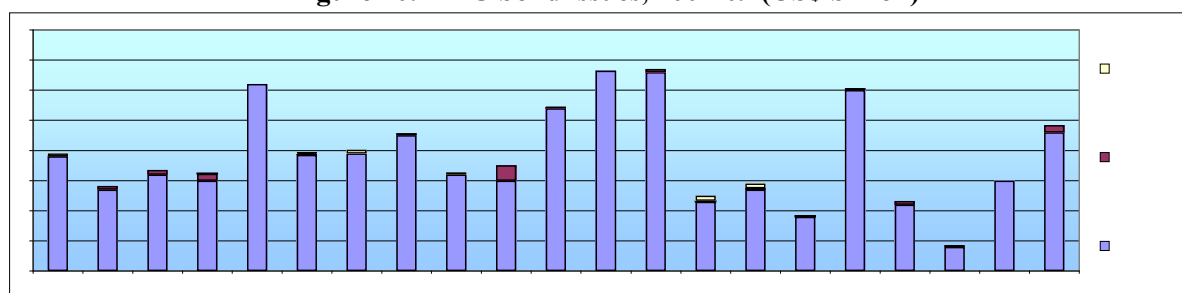
Figure 19. Performance of financial markets in the FEMIP countries



Source: Egyptian Stock Exchange, Tel Aviv Stock Exchange, Amman Stock Exchange, Beirut Stock Exchange, Casablanca Stock Exchange, Bloomberg and Wikinvest. *MSCI is the Morgan Stanley Capital International Index for Emerging Markets.

Thirdly, the limited financial integration of the majority of FMCs (with the possible exception of Egypt) enabled them to **contain the disruption of local financial markets**. FMC bond markets remain underdeveloped and their bond issues represent a very small percentage compared to other emerging markets. The entire MENA region accounts for only 5.6% of the global markets. However, here again it will be necessary to develop these markets over time in order to attract liquidity and hence deal more effectively with the problems of volatility of short-term capital flows, avoid risks linked to exchange rate parities and facilitate the monitoring of macroeconomic expectations.

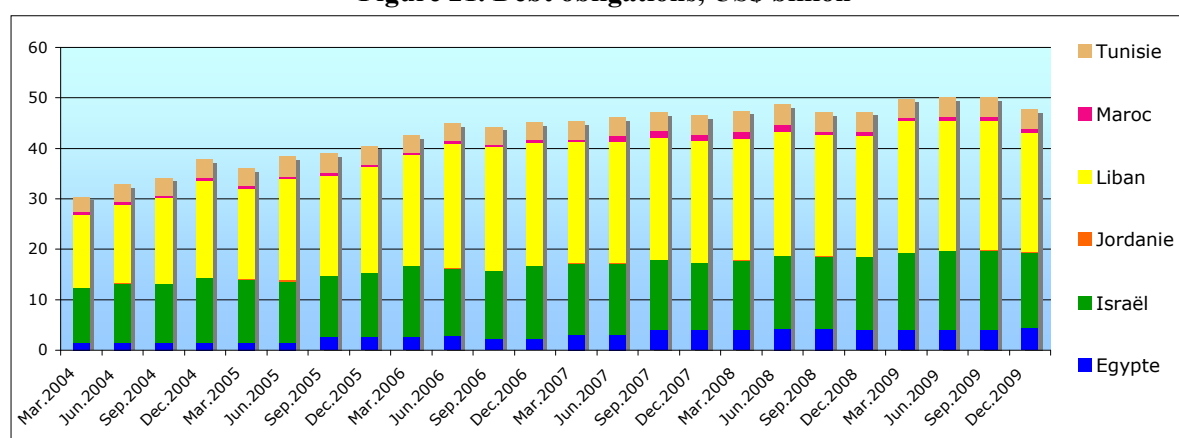
Figure 20. FMC bond issues, 2004-09 (US\$ billion)



Source: IMF, IFS

Exceptional cases are those of Lebanon and Israel, which appear to be more active in the debt market. That applies particularly to the former, and has the drawback of limiting the possibility of loans to the private sector, as public sector issues have had a clear crowding-out effect.

Figure 21. Debt obligations, US\$ billion

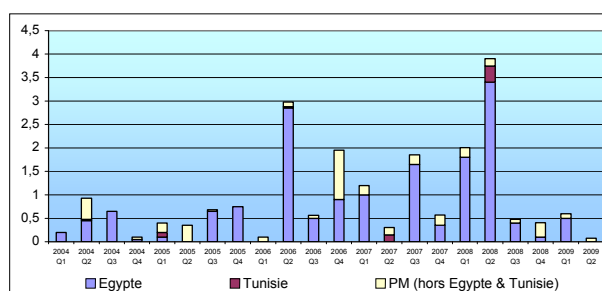


Source: BIS Quarterly Review, March 2010

Key: Tunisia, Morocco, Lebanon, Jordan, Israel, Egypt

Fourthly, the limited effects in the financial sector are also reflected in the low **volume of cross-border credit**, with the exception of Egypt and Tunisia. The effect of this was positive as the banks, encouraged by the monetary authorities, scaled down their activity abroad, thereby helping to maintain an appropriate level of foreign exchange reserves.

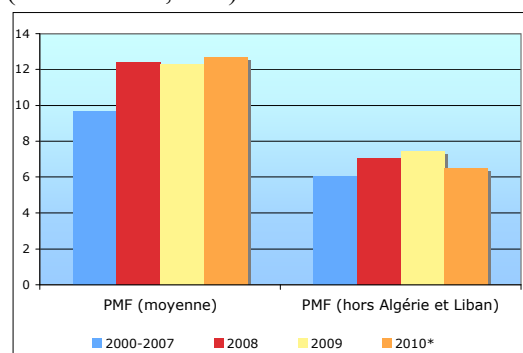
Figure 22. Cross-border loans, 2004-2009, US\$ billion (Source: IMF, IFS)



Key: Egypt, Tunisia, MCs (excluding Egypt and Tunisia)

Generally speaking, therefore, **foreign exchange reserves** remained at pre-crisis levels. They nonetheless fell slightly in a certain number of FMCs (Egypt, Lebanon, Morocco and Syria). It should be noted that reserves fell in the oil-producing FMCs (owing to the limited diversification of exports), and above all in those with a fixed exchange rate (Lebanon and Syria).

Figure 23. FMCs' foreign exchange reserves (No of months' imports),*2010 estimates (Source: IMF, EIU)

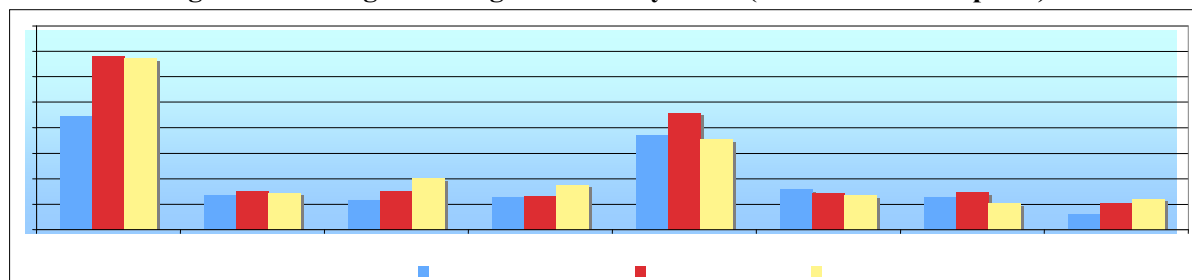


Key: FMCs (average), FMCs (excluding Algeria and Lebanon)

However, over the medium term the risk of a liquidity shortfall and a collapse in reserves remains present. Here the oil price plays an important role. When the price is low, it tends to stem the flow of liquidity from the Gulf States and encourage higher interest rates in the non-oil-producing FMCs. Increased interest rates could trigger a rise in nominal exchange rates, a loss of competitiveness, trade and budget deficits, a build-up of debt and – potentially – a currency crisis. When the oil price is high, it will handicap dependent countries and tend to increase the cost of exports and imports, leading to the same consequences for those countries. It is this disparity which accounts for the fact that a number of countries that are particularly sensitive to

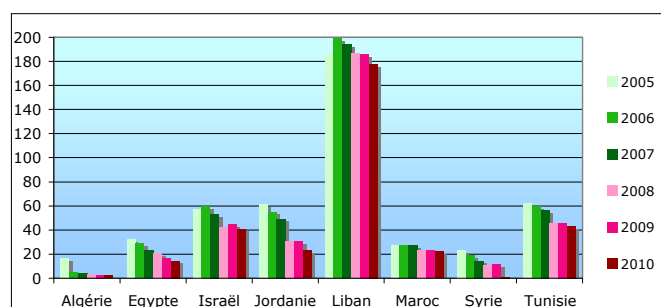
this issue have not yet been able to join the WTO (which requires the domestic oil price in the country to be on a par with the global price in order to avoid distortions that would benefit producers).

Figure 24. Foreign exchange reserves by FMC (No of months' imports)



Source: EIU

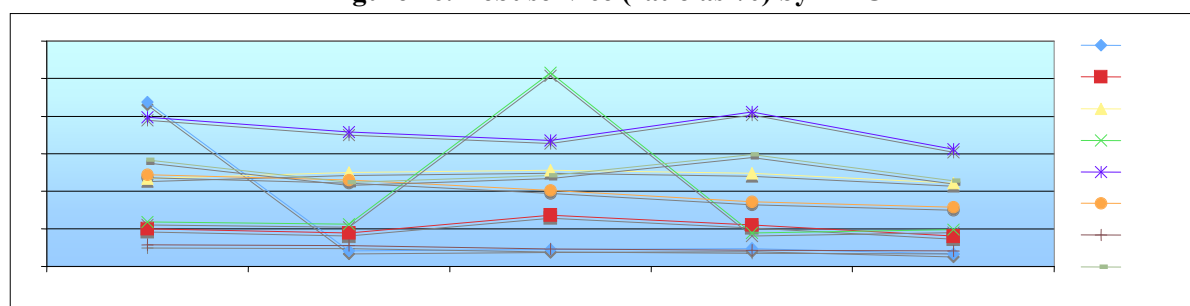
Figure 25. FMCs' external debt (as % of GDP) (Source: EIU)



Key: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia

In fifth place, external public debt has remained relatively low (except in Lebanon), and in all cases below the level seen at the start of the 2000s. This explains the fact that sovereign debt issues in the international markets have been few and far between (except in the case of Lebanon). Since the start of the crisis the only countries to issue international bonds have been Lebanon and Israel. A large portion of the Lebanese issues were acquired by local investors. After December 2009, Lebanon regained its rating as an issuer of debt securities at a level last seen in 2006-2007. In March 2009, Israel launched a substantial US\$ 1.5 billion 10-year international bond issue. The spread was 262.5 basis points above that for US Treasuries. Demand for that issue exceeded US\$ 12 billion, and it was acquired by 300 investors in 14 different countries. As for Egypt, a Euro-denominated bond issue planned for the first quarter of 2008 was deferred to July and then postponed to a later date pending stabilisation of the markets. In 2010, no countries (with the possible exception of Lebanon and Egypt) are planning to issue on the international bond market.

Figure 26. Debt service (ratio as %) by FMC



Source: IMF, EIU, FEMISE calculations.

CHAPTER III. EFFECTS OF THE CRISIS ON THE MACROECONOMIC EQUILIBRIA, THE ABILITY OF THOSE AFFECTED TO WITHSTAND IT AND THEIR EXPECTATIONS

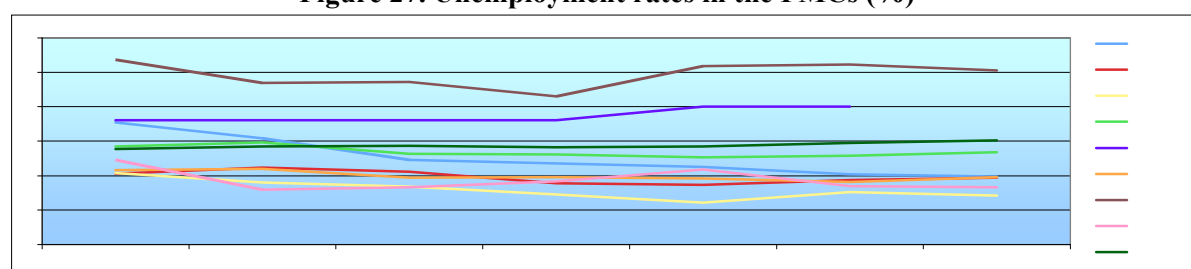
The collapse in net revenues triggered a sharp fall in GDP growth and an increase in unemployment. Worst affected countries were Jordan, Israel and Egypt. Inevitably, this decline in GDP growth had consequences for unemployment, which is particularly high in Jordan and Lebanon, with the young being especially hard-hit.

Table 6. Average annual growth (in %) in the FEMIP countries

	1995-2000	2000-2007	2008	2009	2010*
<i>Algeria</i>	3.2	4.1	2.8	2.2	4.3
<i>Egypt</i>	5.4	4.6	7.2	4.7	5.2
<i>Israel</i>	4.5	3.0	4.0	0.7	3.2
<i>Jordan</i>	3.1	6.1	5.8	2.4	3.2
<i>Lebanon</i>	2.3	3.9	9.3	6.9	6.8
<i>Morocco</i>	3.6	5.1	5.6	4.9	4.3
<i>Syria</i>	3.6	5.1	4.3	5.0	4.0
<i>Tunisia</i>	5.6	4.9	4.6	3.0	3.3
FMCs (median)	3.6	4.7	5.1	3.9	4.2
FMCs (average)	3.9	4.6	5.5	3.7	4.3

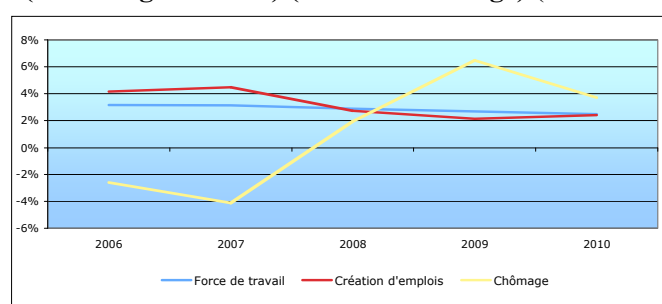
Source: EIU, FEMISE calculations.

Figure 27. Unemployment rates in the FMCs (%)



Source: EIU, FEMISE calculations, *2010 estimated.

Figure 28. Growth in job creation and unemployment rates in the FMCs (excluding Lebanon) (annual % change) (Source: EIU, FEMISE calculations)



Key: Workforce Job creation Unemployment

As regards the inflation rate, this naturally fell everywhere in 2009, reaching an average of 4.3%; Egypt and Algeria stood significantly above the average (with rates of 11.8% and 5.5% respectively in 2009).

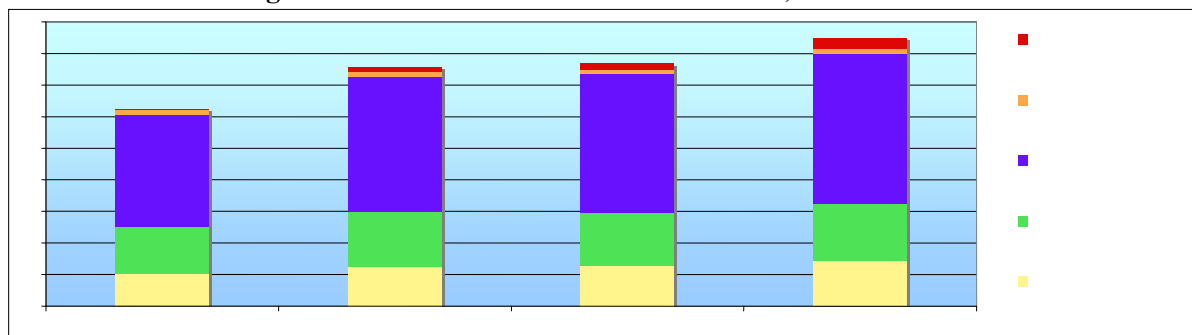
It therefore appears that, despite the gravity of the crisis, the macroeconomic policies of the FMCs enabled the main equilibria to be kept within acceptable bounds and allowed the main stakeholders, especially banks, to hold up well, with their positive expectations intact.

I. A macroeconomic response which led to a significant but sustainable increase in public deficits

I.1 Activity bolstered by consumption

With external demand in the doldrums, the challenge of macroeconomic policy was to maintain adequate domestic consumption, with public consumption and investment acting, as they did universally, as shock absorbers when private consumption and investment were flagging. It is clear (see Figure 29) that it was consumption that enabled the rate of economic growth to be maintained.

Figure 29. Breakdown of GDP in the FMCs, in US\$ billion



Source: IMF, EIU, *2010 estimated.

Private consumption in 2009 remained particularly strong in Lebanon, Morocco and Egypt (with its contribution to GDP growth > 4%), compared to a figure of close to 3% in Syria, Jordan and Tunisia, and a very low figure in Israel (1.5%). Forecasts suggest a broader revival to around 4% in 2010, with Tunisia and Israel showing the weakest recovery. This decisive driver to preserve GDP growth at potential was complemented by public consumption (which rose by 6% on average), indicative of the economic support measures deployed in all FMCs except Israel, Jordan and Lebanon. The growth in investment was negative in Egypt, Israel, Jordan and Syria but very positive in Algeria (thanks to public investment) and Morocco. However, it remained particularly weak in Tunisia. 2010 forecasts suggest that investment will increase, albeit at much slower rates than in the pre-crisis period.

Faced with the collapse in external demand, four responses are worthy of note:

- ✓ A response, common to all countries, of supporting consumption and investment through the budget.
- ✓ Less intense pressure on the public finances in countries such as Lebanon, Morocco and Egypt, where private consumption is still buoyant (the most impressive cases being Morocco and Egypt, where the rise in private consumption has been accompanied by a sharp fall in imports).
- ✓ More severe problems in countries where both private consumption and investment had seen slow growth (Jordan, Syria, Tunisia and Israel).
- ✓ A particularly unusual situation in Algeria, which was able to safeguard domestic demand through public action when oil prices rose.

I.2 A significant increase in deficits

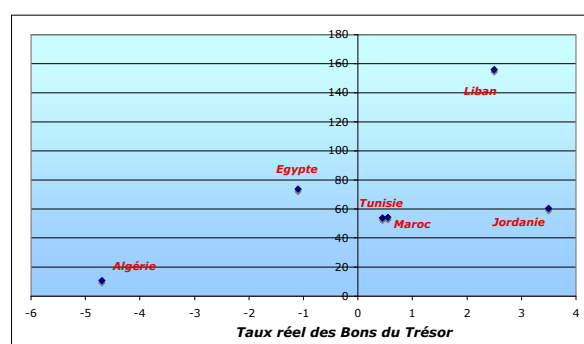
Conditions prevailing at the start of the crisis proved to be an influential factor. Some FMCs, such as Morocco, Tunisia, Algeria, Syria and Egypt, entered the crisis with either a robust budgetary situation or significant quantities of accumulated foreign exchange reserves. Those countries were able to implement countercyclical macroeconomic policies as a way of reviving their economies. From a budgetary standpoint, this was achieved primarily through fiscal stimuli⁵ and the operation of the automatic stabilisers, although the latter played a far less important part than the former.⁶

Table 7. The FMCs' budgetary balance (as % of GDP)

	1995-2000	2000-2007	2008	2009	2010*
<i>Algeria</i>	1.6	7.4	3.4	-7.9	-9.0
<i>Egypt</i>	-1.9	-7.2	-6.8	-6.6	-8.2
<i>Israel</i>	-1.8	-2.6	-2.1	-5.1	-4.0
<i>Jordan</i>	-9.6	-10.2	-9.6	-11.9	-10.8
<i>Lebanon</i>	-17.9	-13.8	-9.8	-8.8	-10.7
<i>Morocco</i>	-3.5	-3.8	0.4	-2.1	-4.4
<i>Syria</i>	-0.2	-2.0	-2.5	-9.5	-5.7
<i>Tunisia</i>	-4.5	-2.9	-0.8	-6.2	-5.7
FMCs (median)	-2.7	-3.4	-2.3	-7.3	-7.0
FMCs (average)	-4.7	-4.4	-3.5	-7.3	-7.3

Source: EIU, IMF, *2010 estimated.

Figure 30. FMC treasury bond and debt rates in 2009 (%) (Source: IFS, Audi Bank)



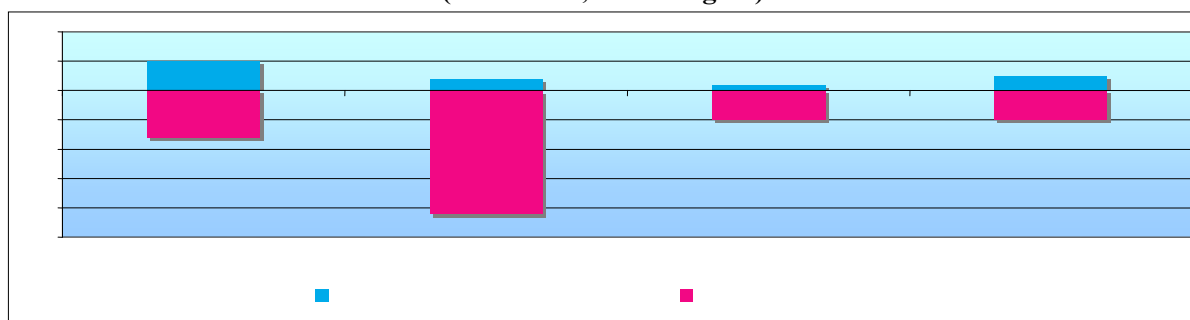
However, countries such as Jordan and Lebanon, both of which have fixed exchange rates and a relatively high level of public debt as a percentage of GDP (160% in the case of Lebanon and 70% in the case of Jordan) as well as high interest rates, found it harder to implement an appropriate policy. While Lebanon enjoyed a significant inflow of liquidity prior to and at the time of the elections, Jordan was in a more difficult situation and suffered the effects of the crisis more acutely.

Key: Lebanon, Egypt, Tunisia, Morocco, Jordan, Algeria Real treasury bond rate

⁵ The fiscal stimulus indicator is a quantitative indicator of the direct expansionary effect of fiscal policy.

⁶ Automatic stabilisers enable the budget to play a countercyclical role without the need for any discretionary change in taxation or the structure of expenditure. The flow of expenditure increases without any political intervention.

**Figure 31. Change in primary budget deficit, excluding oil, 2010
(% of GDP, excluding oil)**



Source: IMF, IFS.

Figure 31 shows that the primary budget deficit excluding oil is likely to be negative in 2010 in Jordan, Lebanon, Syria and Tunisia, a fact which emphasises the limited fiscal room for manoeuvre in those countries. Moreover, the automatic stabilisers are likely to play a very small role (less than 1% of GDP).

I.3 Establishing a monetary/exchange rate policy mix

Against the background of the crisis, the FMCs will be confronted with three obstacles in 2010: (i) lower GDP growth rates than in the pre-crisis period, and hence lower tax revenue, larger budget deficits and a higher unemployment rate, (ii) lower capital inflows, and (iii) weaker exports, with external current account deficits and greater difficulty in servicing foreign currency debt.

Countries which, like Lebanon⁷, Syria and Jordan, have fixed exchange rate systems, limited fiscal room for manoeuvre and inadequately developed financial markets will be hardest hit by the crisis.

- ✓ Fixed exchange rates will only be maintained by depleting reserves.
- ✓ These countries will no longer be able to rely on monetary policy to revive their economies, as it will be absorbed by the need to maintain their exchange rate system through appropriate interest rates.
- ✓ If the central bank is unable to defend the exchange rate, they will be in danger of seeing a sudden, sharp devaluation and risk a crisis similar to the one that affected Russia in 1998. There is thus a risk of a foreign exchange and balance of payments crisis due to an appreciation in the real exchange rate following a return to higher inflation.
- ✓ On top of that, there is the possibility of bank collapses, depending on the exposure of the commercial banks to sovereign debt and the construction sector, as we have seen in the GCC States, or their exposure to other types of non-performing loans, with no possibility of recourse to the international financial markets.

These comments, which also concern the other countries in the region that use a crawling peg exchange rate system tied more or less closely to a basket of currencies, will also apply if the exchange rate is unable to adjust sufficiently to prevent the local currency from appreciating in real terms. The adjustment would even need to be large enough to accentuate the rebound through a recovery in exports. We have seen that countries such as Egypt, Morocco, Tunisia and Algeria, with their more flexible exchange rates, have managed to avoid any appreciation of their real rate of exchange (see Figure 32). These countries have more scope to implement countercyclical monetary policies as long as capital movements have not been entirely deregulated.

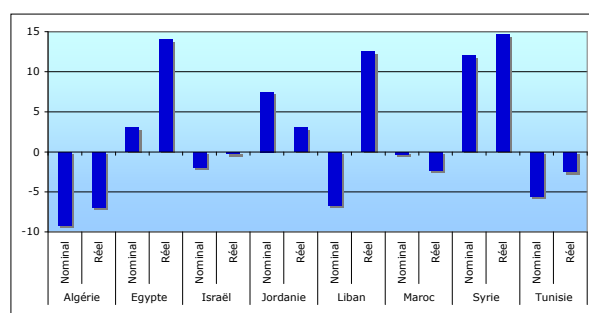
On the other hand, where the capital account is wholly convertible, monetary policy will once again be constrained by the future exchange rate expectations of the various market players via interest rate

⁷ However, Lebanon was able to mitigate the effects of the crisis through its increased political stability and the resulting inflow of tourists, and also because the assets of the majority of commercial banks consisted of treasury bonds, rather than structured financial instruments.

parity. The ideal mix therefore appears to be greater exchange rate flexibility, combined with a cautious approach to capital account convertibility.

A case worthy of note is Egypt, which was able to withstand the shock effects of the crisis, despite the considerable losses suffered on its stock exchange, due to the fact that it was better integrated into the more developed financial markets. The recent floating of the Egyptian pound has made monetary policy more effective by enabling it to ease pressure on domestic interest rates and helping to reduce the debt service burden significantly. Moreover, it has proved possible to contain both the budget deficit and the current account deficit. Thanks to a series of minor devaluations prior to the crisis, Egypt was able to boost its exports and generate adequate foreign currency reserves to reduce the level of its external debt. Egypt's success in implementing a flexible exchange rate has created the conditions for a smooth transition towards inflation targeting. It is the approach that enables the central bank, within a flexible exchange rate system, to create the positive expectations that enable a transition with greater confidence towards convertibility of the capital account, a necessary precondition for greater integration into international financial markets⁸.

Figure 32. Effective real and nominal exchange rates in the FMCs, change in 2009 (%) (Source: IMF, IFS)



Key: Nominal, Real Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia

presupposes greater central bank independence. The majority of FMCs are moving towards this situation, which is a vital step, as we have said, towards greater financial integration on a regional level, as well as greater capital account convertibility.

Elsewhere, the policy of inflation targeting towards which Tunisia and Morocco are also moving, albeit implicitly, allows for better control of the various inflationary pressures that accompanied the crisis. That helps to improve the effectiveness of monetary policy by neutralising the effects of the crisis. On the other hand, targeting an exchange rate with the help of a more discretionary monetary policy increases uncertainty in the event of a crisis and, ultimately, can require a larger real adjustment to be made. It should also be noted that a policy of this sort

⁸ With full convertibility of the capital account, anyone can compare the expected return on an investment in domestic currency with the expected return in foreign currency. As the comparison depends on the difference between domestic and foreign interest rates and the expected future exchange rate, it is the exchange rate expectation that is the key determinant of the decision (together with the interest differential). If the central bank has a credible inflation target, expectations for the value of the domestic currency will be favourable, making low interest rates viable while at the same time preserving the country's attractiveness for investment in its domestic currency.

II. A relatively sound banking sector, but still inadequate intermediation

The banking system also withstood the effects of the crisis relatively well because of good profitability before the event and support from the authorities after it. Banks were, nevertheless, reluctant to lend to the private sector and have failed to participate adequately in the recovery.

In general, the banks remained solvent and profitable in 2009. Capital ratios continued to easily exceed regulatory requirements and, in most countries, the level of non-performing loans remained relatively low or continued to fall. However, we can see (Figure 23) that returns on equity and on assets both declined in 2009. Particularly noteworthy are the following (see table below):

- ✓ As regards **non-performing loans**, Israel (with 1.5%) and Morocco, Jordan, Lebanon and Syria (with between 5 and 7%) are in a comfortable situation. On the other hand, this rate is significantly higher in Algeria, Egypt and Tunisia (between 15 and 18%). It should, however, be noted that this percentage has fallen or remained unchanged everywhere over the past three years, despite the crisis.
- ✓ The **capital adequacy ratio** (Basel criteria) is adequate in all countries (18% on average) and has even risen significantly in Syria (22% in 2009 compared to 6.5% in 2007).
- ✓ **Return on assets** (ROA = net income/average total assets) fell significantly during the crisis (from an average of 1.4% to 0.8%), a trend that is only to be expected given the effects of the crisis on asset values.
- ✓ **Return on equity** (ROE) is relatively high (except in Israel), but also declined significantly from 17.7% in 2007 to 11.6% in 2009, an average performance which reflects a sharp fall in the profitability of banks across all the FMCs.

Table 8. Financial soundness indicators (FSIs) of FMCs, latest available year*

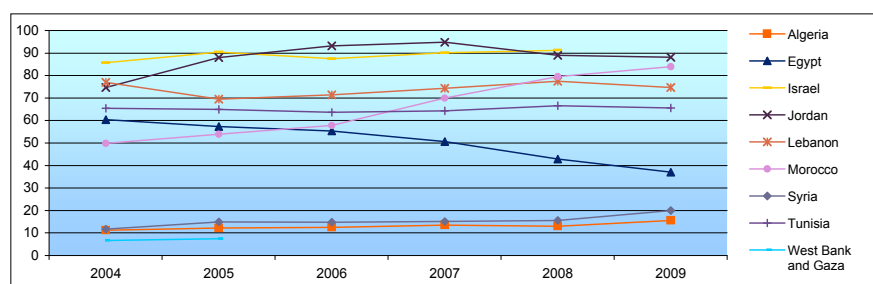
	<i>Algeria</i>	<i>Egypt</i>	<i>Israel</i>	<i>Jordan</i>	<i>Lebanon</i>	<i>Morocco</i>	<i>Syria</i>	<i>Tunisia</i>
<i>Capital adequacy ratio</i>	17	14.7	11.1	19.3	11.8	11.7	23	11.7
<i>Capital to assets (%)</i>	n. a.	5.7	6	10.4	7.8	7.3	n. a.	n. a.
<i>Non-performing loans (% of total loans)</i>	18	14.8	1.5	4.2	7.2	5.5	6	15.5
<i>Return on assets (%)</i>	n. a.	0.8	0.2	1.4	0.9	1.3	0.8	1
<i>Return on equity (%)</i>	25	13.5	4.1	11.5	11.9	17	17.2	11.2
<i>Specific provisions (% of non-performing loans)</i>	62	92.1	n/a	63.3	61.8	77.6	23.7	56.8

Source: IMF, *detailed explanations of these terms are available in the annex; year 2009 or 2008.

With growth in deposits and inflows of capital in certain countries (especially Lebanon), the banks have become better capitalised. However, lending to the private sector is still inadequate in a number of countries, reflecting risk aversion, the difficulty in raising sufficient capital, and stricter supervision.

Thus, the crisis has both confirmed and accentuated a number of phenomena:

- ✓ A certain vulnerability in the banking sector, implying that supervision must be maintained or even reinforced.
- ✓ The abnormal structural weakness in private sector lending in certain countries (Syria and Algeria), which reflects a lack of dynamism and suitable projects, the weakness of the banks and the crowding-out effect of the public sector.
- ✓ A slight decline in private sector lending in Jordan, Tunisia, Lebanon and Israel (with Morocco being the notable exception).
- ✓ The very sharp decline in private sector lending in Egypt, which must be a cause for concern as it will certainly be a major handicap to the recovery now under way.

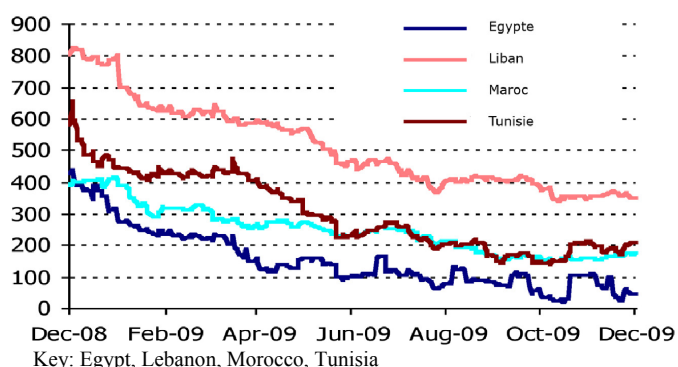
Figure 33. Private sector lending (as % of GDP) (Source: World Bank WDI)

Overall, however, the situation of banks after the crisis remains sound and a credit crunch appears unlikely in any of the FMCs. The crisis has, though, revealed the well-known weaknesses in bank intermediation in

these countries. They will need to be remedied rapidly, particularly if external finance remains at its current level.

III. Expectations conducive to recovery

The cost of emerging countries' external debt on the international financial markets began to rise in July 2008. Spreads remained moderate until the start of the financial crisis. Tunisia was the first country to feel the burden of the crisis when it attempted to issue bonds on the international markets in July and August 2007 (and was forced to improve the terms by 25 basis points to attract investors). With the onset of the crisis, spreads rose (250 basis points for emerging countries from October 2008), 100 basis points for Egypt, and 200 basis points for Tunisia, at a time when US bank failures were at their height. In December 2008, spreads on Tunisian sovereign debt rose sharply (600 basis points in December), although that level was still below the MENA region average, which hovered around 900 bp.

Figure 34. Spreads on FMCs' external debt (Source: Bloomberg)

After December 2008, spreads fell steadily, reaching low levels. Two lessons can be drawn from this trend. The first is that countries must avoid the need for international liquidity during a crisis, because its price is exceptionally volatile and leads to uncontrollable debt levels. That suggests that the macroeconomic fundamentals must be managed cautiously, and that great prudence is needed in the vital process of opening up

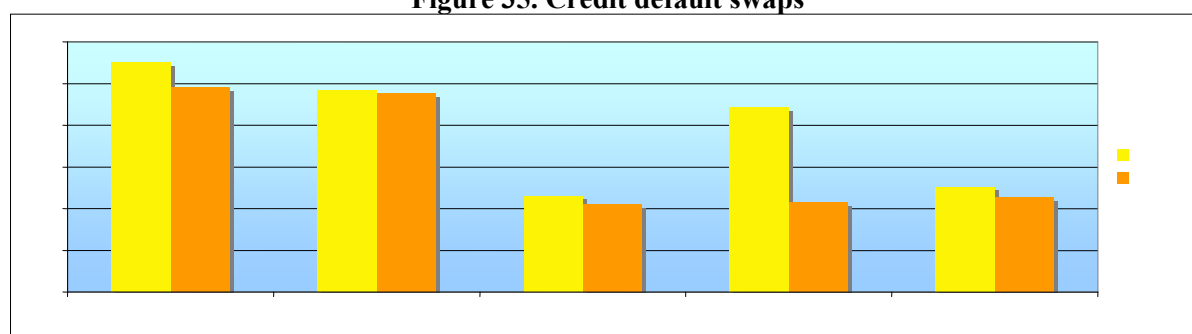
to the international capital markets by countries not in a position to manage market expectations. That also accounts for the fact that Asian economies, which are more integrated into the international capital markets, have recently felt it useful to create a support fund in ASEAN +3. The second lesson to be learned is that the grounds for confidence in the FMCs have clearly reasserted themselves, as shown in the ratings of the leading agencies, which have been improving for the FMCs (except Egypt). CDSs also confirm this observation, with those for Lebanon and Egypt, the two countries in the region whose sovereign debt is viewed as being riskiest, now standing at levels some 50% lower than those of Greece.

Table 9. Ratings of FMCs' external debt issues

<i>Issuer/entity</i>	Moody's	Action	Date	S&P	Fitch
<i>Lebanon</i>	B2	Upgrade from B3 (2008)	1 April 2009	B-	B-
<i>Egypt</i>	Ba1	Downgrade	23 June 2008	BB+	BB+
<i>Israel</i>	A1	Upgrade from A2 (2006)	17 April 2008	A	A
<i>Morocco</i>	Ba1	New entry	25 June 2007	BB+	BBB-
<i>Jordan</i>	Ba2	Upgrade	21 August 2003		
<i>Tunisia</i>	Baa2	Upgrade	17 April 2003	BBB	

Source: Moody's, Standard and Poor's, Fitch.

Looking ahead, therefore, there is clearly a need for caution. If budget equilibria do not improve at a time when the regional and global recovery is becoming established, interest rates will probably increase, thereby limiting investment and making it more difficult to respond to the private sector's demand for capital. There is limited room for manoeuvre owing to the significant increase in budget deficits, at a time when the FMCs also have to prepare themselves for the future by developing structural policies.

Figure 35. Credit default swaps

Source: Bloomberg.

CHAPTER IV. EMERGING FROM THE CRISIS AND FUTURE GROWTH

Our observations so far have centred on the FMCs' strategies for managing the crisis and on the short-term economic consequences. It is now time to look at the longer term, in a post-crisis context in which the FMCs could potentially improve their relative position if they are successful in developing new catalysts for growth.

These growth catalysts will need to help accelerate the current rate of growth, not just to enable the FMCs to converge with other countries in the region (which will require average annual GDP growth of 7%), but also to equip them to cope with the growth in the active population over the next 20 years (the potential workforce in the 15 to 65 age range is set to increase by more than 60 million by 2030).

Observations made over a long period show that GDP growth in the FMCs has been driven primarily by demographic expansion and capital accumulation, and only to a very limited extent by improvements in productivity (total factor productivity, TFP).

With regard to growth in per capita GDP, the most widely used welfare indicator, the following points should be noted:

- (i) the contribution to that growth of human capital accumulation (via education and training) has been positive but relatively modest, with big discrepancies between countries and time periods. That suggests that the significant progress made in terms of literacy and basic education has not delivered the expected results. The reasons for this bring us on to the issue of active public policy, which we shall cover in the next chapter;
- (ii) physical capital accumulation appears to have been the main driver of per capita GDP growth in most FMCs (Egypt, Morocco, Palestine and Turkey in particular), regardless of the periods studied, a situation which distinguishes the FMCs from other developing regions. However, in the case of the FMCs physical capital accumulation has not had any additional spillover effects. This is probably due to inadequate technology transfer, insufficient investment in the value chain of the industries concerned, and the lack of any take-up by local businesses, especially SMIs-SMEs (see FEM33-09);
- (iii) the contribution of TFP to growth has always been relatively limited. It should be noted that in the 1980s and 1990s, that contribution was at best zero, or even negative (except in the case of Tunisia and Israel). It is only in recent years that a more general move towards an increase in total productivity has begun to emerge, coinciding with a period when the FMCs were becoming considerably more attractive to foreign direct investment (their share of FDI has doubled since the late 1990s).

Thus there is little doubt that success in emerging from the crisis, assuming that the FMCs do not abandon their strategy of opening up their economies internationally, will depend very much on (a) their ability to remain attractive to foreign investors and to take greater advantage of the spillover effects of that investment (which is a clear sign of an improvement in the business climate), and (b) the progress they are able to make in establishing a system of productivity-based growth. In the latter case, this involves a more general approach relating to the overall dynamism of the economies concerned and, in particular, their ability to set up a knowledge-based economy.

I. Foreign direct investment: a recovery with a different profile⁹

I.1 A changing global situation for FDI

After a sharp fall in 2008, which saw global direct investment flows decline from a peak of over US\$ 2 000 billion in 2007 to US\$ 1 000 billion at the height of the crisis, there was a slight recovery from the second half of 2009 onwards. FDI flows are now forecast to reach US\$ 1 200 billion in 2010 and to continue increasing to between US\$ 1 600 and US\$ 2 000 billion by 2012.

However, UNCTAD, the author of these forecasts, stresses that these estimates should be viewed cautiously as they have been made against a backdrop of extreme fragility and great uncertainty as to the recovery of the global economy. Despite this, the amounts involved (five times higher than in the mid-1990s) suggest that the flow of long-term capital will remain a central factor in the consolidation of the global economy over the next few years. At the same time, the infusion of international capital will need to be more effectively supplemented by processes of domestic capital accumulation and to contribute further to new sources of growth. This explains why the very nature of these flows and the behaviour of the underlying investors (i.e. transnational firms and investment funds) are undergoing a radical change. These trends are also having an impact on domestic policies to attract investors and on regulation.

Box 2. Points of reference based on general FDI trends

To define the relative position of the EU's partner countries in this area, we shall now identify a number of points of reference based on the general trends. Nine key observations can be made.

*The first is the very clear shift in the **destination of investment flows** towards developing and transition countries. Whereas in 2007, 70% of flows were between developed economies, this figure had fallen to 50% in 2008 and 2009. This significant increase in the share of developing and transition countries is due to the improved business environment, greater international openness, the development of stock exchanges and the outlook for future growth.*

*The second observation is that despite the crisis, which restricted **outward investment from the developed countries**, those economies still constitute the main source of direct investment. However, outward investment flows from developing and transition countries saw a relatively lower decline, and thus their share of outward flows rose from 19% in 2008 to 25% in 2009.*

*The third observation concerns the **process** through which the most advanced emerging countries are beginning to participate in the global economy. Here, the example of the BRICs provides a good illustration: initially, cross shareholdings and equity investment tend to develop within a single large region owing to cultural affinities, the influence of the diasporas and commercial familiarity. Later, domestic transnational firms develop, capital markets acquire extra depth and investment is made outside the wider region.*

*The fourth comment relates to the **make-up** of these FDI flows. A distinction is normally drawn between cross-border mergers and acquisitions (M&As) based on equity investment, a large part of which is channelled through the stock exchanges, domestic cross-border stakes in transnational corporations, and green investments, which (as the name suggests) involve new activities in previously untapped sectors. As the crisis recedes, a general rebound is beginning to take shape, but with greater emphasis on M&As. Arguably, however, they will face increasing competition from investment in new activities involving less expensive projects promoted in future by host countries, a trend that would help develop those countries' comparative advantages.*

*The fifth observation concerns the problems being encountered by **private investment funds** and the*

⁹ This section was produced in close cooperation between Femise and Anima.

increasing role of **sovereign wealth funds**. These difficulties have led to a sharp fall in big-ticket investments. There are several causes for this, including increased risk aversion, a shortage of new projects and the credit crunch. Changing practices in the private equity industry have led to increased investment in small and medium-sized enterprises: being more decentralised, closer to firms in the countries in which they are investing, and often operating through local partners, these funds have access to a greater number of projects. As UNCTAD points out, the improved situation in the global securities market has underpinned a partial recovery in the value of their assets.

The sixth comment concerns the development of **transnational corporations (TNCs)**. Foreign-based subsidiaries of TNCs now account for value added equal to some 11% of global GDP. Thus, production has continued to become more international, although with two differences: (i) an organisational difference (TNCs have delegated more responsibilities to their subsidiaries in the host countries), a positive development as those countries gain the benefit of increased technology transfers and job opportunities for their graduates, and (ii) a sectoral difference, with investments in water, energy, ICT, electronic equipment and construction being the only ones that have managed to hold their own.

The seventh observation concerns countries' **policies of receptiveness to investment**. These have been driven, on the one hand, by increased liberalisation and, on the other, by an effort to pass regulations with the aim of making the focus of FDI compatible with structural policy goals. That leaves each country with a difficult balancing act between incentives and regulation, a mix that is largely dependent on its particular attractiveness and the tax benefits it can offer.

The eighth comment refers to the **development of international treaties** in the field of international investment (International Investment Agreements, or "IAAs"), a trend which continued throughout the crisis. By the end of 2009 close to 6 000 international treaties had been signed, half of which concerned bilateral obligations. One interesting development is the existence of provisions on investment in a context of broader regional cooperation, enabling commercial issues to be linked more effectively to investment issues (national treatment, double taxation, arbitration, etc.). A good example is the Asean Comprehensive Investment Agreement (ACIA).

The ninth observation centres on **the results of academic research**. This shows the vital importance of market size as defined by GDP and growth potential. Other influential factors, although clearly of secondary importance, are the availability of an abundant workforce, the quality of infrastructure and the telecommunications system, and the business climate. Leaving aside the differing emphasis placed on one or other of these factors (Nunnenkamp and Spaz (2002), Khondoker Andul Mottaleb and Kaliappa Kalirajan (2010) on market size and growth; Didier and Mayer (2004) and Daude and Stein (2007) on the business climate as reflected in the time needed to set up a company; Kimura and Todo (2010) on the influence of bilateral aid in the development of FDI), academic opinion can be summarised as follows:

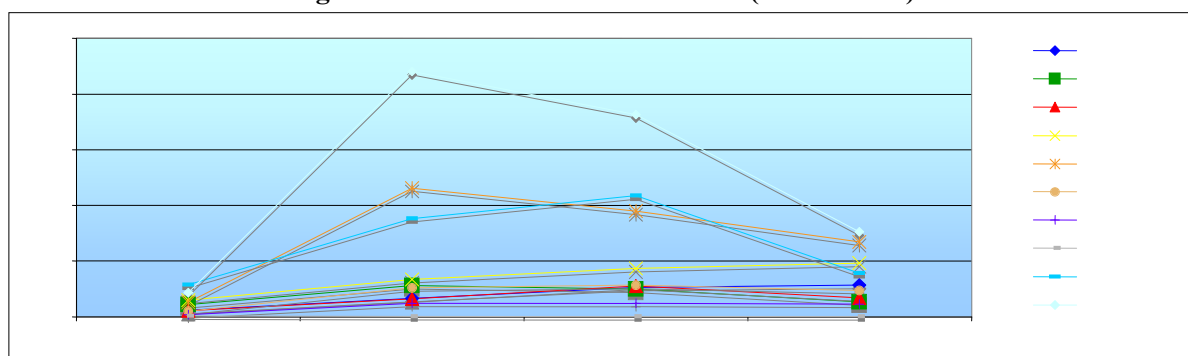
"For middle-income developing countries, a category that encompasses the EU's Mediterranean partners, studies show that those most successful in attracting significant amounts of FDI – notably in Asia – have a large domestic (or regional) market with strong links to the global market through international trade. They also offer a congenial business environment. Empirical studies also show that, in addition to the size and growth potential of the market, the quality of the relationship with the main providers of external aid, especially on a regional level, is also an influential factor."

I.2 A significant fall in FDI flows to the MCs, but no change in the relative position during the crisis

All the Mediterranean countries have tended to follow a process of opening up to FDI. This has been a characteristic feature since the early 1990s and reflects the particular progress made in the Mediterranean (greater opening up to trade, changes in the business environment, and incentives). Whereas in the period 1995-2005, the MCs only represented 1.5% of annual average global FDI inflows, they now account for 3%, a level more consistent with the ranking of this group of countries in the global economy (by population, GDP, etc.).

This share of inward investment saw a slight reduction in the context of the global crisis, in which long-term capital movements were adversely affected. Nonetheless, FDI has continued to act as a key driver for domestic growth, particularly since outward FDI from the Mediterranean countries is very small (with the exception of Turkey and Israel). In terms of net inflows, the relative share of the MCs has increased. This is due to the fact that those countries have few TNC "champions" expanding abroad. Moreover, the behaviour of the region's TNCs has been significantly affected by the international crisis: According to the ANIMA-MIPO Observatory, whereas intra-MC FDI has been stable since 2004, the share of TNCs has fallen by half (by value) since 2008, to the benefit of SMEs, which have seen their share double over the same period. 2010 appears to confirm this trend.

Figure 36. FDI inflows into the MCs (US\$ million)



Source: UNCTAD, Database 2010

These observations call for two comments: firstly, the Barcelona partnership, and the process of opening up internationally, together with the change in mentality to which it contributed, have unquestionably helped to make the region a stronger magnet for international capital, thereby recovering the lost ground clearly visible in the 1990s; secondly, this trend must enable the MCs to become better established within the global economy (a situation that will be reflected in increasing outward FDI flows led by large firms). It should also produce more decisive spillover effects in the domestic economy (new comparative advantages, positive impact on the local SMI-SME fabric, improved quality through technology transfers, and the mobilisation and upgrading of domestic human capital, etc.).

All MCs (except for Algeria and Lebanon) saw a sharp fall in inward direct investment during the crisis. However, those most affected were Turkey, Morocco, Egypt and Israel, which are also the countries that had made the most progress in recent years. As everywhere else in the world, the sector most affected was M&As (which saw numbers collapse from over 16 000 in 2008, the peak level during the period, to fewer than 1 500 for the whole of North Africa in 2009).

Table 10. MCs' share of global inward FDI flows

	Total MCs	World	MCs %
<i>FDI 1995/2005 (annual average)</i>	10978	741045	1.48%
<i>FDI 2007</i>	55748	2099973	2.65%
<i>FDI 2008</i>	54867	1720873	3.19%
<i>FDI 2009</i>	32437	1114189	2.91%

Source: UNCTAD, Database 2010

I.3 A significant recovery on different bases¹⁰

According to the Mediterranean Investment and Partnership Observatory ANIMA-MIPO, which has provided the information used in this section, the number of foreign direct investment project announcements started to increase again in the MCs in the first half of 2010 as compared to 2009, with a rise of 47% in numbers of projects. However, that recovery does not imply that the total amount invested will be significantly higher than in 2009. The total amount of FDI announcements has, in fact, remained relatively unchanged from 2009, with €13.6 billion in H1 2010, compared to €29.6 billion in 2009, a reduction of 8%.

The main comments to be made on these observations (ANIMA-Invest in Med, 2010) are as follows:

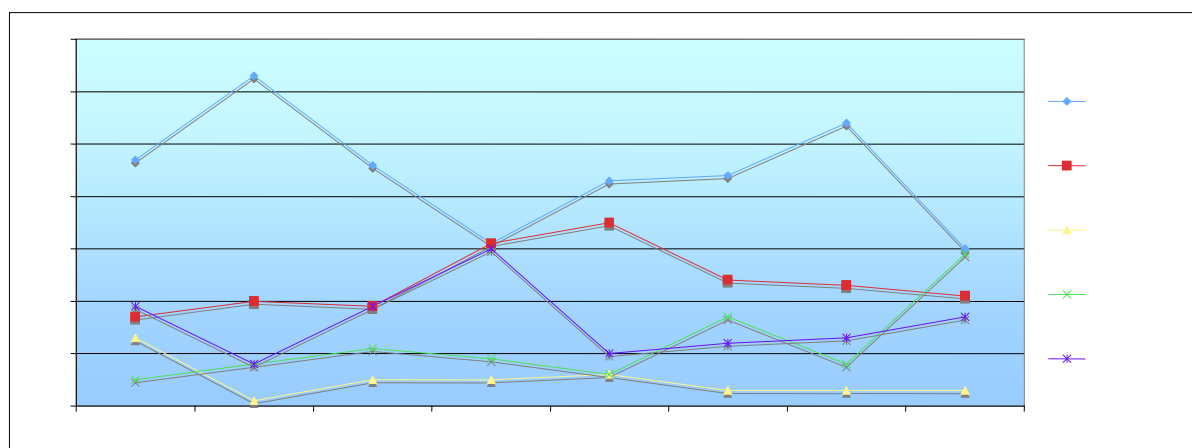
- ✓ The decline in the average amount of FDI announcements is accelerating. The average project was €34.6 million in the first half of 2010, compared to €55.7 million in 2009 and €87.4 million in the record year of 2006.
- ✓ Enterprise partnerships (defined as projects in which a foreign firm approaches a domestic market either through an identified partner or by establishing a local presence) are cementing the recovery in line with the global trend and at a similar rate (246 announcements in the first half of 2010 compared to 302 for the whole of 2009, an increase of 63%). 2010 is therefore showing a continuation of the trends seen in 2009: the recovery in investment decisions by foreign businesses is confirmed, although the projects are more modest and less risky. As ANIMA has pointed out, this is evidence that firms are adapting to the post-crisis environment: "After the golden era of mega-projects in the telecoms, banking and real estate sector (2005-2007), and the financial and economic crisis (2008-2009), companies [have] resume[d] their investment projects but [are] limit[ing] their size, and pay[ing] more interest to developing their activities in the region".
- ✓ The economies which appear to be rebounding most strongly are Israel and Turkey (+75% by number of projects, +13% by value in the first half of 2010). The Mashreq area also appears likely to see a significant upturn in inflows: +40% in the number of FDI projects and €5.7 billion announced an increase of 14% over full-year 2009. The largest increases were seen in Lebanon, which in the first half of 2010 attracted the same value of announcements as in the whole of 2009, and Syria, which recorded €2.2 billion of announcements on the same date, compared to €0.9 billion for the whole of 2009; this was helped in particular by investment by the Chinese company CNPC, which acquired Shell's Syrian assets, and the UAE's Majid Al Futtaim (MAF), which began constructing a second shopping centre in Damascus. Partnerships are also seeing a substantial increase in the Mashreq countries, which are catching up with their Maghreb neighbours by attracting around one third of total partnership projects in the first half of 2010.
- ✓ The situation in the Maghreb, however, is patchier: FDI announcements were up by 29%, but there was a fall in value of 20% in H1 2010 as compared to full-year 2009. Tunisia was the exception, with announcements up by 350% thanks to the mega project of the UAE's Gulf Finance House (GFH), which is building the Tunis Financial Harbour after purchasing land for

¹⁰ This section draws heavily on information provided by Anima-Invest in Med (2010), "Review of Foreign Direct Investment and Partnerships during the first half of 2010", August.

the project in 2009. Excluding this announcement (US\$ 3 billion to be invested over the next 7 years), Tunisia would have seen a fall comparable to that of its Maghreb neighbours. In Morocco, despite poor first-half figures, FDI inflows are unlikely to decline in 2010, thanks to the recent announcement of France Telecom's acquisition of 40% of Meditel, Morocco's second mobile phone operator. However, the situation is more mixed in terms of the numbers of projects announced: Tunisia has a comfortable lead (+76%); Morocco has also posted creditable figures (+29%). Algeria has seen a significant fall (-23%), but this is entirely attributable to the energy sector, which has accounted for one third of its FDI portfolio since 2003, whereas announcements in other sectors are virtually unchanged from 2009.

- ✓ The origin of FDI projects also varies significantly. The innovation is the arrival of the emerging economies, which now account for 30% of the projects announced. However, Europe, which is still the main source of FDI with a contribution of 30-40%, is concentrating on projects that are smaller in average size (€22 million compared to €112 million for emerging countries in the period 2003-2010) and more diversified, with over a quarter initiated by SMIs-SMEs. Among emerging countries, the leading investor is China, with a diverse portfolio of projects (energy, distribution, construction and public works, automotive, water, etc.) in Egypt, Israel, Syria and Turkey.

Figure 37. Source of net FDI flows



Source: ANIMA-MIPO, 2010.

- ✓ On a regional level, investment decisions are on the increase in a number of sectors: these include banking (Syria has attracted 10 projects following the January 2010 law which allows foreign investors to own up to 60% of the capital of Syrian banks, as against 49% previously), business services (where Morocco and Tunisia account for half of the projects), electrical and electronic equipment, which is seeing a strong recovery, distribution (with 50% going to Turkey thanks in particular to the Chinese Li & Fung Group, which is locating its European, African and Middle East operations centre there), and the pharmaceutical sector, in which Israel is continuing to attract European investors, while Tunisia is forging ahead with the strategy of developing its pharmaceutical industry.

I.4 Contribution of FDI to the future growth of MCs

If we look more specifically at the situation of the different countries and their reactions to the crisis, five main observations can be made:

In the first place, FDI plays a markedly different role in the economy depending on whether: (i) the country has followed a policy of changing the business climate, privatisation, liberalisation of the capital account and the use of more flexible exchange rates, or (ii) has retained tight domestic regulation, firmly fixed nominal exchange rates and significant restrictions on the mobility of capital. The situation in the MCs is thus fairly mixed. A distinction can be drawn between:

MCs where FDI has a central place in the economy and which have an aggressive policy for welcoming it. These are, in descending order: Jordan, where the stock of FDI accounted for 80% of GDP at the end of the period, Tunisia (77%), Morocco (45.5%), Egypt (34.8%, the African country which, according to business surveys, has the largest number of planned new establishments), and Israel (36.6%). It is clear that in these countries foreign firms now play an important quantitative role in the growth process.

MCs where the stock of foreign assets represents a significantly lower percentage of GDP, either because their economies are relatively large or because they have financial resources or savings that make the need for FDI less pressing. The former category must include Turkey (where the FDI stock represents 12.6% of GDP), while the latter includes Algeria (12.7%), Syria and Lebanon (13.9%).

The second observation is that, as a general rule (with the exception of Algeria and Syria), FDI has become a key growth factor in the course of a decade. That is undoubtedly due to its importance in terms of capital accumulation (in certain countries, notably Jordan and Egypt, it has even accounted for more than a third of gross investment in recent years), and less obviously to its contribution to dynamic growth through total factor productivity (TFP), employment and regional equilibrium.

Table 11. Inward FDI as % of GFCF

	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Palestine	Tunisia	Turkey
1995/2005	4.6%	8.8%	13.0%	24.3%	5.4%	10.4%	4.5%	3.4%	10.7%	4.0%
2007	4.7%	42.2%	28.1%	48.2%	17.6%	11.9%	14.8%	-0.9%	19.0%	15.9%
2008	5.6%	31.2%	30.0%	44.5%	16.2%	9.0%	12.0%	-0.7%	27.0%	12.5%
2009	5.9%	22.3%	12.2%	39.0%	16.3%	4.5%	10.2%	3.3%	15.6%	7.3%

Source: UNCTAD, Database 2010.

The third observation refers to the post-crisis challenges. These are perfectly clear. For countries which have not yet opened up their economies to FDI other than for their raw material resources and infrastructure, the challenge now is to attract it into different sectors while remaining within the terms of their planning framework. Several studies have shown that FDI will not necessarily conflict with long-term planning combined with an industrial policy (Klaus Desmet, Felipe Meza, Juan Rojas 2008). For other countries, there will be a clear need to maintain their attractiveness and ensure that FDI plays its role both of rolling back the technological boundaries and helping, through its spillover effects, to propel large parts of the system of production towards a growth dynamic more focused on productivity. That is clearly the direction chosen today in Egypt, Jordan, Tunisia and Morocco, where attempts are being made to combine more effectively an exogenous component driven by the dynamism of FDI in moving the technological frontier, with an endogenous component fuelling systematic progress in the domestic production environment through transfers of technology and spillover effects. Previous experience shows that FDI is a very effective driver of long-term growth if the recipient country has the capacity to absorb the technology and if investment is received in an organised way over a long period of time in order to facilitate the growth.

Box 3. Experience with Qualifying Industrial Zones (QIZs) in Jordan and Egypt

QIZs involve memoranda of understanding offered by the United States to Jordan, Egypt and Israel to reinforce regional cooperation by giving access, without customs duties or quotas, to certain sectors of the US market (principally textiles and clothing). The first of these agreements was signed with Jordan in 1998, followed by a second one with Egypt in 2004. The initial agreement had a major effect on the growth of Jordanian exports to the US market (and on trade between Jordan and Israel). It was that success which led Egypt to follow suit, despite political reservations. The mechanism seeks to enable the signatories to benefit from the free trade agreement between the US and Israel. The principle is that firms located in the QIZ are required to use a minimum amount of inputs sourced from Israel, and that at least 35% of the value of the product must be added in situ. Thus it is not merely a free zone, because of the stipulation of reciprocal trade (Palestine is also involved) and there is an obligation to process the product. Considerable trade has been created in the textile and clothing sector between the countries concerned, and new forms of cooperation have been introduced. One of the results has been to enable these countries to be better placed in the US market than their Asian competitors.

The effects in terms of quality are not clearly discernible in Jordan, as the unit prices of exports have not increased significantly. In Egypt, however, the increase in the quality of clothing has been considerable. With some exceptions, few new products have been launched by domestic firms. This is principally due to the lack of a skilled workforce in the sectors concerned. In Jordan, however, the equipment installed was modern and resulted in considerable improvements in productivity in the sector. Nonetheless, with the exception of the original equipment, the transfer of technology to Jordan and Egypt has been modest. This is one of the current areas of concern for their governments.

The initial effect on employment was significant, as the sector accounts for nearly one third of industrial value added. It is estimated that the 13 QIZs operating in Jordan provide 75 000 jobs, more than 30% of total employment in industry. However, because of the inadequate skills of the local workforce, there appears to have been a substitution by foreign workers over the past few years. This is an example of the lack of a local ability to absorb investment, which tends to temper the dynamic effects of FDI.

Finally, the creation of QIZs has fuelled a boom in foreign direct investment (especially from Asia) and is viewed as one of the crucial factors (together with privatisations) accounting for the success of the policy of welcoming foreign investors introduced in Jordan in the late 1990s. The same phenomenon occurred with something of a time lag in Egypt, where the sector was of particular interest to Turkish investors.

Jeffrey Nugent and Abba Abdel-Latif (2010)

The fourth observation concerns the link with trade and the regional dimension of this issue. Everything suggests, as we have previously noted, that the absence of a major integrated – particularly South-South – market and the impediments to the establishment of a large Euro-Mediterranean market are limiting economies of scale and preventing the potential emergence of Mediterranean champions in the region that will be able to take on a role in structuring production on a global level. Part of the problem is the way FDI is dealt with on a regional level. FEMISE considers that the UfM would be an appropriate framework for establishing an agreement on foreign investment along the lines of the Asean Comprehensive Investment Agreement (ACIA), which, while maintaining national sovereignty with regard to tax matters and grants, guarantees freedom to use any currency and repatriate the initial capital, profits and capital gains; national treatment for the companies of signatories; a most favoured nation clause among its members; free movement of the related jobs; the possibility of dealing with conflicts in a permanent arbitration tribunal independent of the TNCs and countries concerned; and joint promotion of the region. This system, accompanied by the establishment of a currency stabilisation fund (a must-have in a situation of flexible exchange rates) together with continued progress towards trade liberalisation, illustrates the approach of the ASEAN countries in developing

their integration strategy.

The fifth comment concerns the recent trend towards developing public-private partnerships using European firms and funds available under the EU's new neighbourhood policy (NNP) to launch new activities (notably with regard to water, solar energy, infrastructure and training). This development, which is currently being studied by the Council for Economic Cooperation (Canino, 2010), is consistent with the approach to integration desired by the UfM members.

It should be borne in mind that this concept of integration is the one adopted by Europe itself when the Union was being established, and it is also the one recommended by the EU to its Mediterranean partners (and other neighbours). It entails a combination of operations to liberalise the internal market for goods (through a customs union in the case of Europe and Turkey, and a free trade area with diagonal cumulation of the rules of origin in the Euro-Mediterranean partnership) and the factor market (capital, labour), with substantial transfers of public capital either free of charge or at highly preferential rates. These "convergence transfers" are intended to enable adjustments to take place and to foster economic and social integration.

Box 4. ASEAN Investment Agreements

Countries participating in the ASEAN agreements have agreed on the following aims:

- (a) to establish a competitive investment area (AIA) with a more liberal and transparent investment climate among its member States;*
- (b) to ensure that establishment of the investment area will contribute to the free circulation of investment by 2020.*

Accordingly, the countries concerned recognise:

- (a) the existence of a coordinated ASEAN investment cooperation programme that will generate increased investment from ASEAN and non-ASEAN sources;*
- (b) that national treatment (Article 8) is to be extended to ASEAN investors by 2010, and to all investors by 2020, subject to the exceptions provided for under the agreement;*
- (c) that all industries are to be open to investment from ASEAN investors by 2010 and to all investors by 2020, subject to the exceptions provided for under the agreement;*
- (d) that the business sector is to have a larger role in the cooperation efforts in relation to investments and related activities in ASEAN; and*
- (e) that there is to be greater freedom of movement of capital, skilled labour and professionals, and terminology amongst Member States.*

Member States are subject to general obligations (Article 5), Emergency Safeguard Measures (Article 14) are in place to protect them from any threats, and a permanent arbitration tribunal (based on the "Protocol on Dispute Settlement Mechanisms for ASEAN") is available for dispute resolution (Article 17).

Source: Framework Agreement on the Asean Investment Area.

The keyword is therefore co-development, which presupposes a joint mobilisation of public and private funds to implement projects that, thanks to public participation, should eventually prove profitable. These projects must have a significant social, environmental and developmental connotation. It is clear that the benefit is being able to render the deployment of private capital more consistent with the creation of new, greenfield activities that can subsequently generate comparative advantages compatible with the national strategies of the FMCs. Obviously, the risk is that these activities are unable to achieve adequate economic viability over time. A partnership model should be tested in which the public stakeholder would undertake to dispose of its initial shareholding at its value at the time of disposal once the project had reached breakeven; that would be a strong incentive to the mobilisation of private funding. This is the model used by Israel to develop its private equity

industry, which is currently ranked second behind the US. It is an appropriate time for a complementary strategy of this kind, which should concentrate on smaller projects and which, in any event, is not intended to take the place of the major trends in goods, technology and finance as interpreted by ASEAN. We should note that although the eastern Mediterranean, as we have seen, has tended to follow the traditional route (especially Egypt and Jordan), the case of Turkey shows that these two options are compatible if carefully implemented. This is one of the justifications for having a development bank in the Mediterranean which could facilitate such public-private partnerships (Charles Milhaud, 2010).

II. The need to develop new growth momentum through total factor productivity

All studies carried out on the Mediterranean countries over the past two decades have pointed out that, in general, their approach to economic growth is still based on a system of capital accumulation. Indeed, it is one of the world's regions where this phenomenon is most marked. Enjoying robust capital accumulation through domestic investment and FDI is a favourable situation provided growth is more than proportionate and employment keeps pace with it. However, the situation is far less rosy if capital accumulation is inadequate or gives rise to large-scale substitution of capital for labour, or if it is extensive and leads to a fall in productivity.

In the best case scenario emerging economies obtain a significant accumulation of capital (with investment rates close to or even exceeding 30% of GDP) as well as substantial increases in total factor productivity (TFP). It is the combination of these two elements that delivers the growth needed for convergence of per capita GDP (namely around 7% per annum in the Mediterranean). However, the most decisive factor over the longer term is productivity. Virtually all the economic literature stresses that differences in per capita income over the longer term are principally due to differences in productivity.

It should also be borne in mind that if a substantial increase in productivity (especially labour productivity) can be achieved without any reduction in employment, this significantly eases the constraints on day-to-day macroeconomic management. The exchange rate can remain at nominal levels that enable competitiveness to be maintained and raw materials and inputs to be acquired at prices not inflated by excessive currency depreciation; purchasing power can be maintained, with wage/salary increases keeping pace with productivity and not prices; and, thanks to the close correlation between productivity and profitability, company profitability is normally higher.

Box 5. An overview of the concept of total factor productivity

This is a concept that has proved controversial, but is attracting increased attention from economic researchers. An intuitive but clear illustration is as follows: if a country has GDP growth of 5%, with investment growth of 10% per annum over 20 years and a 2% rate of population growth, it is highly probable that, on average, each additional monetary unit invested will create less value than it costs. That economy is therefore clearly showing signs of entropy as its production infrastructure lacks dynamism.

There are several techniques for measuring TFP on a macroeconomic level. The most famous and widely used is Solow's (1957), based on a Cobb-Douglas production function:

$$Y = AK^{\alpha} L^{1-\alpha}$$

Where Y is aggregate income, A the efficiency factor, K the stock of fixed capital, L the number of workers, and α the share of fixed capital in production.

The residual obtained by tests on functions of this type is considered as an indicator of the capacity of an economy to create growth other than by accumulating fixed and human capital; this is TFP. This concept provides an indication of everything that can give rise to growth other than through the accumulation of factors of production; however, it says nothing about how to transform inputs into outputs more dynamically. For this reason, a large body of work has been done the past few years using business surveys in an attempt to reduce the "extent of our ignorance" pointed out by Abramovitz in his critique of the index of total factor productivity.

The broad conclusion of such macroscopic work as has been undertaken is nonetheless interesting as it shows that the Mediterranean is one of the world's regions in which per capita GDP growth can be attributed predominantly to the increase in capital. However, since 2000 it appears that TFP has contributed more to growth, especially in countries which have opened up their economies and striven to modernise their institutions and focus on the knowledge-based economy. By using the method known as "growth accounting", which considers TFP as a residual, we can test the function as shown below:

$$(d/dt) \log A = (d/dt) \log y - \alpha (d/dt) \log k - (1 - \alpha) (d/dt) \log h$$

where y = GDP; k = the stock of physical capital, h = human capital

A recent test (Pipitone, 2009) carried out after estimating the stock of physical capital and making two extreme assumptions regarding the share of capital α in GDP (0.30 is the minimum rate normally used, and 0.74% is the rate given by the author's estimates of the capital stock), shows for the recent period:

- √ *relatively stronger growth of TFP since the mid-1990s in Lebanon, Tunisia, Egypt and Israel;*
- √ *progress made in Morocco, Turkey and Jordan;*
- √ *Algeria and Syria clearly lagging behind from this standpoint.*

This issue becomes particularly important in the current period, when foreign investment is recovering and governments, grappling with their public deficits, will inevitably put pressure on domestic savings by issuing sovereign debt. However, it is nonetheless true that academic studies clearly show that a policy of targeting growth in TFP tends to become self-sustaining as soon as it is under way (the auto-regression coefficients of deferred productivity levels are high). FEMISE therefore believes that the new trend for a return to proactive policies, especially in the industrial field, must not under any circumstances lead to any abandonment of these factors that have enabled most MCs to follow this route from 2000 onwards. This is also the constraint that needs to be imposed on new co-development operations undertaken by the UfM.

Table 12. Annual TFP growth with $\alpha = 0.30$

	1990-1999	2000-2006
<i>Algeria</i>	-2.42%	-0.20%
<i>Egypt</i>	2.12%	0.28%
<i>Israel</i>	1.11%	0.30%
<i>Jordan</i>	-2.48%	2.09%
<i>Lebanon</i>	2.49%	1.25%
<i>Morocco</i>	-1.10%	1.42%
<i>Palestine</i>	3.74%	-3.39%
<i>Syria</i>	1.22%	-0.91%
<i>Tunisia</i>	1.16%	1.18%
<i>Turkey</i>	-0.10%	2.19%

Source: Vito Pipitone 2009.

It is therefore not surprising that the countries that have been most active in opening up their economies and reforming their institutions are also those where the dynamics of economic growth are seeing the most rapid transformation.

II.1 Factors explaining the increase in total factor productivity

TFP, calculated as explained above, is a residual that provides little information on which to develop a policy. Extensive work has been done to "give this residual a face". With considerable simplification, it can be argued that there are two main explanations: firstly, better allocation of factors and resources from locations of low productivity to those of high productivity, and secondly, a shift in the technological frontiers.

Efficient factor allocation

The first element therefore relates to efficiency in the allocation of factors within a given technological frontier (normally characterised by the ratio of output to factors utilised). Here the trick is to replicate the momentum of the curve for that ratio, by reallocating factors of production from places where they are used least effectively to places where they are used most effectively. This may involve allocation between sectors, or between companies in the same sector, or between production programmes within the same company. That is referred to as efficient factor allocation. All policies seeking greater international openness and liberalisation of goods markets adopted in the Mediterranean and in the former Eastern Bloc countries have sought to achieve this type of efficiency. Increased international openness has reallocated factors of production into competitive sectors and out of others, which has tended both to alter the specialisations of the countries concerned and to effect significant reallocations between firms and sectors within each country. Here, the Mediterranean countries are in a position that is far from ideal given the restrictions on trade and the free play of market forces that still exist. This is also partly due to the typically gradual nature of change in the Mediterranean, and the lack of flexibility in the production systems. Efforts made since the early 1990s have led to forms of specialisation that now clearly appear to have added value (textiles, clothing, agrifoodstuffs, mechanical and electrical engineering industries, organic chemistry, etc.), but not sufficient value (the relative prices of these specialisations in international markets are fairly low). This is not just the result of any deliberate intention, it also has to do with the social cost of this flexibility. The length and cost of the transition phase became clear during German reunification and at the time of EU enlargement. The cost in terms of public convergence funds provided by the more

developed countries in the region to smooth the adaptation process bore no relation to the amounts of free transfers received by the MCs. These are obviously the reasons why the additional steps still to be taken are so important (see Chapter 1).

It is clear that the crisis and the impact of the differentials in domestic demand between the MCs and their developed neighbours, which make penetrating the markets of those countries more hazardous and difficult (and make domestic markets easier to penetrate by foreigners) is hardly a factor encouraging any stepping-up of these policies today. This explains why a number of countries have, in one way or another, scaled back their ambitions for greater efficiency in factor allocation, at the risk of delaying the introduction of a new growth dynamic.

Shifting the technological frontier

The second component in the increased contribution of TFP to growth is achieving a shift in the technological frontier through step changes in product innovation, procedures and organisation and by introducing training processes through which endogenous growth can be achieved. In this scenario, each unit of input or factor is more productive in the place where it is located. This mechanism presupposes a degree of maturity of the economic and social system, and is naturally the focus of attention of proactive policies. The concept of shifting the technological frontier entails creating a knowledge-based economy, something which the majority of Mediterranean countries are now expressly seeking to achieve, particularly Tunisia, Jordan, Egypt, Morocco and Turkey.

Economists' studies have shown that these two approaches are not always immediately compatible. Achieving endogenous growth requires good infrastructure, which may be under-utilised for a certain period of time, as well as investment in education and training, which will only bear fruit in the medium to long term. Also, expenditure on research into innovation will take time to convert into market value, and it presupposes that innovation will generate consumable products and that adequate demand will exist for them. Hence, the lead time is long and difficult to sustain at a time of increasingly scarce public resources – resources which tend to be domestic in origin as they relate to the creation of an endogenous growth process.

II.2 Ways of reinforcing the complementarity between external and internal stimuli for TFP

Today, we have such an impressive body of empirical work based on surveys across the world into the factors contributing to increased productivity that it is impossible to integrate them into a single unified concept. This has the drawback of making it difficult to rank the causes but the advantage of leaving a margin of imprecision in which policies appropriate to the circumstances of each country can be posited (see Chad Syverson, 2010).

The general conclusion to be drawn from this body of work is that total productivity increases when the economy becomes more open and allows free rein to market forces in the case of goods (although it is less clear for the market in factors) and that it is flexible as it allows companies to enter and leave the market more easily (see Khalid Sekkat, 2010, for an analysis of the effects of these arrivals and departures on productivity), that it has a substantial capacity for innovation, and that it advances in the direction in which the most dynamic factors are leading the rest of the economy. A climate is thereby created that is conducive to the search for performance and inventiveness and able to drive progress for society as a whole. Areas on which there is a general consensus are, firstly, that driving forces exist that are at work throughout the world, and secondly, that the responses of companies to the stimuli provided by these factors are extremely varied. That means that we need both to recognise the role of catalysts for change and to differentiate our actions in order to make it easier for companies to respond, given the context in which they are operating.

In this general context, we shall identify here four crucial points that can explain why the same policy may not necessarily give the same result at sector or company level.

The first point concerns the level of demand. If the level of final demand is inadequate (as it generally is in periods of budgetary rebalancing), rates of capacity utilisation fall and productivity naturally follows suit. Moreover, part of any increase in productivity is naturally fuelled by growth in demand, as this creates conditions in which a company is forced to learn. For technical reasons, most empirical studies on this issue focus on supply-related questions, owing to a shortage of information on the individual prices of products and on capacity. However, some recent studies (P. Augier and Marion Dovis, 2010; Foster et al. 2010) confirm the importance of demand pressure and emphasise the role of the size of the market. This reveals an obvious truth that was concealed during the period of expansion preceding the crisis. When demand is weak as a result of austerity programmes, productivity falls if installed capacity (especially employment) is to be maintained.

The second question concerns economies of scale. Apart from increasing efficiency in factor allocation, a more open economy increases the size of the market available to businesses and therefore enables them to develop economies of scale if they are able to grow. This mechanism, which applies in the sector of tradable goods, should normally lead to a reduction in, or disappearance of, uncompetitive firms and a simultaneous increase in competitive ones. The latter will reap the benefit of increasing returns which, from the productivity standpoint, have the same effect as moving the technological frontier. Here it is vital that the institutional framework should evolve. We are aware that entering and leaving the market must be made simpler through the rules for establishing and closing down businesses, that there must be greater labour mobility, handled better (through training and retraining), and that financing facilities to enable competitive firms to expand need to be available. It is true, however, that at a time of crisis all the traditionally recommended reforms (e.g. in "Doing Business") must be prioritised on the basis of a strategy of winners and losers (provided they are clearly identified, which is not usually the case). Additionally, the net benefits of a more open economy have to be assessed, and the differences between sectors and between markets need to be taken into account. It is therefore clear that the current period requires subtler strategies than merely adopting a "shopping list" of undifferentiated institutional reforms whose individual impact is unknown. These are the reasons that best explain the re-emergence of more targeted proactive policies and are leading a number of governments in the Mediterranean area to argue that during this period the adoption of newly based industrial policies is the best antidote to any return to protectionism.

The third question relates to the "between", i.e. the role of the system of relationships linking companies to one another. Here, two factors are fundamental: first, the introduction of competition in the market for goods and, second, the development of externalities and the spillover effects between large companies and SMIs-SMEs.

Competition is now an undisputed factor in productivity growth (and in lowering the prices of goods produced). Studies – in particular those looking at the Eastern European and Central Asian economies (Sandra Ospina and Marc Schiffbauer, 2010) – have shown that countries introducing deregulation facilitating the access of new firms to the market and thereby creating competitive pressures, have seen significantly higher productivity gains. It has even been commented that this is no doubt the clearest reason for productivity improvements, as the pace of reform in other areas has been broadly identical in those countries. However, a longer-term question still remains. Is there a danger that the increase in competitive pressure will limit R&D spending and dissuade businesses from risk-taking when implementing a policy of innovation? Behaviour identified in the developed countries suggests that the most effective combination is deregulation, which enables competitive pressures to be accentuated, thereby driving productivity gains, accompanied by greater state intervention to foster support for research and development. On a more general level, given the inevitably slow pace at which competitive markets for goods can be established (a slowness due, in particular, to the need to manage the social adjustment), it has been recommended (Dani Rodrik, 2009) that in the current context the production of tradable goods should be subsidised more directly by maintaining the level of the nominal exchange rate. The key idea is that, in this period when the industrialised countries need to resolve their current account imbalances, it is difficult to see how developing economies could base their growth on a search for exportable surpluses supported by policies intended to achieve rapid liberalisation of the market for goods. This market liberalisation, which all economists consider to be

necessary, will be achieved all the more effectively according to Rodrik (2009) if the production of new tradable goods is subsidised by maintaining parities.

An SME sector well stocked with businesses having the potential to develop is essential for productivity improvements. Here an important factor is the relationship between SMEs themselves and their relationships with large firms, especially multinational subsidiaries established in the country. Studies have identified several important factors for reinforcing the SME system: the existence of industrial clusters that are not enclaves and in which SMEs are represented, the development of an ability to incorporate new technologies, improved qualifications for managers, and a transition to less family-based forms of organisation. One factor which appears to have a special role to play in Mediterranean countries is credit allocation. In Morocco, for example, one of the main causes observed for differences in the productivity of companies is their access to credit (Augier et al., 2010). This issue is crucial as not only the efficiency of credit allocation but also the ability of SMIs-SMEs to expand depend on it.

The fourth question concerns penetration of the knowledge-based economy. This involves a general approach, encompassing institutional reforms, development of the ICT sector, improvements in education and training, and innovation – areas where the FMCs area as a general rule still lagging behind significantly (Jean-Eric Aubert, Jean-Louis Reiffers, 2003).

If we look at the knowledge economy index developed by the World Bank, and if we ignore Israel, which is in the top group (22nd), we can see that the MCs are ranked somewhere between 50th and 100th in the world. Turkey, the highest-placed country, is 53rd, followed by Jordan (62nd), Lebanon (66th), Tunisia (71st), Egypt (83rd), Morocco (90th), and Algeria and Syria (around 100th). Mindful of all the limitations of this sort of indicator, we can nonetheless point to the significant improvement in the rankings of Turkey, Jordan, Tunisia and Morocco.

The principal challenges that MCs are facing in this area include:

- ✓ low levels of investment in science and technology, and inadequate IT and telecommunications infrastructure, even by the standards of developing countries;
- ✓ the low returns on those investments in terms of patents and the production of scientific goods;
- ✓ the mismatch between locally-trained engineers and scientists and the demands of the local labour market. This has led to a high level of graduate unemployment;
- ✓ a low correlation between expenditure on education and growth. Although large sums are being spent on education and training, the quality of education is inadequate and its content remains of limited relevance to the demands of the labour market;
- ✓ inadequate ability to absorb the technology available throughout the world.

These are some of the points highlighted in all studies on the region but they are part of a broader problem, namely the dynamism of all the societies in question. This issue should be considered as a whole, because while everyone agrees with the need to move towards the knowledge-based economy, leadership in that direction is still fragmented and centred on a few administrative authorities. If further progress is to be made, an interministerial approach appears necessary given the number of sectors involved.

CHAPTER V. OPTIMISING STRUCTURAL MEASURES

Various indicators suggest that future growth prospects and global interdependence cannot escape the crisis unscathed. There is a marked tendency among the industrialised nations (EU members and the United States, in particular) to revert to structural policies. The same holds true of the major emerging economies, such as China, which has patently been travelling down this road for a number of years.

To avoid lagging even further behind, the FMCs will also need to adopt policies that will increase and build on their comparative advantages. However, everything suggests that this must not be done by abandoning their strategy of opening up and liberalising their markets.

The FMCs have, for the most part, introduced diverse structural action plans going beyond the 1990s' clarion call to "upgrade". Today's slogan is "emergence", which unambiguously spells out the determination to be a stakeholder in the new global growth model that is taking shape. FEMISE considers that neither the problems spawned by the crisis nor the aforementioned fragilities should jeopardise these policies, which are particularly deserving of EU and FEMIP support.

The purpose of this chapter is, first, to place the thinking behind these policies in its proper context, second, to offer a brief résumé of the structural policies that have been followed and, third, to propose a number of key strategies and safeguards.

I. A climate calling for the revival of structural policies

I.1 Background

Economic pragmatism is taking hold, signalling the resurgence of public sector policy-making. The market is still a priority, but exports are also coming under the public domain with a view to overcoming inefficiencies in information and coordination. Consequently, those structural policies taking shape at present stand in contrast to the activism of the post-war period: no longer is it a question of harnessing local production for import-substitution purposes but of fostering new comparative advantages in the production of tradable goods, an approach all the more opportune now that external demand is flagging.

Three observations justify this pragmatism:

(1) More than two decades of stabilisation measures, sterilisation policies and reverting to the macroeconomic fundamentals have failed to reduce the global economy's volatility. Furthermore, those hardest hit by today's crisis are the developed countries, which are supposed to apply the precepts of stabilisation policy most effectively. Moreover, the main engine of growth in the emerging countries remains sustained domestic demand (consumer and investment-led), as in the case of Brazil.

A second point shared in common between the developed countries, notably those in Europe, and the developing countries is that the steady increase in net gain (GDP) has not resulted in an equivalent reduction in either unemployment or poverty. Average per capita income convergence between countries has gone hand in hand with internal divergence on the back of wider inequalities. In Morocco, for example, growth of four percentage points reduces the number of those on the poverty line by merely two points, translating into a two-point rise in inequality (as measured by the Gini coefficient, for instance).

Box 5. The case for a return to industrial policies

There is a risk that the new growth will be less favourable for the developing countries, as growth in international trade is likely to ease off. Added to this there is less external finance available and the developed countries with large current account deficits must reduce them.

Hence the problem is to reconcile the need for global economic stability – which means avoiding large current account deficits – with the need for developing and intermediate countries to achieve strong growth in the production of tradable goods. In other words, a core strategy reliant on gaining market share in the developed countries to facilitate convergence between the developing countries is little more than a pipe dream.

Be this as it may, according to Rodrik, there is a way of softening the contradiction between the quest for trade surpluses as a means of spurring growth and the need to rectify imbalances: directly encourage production of tradable goods in the developing countries, while at the same time reaping the benefits of domestic demand for these products.

The reasoning is as follows:

- ✓ *The advantage of the trade surplus normally generated by an undervalued exchange rate is that it subsidises the production of tradable goods, but with the downside of taxing the domestic consumption of those goods. The logical response is to directly subsidise national production of those goods without reducing their consumption.*
- ✓ *Countries such as Japan, South Korea and China, with their beefed-up industrial capacity, have, according to Rodrik, become industrial superpowers far more by virtue of national single-mindedness than of endowment: ‘poor countries become rich by producing what the rich countries produce’.*
- ✓ *Solid fundamentals are called for, provided that they are broadly interpreted and not reduced to a list of policies playing to the same hymn sheet as the consensus in Washington or in tune with benchmark criteria listings.*
- ✓ *The limiting factor for growth is basically not access to international finance but low private-sector profitability from the production of tradable goods.*
- ✓ *Differences in domestic demand pressure impact the terms of trade to the detriment of countries where demand is strongest.*
- ✓

The proposed solution:

- ✓ *Don’t hesitate to subsidise industrial policies geared to increasing the production of tradable goods, especially new lines of business and innovative products traded internationally.*
- ✓ *Rather than going for undervalued exchange rates with a view to gaining international market share and generating surpluses, countries should accept higher nominal exchange rates in the knowledge that these will boost the supply of industrial tradable with little or no impact on the trade balance.*
- ✓ *WTO rules are the main stumbling block here, although Rodrik makes the point that: “if the need for such a strategy is not recognised and trade rules on subsidies are enforced blindly, we are likely to find ourselves in a period of great tension in international economic relations.... Restricting the policy space on industrial policies will have the unintended consequence of fostering trade protection.”*

Rodrik, Dani (2009) ‘Growth after the crisis’, Harvard Kennedy School, paper prepared for the Commission on Growth and Development, May.

(2) The stock response to the current crisis has not taken the form of either a change in world governance or more sustained action on opening up markets. What we have seen has been a proliferation of national and regional industrial plans targeting specific sectors, such as banking and the automobile industry. In other words, it looks as if the response to the crisis has been largely at state level and through national plans, albeit without challenging the primacy of the market.

(3) The way in which the crisis impacts different regions is creating differentials in terms of dynamics and expectations. Some go so far as to suggest that the developing countries are set to become the new locomotives of world economic growth (see World Bank). But for this to become reality, the right strategy needs to be put in place and a number of initial handicaps have to be ironed out without delay. We side with the view that this can be achieved through properly thought out and correctly implemented structural policies that will offer the FMCs a new window of opportunity.

I.2 The rationality of structural policies seen against this new backdrop

The current prevailing paradigm, encapsulated in private sector export-led growth, is based on the fact that the most efficient firms command the best national resources, enabling them to compete on the world stage and gain market share from their foreign rivals. Since they are the most efficient internationally, by extension they will be efficient in the domestic economy.

The other domestic competitors are similarly obliged to achieve a high level of efficiency and profitability in order to survive the pressure of domestic competition. This means that the entire domestic economy is caught up in a virtuous circle driven by competition between firms fighting over the factors of production. And this, broadly speaking, is the basis for those general economic policy recommendations made to the developing countries: ‘Improve your business environment so as to optimise the operation of market forces, and your firms will become competitive internationally. Open up and your firms will gain a foothold on international markets. Orchestrate competition between private companies on your local markets, and this rivalry will benefit the corporate sector as a whole’.

But how to replicate these “successes”? As we have already seen, both the global context and world governance have changed radically over the past 50 years, and the Asian countries, often lauded for their exemplary structural policies, have benefited from a favourable, if not exceptional, set of circumstances which the FMCs are not set to enjoy in today’s world (M. Noland & H. Pack, 2008).

From now on, for each country, the first priority is to find the right mix between, on the one hand, liberalisation with a view to reducing the distortions hindering factor allocation and, on the other, the introduction of appropriate measures to restructure, reduce vulnerabilities and improve the distribution of the fruits of growth. The second priority is to find the right mix between satisfying the requirement of economic stability and intervening (by, among other means, mobilising public funds) in order to pave the way for increased growth by supporting demand. Clearly nowhere is it an easy task to achieve these mixes in view of their inherent contradictions: between the optimal allocation of resources and government intervention, and between burdensome public financial commitment and stability. But even static effects that are sub-optimal in terms of resource allocation (such as deflection of trade within customs unions) are known to be more than offset by the dynamics of large markets (economies of scale, technology transfers) backed by convergence policies.

It is also acknowledged that there is little point in the State’s intervening in the economy by nationalising the entire productive sector, since this only leads to distortions. On the other hand, one forward-looking solution is for the State to team up with the private sector in order, for example, to facilitate the development of new activities, particularly those calling for serious training inputs, with a view to increased economic diversification.

Consequently, the question is not one of whether but how the State should intervene so as to develop new comparative advantages without giving rise to rent-seeking behaviour.

I.3 Putting flesh on the policy bones. A strategically focused State promoting positive externalities

Implementing structural policies is a far more complicated affair than taking a list of measures and applying them mechanically. Where the logjam is confined to one segment of the economy, it is this segment that must be targeted structurally.

In many sectors of the economy in the Mediterranean region, where the agrifoodstuffs or textiles industries account for the bulk of the FMCs’ manufacturing activities, family-run firms are not very

large. Moreover, as such firms are in direct competition in areas of the market typified by a small specific labour force (see Williamson, 1985), this clearly all but rules out cooperative strategies.

Hence one of the goals facing productive concerns is to acquire new critical mass on a par with operators on the global market. It continues to be difficult in the Mediterranean region to achieve economies of scale through mergers or acquisitions. Apart from Jordan and Israel, where in 2008 the stock market capitalisation amounted to 189% and 130% respectively of GDP, the stock market mechanism is still underdeveloped and relatively rarely harnessed for industrial restructuring purposes¹¹. Market capitalisation amounted, for instance, to only 13% of GDP in Tunisia and 34% in Lebanon, whereas in Algeria and Syria the figure was insignificant.

Faced with worsening conditions, notably brought about by market inefficiencies, commercial banks are reluctant to take the lead in supporting structural reforms. Hence the potential for greater cooperation across the corporate sector to become an alternative means of working towards economies of scale. All the same, cooperation of this kind is not without its difficulties and tends to be costly and uncertain. Entrepreneurs are more naturally inclined to copy and imitate: in other words, to capture part of the rent generated by the *first movers*, commensurately eroding the private return on innovation.

The State can help to achieve socially profitable cooperative solutions. But rather than imposing cooperation from above, it should encourage private firms and public sector partners to become aware of the need for such cooperation. After all, the State is probably best placed to play this role of facilitator, to stimulate dialogue with the corporate sector and to arrange financing partnerships with international lenders. EIB funds and FEMIP resources are among those initiatives that alleviate market inefficiencies in terms of access to finance or coordination, notably through the development of infrastructure.

With the focus on rehabilitation and restructuring, the “upgrading” programmes that have involved the European Union’s MEDA funds have also fulfilled similar functions (see below). Hausmann et al. (2008) have posited the general principles underlying a new round of structural policies. They suggest that the evaluation of public policies should be based not so much on the choice of instruments (e.g. subsidies, taxes, selective credit allocation to the corporate sector) as on the State’s ability to resolve problems of coordination and information and to initiate strategic collaboration. Hence the matters to be settled relate to those inputs that are potential obstacles to productivity (TFP). This applies not only to public services such as logistics, the supply of energy and health certification but also to training. The State is capable of providing these services itself, but it can also mobilise PPPs (public-private partnerships) and must learn to listen and be ready to respond selectively to requests from the corporate sector for measures that are compatible with competitiveness on the international market.

One of structural policy’s focal points is regional development, an area in which the State endeavours both to reduce the traditional market inefficiencies and to stimulate initiatives that will encourage diversification and increase the sophistication of goods for export. There is nothing new about the idea of the State’s stepping in to support businesses in their development plans. The free zone is a well-tried concept, nowadays taken forward by local ventures in which the cooperative element is higher, such as competitiveness clusters, technology parks and technopoles. These forms of regional development are dynamic, narrow the cooperative divide and lay the foundations for internalising local external economies.

In other words, the region is ideally suited to become the locus of complex interactions between private enterprise and economic policies. It offers the right combination of population density, infrastructure and ‘industrial atmosphere’. Not only does it make “generic” resources available but it spawns new technology and product innovation.

¹¹ The average stock market capitalisation in the FEMIP countries rose from 32% in 2000 to 110 % in 2007. However, the scale of new share issues and stock exchange listings was far more modest, with stock markets in the Mediterranean partner countries generally characterised by a small number of listed companies, most of these large privatised corporations (see FEMIP Report, 2009).

II. THE FMCs' structural policies: too sectoral and too vertical

II.1 A long history of structural policies

At the heart of the structural policies pursued by the FEMIP countries lies a long-standing tradition of industrial policies, the pillars of economic development from the time of independence. These policies centred chiefly on import substitution, centralised planning and tariff protection. Towards the end of the 1980s, such solutions were abandoned as a consensus emerged in favour of macroeconomic stabilisation, market liberalisation and competition. As far at least as the Mediterranean countries were concerned, this new framework was insufficient to provide the development needed to make up for the ground lost in terms of quality of life. On top of this, as already noted, the crisis changed the rules of the game.

This section of our study looks first at the main thrust of the Mediterranean countries' proactive policies, before detailing those strategies recently adopted by most of the MCs. The following section will then compare these developments with the present situation looked at through the prism of international benchmarks, reflecting how the region is perceived by international observers, albeit not from intrinsically objective viewpoints.

Proactive policies pursued in the Mediterranean countries coincided with independence and global industrial growth. They started with waves of nationalisations, creating an industrial sector dominated by public corporations. The primary feature was that the action taken was focused mainly on protecting (by way of tariff and non-tariff barriers, licences, etc.) sectors exposed to international competition, with a view to promoting the emergence of local industry. As a consequence of nationalisations, the next major development was for industrial policies to be formulated swiftly and implemented by public companies, which, numerically, accounted for the bulk of the economic fabric. The FMCs adopted a framework for action characterised by vertical policies designed to shield specific sectors and safeguard the organisation of the market, policies patently bearing the imprint of the social role of the State, with underlying objectives of redistribution, far removed from the initial industrial objective (Nabli, 2008).

Such policy stances have significant consequences: (i) national corporations are "spared" from international competition, making them less likely to rush ahead with efficiency drives; (ii) public enterprises, the main targets of proactive policies, benefit from distortions in competition at the domestic level (unless they are monopolies) to the detriment of the private sector; (iii) the public sector's pre-eminent role in the productive arena has also meant combining the economic with the social, with businesses becoming an important part of social management, either through guaranteed employment or by resorting to the safety nets of national budgets to cover losses; (iv) when the idea arose in the mid-1980s of cutting these businesses off from the public purse by making them responsible for balancing their own finances, most, in actual fact, came up against solvency problems and were operating at cost levels above global market norms (partly owing to their inability to restructure, the level of non-operating expenses as a result of social policy considerations, the price of imported inputs, etc.).

At a time when the global economy was expanding, this strategy made for considerable social progress and strong growth in production (as well as in productivity). But this ground to a halt in the mid-1970s: the Mediterranean countries' position in the world economy was caught in a downward spiral, progress on social agendas fizzled out and both economic fundamentals and productivity levels deteriorated. The mid-1980s saw a proliferation of macroeconomic stabilisation, plans in the Mediterranean countries in tandem with plans to restructure public enterprises: it followed that there was hardly any leeway for such intense government action as had prevailed in the preceding decades. Also during the 1980s, other emerging regions combined macroeconomic stabilisation policies with more modern-looking structural policies: industrial policies were therefore geared more to promoting exports and the private sector and to providing increased horizontal support for the entire productive sector. Policy modernisation of this kind in the Mediterranean countries was to come much later, not until the second half of the last decade.

A number of studies have compared the industrial policies pursued over the past 20 years, notably in Egypt, Morocco and Turkey. When these are considered in the light of studies conducted on the proactive policies adopted in Asia and emerging nations in other parts of the world – which are generally considered to have succeeded in changing the workings of their economies for the better – it is pertinent to bear in mind that:

- (i) the need for an “industrial” or proactive policy is indisputable, particularly in the context of the FMCs, which urgently need to diversify their trade (and their partners);
- (ii) policies implemented over the past two decades have scarcely borne fruit, at least in terms of the diversification of production and the level of total factor productivity;
- (iii) the international context and the initial conditions for each economy have a profound influence on the likelihood of success, which explains why there is no magic formula. Nonetheless, the most effective strategies share certain points in common (Galal, 2008) in that they have: (a) tended to centre on new activities; (b) been founded not on credos or economic convictions but on tangible, measurable results; (c) provided support of limited duration so as to encourage businesses to make the most of this breathing space to pave the way for their future competitiveness; (d) deliberately supported cross-cutting activities such as R&D, subsidised loans or human capital formation, far more than opting for a vertical sector-by-sector approach.

Horizontal structural policies are also particularly important. Whereas vertical industrial policies focus primarily on the quantitative aspect of production within specific sectors, horizontal policies are more concerned with the quality of inputs throughout the production chain (Nabli, 2008). It is therefore presumed that a horizontal policy will potentially benefit all firms and it involves elements relating to education, vocational training, infrastructure, technology transfer, etc.

In the case of the FMCs it is the public sector that long benefited from policies that were too vertical in their orientation. Inevitably, public sector employees are therefore reluctant to accept rapid reforms that can only undermine their status. Faced with the anaemic economic performance of the 1980s and 1990s, the private sector came to assume a more important role, backed by public support. But, rather than bringing about a decline in rent-seeking, quite the reverse occurred: the private sector, composed for the most part of a few large corporations alongside a large number of micro-firms with no power of representation, became the mainstay of the vertical system (Nabli, 2008).

One of the main difficulties associated with ushering in horizontal policies, including through exchange rate policy, the proactive nature of which implies a positive distortion in favour of the tradable goods sector, resides in the appetite for such policies among the population. In fact, every proactive policy has its winners and losers, which is why the tendency is invariably to favour vertical policies, even if it means introducing them one after another, rather than horizontal policies, which affect a larger number of people and require the subsequent redistribution effects to be spelled out.

There are, nevertheless, a number of horizontal policies without these problems and which deserve close scrutiny from now on, such as the creation of a knowledge economy, encouraging the development of cutting-edge activities, targeted town and country planning policies, and health policies.

II.2 Recent developments by country

Morocco: Towards emergence

In terms of industrial policy, *Morocco*'s experience is similar in some ways to that of the most advanced countries in the region. Some of the contributory factors can be traced back to the 1995 Barcelona Declaration (signature of international agreements, establishment of free trade, "upgrading" programme to increase productivity, particularly by deploying better technology). There are limits, however, to these similarities and Morocco has experienced major setbacks. When it was launched in 1998, the Euro Maroc Entreprise (EME) private sector development programme was broadly supported by the European Union although the rate of deployment of available funds was very low until the early years of this decade. According to the World Bank (2006), disbursements up until 2005 totalled no more than EUR 14m to 85 beneficiary enterprises, mostly in the textiles and chemicals sectors. In 2004, a new programme entitled "Modernising SMEs" took over for the period 2004-2008, with the aim of supporting the development and modernisation of SMEs.

The initial lack of interest in and effectiveness of the modernisation programmes was partly related to the private sector's failure to embrace them and the Government's role in development, which was less proactive than in Tunisia, where interventionism was the order of the day, with a more aggressive approach to drawing up and implementing the indicative programmes. From the outset, the Tunisian Government designed and managed the programme to upgrade the economy. Morocco's strategy has been much more liberal, focusing more on correcting traditional market inefficiencies, especially the difficulty in obtaining credit. In the 1990s, the development of tourism was one of the State's priorities. The *Vision 2010 Framework Agreement* outlined a strategy aimed at tackling inefficiencies in coordination. The results of the "Plan Azur" have been very convincing, although Morocco will not quite achieve its goal of attracting 10 million tourists by 2010.

With Driss Jettou's Government (2002-2007), industrial policy took on a new dimension via the Ministry of Trade, Industry and Economic Development. In 2002, an Upgrading Committee (CNMN) was set up to adopt a series of measures concerning the institutional framework, administrative procedures, the public authorities' reception infrastructure, the business environment and also taxation. Management and coordination of the technical assistance component were entrusted to the National Agency for the Promotion of SMEs (ANPME). In 2003, the National Upgrading Fund (FOMAN), a co-financing facility aimed at reducing financial market inefficiencies and raising corporate productivity, was established.

Alongside upgrading initiatives in Tangier, Morocco created a free zone aimed at offsetting the additional costs inherent in market and economic policy inefficiencies. Over 60% of organisations operating in the free zone are foreign and involve such diverse sectors as textiles and leather, electrical equipment and electronic components, mechanical parts and even offshore services such as call centres. Businesses in this economic area enjoy tax incentives and a favourable geographic location as it is right on Europe's doorstep. They also benefit from a quality of infrastructure that the Government is tailoring to the needs of businesses, particularly in terms of ease of transport, thereby reducing coordination difficulties. A 2006 World Bank study highlighted the success of this free zone, especially in terms of employment, with around 20 000 jobs created since 2001, although there are reservations about the diversity of the activities represented. Such a mix does not facilitate the dynamics of cooperation despite the vertical relationships that may exist between companies, and the innovation process is limited due to a lack of back-up from training and research institutions. In a way, the conglomerate-based approach has prevailed over a horizontal (product) or vertical (production process) structure, which only work with the creation of specialisations.

That is no doubt one of the explanations for the strategic shift observed at the end of 2005 with the official launch of the "emergence" programme. The initial goal is to reinvigorate Morocco's economy on the basis of the following two pillars:

- (i) strengthening Morocco's industrial fabric and increasing its competitiveness;
- (ii) promoting promising new sectors in which Morocco supposedly has a competitive advantage. There are considered to be seven strategic growth sectors, which are expected to account for 70% of industrial growth in 2015, with an annual impact in GDP growth terms of 1.6% and the creation of

400 000 jobs. These sectors are offshoring; automobiles; specialist electronics; seafood processing; aeronautics; textiles, leather, fast fashion and co-contracting; and agrifood. Support for these sectors is based on a “traditional” package comprising the creation of dedicated industrial zones and platforms, an attractive incentive framework and an integrated training programme.

The strategy clearly followed in this programme is to diversify the production of tradable goods beyond the more traditional manufacturing activities (textiles, agrifood, car parts), including the services sector, to underpin sustainable, dynamic job growth. In line with what has been referred to above, this therefore involves orchestrating a shift to new strategic activities in close cooperation with the private sector and creating a production universe that will enable people to be trained to the best technological standards. Through this proactive policy, Morocco intends to make the most of its proximity to Europe and of the opportunities afforded by free trade agreements, in particular those signed with the European Union and the United States. The emergence programme is based on developing and extending what has been achieved in terms of upgrading. Above all, it identifies new strategic activities. Seven competitiveness clusters have been targeted with a geographical focus and, although there may be multiple locations, these are intended to lay down a marker for each economic area: (1) offshore services, set to be based in Casablanca and Rabat in particular, combine geographical advantages with the quality of human capital available; (2) free zones similar to those in Tangier, focusing on the automotive and electronic components sectors; (3) the aeronautics sector; (4) specialist electronic components; (5) agrifood industries with a whole host of establishments planned in Meknès-Fez, Ghareb, Souss Draa and the Eastern cluster; (6) seafood produce; and, lastly (7) continued upgrading initiatives in the textiles and crafts sectors.

Since 2006, this programme has been supplemented by a “Lift-off” programme, which focuses on more modern sectors: microelectronics, biotechnologies and nanotechnologies. These programmes have been slightly amended for their second phase (2009-2015), to be more in keeping with the economic requirements identified in this report. “Emergence 2” comprises 111 measures organised into three pillars:

- (i) developing worldwide “business lines” within a sectoral approach combining industries capable of attracting foreign capital (offshoring, automobiles, aeronautics and space, electronics) and traditional industries in which Morocco enjoys a comparative advantage (agrifoods, textiles and leather). This mainly involves creating “integrated industrial platforms” and modernising/upgrading existing industrial zones;
- (ii) increasing SMEs’ competitiveness, in particular by improving businesses’ access to credit, establishing a seed fund or creating SME “estates” to facilitate start-ups;
- (iii) the human resources aspect, the importance of which has increased considerably: this mainly entails tailoring training better to industry requirements, firstly by introducing business modules in the classes of the public higher education institutes and by setting up new colleges (two agreements have been signed for the creation of an aeronautical college in Casablanca and an engineering college in partnership with the Ecole Centrale de Paris).

In their design, these programmes manage to combine a number of aspects that are likely to improve the results of the active policies, in particular the emphasis on new activities and new “business lines” and a more horizontal approach incorporating financing and human resources elements.

Tunisia: Modernisation

Of the various countries eligible for FEMIP, *Tunisia* is probably one of the most responsive to the long-term trends and implications of globalisation. The country has a long tradition of public intervention via indicative planning, which combined a proactive approach with market requirements. In 1972, an offshore regime was established, accompanied by tax and financial incentives, which were partly responsible for the growth of the textiles sector. In 1985, and again in 1992, the incentives were streamlined in order to stimulate foreign direct investment and promote the development of tradable goods by bypassing protectionism. This policy contributed to the involvement in the European automotive manufacturing networks, which led to a big increase in electrical and mechanical engineering exports. In 1996, the authorities launched an “upgrading” programme to support the creation of the free trade area with the EU. This programme, with its focus on productivity and

competitiveness, was also based on the principle of voluntary participation, although eligibility was conditional on a company's performance potential, as demonstrated by an external audit of its strategic positioning and management.

The Upgrading Office, an ad hoc unit created within the Industry Ministry, oversees the execution of the programme on behalf of a steering committee comprising representatives of the public authorities, the financial system and social partners. The programme has benefited several thousand enterprises of all sizes, including those with fewer than 10 employees. Through this programme, enterprises with an upgrading investment plan receive a subsidy of between 10% and 70% depending on the financing model and the type of initiatives undertaken. In 2005, over 50% of manufacturing industry's expenditure was covered by the programme. Over time, there have been innovations to the programme, such as a support facility for priority technological investments in 1999. In 2000, it was extended to include industry-related services in activities eligible for the programme. Lastly, in 2002, the Competitiveness Development Fund (FODEC) established financial facilities for companies with fewer than 50 employees. Analysis of the programme's beneficiaries suggests that the textiles, clothing, leather and shoe sectors were covered by the programme, more by virtue of the number of enterprises and levels of jobs concerned than by virtue of the induced investment – a very different scenario to that observed in the building materials, ceramics and glass industries.

As regards the latest programmes launched, the blueprint is the IMP (Industrial Modernisation Programme 2003-2009). This programme enables a quantitative assessment to be drawn up. At end-2009, it concerned more than 3 000 enterprises with an aggregate volume of approved investments of nearly TND 5 400m, of which TND 4 610m of tangible investment and TND 745m of intangible investment. These figures highlight a considerable shift by Tunisian businesses since 2005 towards intangible investment, which was lacking under the upgrading initiative owing to their enthusiasm for equipment and tangible investment. 1 311 enterprises, 47 public/private institutions and 34 laboratories have been assisted by the IMP, as a result of 47 079 man-days of expertise (28 023 domestic and 19 056 international) being "invested" in the economy.

This development is directly linked to a new dynamic strategy, where tangible investment is no longer the sole aim. That makes it possible to increase enterprises' (and political leaders') awareness of a more modern international competitiveness model very much geared to increasing export capacity, e.g. by endeavouring to develop the industrial property system, facilitate SMEs' access to diverse sources of financing and develop quality infrastructure. In this context the important aspect, particularly as an illustration of the type of action required to enable the emergence of a knowledge economy, is to structure or change behaviour and create new momentum. This part of Tunisia's programme shows, using figures, that this active policy has been a genuine catalyst for intangible investment. It has also highlighted an approach based on expertise and skills, translating these concepts into constructive, decisive action that is vital to the competitiveness of the various industrial sectors, in particular technical coaching and quality management.

Future strategy aims to prolong and increase this momentum, with the focus on international trade. For instance, in 2010 a new programme is scheduled to support the competitiveness of enterprises and facilitate access to the markets (Pcam) over the period 2010-2013. It comprises two parts, the first of which is aimed at industrial businesses that have already started implementing the IMP. The second component is designed to target economic stimulation in general, focusing on quality infrastructure, and aims to help Tunisia to enter into a mutual recognition agreement with the EU in the field of industrial compliance, initially covering electrical products and construction materials.

An appraisal of Tunisia's upgrading would require analysis that goes beyond the remit of this chapter. However, the Upgrading Office's surveys have highlighted the satisfaction of businesses with the material impact on growth in investment, exports, jobs, and in particular the recruitment of qualified personnel. It would be overstating things, however, to claim that the programme has been an unqualified success. Although two thirds of businesses are satisfied, most have pinpointed a number of problems. In 2006, on the initiative of a conference organised by the Upgrading Office, the Tunisian Union for Industry, Commerce and Handicrafts (UTICA) was critical of cumbersome bureaucratic procedures, the lack of attention paid to intangible investment and the fact that banks continued to provide very limited financial support. It was partly to remedy those weaknesses that in 2004 the Government launched the IMP, in cooperation with the European Union, which contributed

MEDA funds totalling EUR 50m. The EU insists on a technical assistance component to support business start-ups, but also innovation and higher quality. The IMP is also a shareholder of Société Tunisienne de Garantie (SOTG), which helps to partly cover the SME credit risk.

Innovation, facilitating enterprises' access to finance as well as tapping and penetrating new external markets are the public authorities' strategic guidelines. Two major programmes associated with the activities of the Export Promotion Centre (CEPEX) have also been launched to meet this objective: the Export Market Access Fund (FAMEX), which subsidises the cost of identifying new markets, and the Pre-Shipment Export Finance Guarantee Facility (GFEAE), which encourages banking institutions to press ahead with funding the working capital of emerging exporters. Following encouraging results at first, the GFEAE has – in fact like the other more general programmes – experienced difficulties in carrying out this role. However, in spite of these obvious weaknesses, Tunisia has shown a remarkable ability to critically evaluate its industrial policy and react dynamically to the most sensitive aspects of developing exports, even if the most appropriate solutions have not always been found for the problems identified. Consultation and public-private partnerships are now customary, reflecting what might be expected from a modern State.

The lessons learned from the industrial upgrading programme were applied successfully to the tourism and agriculture sectors and also generated externalities facilitating the creation of business incubators and especially technological clusters, which are destined to become the new public drivers of industrial policy. These technological clusters are a manifestation of regional development, based on exploiting the advantages conferred by the natural factor endowment, the presence of human skills. The Government is responsible for developing the clusters and the risks associated with the conduct of innovation are shared with the local authorities. The clusters can be distinguished from the free zone in this sense, as they are more specialised and have dynamic ambitions beyond merely correcting market or economic policy inefficiencies. In total, the project involves a marine technology network and eight technological clusters, the first of which were established in Tunis's inner suburbs: El Ghazala (telecommunications, IT) and Borj Cédria (renewable energy, biotechnology). On the basis of feasibility studies, initiatives will follow in various sectors in Sousse (mechanics and electronics), Gammarth (cinematography), Sfax (IT, multimedia and telecommunications), Monastir (textiles and clothing), Sidi Thabet (biotechnology) and Bizerte (agrifoodstuffs).

Lastly, it should be noted that Tunisia has integrated some important aspects of “sound industrial strategies”, in particular measurable indicators and cross-disciplinary horizontal measures. The 2009-2014 programme's objectives do not feature lists of sectors but figures to be achieved in industry, targets perfectly in keeping with the diversification requirements pinpointed (e.g. the inclusion each year of 300 additional enterprises from the industrial and services sectors in the national industrial upgrading programme; the awarding of certificates of compliance with international standards to a further 700 businesses; the achievement of 17 500 accredited standards by 2014 compared to 10 400 at present; the doubling of new patents, with a view to increasing the number to 200 over the period 2010-2014 compared to 90 over the period 2005-2009, etc.).

Algeria and the temptation of protectionism

Though committed to a planned economy approach in the late 1980s, *Algeria* has since undergone profound restructuring in order to promote a market economy open to private initiative and trade liberalisation. With that in mind, the State gradually withdrew from the productive system, with more than 400 operations of this kind being carried out between 2003 and 2007 under the strict authority of a Privatisation Board, and an economic upgrading programme was launched with a pilot scheme in 1998. Through the creation in 2000 of the Fund to Promote Industrial Competitiveness (FPCI), in cooperation with the UNDP and UNIDO, the Industry and Restructuring Ministry worked on finalising a facility to promote greater competitiveness. Cooperation in support of developing SMEs then spread to other partners, in particular the World Bank, AFD (Agence Française de Développement), GTZ and especially the European Union via the MEDA programme. Numerous initiatives were launched, preceding by a few months the signature by Algeria and the EU in April 2002 of the Association Agreement on a free trade area by 2017. Financed jointly by the Commission and the Algerian Government, the SME support programme was coordinated by the Euro Développement PME management structure. By the end of May 2007 after five years of actual operation (2002-2007), the programme had been involved in hundreds of operations with enterprises

of more than 20 employees, with mixed results, which were acknowledged by private operators but were difficult to correlate with expectations in terms of productivity and competitiveness gains¹².

The business segments most concerned were agrifoodstuffs (one third of all SMEs upgraded), the chemicals industry, building materials, ceramics and glass, and mechanical engineering. In March 2008, a new SME support programme was signed between the SME and Craft Industries Ministry and the European Commission. This new programme carries on the activities of the previous one, with a greater focus on services and crafts and an upgrading target of 500 SMEs. In February 2007, the SME and Craft Industries Ministry also launched a six-year programme targeting all enterprises covered under the 2001 Framework Law aimed at upgrading them under the authority of the National SME Development Agency (ANDPME) established in 2005. Apart from efforts in recent years to upgrade each of the organisations, the public authorities have endeavoured to structure activities geographically in order to strengthen competition and regional cooperation. This regionalisation policy is dependent on increased exchanges between enterprises, research institutes and public institutes of higher education. The aim of this approach is therefore to facilitate these exchanges and institutionalise cooperation to take full advantage of the regions' inherited specialisations, whether from natural factor endowments or economic development.

The Government is investing in these regional networks but will inevitably encounter obstacles, which are to some extent inherent in the long-term public dynamics. There is undoubtedly a "path dependency" effect caused by the historic position of the public sector. Until the early 1990s collaboration between companies was very rare, apart from the traditional trading taking place within an environment that was highly protected commercially. There are therefore new habits to be formed, substituting a proactive public market approach based on consultation and partnership for the past inhibitions of State intervention. The spatial invigoration of economic relations is therefore an important phase for the long-term integration of an economy that the authorities want to be less dependent on oil resources. That is the challenge faced by the Regional Development Master Plan (SNAT 2025) and reflected in the constitution of competitiveness clusters with government involvement that can neither be bottom-up nor increasingly top-down due to the desire to be associated with and share the development vision with the private sector. This is therefore an approach where the Government stimulates and supports the development of an enterprise, provides the region with services and the necessary infrastructure, but also ensures that lasting relations are established within the cluster involving specialist innovation structures (technology or innovation parks, incubators to encourage the industrial application phase of research).

The application of a multi-criteria approach has made it possible to identify six competitiveness clusters, including the capital's twin cluster with two sites of excellence, one in Sidi Abdellah for information and communication technologies (ICT) and the other in Bouinan for biotechnologies and sports and leisure technologies. The other regional clusters and their areas of specialisation are: Oran-Mostaganem/Sidi Bel Abbès/Tlemcen (organic chemistry, space technologies, telecoms); Constantine/Annaba/Skikda (food biotechnologies, health, metalworking and mechanical engineering); Sétif/Bejaia/Bordj Bou Arréridj/M'Sila: (plastics, food biotechnology, computer-integrated manufacturing); Médéa/Boughezoul/Laghouat (new forms of energy, environment, water resources); and Ouargla/Hassi Messaoud/Ghardaïa (petrochemicals, new forms of energy and Saharan agriculture).

Today, however, unlike most FMCs (and we were beginning to clearly sense this shift), Algeria is once again moving towards protectionism, described as "economic patriotism" (see the statement by Hamid Temmar, Minister for Industry and the Promotion of Investment, in February 2010). Although on the surface the principle is to re-establish the Government's role in addressing market failures and support local businesses as well as place general recommendations in a local context – all legitimate responses – in practice it looks more like a return to support via protectionism. The Trade Minister stated that "imports of goods including toys will henceforth be subject to an import licence issued by a specialised technical committee comprising representatives of twelve Ministerial departments responsible for consumer health and safety." Other statements, particularly regarding membership of

¹² Algerian SME support programme, Euro-Développement PME.

the WTO or negotiations with the EU or the US, when seen alongside “national sovereignty”, indicate a shift in emphasis.

It is therefore fairly clear that Algeria’s economic policy is still marked by the 1970s goal of autocentric development and that doubts persist about the desirability of opening up the economy further, which the country is now in a position to do thanks to the financial security afforded by oil revenues. That has not prevented Algeria from increasing the decentralisation of its planning and launching major operations in the fields of infrastructure, energy and housing construction, in particular. What distinguishes Algeria’s proactive policy from that of the 1970s is that it is no longer based on the desire to develop a production base revolving around public enterprises holding a monopoly position. We are even witnessing remarkable efforts being made to promote participation at the most decentralised levels in the identification of projects (see rural development plan).

Egypt: Continued opening up of the economy to the outside world supported by an industrial policy with mixed results

Egypt, whose growth fell between 2008 and 2009 (from 7.2% to 4.7%), as did its rate of investment (from 22.3% of GDP to 19.3%) and share of private investment (67% of total investment in 2008 compared to 57% in 2009), clearly continued its policy of opening up to external markets in the EU, the United States, Turkey, East and Southern Africa (agreement with COMESA and a special economic zone with China, which will open in 2011). With this policy, it targeted competitiveness and quality on specific markets.

The public sector for decades spearheaded the industrial sector. Its grip gradually loosened in the 1990s under the combined impact of privatisation and trade liberalisation. The development of the private sector and the specific role of small export businesses are now among the Government’s priorities. This strategy was underpinned by an improved business environment as well as a policy of modernising productive organisations, which has been supported financially by the European Union since 2002/03, initially to the tune of over EUR 400m. The targets set for this programme are much in keeping with those mentioned for other beneficiaries of the MEDA facility, with the emphasis, however, firmly on improving the quality of products, on which exports to Europe and the United States depend. Although Egypt was less reactive than other countries in the region in launching its modernisation efforts, certain aspects of industrial policy preceded these initiatives, demonstrating the proactive approach of the public authorities.

With the aim of reducing, if not eliminating market and economic policy inefficiencies, free zones were opened under the 1997 Law on investment guarantees and incentives. Egypt set up seven free zones around its ports, offering the infrastructure qualities required for exports. Industrial zones were also created, which are an instrument of regional development in that they involve numerous governorates, with specific advantages being granted to some of them such as Upper Egypt. The number of industrial zones has increased considerably over the past 25 years, from 12 in 1981/82 to 90 in 2005, including a dozen or so in Greater Cairo, 27 in the Suez Canal region or Upper Egypt, 13 in Alexandria and three for the heavy and extractive industries in the Suez and Sinai governorates.

In these zones all economic activities are represented – pharmaceuticals and chemicals, electrical goods, metalworking industries, building materials and, of course, clothing. In a number of clusters, links have been developed between the manufacturing sector and educational and research organisations, encouraged by the Ministry for Scientific Research, while specialist regional clusters have achieved recognition, such as furniture manufacturing in Damiette and sheet metal production workshops in Meet-Ghamr. In addition, the initiative to create new towns is very much ongoing. The Government’s proactive approach is therefore being felt over time in a wide variety of regional development schemes aimed at improving efficiency and meeting the requirements of competition, but also with the goal of distributing these activities evenly so as to promote regional development. This proactive approach is also noticeable in State support and the public structures facilitating exports and diversification in consultation with the economic partners. The Egyptian Export Promotion Center (EEPC) supports exports and oversees the export advisory bodies set up in 1997. The activities of this public body also involve close cooperation with ExpoLink, the leading private association tasked with stimulating international trade.

The most recent initiatives focus on international competitiveness. Egypt has thus joined Jordan in creating Qualifying Industrial Zones, which can export to the US market without being subject to tariff or non-tariff barriers. Apart from exchange rate flexibility, Egypt is gradually liberalising energy prices and has introduced various instruments to regulate the market, including a competition authority. This emphasis on liberalisation has led to Egypt being ranked best performer among the FMCs according to the Ease of Doing Business index. However, although it is the country that has made the most progress in terms of liberalisation and opening up its economy (along with Jordan), major structural policies have also been implemented. These policies are included in a 6-year plan, extending to 2015, which comprises a programme to construct 1 000 factories, a rural development programme, an integrated tourism development project, the construction of 500 000 homes and a major training and job creation programme. The long-term strategy is to develop new industries such as green cars, electronic industries, medical equipment, genetic engineering and biotechnologies. In addition, there is a “green plan”, partly financed by the World Bank’s Clean Technology Fund.

Nonetheless, the results achieved under previous plans failed to meet the requirements of the economy, especially in terms of industrial policy (Galal, 2008). Over the past two decades Egypt’s plans have mainly attempted to support the traditional sectors in a more sector-based rather than activity-based approach, without looking at the action taken in terms of the results achieved or making support conditional upon those results or limiting the period for which the support is available. In fact, indicators such as changes in overall productivity, the actual rate of protection and barriers to entry suggest that over the period in question the economic objectives of the plans have not lived up to expectations.

Jordan: The opening up of the economy has contributed to the success of the QIZs

In *Jordan*, as in most of the FMCs, the structures to support the development of the private sector focused on exports of tradable goods and took the form of specialised production zones similar to free zones. The industrial modernisation programme (EJADA) was financed by the European Union, with the aim of helping to integrate SMEs into the world economy and enabling them to adapt to the consequences of the Euro-Mediterranean free trade area. Against this backdrop, facilities were introduced to provide financial support (via a guarantee fund for medium and long-term loans) and technical training or to strengthen trade associations. This support programme ended in 2006 at the same time as AMIR (Achievements of Market-Friendly Initiatives and Results), a programme backed by USAID with fairly similar goals to those of EJADA (an improved business environment, accessibility to sources of finance, strengthening of public-private partnerships). Under the authority of the Industry and Trade Minister, a national modernisation programme (JUMP) was also established with similar objectives of moving up the value chain and improving the quality of products. In 2006, Jordan’s Upgrading and Modernization Programme (JUMP) and the Euro-Jordanian Export Programme (EJEP) merged and became the Jordan Enterprise Development Corporation (JEDCO).

Jordan also has an industrial policy comprising horizontal support measures and special assistance for the export industries: pharmaceuticals, agrifoodstuffs (particularly olive oil), textiles and clothing and high value added industries in the IT sector. Jordan also has a green plan involving renewable energy in particular. The method used to reduce the country’s energy dependence entails abolishing the subsidies given to electricity (which are very costly although the price of electricity forms part of Jordan’s social contract), privatising the sector and developing new generating capacity, with the emphasis on renewable energy (solar, wind and, in the longer term, nuclear). Jordan has launched a number of major infrastructure projects and floated the idea of a canal connecting the Dead Sea and the Red Sea, which is currently at the appraisal stage.

The last decade has been marked in particular by the creation of Qualified Industrial Zones (QIZs). Thirteen have been established, mostly privately managed, comprising more than 50 factories. This initiative, which was launched in 1995 following the signature of the Wadi Araba peace treaty and the Amman Economic Summit, initially had fairly modest results, with nothing really distinguishing the QIZs from the traditional free zones. However, with Jordan joining the WTO and the free trade agreement with the US (which required an agreement with Israel), greater momentum appears to have been achieved. These QIZs now provide access to the US market without duties or quotas. The main requirement is that at least 35% of the value processed in the QIZs must be of Jordanian, American,

Israeli or Palestinian origin. A similar programme was unveiled in Egypt in 2005 (four QIZs at the beginning of 2009).

In 2006, there were more than 1 300 Israeli enterprises in Jordan. Government estimates show that over 40 000 new jobs were rapidly created, particularly for women in rural areas, while in the space of a few years Jordanian exports to the US increased from USD 15m to USD 1 000m. In 2005, the level of exports increased 80-fold.

Syria: Liberalisation one step at a time

In *Syria* the productive system was for a number of decades under strict government control. It gradually opened up to the private sector with increased international competition and the desire of the authorities to firmly establish the economy within the Euro-Mediterranean area. The Government therefore began the process of ratifying the Barcelona Agreements, with the aim of moving towards a free trade area. For both political and economic reasons, progress towards that goal has been slow, as has the restructuring of the economy, where many segments are still outside the free market economy and fall short of the operating standards observed in the FMC sub-region. The liberalisation of the economy started in the early 1990s, as the Government sought to stimulate private investment flows while at the same time remaining the key player in the economy. The need to forge relations with the business community and become more competitive in an economy that is set to diversify and open up to the outside world is, however, not a new phenomenon.

In the 1970s, the authorities drew the conclusion that the size of the economy and the rapid growth in population meant that they had to take the lead in reducing the country's dependence on the oil economy. With that in mind, one of the first initiatives taken was the creation of free zones, the principle of which was formalised in a decree in 1972. Ultimately, the goal of the free zones was to promote the transfer of innovative technologies and train the country's workforce whose activities were limited to trade and industry. The first three free zones were opened in Greater Damascus, followed by others in Aleppo, Latakia and Tartous. In 1994, there were more than 150 companies in the free zones, with the Arab League's setting-up of the Greater Arab Free Trade Area (GAFTA) in 1998 playing a key role. Overall, the free zones have proved successful, albeit not as successful as those of Jordan's Qualified Industrial Zones, by way of regional comparison. Moreover, a decree in 2003 initiated change with the authorisation of investment in the fields of banking, hospitals, tourism, communication and consulting but also in the creation of private industrial enterprises in strategic sectors such as hydrocarbon processing, phosphate mining and cement plants. In 2002, the Government announced the construction of three industrial zones on the outskirts of Syria's main cities of Damascus (in Adra), Aleppo (Cheikh Najjar) and Homs (Hissyia). The purpose of these development clusters is to encourage local industrial investment, create new jobs and curb the uncontrolled expansion of industrial zones in agricultural areas. The concentration of political functions in Damascus and Aleppo's economic role reflect an ever-growing process of urbanisation. The 10th five-year plan (2006-2010) also included the creation of new industrial zones, combining investment with the upgrading of apartment blocks and the provision of services, which will form the nucleus of the future new towns.

Lebanon: Reconstruction

In **Lebanon** the Euro-Lebanese Centre for Industrial Modernisation (ELCIM), financed by MEDA, was established in 2001, with the aim of increasing the competitiveness of businesses in connection with the institutionalisation of the free trade area with the European Union. The EUR 11m programme for the period 2001 to 2004 involved providing technical and financial assistance to some 600 SMEs in eight business sectors: agrifoodstuffs, publishing, packaging, tanning, the shoe industry, textiles, furniture, chemicals and paint. Technical assistance took the form of training sessions aimed at familiarising producers with new technologies. ELCIM does not offer loans to businesses but facilitates their access to the financial system via financial feasibility studies, which can help the businesses to meet the conditions for borrowing from commercial banks, Kafalat and the European Investment Bank (FEMIP).

At the same time, ELCIM has been planning to upgrade industrial infrastructure in the Baalbek and Zahle regions. The project is aimed at providing facilities that are up to international standards at very reduced prices. The Lebanese Government's involvement is very important. Numerous institutions are

also working to make this upgrading project a success, in particular UNIDO, the European Union and the association of Lebanese industrialists. Industry's needs are considerable and the aims of the Government and industrialists must be coordinated. The launch of the EUR 17m ELCIM II project (2005-2008) was intended to create a network of business incubators and develop a special financial facility to guarantee loans for SMEs and start-ups. While during the first phase of the programme, the organisation was primarily a European initiative, ELCIM II established itself locally by becoming part of a Lebanese structure, the Industrial Research Institute (IRI). Since 2001, the partnership culture has flourished, first with representatives of the private sector (chambers of commerce, trade unions) and then with the academic world and financing organisations. Gradually, the Government has begun to build a relationship of trust with its industrial fabric.

Clearly, however, Lebanon's indebtedness following the Paris II Agreements, alongside its reconstruction requirements, call for a proactive strategy in terms of structures, which is very difficult to achieve given the division of institutional powers between the different political parties. At the EU's request, Femise has hosted four Lebanese reconciliation forums, which have laid the foundations of medium-term economic development, social policy, SME development and agricultural development. These forums have led to unanimous agreement among the participants as to the measures required. However, the actual implementation of these measures is slow – proof that the Lebanese Government is still finding it difficult to work in a coordinated manner.

Israel: A successful cluster model

In comparison with its FEMIP partners, *Israel* probably stands out because it was the first and most successful proponent of the cluster approach, with complex exchanges and cooperation between businesses within the same region. What were the underlying factors behind this? There are no doubt several, including easier access to finance than in other countries and the quality of human capital available. The reasons for this are both exogenous and endogenous, the Government being unquestionably responsible for kick-starting the whole thing while remaining the key player as it acquired momentum. In the 1960s, indirectly prompted by the French embargo following the Six Days War (1967), the development of the new technologies sector was based on the promotion of a research and development (R&D) policy. This took shape in increasingly specialised private enterprises, which received public subsidies. The Government also strongly encouraged the establishment of multinational firms in Israel, especially from the US, and of research units that would ultimately enable Israel to forge a reputation for itself based on certain leading high-tech products. In the relatively recent past, one of the instruments that contributed to that policy and to its being backed financially was the creation of a body dedicated to the development of strategic activities.

Established in 1993 on the Government's initiative, Yozma gradually earned its reputation by demonstrating its ability to create the structure for a venture capital industry, acquiring interests in companies that subsequently proved effective in exporting high-tech products worldwide. With the support of American and European investors, in 1998 a second venture capital fund (Yozma II) was launched. It extended the operating model of its predecessor by confirming the body's role in developing the international attractiveness of the Israeli territories. At the same time, through the Industry, Trade and Labour Ministry, in 1991 the authorities supported the introduction of a programme of technological incubators which contributed to the financing and training of entrepreneurs with innovative business ideas. The Government's financial support entailed providing a loan or grant representing up to 85% of the approved budget over the first two years. At the beginning of 2007, 77% of this public financing was going to three sectors (medical, biotechnologies and software production). Of some 1 000 projects approved, 57% managed to attract private investors. The incubators' investment totalled over USD 1.5bn. Since the programme's launch, 24 technology incubators have been established in Israel, of which 15 in outlying areas: Jerusalem, Tel Aviv, Haifa, Beer Sheva, Dimona, Sde Boker, Ofakim, Ashkelon, Kiryat Gat, Kiryat Arba, Netanya, Hadera, Ariel, the Jezreel Valley (Migdal Ha'Emek), Jordan Valley (Tzemah), Nazareth, Segev Bloc (Misgav), Yoqne'am, Golan Heights (Katzrin) and Upper Galilee (Kiryat Shmona).

II.3 The perception of recent structural policies

As we can see from the brief summary above, since the middle of the last decade there has been a shift to a more modern strategy. The “new” industrial policy, which as we have seen existed in some form or other in most FMCs, led to the conclusion that economic results do not derive solely from spontaneous market forces. Clearly, most FMCs have focused on the most critical aspects of their traditional courses of action by placing greater emphasis on human capital, infrastructure (especially ICT) and the financing of local enterprises.

Despite the progress made in terms of a horizontal approach, the clear objectives of international competitiveness or diversification are not necessarily the rule or do not show through in the measures taken to encourage the setting up of businesses. We have thus witnessed a trend still deeply rooted in the strategy of “upgrading”, the sectoral approach and the protection of traditional sectors. The content, in terms of support offered, is often based on a principle of industrial platforms and tax advantages, which are not sufficiently linked to the achievement of specific objectives and whose time limits are vague.

International comparisons have not been favourable for the FMCs, which means that they must pursue and in many cases speed up reforms to improve the business environment from within. Competitiveness starts from this reference framework, on which the profitability of tradable goods and therefore investment and the internal momentum depend.

The key issue is to determine to what extent these recent developments have translated into tangible results. Over such a short period, there can scarcely be any visible material impact on macroeconomic data or in terms of TFP. We therefore decided to look at international benchmarks. These rankings are of course essentially very subjective but that in itself gives an indication of international players’ perceptions and expectations of economies. They create international databases and serve to identify problems both by surveying producers and by seeking expert opinions. International comparisons can then be made on that basis. The competitive position of economies is one of the indicators best suited to assessing a government’s success in achieving its objective of integrating its goods into the global economy.

In the next part of this section, we shall use three of these approaches in turn: the Global Competitiveness Report, Doing Business 2009/2010 and the AT Kearney attractiveness index.

Table 13. Global Competitiveness Report and FEMIP countries

	Aggregate index	Competitiveness fundamentals	Efficiency enhancers	Innovation and sophistication
<i>Algeria</i>	83	61	117	122
<i>Egypt</i>	70	78	80	71
<i>Israel</i>	27	42	26	17
<i>Jordan</i>	50	46	66	51
<i>Morocco</i>	73	57	91	88
<i>Syria</i>	94	72	112	100
<i>Tunisia</i>	40	35	56	45

Source: Global Competitiveness Report, 2009-2010

1) According to the *Global Competitiveness Report*, competitiveness is first and foremost about *basic requirements* that determine how productive resources are channelled. This competitiveness depends on the propensity to stimulate the efficiency of those resources (*efficiency enhancers*) and encourage innovation and increasing sophistication of the products (*innovation and sophistication*). Within the subset of countries eligible for FEMIP, there is a marked contrast in the competitive positions. Of the 133 countries classified, Israel (27th) is the highest ranked of the subset, followed by Tunisia (40th). Syria is the lowest ranked, penalised like Algeria by the difficulty in stimulating productive efficiency.

A review of the factors underlying each of the headings of the World Competitiveness Index highlights the following points. In terms of fundamentals Israel and Tunisia do well, whereas Algeria is affected by the poor quality of its institutions. The main issue for Egypt, Jordan, Syria and to a certain extent Israel is macroeconomic instability. Finally, Morocco's primary education and health issues have a major impact on its ranking (see Table 14).

Table 14. Competitiveness fundamentals

	Competitiveness fundamentals	Institutions	Infrastructure	Macroeconomic stability	Health and primary education
<i>Algeria</i>	61	115	99	2	77
<i>Egypt</i>	78	56	55	120	84
<i>Israel</i>	42	39	44	67	39
<i>Jordan</i>	46	25	42	105	57
<i>Morocco</i>	57	64	70	32	87
<i>Syria</i>	72	57	79	80	70
<i>Tunisia</i>	35	23	37	55	30

Source: Global Competitiveness Report, 2009-2010.

Table 15. Efficiency enhancers

	Efficiency enhancers	Training & higher education	Efficiency of goods market	Efficiency of job market	Sophistication of financial market	Technological quality	Size of market
<i>Algeria</i>	117	102	126	127	132	123	51
<i>Egypt</i>	80	88	87	126	84	82	26
<i>Israel</i>	26	36	49	28	15	26	50
<i>Jordan</i>	66	42	43	106	52	61	82
<i>Morocco</i>	91	99	68	129	96	76	56
<i>Syria</i>	112	104	101	128	123	108	64
<i>Tunisia</i>	56	32	39	98	87	55	66

Source: Global Competitiveness Report, 2009-2010.

As regards efficiency enhancers (Table 15), the two negative aspects identified in almost all FMCs except Israel are the job market and the sophistication of the financial markets. As regards innovation and the sophistication of products, two of the countries moving towards a market economy (Algeria and Syria) are obviously experiencing problems (Table 16).

Table 16. Innovation and sophistication

	Innovation and sophistication	Business sophistication	Innovations
<i>Algeria</i>	122	128	114
<i>Egypt</i>	72	72	74
<i>Israel</i>	17	30	9
<i>Jordan</i>	51	49	59
<i>Morocco</i>	88	78	96
<i>Syria</i>	100	90	110
<i>Tunisia</i>	45	54	38

Source: Global Competitiveness Report, 2009-2010.

To what extent do these comments chime with the perception of the business community? Table 17 lists the five main sources of problems identified in connection with building up a business. Two factors emerge fairly systematically for all of the countries and highlight obvious courses of action for proactive public policies. The problem areas are bureaucracy and access to sources of finance for businesses.

Most of the economies are still subject to tight state control, which leads to excessive costs and interferes with the conduct of business. For six of the seven countries examined this is one of the two biggest obstacles. Naturally these transaction costs, which may be accompanied by corruption, are obstacles to integration into the global economy. At the same time, although we will come back to this subject later, administrative inefficiencies influence the decision to invest. They prompt investors to adopt a wait-and-see approach and impede economic growth. Syria and Algeria are particularly prone to this, as is Israel although it has less of a negative impact on global competitiveness in that country.

Table 17. Main obstacles to international competitiveness

<i>Algeria</i>	Access to finance (23%)	Inefficient government bureaucracy (20.1%)	Corruption (10.2%)	Inadequate vocational training (7.6%)	Excessive labour market regulation (6.6%)
<i>Egypt</i>	Inefficient government bureaucracy (12.3%)	Tax regulation (12%)	Inadequate vocational training (10.4%)	Inflation (9.9%)	Corruption (9.5%)
<i>Israel</i>	Access to finance (19.1%)	Inefficient government bureaucracy (18.8%)	Inadequate infrastructure (9.2%)	Political instability (8.8%)	Government instability (8.7%)
<i>Jordan</i>	Tax rate (12.4%)	Inefficient government bureaucracy (12.2%)	Inadequate vocational training (12%)	Tax regulation (11.4%)	Access to finance (10.5%)
<i>Morocco</i>	Access to finance (15.9%)	Corruption (15.2%)	Inadequate infrastructure (10.6%)	Tax rate (9.8%)	Inefficient government bureaucracy (8.8%)
<i>Syria</i>	Inefficient government bureaucracy (18.7%)	Excessive labour market regulation (14.6%)	Inadequate vocational training (13.4%)	Access to finance (11.3%)	Inadequate infrastructure (11.3%)
<i>Tunisia</i>	Inefficient government bureaucracy (14.3%)	Access to finance (14.1%)	Excessive labour market regulation (11.5%)	Restrictions on foreign exchange transactions (10.5%)	Poor work ethic (9.1%)

Source: Global Competitiveness Report, 2009-2010

Percentages indicate the proportion of people questioned who mentioned the obstacle as being a problem in their country

Financial market inefficiencies are reflected in the criticism of inadequate banking intermediation. The way in which the financial system is organised may be a contributory factor to this shortcoming as the lack of expertise in the institutions in question combined with the fact that there is little potential competition is not conducive to commercial risk-taking. However, the banks also suffer from the poor quality of information regarding businesses. For tax reasons or for fear of local competition, family-run firms are reluctant to share information about the performance of their businesses. Enterprises benefit from an asymmetry of information and therefore banks take refuge in refusing to grant credit lines, without knowing what they will actually be used for or whether the firms in question are able to repay them. Here too the Government's ability to implement restructuring and innovation policies determines the effectiveness of the productive system.

The other obstacles complained about are more diverse although public infrastructure and labour market problems are regularly mentioned. Regarding the latter, the problems relate to training that falls short of producers' expectations but also to restrictive regulations affecting factor utilisation in terms of recruitment, overtime and even dismissal/redundancy procedures. Other complaints concern the consequences of political and government instability, which gives rise to uncertainty (Israel); inflation (Egypt); tax disincentives in terms of rates or regulations (Jordan, Morocco); and restrictions on foreign exchange transactions (Tunisia).

Table 18. Countries eligible for FEMIP and *Doing Business* 2009-2010 (World Bank)

<i>Ranking</i>	<i>Algeria</i>	<i>Egypt</i>	<i>Israel</i>	<i>Jordan</i>	<i>Morocco</i>	<i>Syria</i>	<i>Tunisia</i>
<i>Out of 183 economies</i>	136	106	29	100	128	143	69
<i>Starting up a business</i>	148	24	34	125	76	133	47
<i>Granting of building permits</i>	110	156	120	92	99	132	107
<i>Recruitment of workers</i>	122	120	90	51	176	91	108
<i>Transfer of property</i>	160	87	147	106	123	82	59
<i>Access to borrowing</i>	135	71	4	127	87	181	87
<i>Investor protection</i>	73	73	5	119	165	119	73
<i>Payment of taxes</i>	168	140	83	26	125	105	118
<i>Cross-border trade</i>	122	29	11	71	72	118	40
<i>Performance of contracts</i>	123	148	99	124	108	176	77
<i>Winding up a business</i>	51	132	41	96	67	87	34

Sources: World Bank, *Doing Business*, 2009-2010.

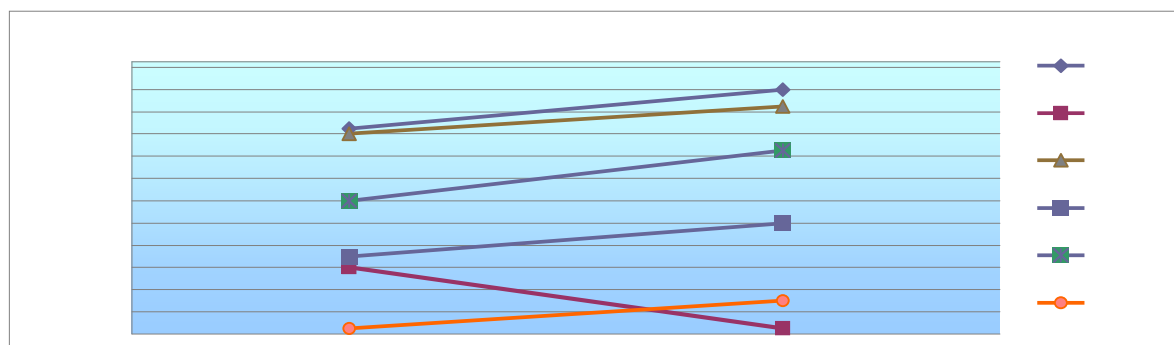
2) The information published by *Doing Business* 2009-2010 complements the previous presentation without greatly altering the international ranking as established above by the World Economic Forum (see Table 18). The ease of doing business is satisfactory in Israel and reasonable in Tunisia. Both countries have potential to do better in terms of both the number of procedures and the time required to perform contracts. We can see that apart from Israel, the other countries are faced with major problems in terms of protecting investors, which does not help to attract direct investment or encourage risk-taking in the field of innovation. Morocco does particularly badly in this respect and is ranked an astonishing 165th out of 183 countries. Tunisia (62.8%) suffers from a punitive tax system, whereby the Government takes the second-largest share of commercial profits, after Algeria (72%). Although Algeria, and to some extent Syria, are lowly ranked, the underlying reasons for their poor showing are somewhat similar. The conduct of business is handicapped by an uncompetitive domestic environment. This phenomenon is encapsulated by the high start-up costs for businesses, resulting in demographics that are not conducive to competition by natural selection. A low rate of turnover, despite exit costs not appearing to be exorbitant in either country, results in an innovation deficit. Relations can therefore be identified that confirm the notion that the lack of a fully-fledged market economy and a competitive environment, especially owing to government regulation and transaction costs, preclude effective innovation strategies. Does this imply that governments have failed to launch industrial policies that can invigorate the productive system by narrowing the gap with the market and encourage cooperation?

3) Finally, the latest A.T. Kearney report of 2009¹³ presents a country attractiveness index for relocation and offshoring, which reflect a more international outlook. First, the report notes that good progress has been made by the Mediterranean countries, particularly compared to Eastern European countries. The FMCs have benefited from the negative expectations concerning Eastern European countries, which were hit harder by the crisis, as well as certain advantages that they have acquired in recent years. The index contains 43 indicators broken down under three major headings: financial attractiveness, workforce skills and availability, and business environment. It is, of course, still difficult to link this progress solely to the impact of the policies actively followed by the FMCs although it is interesting to highlight certain aspects of the index in order to assess the strengths and

¹³ A.T. Kearney (2009), "The Shifting Geography of Offshoring", 2009 A.T. Kearney Global Services Location Index.

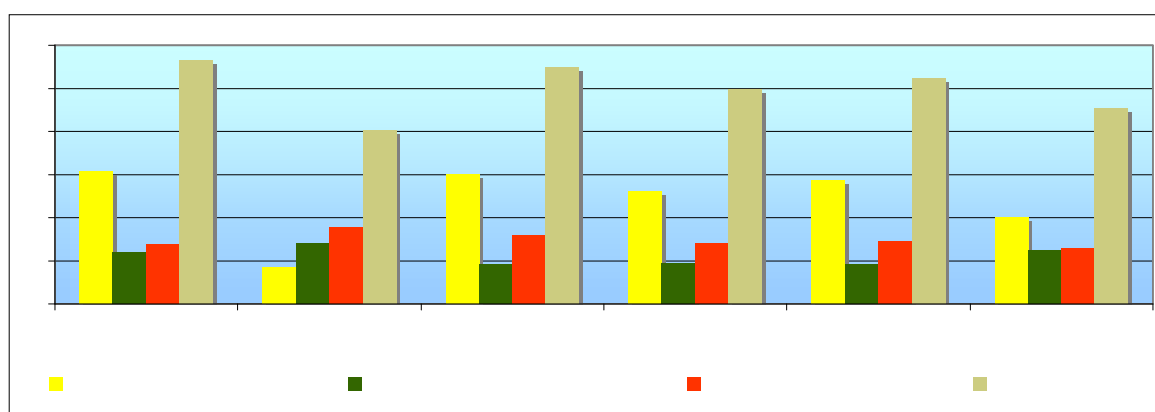
weaknesses. The graph below illustrates the general progress made by the FMCs between 2007 and 2009. Two of the countries are among the ten most attractive economies: Egypt and Jordan.

Figure 38. Progress of FMCs in the TOP 50 offshoring countries according to AT Kearney



Source: AT Kearney

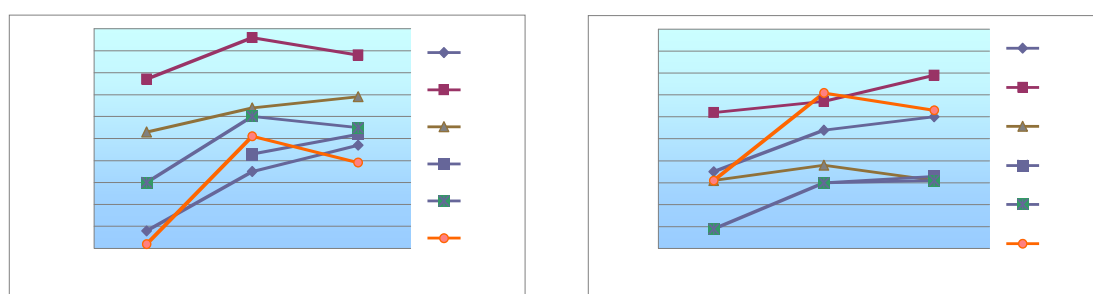
Figure 39. Breakdown of contribution to attractiveness of FMCs



Source: AT Kearney

Figure 39 clearly shows that the FMCs' main attraction is still their advantage in terms of costs, followed by people skills and the business environment, which contribute less, comparatively speaking, to their attractiveness. In the second half of the last decade there was a notable improvement in the business environment although this has begun to slow down. In general, people skills (more than their availability) contributed least to the attractiveness of the FMCs.

Figure 40. Change in impact of the business environment and people skills in the attractiveness of the FMCs

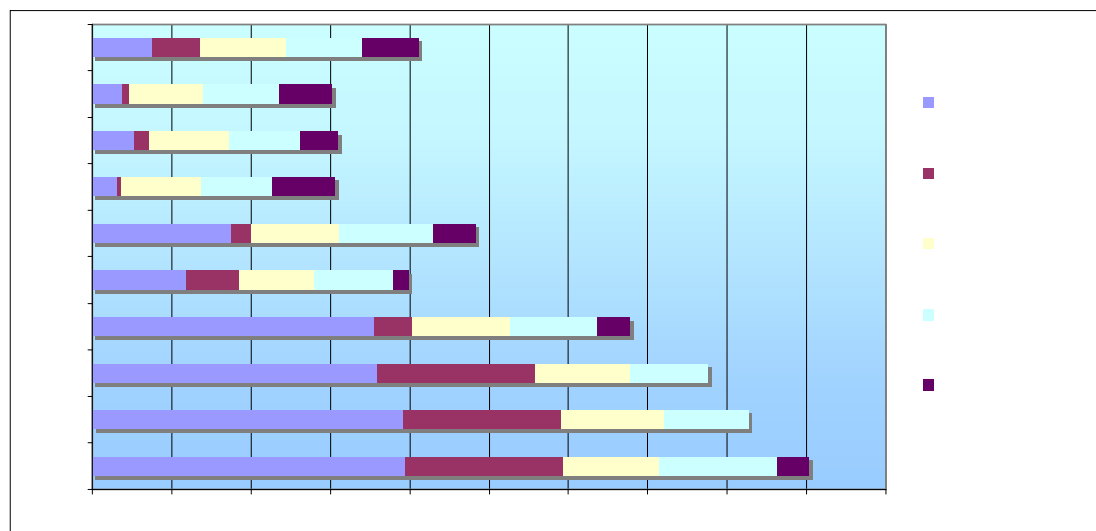


Source: AT Kearney

Furthermore, as the graph above illustrates, there was no significant improvement in the first decade of the millennium. The details of the composition of the index (Figure 41 below) show that the slight gap between the FMCs and developed countries or large emerging countries is not due to initial

education. This gap stems largely from the experience and availability of the workforce. It is common knowledge that the FMCs have made great strides in terms of literacy and basic education. What this type of index indicates is that an effort must also be made in higher education (particularly in terms of specific disciplines and professional expertise), the validation of skills (especially in economies with a large informal sector) and continuing vocational training. Given the reserves of non-working people available, while international players point to difficulties in workforce availability in the FMCs, it is the question of employability that is the prime concern.

Figure 41. Attractiveness of FMCs in terms of workforce



Source: AT Kearney

Thus we can see that the success of the structural policies implemented will depend very much on the progress made with the fundamentals, such as the quality of the workforce, the business climate and the quality of public administration. Given that the impetus provided by opening up the FMCs' economies internationally will inevitably be diminished by the crisis, new drivers of growth will have to be introduced if the FMCs are eventually also to become the region's new locomotives.

CHAPTER VI. RECOMMENDATIONS

The impact of the international crisis on the FMCs was far less severe than might have been feared. The FMCs were protected from a major financial crisis although they did feel the impact via income effects resulting from the fact that they had become increasingly integrated into international trade, which exposed them to the economic slowdown affecting their main partners – Europe and the Gulf countries. In 2010 and 2011, a weak recovery has been taking shape but at the expense of government budgets, and it is not desirable that disproportionate action should increase the imbalance in the public accounts.

In the short to medium term action must focus on two things: maintaining domestic demand at a satisfactory level and improving the situation with regard to trade. Against a background of lower interest rates and lower inflation worldwide, a more expansionary monetary policy is possible, in particular by means of encouraging lending to the private sector. The local banking sectors must be involved in this by granting more credit and improving credit allocation. This will mean major training programmes for bank staff and more extensive guarantee facilities. It is necessary to increase access to the financial markets in the economies in question by developing funds focusing on very small businesses and promoting the bond markets, which would reduce the dependence on capital inflows while at the same time compensating for the reduced room for manoeuvre on the fiscal front. There is also a need to increase exchange rate flexibility, which will make it possible to reconcile monetary and fiscal support policy, while avoiding an excessively sluggish recovery. Finally, since global FDI flows will continue to stagnate until 2012 at least, competition to attract this investment will intensify and the FMCs must continue to make progress on institutional reform in order to improve the business climate.

These issues are currently being effectively addressed in most FMCs and steady progress is being made at a pace commensurate with each individual country's economic and social constraints.

But consistent long-term action is also important and this will be crucial to improving the FMCs' position in the global hierarchy, to promoting convergence with their European partners and to creating the momentum for emerging from the crisis.

FEMISE considers that the long-term economic strategy must be based on continuing to open up the FMCs' economies internationally, by targeting in particular the wider Euro-Mediterranean region, and must develop active structural policies to create the conditions that will make it possible to influence the growth path and generate new comparative advantages.

It is this economic strategy that must be supported by the policies implemented throughout the region.

I. The economic strategy

In economic terms the focus will therefore be on the necessary extension of the regional market and the consistency of structural policies.

Extension of the regional market

A number of recent studies based on gravity models show that there is still considerable potential for expanding the FMCs' trade, particularly with the EU and between the FMCs themselves. But, as these studies point out, the impact on growth of this opening-up process is limited by the fact that the FMCs specialise in segments where there is insufficient value added, consisting of poorly diversified product ranges from firms that do not benefit from economies of scale. The opening-up process cannot therefore really be successful unless it is accompanied by structural policies.

These remarks therefore lead on to the following recommendations:

- ✓ The EU must open up its markets more to agricultural trade with the FMCs and develop mechanisms that will enable them to meet the standards required to obtain access to its market.
- ✓ The FMCs must complete the dismantling of their customs barriers in respect of European products and among themselves, which will increase the volume of trade and improve people's welfare. They must also reduce their non-tariff barriers, especially among themselves.

- ✓ A mechanism for diagonal cumulation under the rules of origin should be finalised, following on from the 2003 Palermo Declaration. The question of moving towards a system of full cumulation must also be addressed.
- ✓ Further liberalisation of the factor services (banking, insurance, transport) is necessary.
- ✓ Progress with horizontal integration between the southern countries is also desirable. This will improve the efficiency of the production processes in this region, mainly via market desegmentation and the creation of economies of scale. This must take the form of: (i) a reduction in trade costs, which are particularly high; (ii) a reduction in distortions through improved fiscal convergence, particularly with regard to foreign investors; (iii) the development of cross-border infrastructure and administrative cooperation; and (iv) greater financial and monetary cooperation, especially with regard to exchange rates.

Structural policies

With regard to the second issue involved in terms of optimising structural policies, the recommendations concentrate on three questions that are crucial for avoiding the flaws inherent in those policies if they are applied without taking precautions.

The first question relates to ***the overall strategy***. This must focus on positioning on the regional market and the global market. This implies significant improvements in the institutional environment, given that markets and institutions have an effect on production and transaction costs and, as we have seen, on productivity and hence competitiveness. Furthermore, there is a growing need for a sustained improvement in social cohesion, through a reduction in the number of poor people, the emergence of a middle class and a greater balance between the regions.

The second question concerns ***the emphasis*** of structural policies and ***ways in which they are implemented***. A number of key aspects can be identified from this point of view:

- ✓ The emphasis on exports must be viewed dynamically, without concentrating on the static comparative advantages, but by encouraging the development of new activities with an international focus from the outset. Here the role of “greenfield” FDI and international cooperation can be crucial.
- ✓ The action taken must be aimed at increasing firms’ profitability and total branch or economy-wide factor productivity. This implies in particular the establishment of business frameworks that will enable the private sector to take its place on the international stage and, more generally, to adopt a training-based growth model. This also entails secondary objectives in terms of employability of a skilled workforce, international competitiveness and moving upmarket with the product offerings.
- ✓ The action taken must be designed to target those concerned and preclude rent-seeking behaviour. This targeting means that the “new sectors” vs “old sectors” aspect must be moderated and an approach based on activities rather than sectors must be favoured.
- ✓ The action taken must, right from the design stage, provide for a framework for evaluating the measures brought to bear, a framework that is based on indicators of quantifiable and measurable results rather than on current economic beliefs.
- ✓ The action taken must ensure that private investment is not reduced and crowded out by public investment. With this in mind, care will be taken to ensure that the private sector is involved in public investment.

Finally, the third question concerns ***the areas*** to which priority is to be given. These may involve:

- ✓ correcting the initial conditions (infrastructure, education, particularly training), which play a key role in terms of the level of transaction costs and in sustainable productivity growth;
- ✓ improving the conditions under which businesses are currently operating but also under which they enter and exit markets;
- ✓ encouraging the development of localised cross-border production networks;

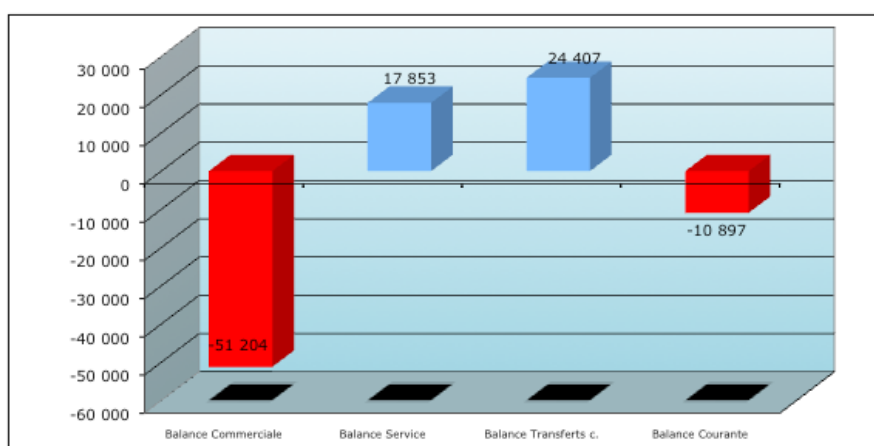
- ✓ promoting skills and the employability of human capital at the regional level through networks of training institutes for specific trades and professions, with mutual recognition of qualifications;
- ✓ developing research and innovation and, more generally, putting in place measures that will enable a knowledge economy to be established.

II. Political repercussions for the Euro-Mediterranean mechanisms

The way in which regional management, by the UfM as well as the new neighbourhood policy, will take account of the above items will be crucial to the outcome. Attention will be drawn to the following points:

- (1) The first question concerns the transfer equation (which reflects the system of interdependence within the region) and the amount of the transfer between the EU and its Mediterranean partners, to which particular attention must be paid. Up until 2008, the FMCs managed to cover their trade deficit (of which the EU accounts for around two thirds) thanks to the surplus on services (tourism) and current transfers (remittances in particular). But in 2008 and 2009, as shown in Chart 42, there was a current account deficit, as tourism and remittances were no longer sufficient to cover the trade deficit. This led some FMCs to draw on their reserves and seek exceptional forms of financing so as to bring the balance of payments back on to an even keel. Furthermore, the trade deficit is inevitably going to increase due to differences in pressure on both sides resulting from domestic demand in the aftermath of the crisis. With regard to balancing flows, the forecasts concerning FDI inflows and the variability of earnings from tourism and above all of immigrants' remittances (particularly because of unemployment in the host countries and the general context surrounding migration) mean that there is uncertainty as to whether the transfer equation can be balanced. There is therefore clearly a risk of the transfer being inadequate (on the transfer problem, see A. Cartapanis, Jean-Louis Reiffers, 1993).

Figure 42. FMCs' transfer equation (excluding Algeria), 2008, US\$ million



Key: Trade balance Services balance Current transfers balance Current account balance

Source: IMF, IFS, October 2010.

- (2) The second policy question concerns the completion of the free trade area in goods, which must remain a core objective. This presupposes progress being made on agricultural products and standards, which means that policies must be formulated to support that goal.
- (3) The third question concerns trade in services, which is expected to be the main source of future growth in the free trade area. However, trade in services implies closer links between companies and means that more will have to be done to encourage greater movement of people. This is a key issue within the region and requires, first, progress in creating the conditions that will enable it to take place (mutual recognition of skills and qualifications) and, second, the question to be raised explicitly of how this is to be achieved on a regional scale. This point concerns the North-South as well as the South-South.

- (4) The fourth question concerns the Projects Union and, more generally, co-development, which requires a common approach to strategy, the arrangements for establishing public-private partnerships and evaluation.

FEMISE considers that a project-based approach is justified, provided that the decisions are taken with due regard for criteria such as long-term economic viability and the need to address the major issues facing the FMCs (changing the content of growth by developing new activities, creating the momentum for increased productivity, improving the regional balance and narrowing the gap in living conditions).

Here the methods used are as important as the approaches adopted. This implies public-private partnerships (the leverage effect of this type of partnership is welcome at a time of limited financial resources) and a consistent strategic framework, which could consist of four elements: (i) innovative projects that prepare for the future by helping to create new specialisations and comparative advantages; (ii) projects that consolidate regional integration; (iii) projects that raise the quality of traditional lines of productions and provide them with better access to the global market; and (iv) projects that generate externalities that structure businesses' external environment.

Here a new development bank could have an important role to play, in terms of both the resources that it would be able to mobilise and the expertise it would bring to bear in identifying and selecting projects.

- (5) If the situation is unlikely to change in terms of free transfers or a development bank, the FMCs will have to accelerate their integration into the international capital markets and their movement towards greater exchange rate flexibility. In this case, there is a risk of a significant increase in volatility. The creation of a stabilisation fund – backed by the ECB – to prevent reserves crises (like Asean has done) might then be the appropriate response.

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Annex

Table A1. Rate of opening up of the goods sector (X+M)/GDP, by FMC, in %

	1995	2000	2005	2008
<i>Algeria</i>	48%	57%	64%	68%
<i>Egypt</i>	25%	19%	33%	50%
<i>Israel</i>	53%	58%	65%	63%
<i>Jordan</i>	81%	63%	117%	119%
<i>Lebanon</i>	53%	42%	52%	67%
<i>Morocco</i>	40%	54%	54%	70%
<i>Syria</i>	52%	43%	51%	63%
<i>Tunisia</i>	74%	74%	83%	109%
<i>Turkey</i>	34%	41%	39%	46%
FMCs with Turkey	39%	45%	49%	54%
FMCs without Turkey	47%	47%	58%	66%

Source: COMTRADE

Table A2. Rate of opening up of the services sector (X+M)/GDP, by FMC, in %

	1995	2000	2005	2008
<i>Algeria</i>	4.9%	4.5%	7.1%	5.7%
<i>Egypt</i>	22.5%	17.7%	27.0%	26.4%
<i>Israel</i>	18.2%	23.6%	23.2%	21.5%
<i>Jordan</i>	49.4%	39.8%	38.7%	41.3%
<i>Lebanon</i>	<i>n.a.</i>	<i>n.a.</i>	86.4%	102.6%
<i>Morocco</i>	12.3%	14.1%	20.1%	21.0%
<i>Syria</i>	25.6%	17.2%	18.7%	14.6%
<i>Tunisia</i>	21.4%	20.5%	21.7%	22.0%
FMCs	17.2%	17.4%	23.1%	22.1%

Source: Unctad 2009, EIU

Table A3. Tourism in the FMCs in 2009

	<i>Revenue</i>	<i>Volume</i>
<i>Algeria</i>	0.0%	9.5%
<i>Egypt</i>	-2.0%	-2.3%
<i>Israel</i>	-13.7%	-10.0%
<i>Jordan</i>	-1.1%	1.6%
<i>Lebanon</i>	-12.5%	64.0%
<i>Morocco</i>	-5.0%	6.5%
<i>Palestine</i>	<i>n.a.</i>	<i>n.a.</i>
<i>Syria</i>	0.0%	12.0%
<i>Tunisia</i>	2.1%	-2.1%
<i>FMCs</i>	-4.3%	6.5%

Sources: Econostrum, central banks, WTO

Table A4. Exchange reserves (No of months of imports) by FMC

	<i>1995-2000</i>	<i>2000-2007</i>	<i>2008</i>	<i>2009</i>	<i>2010*</i>
<i>Algeria</i>	7.0	22.3	34.0	36.0	37.3
<i>Egypt</i>	10.2	6.9	7.5	7.3	7.5
<i>Israel</i>	5.5	5.8	8.3	10.4	10.0
<i>Jordan</i>	5.6	6.4	6.6	8.8	8.7
<i>Lebanon</i>	14.8	18.6	22.9	17.7	
<i>Morocco</i>	4.8	7.9	7.3	6.8	6.7
<i>Syria</i>	5.1	6.3	7.3	5.2	
<i>Tunisia</i>	2.6	3.0	5.2	6.0	5.8
<i>FMCs (average)</i>	7.0	9.6	12.4	12.3	12.7
<i>FMCs (excluding Algeria and Lebanon)</i>	5.6	6.0	7.0	7.4	6.5

Source: FEMISE calculations, *estimates

Table A5. Debt service by FMC (%)

	1995-2000	2000-2007	2008	2009	2010*
<i>Algeria</i>	30.9	15.7	1.4	3.0	2.0
<i>Egypt</i>	10.8	7.9	4.7	10.2	4.5
<i>Israel</i>	17.2	13.0	13.0	11.9	10.6
<i>Jordan</i>	13.8	9.1	25.9	4.4	4.8
<i>Lebanon</i>	14.2	24.1	n.a.	n.a.	n.a.
<i>Morocco</i>	26.4	16.1	10.1	8.6	8.0
<i>Syria</i>	5.4	3.1	n.a.	n.a.	n.a.
<i>Tunisia</i>	16.7	14.0	7.7	15.8	13.0
FMCs (median)	15.5	13.5	8.9	9.4	6.4

Source: EIU, IMF, *estimates

Table A6. Portfolio investment in the FMCs, US\$ bn

	2007	2008	2009	2010*
<i>Algeria</i>	0	0	0	n.a.
<i>Egypt</i>	0.8	-7	0.3	n.a.
<i>Israel</i>	-2.5	-2.3	-4	-4
<i>Jordan</i>	0.8	0.6	-0.1	0.4
<i>Lebanon</i>	-2.1	4.8	2.8	2
<i>Morocco</i>	-0.1	-0.1	0.1	0.1
<i>Tunisia</i>	n.a.	0	-0.1	n.a.
FMCs (total)	-3.1	-4.1	-1.1	
FMCs (average)	-0.5	-0.6	-0.2	-0.4

Source: IMF country reports (2009/2010), central banks, *estimates 2010 (IMF)

Figure A1. Stock market prices by FMC

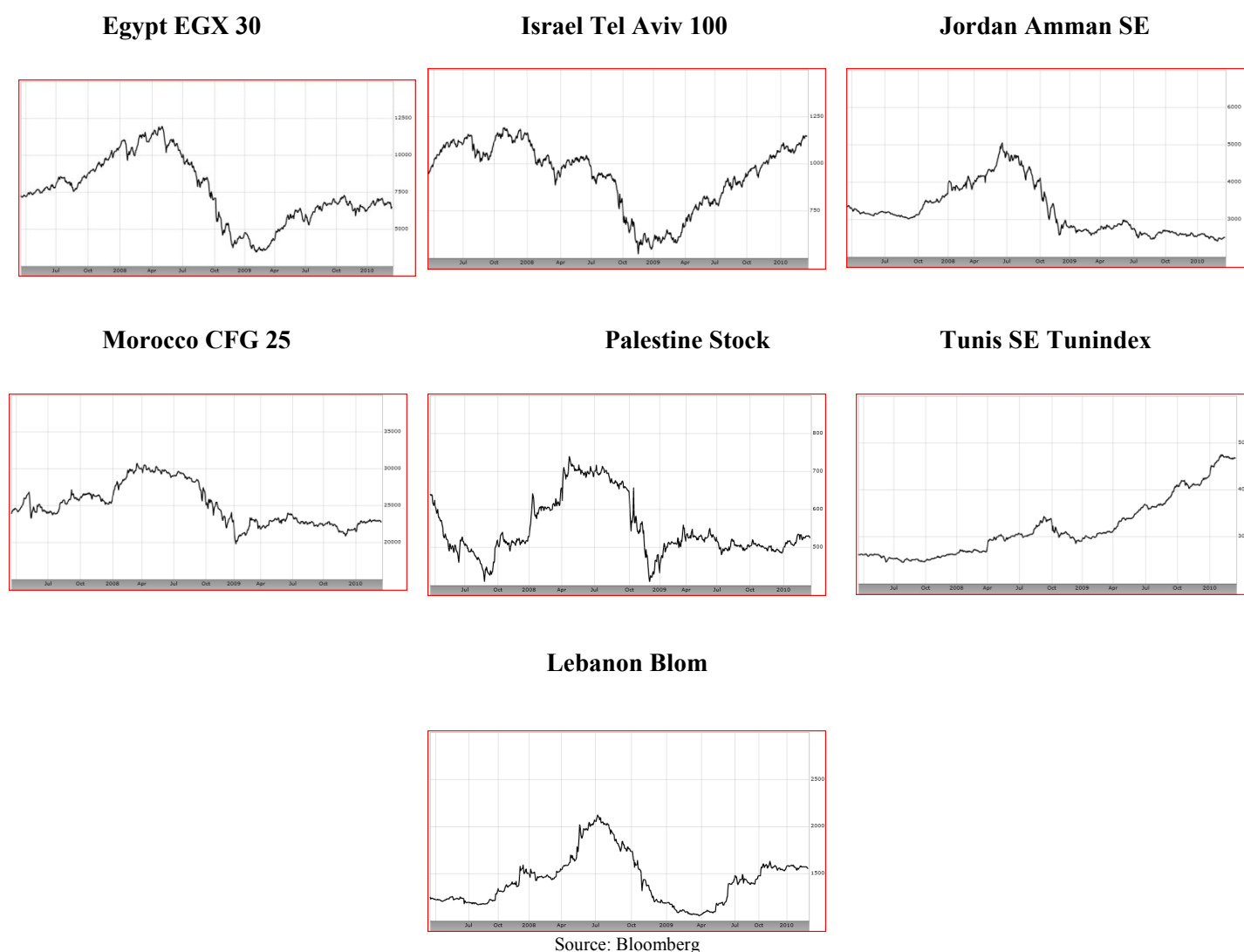
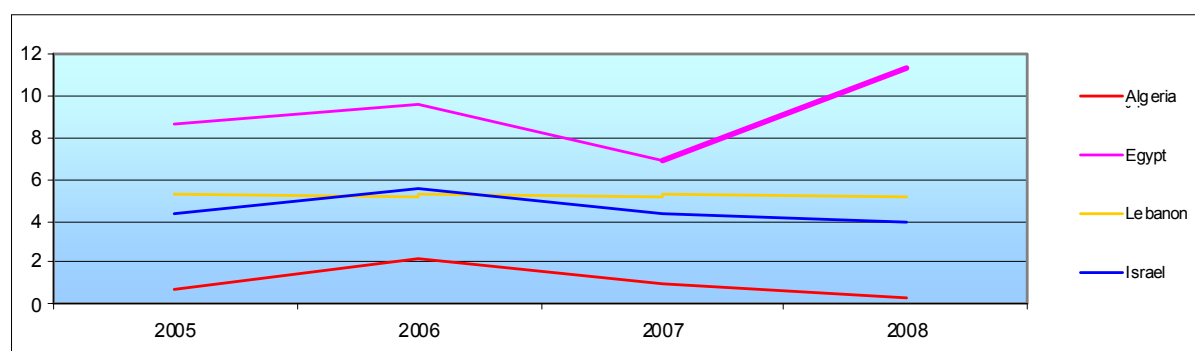
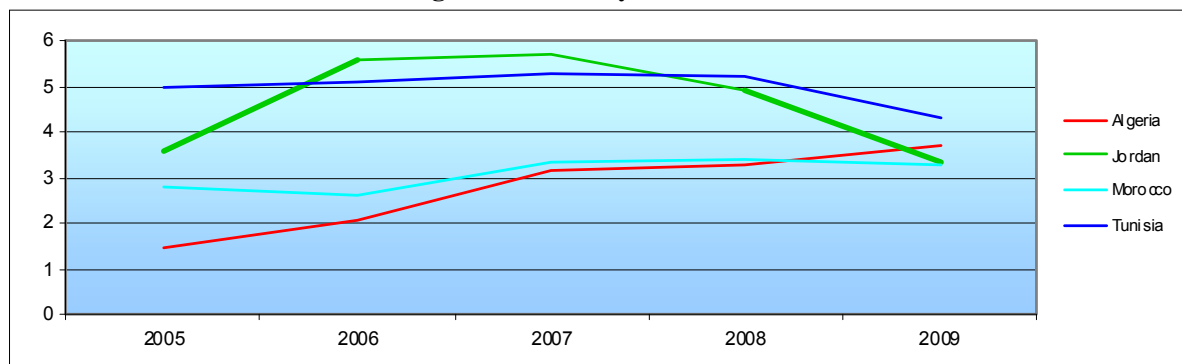


Figure A2. Treasury bond rates in 4 FMCs



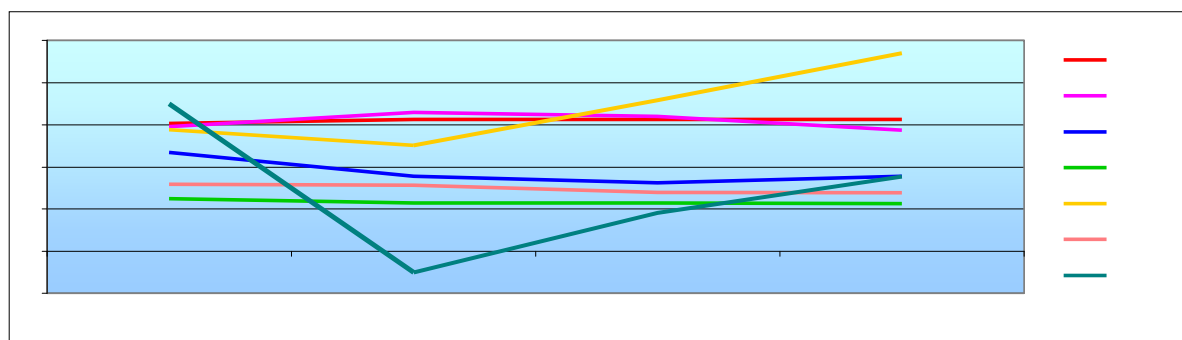
Source: IMF, IFS

Figure A3. Money market rates



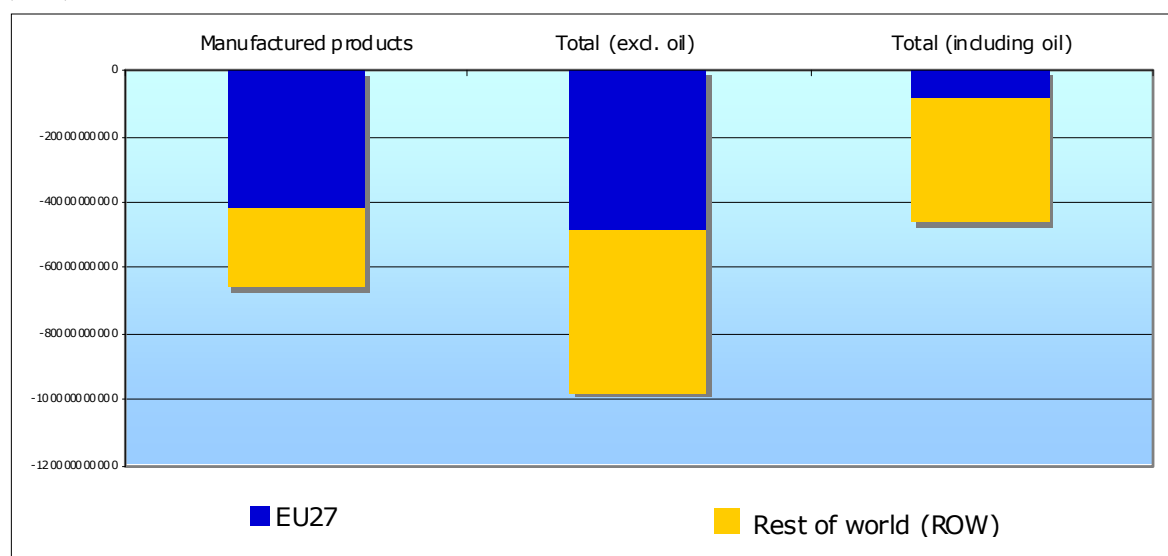
Source: IMF, IFS

Figure A4. Interest rate spreads in the FMCs



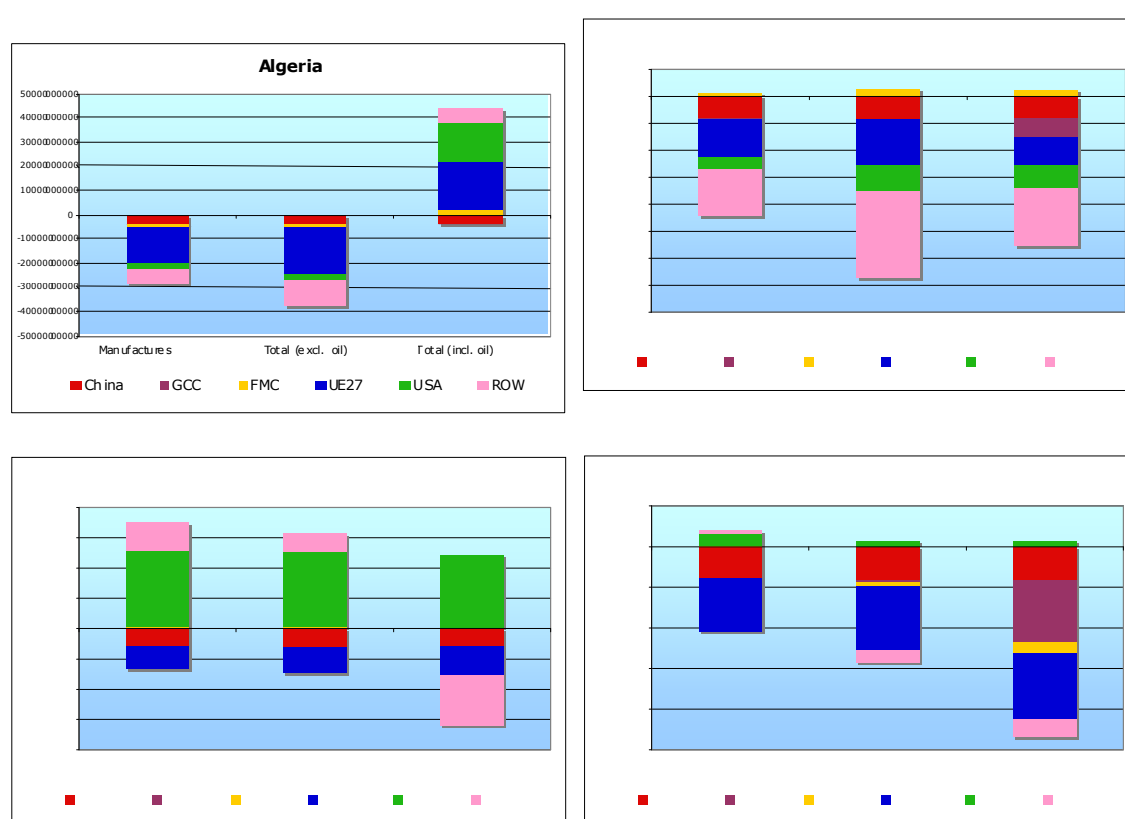
Source: IMF, IFS

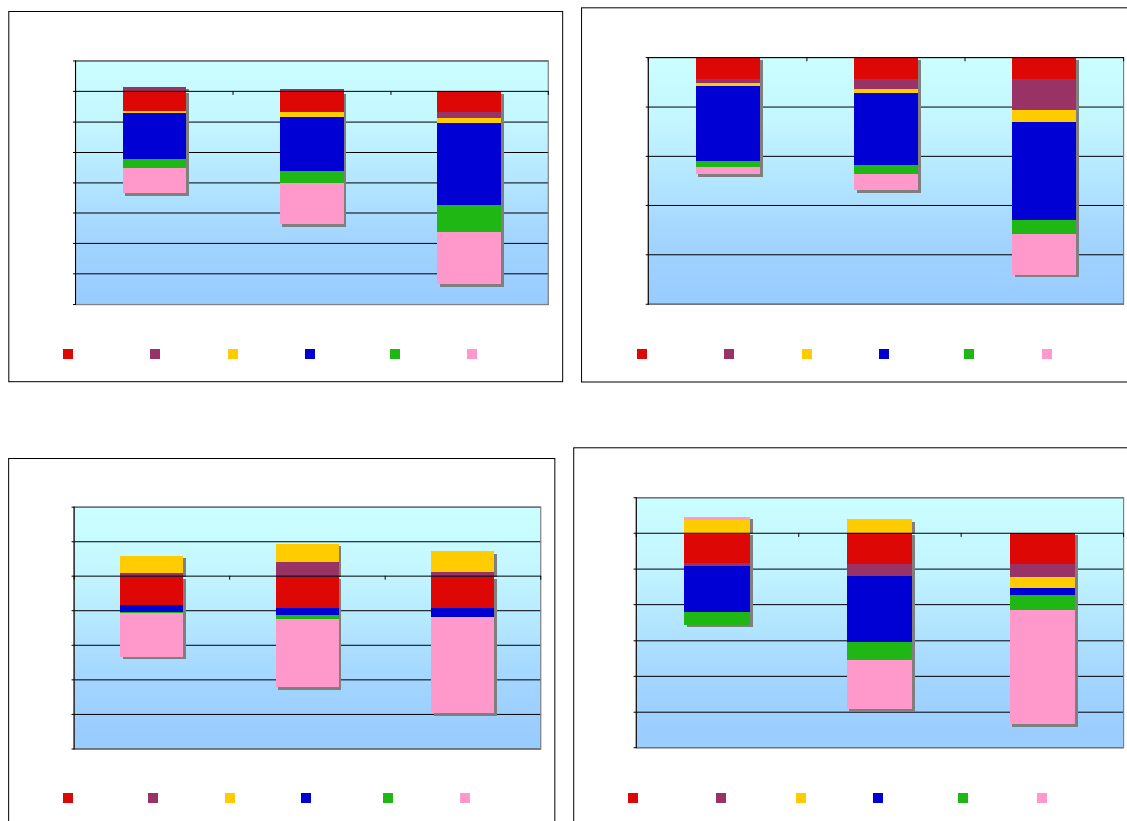
Figure A5. Trade balances in the FMCs (excluding Turkey), 2008, by specific product category (US\$)



Source: COMTRADE

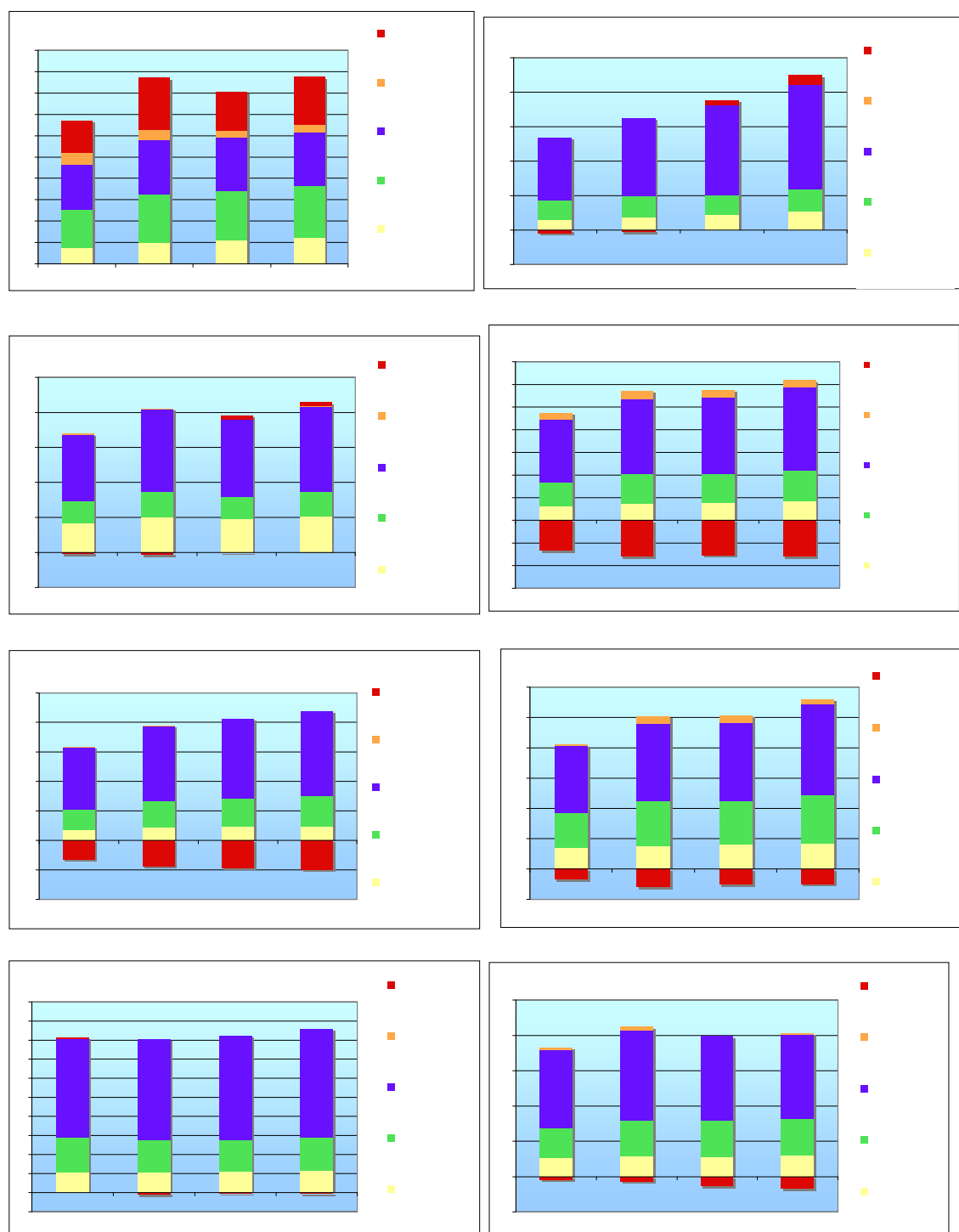
Figure A6. Trade balances by FMC (2008), by trade partner and product, US\$





Source: COMTRADE

Figure A7. Breakdown of GDP by FMC, US\$ bn



Sources: IMF, EIU, estimates for 2010

Table B1. Annex Foreign direct investment (FDI)

(\$ m and %)	Algeria	Morocco	Tunisia	Lebanon	Egypt	Jordan	Syria	Palestine	Israel	Turkey	World
FDI 95-05 (annual. average)											
<i>Inflow</i>	611	1109	566	1495	1311	523	195	98	2886	2184	741.045
<i>Outflow</i>	46	35	5	225	59	16	36	15.7	1657	483	717852
FDI 2007											
<i>Inflow</i>	1662	2803	1616	3376	11578	2622	1242	28	8798	22023	2099973
<i>Outflow</i>	295	621	20	848	665	48	-11	-8	8604	2104	2267547
FDI 2008											
<i>Inflow</i>	2646	2487	2758	4333	9495	2829	1467	52	10877	18148	1720873
<i>Outflow</i>	318	485	42	987	1920	13	2	-3	7210	2532	1928799
FDI 2009											
<i>Inflow</i>	2847	1331	1688	4804	6712	2385	1134	33	3892	7611	1114189
<i>Outflow</i>	309	470	77	1126	571	72	-3	36	1172	1551	1100933
% GFCF 95/05 (inflows)											
<i>2007</i>	4.60%	10.40%	10.70%	5.40%	8.80%	24.30%	4.50%	3.40%	13.00%	4.00%	10.30%
<i>2008</i>	5.60%	9.00%	27.00%	16.20%	31.20%	44.50%	12.00%	-0.70%	30.00%	12.50%	12.60%
<i>2009</i>	5.90%	4.50%	15.60%	16.30%	22.30%	39.00%	10.20%	3.30%	12.20%	7.30%	9.10%
FDI stocks											
1995	1671	5126	10963	138	14690	1379	460	123	5813	14933	3381329
% GDP	4%	13.90%	60.80%	3.40%	21.30%	20.50%	3.40%	3.80%	6.20%	7%	11.40%
2008	14498	38613	26193	27282	59980	16320	5900	1172	104013	70118	1549182
% GDP	8.50%	51.30%	70.30%	10.80%	36.70%	76.30%	10.80%	22.70%	31.70%	9.60%	25.40%
2009	17344	39388	31857	32085	66709	18705	7334	1205	71258	77729	17743408
% GDP	12.30%	45.50%	77.10%	13.90%	34.80%	81.40%	13.90%	23.30%	36.60%	12.60%	33.20%

Source: UNCTAD, Data base 2010

Note: Financial Soundness Indicators (FSIs), calculation and interpretation (Source: IMF, 2006, *Financial Soundness Indicators: Compilation Guide*)

Capital adequacy ratio: Corresponds to regulatory capital divided by risk-weighted assets. This FSI measures the capital adequacy of deposit takers and is based on the definitions given in the Basel Capital Accord. It is calculated by (1) aggregating the data on regulatory capital for the reporting population, (2) aggregating risk-weighted assets for the reporting population and (3) dividing (1) by (2).

Capital/assets

This FSI gives an indication of the financial effect, i.e. the extent to which assets are funded by other than own funds, and is a measure of the capital adequacy of the deposit-taking sector.

Return on assets (net income/average value of total assets)

This FSI is intended to measure deposit takers' efficiency in using their assets. It may be interpreted in combination with the FSI for return on equity. This indicator takes net income as the numerator and the average value of total assets over the same period as the denominator.

Return on equity (net income/average value of capital)

This FSI is intended to measure deposit takers' efficiency in using their capital. It may also provide information on the viability of their capital. It must be interpreted alongside the FSIs on capital adequacy, as a high ratio could indicate a strong return and/or poor capitalisation, and a low ratio a poor return and/or strong capitalisation. The return on equity is calculated by dividing net income (gross income less gross expenses) by the average value of capital over the same period.

Non-performing loans (NPLs)/total loans

This FSI is intended to identify problems with asset quality in the loan portfolio. It may be interpreted in conjunction with the ratio of NPLs less specific provisions to equity as described above. An increase in this ratio may indicate a deterioration in the quality of the loan portfolio, although this is generally a backward-looking indicator in that NPLs are identified when problems arise. It is essential for NPLs to be accounted for properly if this ratio is to be meaningful. This indicator may be looked at alongside the ratios for the non-financial companies sector, as a deterioration in the financial situation of these companies in particular could well be reflected in the indicator.

In order to provide some key pointers for analysing scenarios for enabling the Mediterranean partner countries to emerge from the crisis, the European Investment Bank asked the Forum Euro-méditerranéen des Instituts de Sciences Économiques (FEMISE) to carry out a new study.

This study points out that the global context of emergence from the crisis – characterised by a change in the relative ranking of economies and a return to structural policies – offers the partner countries an opportunity to develop new forms of growth. In this connection, the countries concerned will have to formulate an overall strategy based on intensifying the opening up of their economies to the outside world, developing new activities and achieving growth that is more inclusive.

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