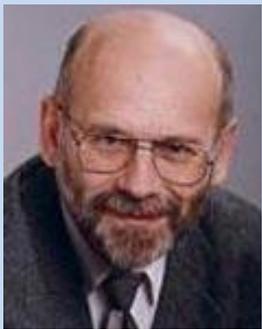


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Economic Development, Trade and Investment in Southern and Eastern Mediterranean Countries:

An Agenda towards a Sustainable Transition

No. 5 April 2013

1. Introduction

The average GDP per-capita in southern and eastern Mediterranean countries (SEMCs)¹ is below the world's average and in 2010 ranged from a high of nearly \$30,000 for Israel to less than \$5,000 in Morocco. The pace of economic growth in the SEMCs was not particularly impressive for quite a long time, especially in the 1980s and early 1990s, when several countries recorded either a decline or stagnation of output (related to low oil and commodity prices, among other reasons). A visible improvement came only in the decade of the 2000s, but it did not fully compensate for previous poor performance and differed across countries. Those countries that pursued reforms – such as Jordan, Morocco and Tunisia – recorded higher growth of GDP per capita than the regional average. They benefited from sounder monetary and fiscal policies that contributed to declining rates of inflation, narrowing fiscal deficits and falling public debt-to-GDP levels.

¹ SEMCs refers to the group of 11 countries of the southern and eastern Mediterranean region (Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestinian Authority, Syria, Tunisia and Turkey) that are the subject of research conducted under the FP7 MEDPRO project.



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Per-capita income growth was tempered by high population growth (more than 2% annually) compared with the annual rate of 1.2-1.3% for the entire world. The growth performance of the region was not sufficient to reduce unemployment, which is in excess of 10% in most countries, with even higher rates for female workers. Youth unemployment at 25% or more is the highest rate worldwide as recorded by the International Labor Organization.² Emigration is high and labour migrant remittances contributed to strengthening the external positions of several SEMCs, particularly Lebanon, Jordan and the Palestinian Autonomy and, to a lesser extent, Morocco, Tunisia and Egypt. The prospects for economic growth by the major hydrocarbon producers (Libya, Algeria and, to a lesser degree, Syria), remain highly dependent on oil and natural gas prices.

Persistent high unemployment, growing income disparities, an unequal playing field in business, corruption and nepotism, poor governance, the conspicuous consumption of a small elite, and the lack of a political voice have led to broad discontent, as seen in the revolutionary events of the Arab spring in 2011-12. It is too early to assess their impact on long-term economic policies and growth performance. In the short term, the political turbulence caused a lot of damage in growth performance and macroeconomic stability. Political instability also produced populist policy decisions. For example, the phasing-out of subsidies has been reversed in some countries as social unrest has put pressure on governments to offset the impact of surging global food and fuel prices, putting strains on the fiscal balances.

The World Bank's review of the experience of countries that managed a successful transition to democracy suggests that even though growth declined by about 3% during transition, it recovered to the pre-transition rate within two years. Investment took about five years to recover (World Bank, 2011, p. 2). This suggests that the dip in regional growth rates being experienced can be temporary and that with the right policies in place the long-term growth trend can be resumed.

² See "Youth unemployment getting even worse", ILO, 4 September 2012 (http://www.ilo.org/global/about-the-ilo/newsroom/news/WCMS_188797/lang-en/index.htm).



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This policy paper spells out the policy recommendations that emerge from a series of detailed studies undertaken for MEDPRO Work Package 5 on “Economic development, trade and investment”. Below we discuss recommendations for the SEMCs and the EU in the areas of macroeconomic management, trade, investment, private sector development and privatisation, and sectoral policies.

2. Policy recommendations for the SEMCs

2.1 Maintaining fiscal stability

The analysis of Coutinho (2012) confirms that macroeconomic stability as measured by inflation and budget deficits, openness to trade, investment and foreign direct investment (FDI, for which a good business climate and predictable macroeconomic environment are essential), a developed financial market and good infrastructure help economic growth. In addition, education in an environment of good governance is also favourable to economic growth (De Wulf et al., 2010). These findings suggest the recommendations below in the area of fiscal policy.

2.1.1 Careful public-expenditure policies

Expenditure growth should be contained and targeted at budget objectives that are clearly defined. This requires a continuous expenditure review that involves the detailed analysis of those policies that have the biggest impact on the total spending bill. In particular, the reduction of price subsidies and rationalisation of public employment are the two priority measures that may reduce fiscal imbalances in the SEMCs.

Although alleviation of poverty remains a major and legitimate policy objective, it too often serves as a justification for substantial price subsidies for food, electricity and fuel. These subsidies create a large fiscal burden for several SEMCs, especially in Egypt (over 10% of GDP), Algeria and Lebanon, and have increased in some of them in the wake of the Arab spring. Yet, the higher- and middle-income groups are major beneficiaries of these subsidies. In addition, they have devastating microeconomic and structural impacts: discouraging the producers of subsidised products (agricultural



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products and energy) from increasing their output and quality parameters, stimulating excessive and wasteful consumption, damaging the environment, hampering development of renewable energy, etc. (see Bergasse, 2013 for an analysis of energy subsidies).

There are some countries in the region (for example Iran, Jordan and Turkey) that have gradually removed most of their price subsidies. Price subsidies should be replaced by better-targeted social safety nets, including specifically focused cash transfers. Countries that postponed or reversed respective reforms in this sphere should reconsider them again as one of the priority measures.

Increasing job creation in the public sector, which serves as the social policy tool in several SEMCs, should be replaced by policies that emphasise job creation in the private sector (this requires labour market reform and business climate improvement – see below). The present policies create a heavy fiscal burden and tend to keep wages low, which undermines the recruitment of the best candidates to public service and therefore undermines the efficiency of service delivery.

2.1.2 Promote active revenue policies

Fiscal policies should take into account that revenues from foreign trade have already been eroded and will continue to do so as result of trade liberalisation. They should be replaced by less distortive taxes, preferably by broad-based VAT or sales taxes. Income distribution considerations that would favour greater reliance on income taxes – personal and corporate – should be carefully weighed against their distortive effects, which tend to negatively affect economic growth (see De Wulf et al., 2009).

2.1.3 Strict coordination between monetary and fiscal policies

Budget deficits should be contained and financed in a non-inflationary manner. This means further development of domestic treasury bond markets and refraining from monetary financing by central banks. Improvements in the coordination between fiscal and monetary policy that the region experienced in the decade of the 2000s should be continued.



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2.2 Attracting more and better FDI

FDI is usually an important conveyer of technological innovation and management changes – it connects the new production centres to the world market, has important backward linkages to the local economy and thus fosters growth beyond the FDI-financed economic activity and, not least of all, adds to the local savings available for investment (see Sekkat, 2012). In the period 1995–2000, the SEMCs scored one of the lowest ratios of FDI flows to GDP (1.11%) compared with other regions in the world. By 2005–09, this had changed and the region exhibited one of the highest ratios (4.19% of GDP), just behind Europe and Central Asia (4.53%) and the EU (4.65%), and far ahead of the other regions. Since the Arab spring, FDI flows have fallen off sharply, leading to the following recommendations:

- Maintain an open economy that welcomes investors, especially in high growth and employment-generating sectors. Capital account openness matters too, as it permits investors the unrestricted transfer of profits.
- Maintain an exchange rate regime that ensures continual competitiveness and smooth exchange rate adjustments if domestic inflation rates exceed those of competitors and countries that are the destinations of exports.
- Improve infrastructure, which helps to reduce production costs.
- Good governance – in all its dimensions – matters, as in its absence investors will require higher rates of return to compensate for the cost of a poor business climate.
- Invest in human resources so that employers can find the workers who are able to take on jobs created by modern manufacturing.
- Be very careful in extending tax advantages to investors, as these have not been shown to positively affect the inward flow of FDI. Ensuring a favourable investment climate is much more important than granting tax privileges. Investors are more interested in generating decent profits than paying lower taxes on small profits.



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2.3 Deepen Euro-Mediterranean economic integration

Trade plays a crucial role in most of the economies analysed, which are relatively small (apart from Turkey, whose economy can be considered medium-sized) and often heavily dependent on energy and other commodity exports. Their relative under-industrialisation and the continually high share of agricultural production in GDP make their modernisation prospects dependent on free imports, robust exports and investment openness. While the openness of the SEMCs has improved considerably it is still significantly below potential. The trade flows of the SEMCs, except Jordan and the Palestinian Autonomy, are concentrated on the EU. Intra-SEMC trade is rather limited.

The analysis undertaken by Ghoneim et al. (2012) identifies measures that would further boost the openness of the SEMCs, with a positive impact on their external competitiveness, balance of payments and job creation. These include removing tariffs, reducing trade-restricting non-tariff barriers (NTBs), decreasing high transport costs and improving uncompetitive trade logistics. Trade in services also faces serious restrictions, the removal of which could lead to considerable trade expansion.

Despite the tariff-reducing implications of multilateral trade negotiations under the aegis of the World Trade Organization (WTO) and gradual implementation of the Euro-Mediterranean Association Agreements, import tariffs in several SEMCs still constitute a significant barrier to imports, particularly of agricultural products. Israel and Turkey have basically abolished tariffs on their imports from the EU, but in Algeria, Egypt, Tunisia and Syria, their average level still exceeds 10% (as of 2009). Exports of manufactured products from the

SEMCs to the EU and to signatories of Association Agreements no longer face any tariffs. Tariffs on agricultural products are higher than those for manufactured products. Under the Greater Arab Free Trade Area (GAFTA) agreement, tariffs on intra-SEMC trade have been largely abolished.

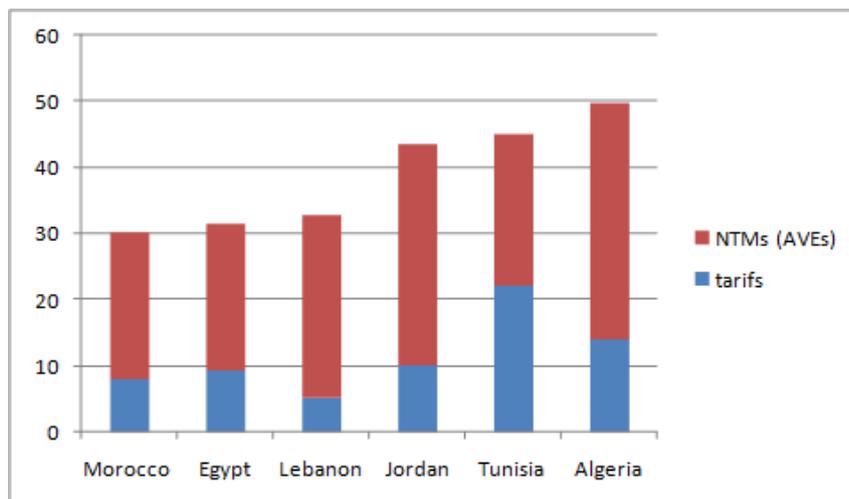
NTBs are the procedures that hamper trade, in addition to those that intend to achieve legitimate sanitary and other objectives. They can be summarised as follows:

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- *Technical standards.* There is no system of mutual recognition of conformity assessments issued by the exporting country. Despite progress made so far, there are still major problems with labelling and packaging requirements, testing procedures and their results, the performance of testing laboratories that struggle with inadequate equipment and poorly trained staff, poor market surveillance systems and the decision on which standards to choose for all traded products.
- *Sanitary and phytosanitary measures (SPS).* The harmonisation of SPS measures still has a long way to go, despite progress in some countries.
- *Customs procedures.* Inefficient customs procedures result in a long and costly clearance process at customs. Failure to make the best use of information technology, redundant clearance procedures, the absence of post-clearance audits, and cumbersome and excessive inspection practices are among the factors responsible for this poor performance.
- *Protection of intellectual property rights.* While the legislation is mostly in place, enforcement lags seriously.
- *Competition and government procurement.* Legislation to enforce competition and government procurement is still in its infancy in most SEMCs.

Estimates by Ghoneim et al. (2012) of the tariff *ad valorem* equivalents (AVEs) of the NTBs (see Figure 1) suggest that they are consistently higher than the tariffs themselves. Given the nature of NTBs, they are more difficult to remove, as they require major institutional reforms and institution building whereas the reduction of tariffs, while difficult to negotiate, can be easily implemented.

Figure 1. Overall trade protection in selected SEMCs: Tariffs and NTBs (%)



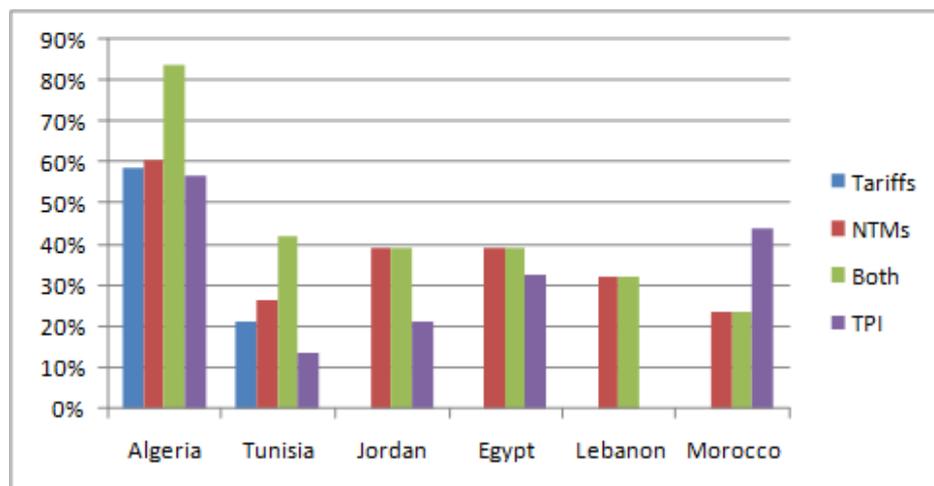
Source: Ghoneim et al. (2012), Annex 3.

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Average transport costs in the SEMCs exceed those of European countries by about 16%, being lowest in Egypt and Israel and highest in Algeria. Trade logistics in most countries in the region are significantly more costly than in many other regions of the world, particularly in the EU. According to the World Bank Trade Logistics Indicator (TLI),³ Israel, Lebanon and Turkey rank rather well, while other countries lag significantly behind, especially Algeria and Libya.

If all tariffs were abolished, NTBs removed and TLI substantially improved, trade would expand substantially (see Figures 2 and 3), more so for those countries whose initial trade restrictions were greater. SEMC exports to the EU would increase less than their own imports, because the EU's initial level of tariffs was practically zero and its TLI much better compared with the SEMCs. Any scenario that assumes slower removal of trade impediments offers less trade expansion.

*Figure 2. Change in SEMC imports from the EU (optimistic scenarios)
(%)*

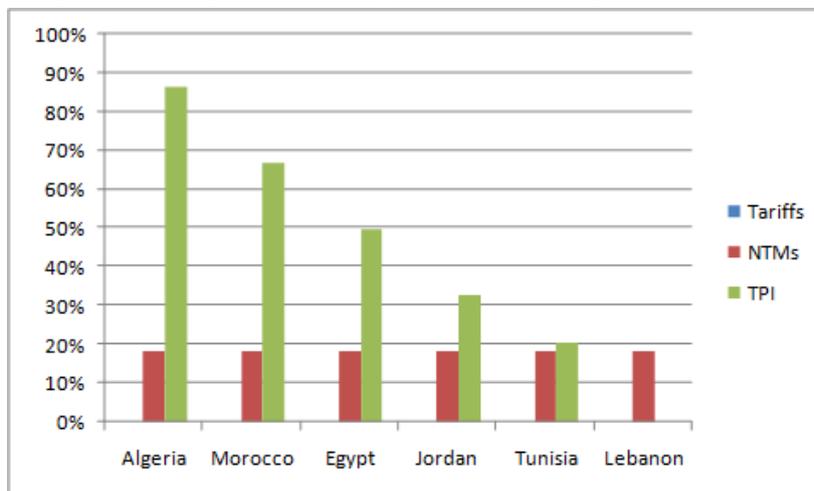


Source: Ghoneim et al. (2012).

³ The TLI is a weighted average of the efficiency of clearance procedures by customs and other border agencies, the quality of transport and information technology infrastructure for logistics, ease of arranging international shipments, competence of the local logistics industry, ability to trace and check international shipments, domestic logistics costs and timeliness of shipments reaching their destination.

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Figure 3. Change in SEMC exports to the EU (optimistic scenarios) (%)



Estimations by Ghoneim et al. (2012) suggest similar conclusions for intra-SEMC trade. In most cases (with the exception of Algeria), tariffs have already been removed under the GAFTA process, so there is little room for further improvement. On the other hand, the removal of NTBs could bring trade expansion by circa 35%. Improvements in TLI would also lead to significant import and export increases, especially in Algeria due to its poor logistics performance.

In view of these benefits, the SEMCs and their economic partners (in the first instance, the EU) should continue the policy of removing the remaining tariffs. They should also identify the most harmful NTBs for the key exports and imports and set up a strategy to ease their trade-constraining effects. Building a domestic consensus and mobilising external resources for the removal of NTBs can speed up this process. Adopting a comprehensive programme of improving TLI could also generate substantial trade gains.

2.4 Develop the private sector and continue privatisation

In spite of several policy reforms in the decade of the 2000s, most SEMCs, except for Israel and Tunisia (the latter before the Arab spring), suffer from a poor business and investment climate. This has been documented in the annual *Doing Business* reports published by the World Bank, and other international surveys and ratings, such as the Heritage Foundation Index of Economic Freedom and Transparency International's Corruption



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Perception Index. The World Bank study conducted before the Arab spring (World Bank, 2009) gives credit for legislative reforms in several SEMCs, but at the same time underlines weak institutional frameworks and arbitrariness in their implementation, i.e. bureaucratic discretion, corruption and unequal treatment of investors (World Bank, 2009, p. 79 ff).

Credit is the lifeline of private sector development. Yet empirical studies (e.g. Anzoategui et al., 2010) suggest that the banking sector in the SEMCs suffers from a low degree of competition compared with other regions, as a result of excessive restrictions on entry into the sector and the relatively high share of state-owned banks. The dominant role of state-owned banks gives them great discretion in credit allocation, to the advantage well-connected and well-established enterprises (see Ayadi et al., 2013a). Coupled with the lack of independent supervision of the financial sector this situation hampers private sector growth see Ayadi et al., 2013b).

All the SEMCs have ongoing privatisation programmes (see Woodward & Safavi, 2012). Some of them began in the 1980s as an element of policies departing from their countries' socialist/statist past. Others are only in the early stages of implementation or are stalled for a variety of reasons. In comparison with other regions, privatisation performance in the SEMCs looks very modest. The regulatory framework for privatisation needs strengthening.

The set of concrete measures to support private business should include, among others, the following:

- mapping out the country-specific legal and regulatory constraints that impede private sector development, according to the categories used in the World Bank's *Doing Business* reports (which have proven to be very effective in focusing the minds of business leaders and policy-makers);
- preparing strategies to tackle the identified impediments to a favourable business and investment climate; building a consensus between government and representatives of the business community on these strategies and making them public;
- focusing on implementation, notably creating an implementation mechanism for the adopted strategies and public monitoring of their progress (or lack of progress);



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- credibly reforming the governance of the remaining state-owned banks and their privatisation; and
- fostering competition in the banking sector by reducing the barriers to entry and improving banking supervision.

2.5 Selected sector analyses and recommendations

Some sectors of the SEMC economies are of key importance for economic development, trade and employment creation, generating foreign exchange revenue and prospects for modernisation. Our analysis has concentrated on five of them, namely transport infrastructure, information and communication technologies (ICT), tourism, the textile industry and agriculture.

2.5.1 Transport infrastructure

The SEMCs lag behind other middle-income countries in terms of the available transport infrastructure (see Carruthers, 2013), which hampers trade and economic growth in the region. Efforts should be made to bridge this gap. The budget allocation for the next several decades should fund a reasonable programme of catching up in this sphere. Domestic resources should be supplemented with external resources.

2.5.2 Information and communication technologies

The SEMCs, on average, lag behind other regions in terms of the telecommunications infrastructure, especially in the density of fixed telephone lines, partly due to the continuous domination of state-owned monopolies (Abbassi, 2011). The situation with mobile telephony looks better and improves systematically, largely because of the opening of this subsector to private sector operators. To ensure further rapid development of the ICT sector in the SEMCs and their catching-up with other middle-income countries, the policy focus must be placed on these areas:

- privatising fixed-line telephony, which is very important for business development and could support the nascent telework business;
- improving the business environment for private sector development; and
- strengthening the regulatory framework to avoid anti-competitive practices.



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2.5.3 Tourism

This sector is very important in several SEMCs in terms of its contribution to GDP and employment, particularly in Egypt, Jordan, Lebanon, Morocco and Tunisia, but also in Israel and Turkey even if their economies are more diversified (see Lanquar, 2011 and 2012). In the 1990s and 2000s, the SEMCs recorded the highest growth rates in inbound world tourism, while domestic tourism also increased rapidly. This trend came to an abrupt halt in early 2011 during the Arab spring, but seemed to resume in 2012 despite the economic slowdown in the EU, its main market. To ensure further development of this sector, future policies should focus on the following aspects:

- a more propitious climate for private sector operations, in particular better access to financial resources for small and medium-sized enterprises;
- greater reliance on Internet services, which would enable local entrepreneurs to retain a larger share of tourist revenues (by elimination of intermediaries from developed countries);
- the impact of climate changes that will affect some segments of the sector and need to be addressed in advance; and
- continuity in government support and greater private sector participation in public promotion activities.

2.5.4 Textile sector

Textile production and textile exports play an important role in six economies (Tunisia, Morocco, Turkey, Jordan, Egypt and Syria). There are important differences, however, in the position of the countries in the value chain and their dependence on specific trading partners (see Haberl, 2012). While Egypt and Syria, the traditional cotton producers, export over 20% of raw textiles, Jordan, Morocco and Tunisia seem to operate higher up the value chain with only 2-3% and Turkey with 9% of raw textile exports. The expiration of the WTO Multi-Fibre Arrangement in 2005 eliminated the export quotas on Asian low-cost producers and exposed the SEMCs to greater competition. To overcome these challenges, the region should

- improve the business environment for the private sector, which could help to attract more FDI;



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- move up the value-added ladder, which is the only solution for the sector to survive against lower wage-cost Asian competitors;
- but bear in mind that moving up the value-added chain will require serious improvement in the technical education system.

2.5.5 Agriculture

Agriculture is another sector of key importance in the SEMCs, except in Israel and Jordan (see Belghazi, 2013). Yet, it suffers from low productivity (only slightly improved in the 1990s and 2000s) underpinned by largely conservative agricultural policies based on import tariff protection and government subsidies. Food self-sufficiency rather than food security is still an argument that influences agricultural policies in the region. The vulnerability of the sector to fluctuations in rainfall, and more generally climate changes, create an additional challenge.

The sector can contribute more to future growth if the following policies are implemented:

- negotiations with the EU (the most important partner in SEMC agricultural trade) do successfully open the EU market to SEMC exports by eliminating tariffs and import quotas;
- irrigation policies are continued with due respect to the regional water scarcity;
- agricultural policies focus more on food security and less on food self-sufficiency; and

food subsidies are gradually eliminated so as to avoid distorting producer and consumer incentives.

3. EU policies to promote growth in the SEMCs

As the large and economically more developed neighbour as well as the key trade and investment partner, the EU (and its member states) could contribute, in various ways, to economic and social development along with modernisation in the SEMCs. The EU's support for the region could involve the areas discussed below.

3.1 Macroeconomic policy

The EU could continue assisting the SEMCs by extending budget support to the region to implement sound fiscal and monetary policies (including the programme of phasing out food and



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energy subsidies). It could also provide technical assistance (TA) to help implement good policies. Areas where such TA may be most productive include resource mobilisation (revenue policies), the design of expenditure reviews and the elaboration of sector strategies to increase the effectiveness and efficiency of

budget expenditures, introducing targeted social-assistance schemes for the poor to replace the inefficient system of consumer subsidies.

3.2 Euro-Mediterranean economic integration

The EU could promote Euro-Mediterranean economic integration in a number of ways (see Ghoneim et al., 2011, Annex 2 for details):

- eliminate or reduce EU import tariffs (increase tariff rate quotas) for agricultural products from the SEMCs;
- open the EU market for importing services from the SEMCs, while urging them to take similar measures with respect to importing services from the EU and eliminating the remaining restrictions to foreign investment;
- provide TA and investment support to the SEMCs in the areas of i) harmonising their technical standards and SPS with international norms (which will require extensive training, strengthening laboratories, etc.), ii) improving customs and other related procedures to reduce border-crossing costs, iii) protecting intellectual property rights and iv) improving competition policies and government procurement;
- move towards a customs union with the SEMCs, while avoiding the asymmetry that characterises the EU-Turkey Customs Union (entailing the free access of countries that have a free trade agreement with the EU to the Turkish market without granting Turkey duty free access to the markets in those countries);

The support that the EU and other donors (such as the World Bank) have provided to Turkey in joining the Customs Union with the EU can serve as an example of what can be done, how much this might cost and what are the conditions under which such support can be effective and efficient;

- assist in improving trade logistics in the SEMCs through TA and financial support; and



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- gradually increase labour migration opportunities for certain categories of SEMC residents.

3.3 Private sector development and privatisation

In the area of private sector development and privatisation, the EU could provide TA to improve the business climate, especially for SMEs and high-growth sectors, and implement regulations that support privatisation processes and ensure a competitive environment.

3.4 Infrastructure

In the area of transport, telecommunication and energy infrastructure, the EU (along with other international donors, such as the World Bank) could support (financially and through TA) both national and regional projects to close the existing gap between the SEMCs and comparator countries, and facilitate regional trade, investment, the movement of people (including tourism), etc.

3.5 Agriculture

Apart from opening the EU market for agricultural products and assisting countries to adhere to international SPS (see above), the EU could support energy-efficient and environmentally friendly irrigation policies and other measures to increase the productivity of this sector.

4. Conclusions

This paper suggests a number of policy measures that could support the future economic and social development of the SEMCs. These recommendations are based on the analysis of data from before the Arab spring. We believe they remain valid since the Arab spring, regardless of how much time will be required to stabilise the post-revolutionary situation in individual countries. Furthermore, their implementation seems to be even more urgent now if growth is to be resumed and unemployment reduced. Studies of countries that have gone through political transitions suggest that they can return to a growth trajectory in a few years if the right policies are undertaken.

For the SEMCs, the ambition should be to build on and improve their growth record from before the Arab spring. The support of



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the EU and other development partners will be crucial in attaining this objective. Still, lessons drawn from several decades of development assistance teach us that such aid cannot be productive if provided in a domestic policy and institutional vacuum. It needs to be supported by domestic demand for reforms and initiatives (country ownership of the reform programme). Domestic stakeholders, including civil society, will need to be convinced that the changes required (some of which, like the elimination of consumer subsidies, can be seen as highly unpopular and politically difficult) are in the country's own interest and will, in the end, contribute to a better future. Their adherence to such a policy package within a democratic context is needed, while outside advice has its obvious limits. But once changes are decided domestically, external support may be crucial in achieving the desired objectives.

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Disclaimer

This paper was first produced in the context of the MEDPRO (Mediterranean Prospects) initiative, a three-year project funded under the Socio-economic Sciences & Humanities Programme of DG Research of the European Commission's Seventh Framework Research Programme.

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