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THE ROLE OF GUARANTEE SCHEMES IN PROMOTING FINANCIAL INCLUSION: THE IMPACT OF DIGITAL SOLUTIONS

Mais Sha’ban (Faculty of business, Al Zaytoonah University of Jordan, Amman, Jordan)

Reviewed by Rym Ayadi (EMEA)

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1 INTRODUCTION

Financial inclusion has been considered as a policy priority in many countries across the Middle East and North Africa (MENA) due to its role in the overall development and inclusive growth of nations. Generally, access to financial services for individuals and businesses improves income and creates opportunities to start up new businesses. This, in turn, has a positive impact on economic indicators, including: enhancing labour market activity and income levels (Bruhn & Love, 2014; Steinert et al., 2018), increasing savings and business investment (Dupas & Robinson, 2013), and enhancing economic growth, capital accumulation and productivity (Barajas et al., 2020). Additionally, financial inclusion tools lead to a series of beneficial social outcomes, for instance positive impact on food expenditure and security, health of children and female empowerment (Chliova et al., 2015; Karlan & Zinman, 2010; Montgomery & Weiss, 2011; Stewart et al., 2010).

The policies that promote financial inclusion targeting businesses aim to provide financial services to all firms - regardless of their size, age and other characteristics. They also specifically improve the access to finance for Micro, Small, and Medium Enterprises (MSMEs), as it is frequently identified as a barrier to their growth - particularly in emerging economies. MSMEs are an important sector in the MENA region and have contributed immensely to the region's socio-economic development. As the largest employer in the region, MSMEs play a significant role in reducing unemployment rates and stimulating economic development and innovation. However, their viability and growth can be restricted by lack of access to credit and equity, which results in a less vibrant private sector (Ayadi et al., 2021). According to the SME Finance Forum, the MENA region has the highest proportion of MSME finance gap compared to potential demand, measured at 85%. Access to credit for MSMEs is limited by a number of factors, including: information asymmetries, as these enterprises are more opaque than large firms, and lack of collateral (Ayadi & Shaban, 2021; Barajas et al., 2020).

One of the key tools used by regulators and policy makers to enhance MSME financial inclusion is guarantee schemes. These schemes act as mechanisms of risk transfer, under which a guarantor (the

guarantee scheme) ensures the lender (financial institutions; mainly banks) against a proportion of the possible losses incurred when extending a loan. This helps banks overcome collateral and information asymmetry constraints. The role of Credit Guarantee Schemes (CGSs) became clear during the COVID-19 crisis, as governments in the region provided financial support to credit guarantee schemes, to channel them to sectors in need (Ayadi & Sha'ban, 2021).

Hence, the development of CGSs in the region can have a clear impact on MSME access to finance. In recent years, CGSs witnessed significant growth, not only in terms of volume but also in product innovations, operations and digitalisation.

This policy paper provides an analysis of the role of CGSs in promoting the financial inclusion of MSMEs and the impact of digital strategies. First, this paper provides an overview of MSME financial inclusion in the region and the challenges faced by these firms in accessing formal banking services. Second, it reviews the design and performance of guarantee schemes operating in Egypt, Tunisia and Lebanon (the target countries for the INVESTMED project). The analysis is based on a comprehensive literature review, desk research, a survey and interviews conducted with guarantee schemes operating in these countries and a survey conducted with the entrepreneurs participating in the INVESTMED project. The paper clarifies the role of guarantee schemes in enhancing access to finance for MSMEs and how digital solutions have the potential to enhance their outreach. Finally, it provides policy recommendations on how to strengthen their role.

2 THE CHALLENGE: OVERVIEW OF MSME FINANCIAL INCLUSION IN EGYPT, TUNISIA AND LEBANON

MSMEs in the region, as in other regions in the world, provide many benefits to the economy, including generating a majority of new jobs, promoting innovation, diversifying the economic base, in addition to integrating women and young people into the economic development (McConaghy, 2013). Despite these benefits, MSMEs remain significantly underserved by financial institutions in the region. In particular, the percentage of firms with an account or a bank loan in the region is significantly lower than the world average, whilst the value of collateral is higher (Table 1). The percentage of firms with a bank loan or line of credit is significantly low for small and medium enterprises in Egypt and for small enterprises in Lebanon and Tunisia.

Table 1: SME Financial Inclusion in the target countries

Economy	Subgroup Level	Percent of firms with a checking or savings account	Percent of firms with a bank loan/line of credit	Value of collateral needed for a loan (% of the loan amount)	Percent of firms using banks to finance investments
All		87.2	32.5	196	25.4
Middle East & North Africa		78.8	24	198.9	24.5
Egypt, Arab Rep. (2020)	Small (5-19)	79.5	3.6	228.6	11.8
	Medium (20-99)	93.5	6.8	168.9	9.2
Lebanon (2019)	Small (5-19)	91.8	32	197.4	27.4
	Medium (20-99)	98.6	52.3	138.2	48.2
Tunisia (2020)	Small (5-19)	97.6	33.4	275.7	19
	Medium (20-99)	97.4	54.1	354.4	57.1

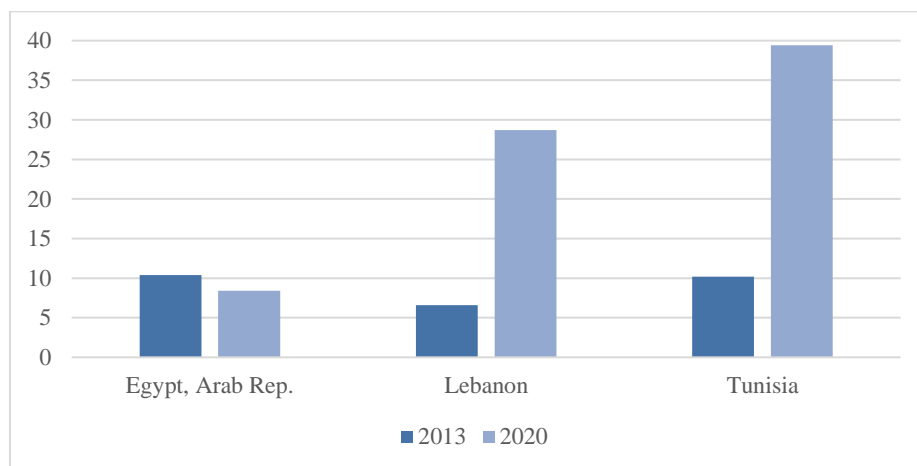
Source: Enterprise Survey

According to the SME Finance Forum (2018), the MSME finance gap to potential demand stands at 94.3% in Egypt, 39.1% in Lebanon and 53.4% in Tunisia. The Financial Access Survey (FAS) also

reports that the outstanding SME loans from commercial banks (% of GDP) in 2021 is only 6% and 18% in Lebanon and Tunisia, respectively. The large finance gap and low outstanding loans to SMEs in these countries highlight the need for policies and frameworks to support their access to finance.

Countries in the region adopted a number of strategies to address this challenge. For instance, in Egypt, the central bank has set a lending target to MSMEs at 25% of banks’ total loan portfolios, in addition to relaxing their credit assessment through the use of alternative (digital) data. These efforts resulted in an improvement in access to finance for MSMEs. On the other hand, Tunisian and Lebanese SMEs' access to finance remains insufficient. According to the World Bank's Enterprise Surveys (2020) in Tunisia and Lebanon, SMEs’ access to financing seems to deteriorate over a period of the years (Figure 1).

Figure 1: Percent of firms choosing access to finance as their biggest obstacle.



Source: Enterprise Surveys

The challenges of MSMEs being able to access to finance include supply-side obstacles, such as capacity and incentives of financial institutions to provide funding, demand side constraints including financial literacy, transparency, formality, technical capacity, and collateral availability, in addition to eco-system obstacles, such as the availability of an appropriate support system and credit registries (Abraham & Schmukler, 2017).

Regarding the sectors covered by the INVESTMED project; namely, green, blue and the Cultural and Creative Industries (CCI), despite the significant role they play in achieving the sustainable development goals (SDGs) and creating job opportunities, the most challenging barrier for entrepreneurs in these sectors across the three target countries, is access to finance (Challita, 2023). In a survey addressed to INVESTMED project sub-grantees, 75% of respondents state that financial support is crucial for their growth, 73% state that access to finance is a high impact barrier to company development, whilst only 29% receive good support from banks and financial intermediaries.

3 ASSESSMENT: OVERVIEW OF CGSS IN EGYPT, TUNISIA AND LEBANON

3.1 General Description

In the MENA region, there is one main guarantee scheme operating in each country, usually supported by the country's central bank¹. Specifically, these are the Credit Guarantee Company (CGC) operating in Egypt, SOTUGAR in Tunis and Kafalat in Lebanon. These schemes have been operational for more than two decades, with the main objective of facilitating access to finance for SMEs. Table 1 provides a general description of the main characteristics of CGSs in these countries.

¹ Except for Kafalat Lebanon that is owned by _____ and the National Institute for the Guarantee of Deposits

Table 2: General descriptions of CGSs

Guarantee Scheme	Country	Purpose	Inception year	Type of credit guarantee scheme (CGS):	CGS approach:	The main objectives of the CGS:
Credit Guarantee Company	Egypt	Profit	1989	Private	Hybrid - combination of portfolio and individual guarantees	Create the needed ecosystem favouring entrepreneurship & facilitating their access to finance through: 1) Apply innovative & dynamic guarantee products 2) Provide capacity building & technical assistance services 3) Function across an advanced platform
SOTUGAR	Tunisia	Non-profit	2003	Public	Hybrid - combination of portfolio and individual guarantees	Facilitate SME's access to financing - Share risk with the lender
Kafalat SAL	Lebanon	Profit	1999	Private	Individual - guarantees extended on a loan-by-loan basis	To assist small and medium sized enterprises (SMEs) in accessing commercial bank funding

Source: Authors' Survey

CGSs in these countries mainly deal with banks and extend guarantees, either on a loan-by-loan basis or as a portfolio that complies with certain pre-approved criteria. CGC Egypt offers programmes dedicated to micro enterprises and other programmes for small and medium enterprises. The majority of their portfolio is dedicated to industrial, agricultural and commercial sectors. Similarly, Kafalat in Lebanon offers a number of programmes for small and medium enterprises, with a special focus on innovation (startups), farming and energy. However, due to the current economic hardship faced by the country and the decreasing trust in the financial sector, many of these programmes have been suspended (from 2020). In an effort to preserve the private sector and reduce business closures and layoffs after the Port of Beirut explosion of August 4, 2020, Kafalat with the support of World Bank introduced “The Building Beirut Businesses Back and Better Fund (B5) Fund” to support the recovery of MSEs damaged by the explosion and to sustain the operations of eligible Microfinance Institutions

(MFIs) in the form of grants. SOTUGAR Tunisia also serves MSMEs and their top three sectors include agriculture & fishing, manufacturing, and technology, media and telecommunication.

All three CGSs support business startups (innovation) and provide special support to projects that contribute to achieving certain development goals or energy efficiency and cleaner production. Currently, none of the schemes have special products dedicated to green, blue and CCI sectors, which are the main focus of the INVESTMED project. However, CGC Egypt and SOTUGAR Tunisia state that one of their main areas of focus in the coming years is green finance.

3.2 The role of CGSs in enhancing access to finance for MSMEs

Credit guarantee schemes have emerged as a key tool, utilised by governments and development institutions to overcome challenges faced by MSMEs in accessing credit, including: high cost, limited supply, complicated application procedures and collateral requirements. CGSs mainly aim to reduce the credit risk of MSMEs, making their financing more available and affordable (by reducing risk premiums).

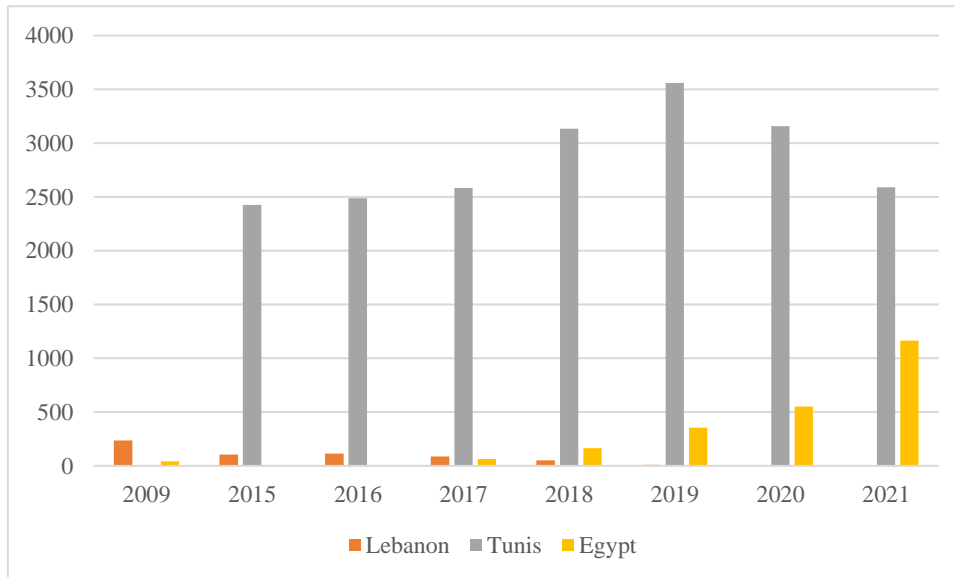
These schemes state that the estimated percentage of borrowers that would not have been able to receive a loan without a guarantee is not less than 70-80%, demonstrating their role as a risk transfer tool in facilitating SME access to finance. CGC and SOTUGAR do not set a cap for the collateral required by lenders, whilst Kafalat does. In both cases, having a guarantee helps reduce collateral requirements. Their rejection rates are very low, however. The reasons for rejecting an application include bad credit history, lack of financial figures, failure to comply with eligibility rules and non-tolerable legal risk.

In addition to collateral requirements, small companies also face the challenge of lack of transparency (which includes reporting financial figures) and understanding the application procedure. CGSs can also overcome these obstacles by offering training, technical assistance, or support activities targeting small companies. Currently, only CGC Egypt offers such support.

Moreover, CGSs play a key counter-cyclical role in times of crisis, for example, in the COVID-19 pandemic these schemes were essential in implementing government strategies in response to the crisis. Considerable public funds were allocated to these schemes to ensure continuity of finance for MSMEs and to stimulate economic recovery. CGSs in the region adopted a number of measures to enhance their role in the pandemic, including introducing special programmes with relaxed conditions, lowering their fees, increasing their coverage rate and accelerating their procedures.

These efforts and the subsequent enhanced strategies resulted in a significant growth in CGS portfolios in the region. Figure 2 shows that SOTUGAR Tunisia has the highest number of guarantees per million people, however, looking at the distribution by size of firm, more than 90% of their portfolio is directed to micro enterprises. CGC Egypt has grown significantly over the years, despite that fact that CGC is providing guarantees to all sizes of firm, the majority are directed to small companies. On the other hand, the number of Kafalat Lebanon guarantees has deteriorated over the past decade, due to the economic situation. In terms of volume, by the end of 2021, the outstanding guarantee portfolio for SOTUGAR Tunisia and CGC Egypt is \$180.7 million and \$7,591.7 million, respectively. CGC Egypt doubled its portfolio between 2020 and 2021. The reasons for SOTUGAR's and CGC's positive growth are mainly due to market demand and government policies, especially after COVID-19, as a policy response to curb the impact of the shock on the economy.

Figure 2: number of guarantees per million people - EMGN survey



However, the CGSs state that there are a number of constraints to their development. In Lebanon, the economic conditions are complex and the banking sector has collapsed, turning the country into a cash-based economy. This, in turn, has suspended Kafalat operations - except for grants from multinational institutions. In Egypt and Tunisia, the CGSs state that they face challenges related to low quality of loan applications and risk aversion or lack of interest from lending institutions. Additionally, the region suffers from a lack of awareness about the existence of credit guarantee schemes and how they operate, which combined with the banks' risk aversion, can be a significant obstacle to their growth and achieving their ultimate goal of enhancing access to finance for MSMEs, empowering and enabling them to create new jobs.

3.3 CGSs and digital solutions

The trend of implementing digital transformation strategies in the financial system including banks, guarantee schemes and other types of financial institutions, has implications on their business

models and outreach. Feyen et al. (2021) show that digital innovation has brought major benefits in connectivity of systems, cost and newly created usable data. Digital solutions have the potential to enhance CGS visibility, productivity and efficiency, which would ultimately enhance financial inclusion of MSMEs. Additionally, direct digital products can be more accessible for SMEs². As for the awareness issue, digital media can be adopted to promote the products and services provided by CGSs amongst financial institutions, MSMEs and industry associations.

Currently, CGC Egypt, SOTUGAR Tunisia and Kafalat Lebanon all have a digitalisation strategy. CGC Egypt started implementing its “Digital Transformation Strategy” in December 2021, with the main objectives of creating a digital-based business model, increasing the scalability of CGC platforms & marketplace, the application of data driven new products and providing a nationwide SME data provider, in order to enhance access to finance for SMEs. CGC introduced a new direct product, called “Engz”, with a fully-fledged digital base and direct MSME outreach. Currently, the guarantee processes whether there is individual or hybrid reliance on manual communication involving bank officers sending emails to CGC for inquiries or case submissions. However, the scheme is in the process of developing a digital portal, which can empower bank officers to seamlessly submit cases, streamlining the process. This would eventually expand their market presence and foster growth.

Kafalat Lebanon is more focused on digitising their business process management, in order to optimise process and procedure flows, reducing response time and increasing revenues. SOTUGAR Tunisia is also implementing digital methods aiming at: process acceleration, lowering paper use and reduction of treatment costs. The scheme is currently looking into digitising their analytical modelling, in order to better manage credit risk measures and align with regulations.

However, CGSs as with other financial institutions, face a number of challenges in their digital transformation, including managing their security and privacy risks, complexity of integration of legacy

² Direct digital products are provided by guarantee institutions in Europe, for example, the French guarantee <https://www.socama.com/>.

systems and new technology, lack of qualified personnel to manage the transformation, and the increased costs for equipment and services.

4 SUMMARY AND KEY RECOMMENDATIONS

CGS has been a key policy intervention tool in facilitating access to finance for SMEs, by sharing the risks associated with their lending and, in a way, providing substitute collateral. Hence, steadily improving the infrastructure for such tools and supporting their growth can contribute significantly to the financial inclusion of SMEs and, ultimately, to economic growth and job creation.

Utilising these tools can be limited by a number of factors, including lack of awareness amongst entrepreneurs and SMEs, lack of interest from financial institutions (mainly banks combined with risk aversion), in addition to limited products and services.

Based on the analysis provided in this policy paper, the following recommendations can be made:

i. Direct digital products

Currently CGSs in Egypt, Tunisia and Lebanon do not have a direct link with potential borrowers. i.e., MSMEs and entrepreneurs and they deal mainly with financial institutions (mostly banks). However, financial institutions may lack interest in using credit guarantee schemes, which may be related to risk aversion on their part, excessive administrative requirements, or unclear definitions of eligible clients. Direct products have the potential to solve this challenge, where the client applies to the CGS through a digital platform, the scheme studies and prepares a file for qualified and eligible borrowers to obtain bank loans and then, upon bank approval, the applicant is granted a loan with a guarantee. Such products have the potential to increase the outreach of guarantee schemes, with the ability to apply online - regardless of physical location - and to help overcome the issue of banks' lack of interest.

ii. Utilising digital technologies

Utilising digital solutions can increase CGSs revenues, as automated procedures help them serve more beneficiaries and applicants with the same number of human resources, increasing their productivity by analysis and reducing their cost by operation, which can result in more attractive pricing for the beneficiary. Digital solutions can also help CGSs build credit risk scoring models, enhance the quality of data and minimise operational risk by reducing errors. In addition, this can ease and accelerate the procedure of issuing guarantees.

iii. Scheme awareness programmes

A stronger awareness of credit guarantee schemes by different stakeholders including regulators, financial institutions, MSMEs and industry associations, is crucial for achieving their development goals. Our research shows that the knowledge of MSMEs and entrepreneurs of the existence and operations of such schemes is rather limited. Hence, adopting a multi-channel approach for creating awareness about guarantee schemes amongst stakeholders - mainly MSMEs - is key to increasing their outreach. This can be done through electronic media, in particular social media advertising, which can increase their visibility amongst younger generations, conducting workshops and seminars, and approaching business incubators.

iv. New products for green, blue, CCI

In order for CGSs to achieve their development goals, they need to be innovative and inclusive in their products and services. CGSs in Egypt, Tunisia and Lebanon do not currently have special products dedicated to green, blue and CCI sectors, which are considered key sectors for accelerating the green transition. Given the current challenges facing these countries, in terms of climate change, resource depletion, pollution and overexploitation of marine resources, supporting green and blue sectors is of utmost importance (Ayadi & Forouheshfar, 2023). CCI is also considered a high potential strategic sector that can boost creativity, innovation and social development (Challita, 2023). However, access to finance is a major challenge for these sectors that can play a significant role in achieving sustainable development goals and job creation. Hence, CGSs can introduce special products to target

these sectors with favourable conditions including higher coverage, lower fees and accelerated procedures.

v. Capacity building

From the demand side, MSMEs face a number of obstacles to accessing finance, including lack of transparency, unclear financial projection and lack of skills, which can lead to the rejection of their loan or guarantee application. CGSs can engage in advisory, training, technical assistance or other support activities targeting smaller companies. This can be done in partnership with SME support organisations aimed at strengthening, for example, their accounting, management and marketing skills, so that they can be better positioned to successfully apply for a guarantee or a loan.

vi. Introduction of a targeted counter guarantee scheme

Counter guarantees are a form of reinsurance or a risk management tool, in which the guarantor provides protection to CGSs against the losses incurred from extending guarantees to lenders. This risk mitigation tool can foster the credibility and outreach of CGSs, providing them with a leverage effect, which allows further extending of guarantees. Southern Mediterranean countries have not yet established such schemes. Hence, it is recommended to consider the setting up of a regional counter guarantee scheme, with a dedicated and focused sustainable development mandate, to create a meaningful economic impact and enhance access to finance for sustainable MSMEs.

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ABOUT INVESTMED

Mediterranean MSMEs face important challenges in terms of competitiveness, sustainability, internationalization and capacity to innovate while urgent measures are needed to tackle common environmental challenges and untap the potential of both natural and cultural heritage to contribute to sustainable growth and economic development. Against this backdrop, the INVESTMED project aims at addressing both economic and environmental challenges, by supporting new, sustainable business opportunities for young people and women in three Mediterranean Partner Countries: Egypt, Lebanon and Tunisia.

The INVESTMED Project (InNoVative Sustainable sTart-ups for the MEDiterranean) is co-funded by the European Union under the ENI CBC Mediterranean Sea Basin Programme 2014-2020. INVESTMED has a duration of 30 months, with a total budget of €3.8 Million, of which €3.4 Million (90%) is funded by ENI CBC MED. It has 8 partners from Tunisia, Spain, Lebanon, Greece, Egypt, and Italy:

- Union of Mediterranean Confederations of Enterprises, BUSINESSMED (TU)
- Euro-Mediterranean Economists Association, EMEA (ES)
- European Institute of the Mediterranean, IEMed (ES)
- Beyond Group / Irada Group S.A.L, BRD (LE)
- Institute of Entrepreneurship Development, IED (GR)
- Libera Università Maria SS. Assunta, LUMSA (IT)
- Confederation of Egyptian European Business Associations, CEEBA (EG)
- Spanish Chamber of Commerce, CCE (ES)

INVESTMED will have an impact on MSMEs, start-ups and recently established enterprises where staff will be trained and coached to become more sustainable and competitive and financially supported via an open competition. Specific business incubation services will also be established for sustainable start-ups as well while relevant public authorities will benefit from capacity building and exchange of best practices to facilitate access and protect IPR for MSMEs.

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