

# CASE Network Reports

## Economic Development, Trade and Investment in the Eastern and Southern Mediterranean Region

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## **Abstract**

Despite its many advantages, the Eastern and Southern Mediterranean region remains relatively backward in economic and social terms and is rightly considered a potential source of social and political instability. Its average GDP per capita lags behind the global average and is increasing slowly due to weak economic policies, poor governance and rapid population growth. The region suffers from high unemployment (especially among women and youth), poor education, high levels of income inequality, gender discrimination, underdeveloped infrastructure, continuous trade protectionism, and a poor business climate. To overcome these development obstacles, MED countries should conduct comprehensive reforms of their economic, social and political systems with the aim of ensuring macroeconomic stability, increasing trade and investment openness, improving the business climate and governance system, and upgrading infrastructure and human capital.

The main economic and political partners of the MED countries, especially the EU, can actively support this modernization agenda through liberalizing trade in some sensitive sectors (like agriculture and services), adopting a more flexible approach to MED labor migration, and cooperating in mitigating climate changes, improving educational outcomes, and promoting science and culture. This will require renewed initiatives with dedicated technical assistance and continued and enhanced financial assistance, particularly to improve infrastructure. There is also a lot of room for improvement in intra-MED cooperation but this requires resolving the protracted political conflicts in the region and taking bolder steps to remove trade and investment barriers.

# Introduction

The purpose of this report is to provide an overview of economic challenges and prospective scenarios faced by a group of 11 countries located in the Eastern and Southern Mediterranean region (MED11). This group includes the 10 countries of the Middle East and North Africa participating in the Barcelona process and the European Neighborhood Policy, identified in many documents and analyses as the ‘Southern Mediterranean’ neighbors of the EU (Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestinian Autonomy, Syria, and Tunisia) plus Turkey, an EU candidate country and an important economic and political player in this region.

The report summarizes the major streams of research work undertaken within Work Package 5 (WP5) on ‘Economic development, trade and investment’ of the ‘Prospective Analysis for the Mediterranean Region (MEDPRO),’ a collaborative project funded under the European Union (EU)’s Seventh Framework Program and conducted by a consortium of 17 institutes led by the Center for European Policy Studies (CEPS) between March 1, 2010 and February 28, 2013 (Grant Agreement No. 244578).

The report concentrates on analytical findings and a discussion of potential prospective scenarios and less soon detailed policy recommendations which are the subject of another publication within the same project (see Dabrowski & De Wulf, 2012).

The report’s structure follows major research topics and tasks undertaken within WP5 of the MEDPRO project. Section 2 briefly presents the economic situation in the MED11 and the region’s role in the global economy and then analyzes key macroeconomic challenges such as growth, inflation and fiscal imbalances. Section 3 focuses on trade flows between MED11 countries and the EU and on intra-regional trade as well as on the factors and mechanisms which could facilitate further trade expansion in both dimensions. Section 4 addresses the issues of private sector development, business and investment climate and foreign direct investment (FDI). Section 5 provides an overview of privatization policies in the region. Section 6 reports on the key findings of a few sectors that are particularly important for MED11 economies: transportation and ICT infrastructure, tourism, agriculture and the textile industry. Section 7 provides a brief overview of the

social factors and policies which are crucial for economic development in the analyzed region. Section 8 offers a summary and conclusions.

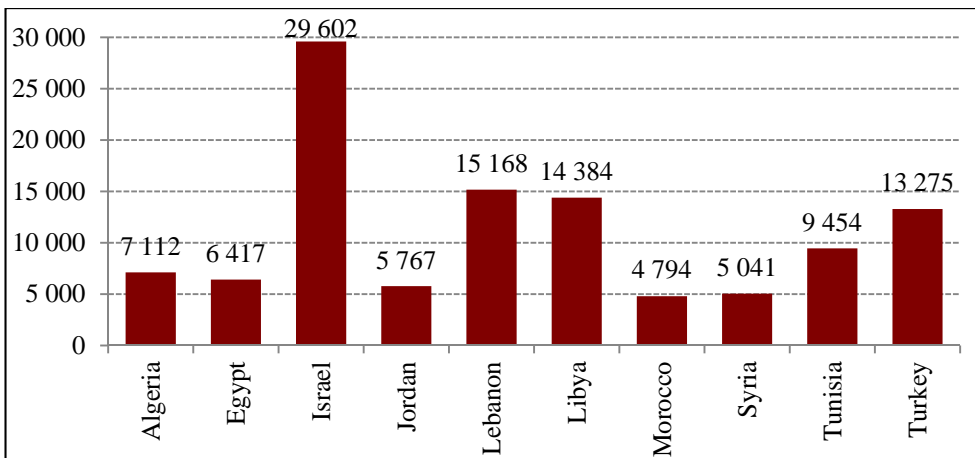
Our report draws extensively from more than 10 reports and papers prepared within WP5 as well as from a few other studies prepared within other work packages of the MEDPRO project. We have also benefited directly and indirectly (via the mentioned background reports and papers) from other studies and data sources, including those published by the World Bank, IMF, UNCTAD, UNDP, OECD, and many other institutions. However, the authors of this paper accept sole responsibility for the content and quality of this report. The opinions and conclusions presented can be attributed exclusively to the authors and not to any institution they have been associated with or any source they have used in this paper. Private sector development.

# 1. Economic Growth and Macroeconomic Challenges

## 1.1. The Economic Status of the MED11 Region

The total population of the MED11 group of countries amounted to 274 million in 2010, i.e. ca. 4% of the world total population, according to the IMF World Economic Outlook database. However, in terms of the share in global GDP, the region's contribution is lower: it amounts to only 3.3%, 1.3% of which is accounted for by Turkey. This means that the region's GDP per capita level is below the global average.

**Figure 1. MED11: GDP per capita, current international dollars, in PPP terms, 2010**



*Note.* Data on the Palestinian Autonomy is not available.

*Source:* IMF WEO database, April 2012.

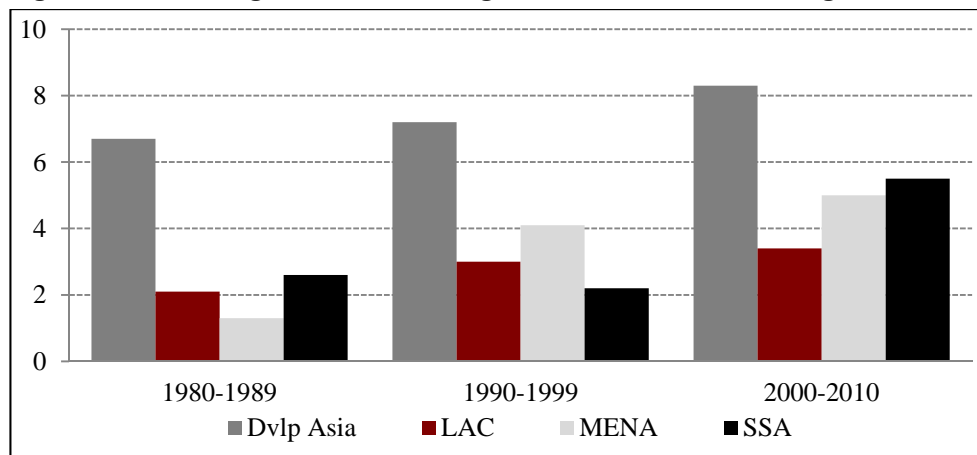
Figure 1 confirms this finding. Israel, with its GDP per capita level (in PPP terms) close to 30,000 USD, is the only country that belongs to the high-income group according to the World Bank classification. Six countries (Algeria, Jordan, Lebanon, Libya, Tunisia, and Turkey) are part of the upper-middle income category.

ry, and the three remaining countries (Egypt, Morocco and Syria) are lower-middle income economies.<sup>1</sup>

## 1.2. Overview of Economic Growth Record

As analyzed by Couthino (2012) and presented in Figure 2,<sup>2</sup> the pace of economic growth in this region was not particularly impressive for quite a long time (especially in the 1980s) compared to other developing regions.

**Figure 2. Real GDP growth in selected regions, 1980-2010, annual average, in %**



*Note.* LAC – Latin America and Caribbean, MENA – Middle East and North Africa, SSA – Sub-Saharan Africa.

*Source:* IMF WEO database, April 2012.

In the 1970s, the MEDregion greatly benefited from the oil price boom, through a sharp increase in exports and investments in oil-producing countries such as Algeria, Libya and, to a lesser extent, Egypt, Syria, and Tunisia. These gains spilled over to their neighbors through significant increases in worker remit-

<sup>1</sup>See [http://data.worldbank.org/about/country-classifications/country-and-lending-groups#High\\_income](http://data.worldbank.org/about/country-classifications/country-and-lending-groups#High_income).

<sup>2</sup> Figure 2 contains data for the Middle East and North Africa (MENA) region, which covers eight economies analyzed in the MEDPRO project (all but Israel, Palestinian Autonomy and Turkey) plus six Gulf states, Yemen, Iraq, Iran, Djibouti, Sudan and Mauritania. Thus it can provide only a very rough estimate of the historical growth record of the MED11 group.

tances, trade, and capital flows. However, a substantial part of these windfall gains were misused for pursuing expensive and inefficient import-substitution strategies, prestige infrastructure investment projects, and populist social policies involving, among others, huge price subsidies.

The economic model which dominated in several Arab countries in the 1960s and 1970s, especially in Algeria, Egypt, Libya, Syria and Iraq and, to a lesser extent in Tunisia, and was sometimes referred to as Arab socialism, relied heavily on public ownership, administrative interference in market forces, central planning, the militarization of the economy and trade protectionism (Dabrowski, 2012; MENA, 2004a). Israel also followed a kind of ‘socialist’ economic model at that time, with a large share of public and collective ownership, and heavy government regulation.

When oil prices collapsed in the mid-1980s, the region had to accommodate to this adverse shock. The deterioration in external economic conditions and poor economic performance became a catalyst for economic reforms in a number of countries (Abed & Davoodi, 2003): the beginning of trade liberalization, incentives to FDI, increased exchange rate flexibility (and the elimination of multiple exchange rate regimes), and a range of fiscal reforms spanning from tax and benefits reforms (e.g. the introduction of value-added taxes and a partial phasing out of food and energy subsidies) to the reform of public expenditure management.

Countries such as Egypt, Jordan, Morocco, Tunisia, and Turkey that pursued reforms subsequently reported relatively high rates of per capita GDP growth. However, if one takes into account the continuous high rate of population growth (over 2% annually – see Section 7.1), the growth rates recorded in the last decade (Table 1) allow for only a moderate improvement in GDP per capita level. Furthermore, they were volatile and suffered both from the global financial crisis in 2008-2009 and the Arab Spring (see Section 2.4).

**Table 1. MED11 countries: annual growth rates, 2001-2011**

Country	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Algeria	2.7	4.7	6.9	5.2	5.1	2.0	3.0	2.4	2.4	3.3	2.4
Egypt	3.5	3.2	3.2	4.1	4.5	6.8	7.1	7.2	4.7	5.1	1.8
Israel	-0.2	-0.6	1.5	4.8	4.9	5.6	5.5	4.0	0.8	5.7	4.6
Jordan	5.3	5.8	4.2	8.6	8.1	8.1	8.2	7.2	5.5	2.3	2.6
Lebanon	4.0	3.4	3.2	7.5	1.0	0.6	7.5	9.3	8.5	7.0	1.5*
Libya	-1.8	-1.0	13.0	4.5	11.9	6.5	6.4	2.4	-1.4	3.7*	-59.7*
Morocco	7.6	3.3	6.3	4.8	3.0	7.8	2.7	5.6	4.9	3.7	4.9
Syria	3.7	5.9	-2.0	6.9	6.2	5.0	5.7	4.5	5.9	3.4	n/a
Tunisia	4.9	1.7	5.5	6.0	4.0	5.7	6.3	4.5	3.1	3.1	-1.8
Turkey	-5.7	6.2	5.3	9.4	8.4	6.9	4.7	0.7	-4.8	9.2	8.5*

Notes. \* IMF estimates; no data for Palestinian Autonomy.

Source: IMF World Economic Outlook database, October 2012.

It is also worth remembering that the prospects for the economic growth of major hydrocarbon producers (Libya, Algeria and, to a lesser extent, Syria) remain highly dependent on oil and natural gas prices. Indirectly, through intra-MENA<sup>3</sup> trade, migrant remittances, tourism and capital flows, other countries (especially Egypt and Lebanon) have also benefited from the oil boom of the 2000s. If hydrocarbon prices decline seriously (as they did in the second half of 2008 but only for a few months), their major producers in the MED region can face a danger of fiscal and balance of payments crises and economic downturn, especially in the context of not always prudent management of oil windfall.

### **1.3. Monetary and Fiscal Stability**

Better macroeconomic management in the 1990s and 2000s led to relative macroeconomic stability. In particular, sounder monetary and fiscal policies resulted in lower rates of inflation (Table 2) and lower fiscal deficits (Table 3) and public debts (Figure 3).

However, the sustainability of this macroeconomic stability may raise legitimate concerns at least in some countries in the region. First, moderate inflation pressures persist in Egypt and Turkey as seen in Table 2. Second, in spite of high growth rates, Egypt, Jordan and Lebanon ran high fiscal deficits through the entire decade of the 2000s. After the global financial crisis, fiscal balances also deteriorated in Morocco and, to a lesser extent, in Israel. The Arab Spring brought fiscal deterioration in Tunisia, Libya, Egypt and Syria, at least in the short term. As a result, the gross public debt-to-GDP exceeds 60% in Egypt, Israel, Jordan, and Lebanon and it has increased in most countries since 2008, reversing earlier moderate gains.

The two biggest fiscal challenges in the region relate to universal price subsidies and socially motivated overemployment in the public sector (Dabrowski & De Wulf, 2012). Large price subsidies to food, electricity, and fuel continue to create a huge fiscal burden in several MED11 countries, especially Egypt (over 10% of GDP), Algeria, and Lebanon. The IMF (2011, p. 44) estimated their total cost in MENAP<sup>4</sup> countries at the level of USD 200 billion, i.e. 7.8% of their GDP.

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<sup>3</sup> i.e. including the Gulf countries and Iraq, which are even larger hydrocarbon producers than the MED11 countries.

<sup>4</sup>This abbreviation stands for the Middle East, North Africa, Afghanistan and Pakistan and includes 22 countries. It covers eight of the economies analyzed in the MEDPRO project

**Table 2. MED11: inflation (end of year) in %, 2005-2011**

Country	2005	2006	2007	2008	2009	2010	2011
Algeria	1.7	3.8	4.8	4.9	5.8	3.6	5.2
Egypt	4.7	7.2	8.6	20.2	10.0	10.7	11.8
Israel	2.4	-0.1	3.4	3.8	4.0	2.6	2.2
Jordan	4.2	7.5	5.1	9.1	2.7	6.1	3.3
Lebanon	0.5	7.2	6.0	6.4	3.4	5.1	3.1
Libya	3.0	7.2	7.6	9.7	0.3	3.3*	26.6*
Morocco	2.1	3.3	2.0	4.2	-1.6	2.2	0.9
Syria	4.9	6.7	4.8	15.4	1.7	6.3	n/a
Tunisia	3.8	3.3	5.1	4.0	4.0	4.1	3.5
Turkey	7.7	9.7	8.4	10.1	6.5	6.4	10.4

Notes. \* IMF estimate; no data for the Palestinian Autonomy.

Source: IMF WEO database, October 2012.

**Table 3. MED11: General Government net lending/borrowing in % of GDP, 2001-2011**

Country	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Algeria	3.7	1.2	4.9	5.3	13.6	13.9	6.2	9.0	-5.1	-0.9	-0.2
Egypt	n/a	-9.2	-9.0	-8.3	-8.4	-9.2	-7.5	-8.0	-6.8	-7.8	-9.9
Israel	-6.3	-7.8	-7.9	-6.0	-4.8	-2.4	-1.3	-3.4	-6.0	-4.6	-4.0*
Jordan	-3.0	-4.1	-2.0	-1.1	-5.6	-4.0	-4.7	-4.3	-8.5	-5.6	-6.8
Lebanon	-20.7	-15.9	-13.6	-9.5	-8.4	-10.4	-10.8	-9.5	-8.3	-7.7	-6.1
Libya	-0.7	6.5	5.6	11.3	30.4	30.9	26.6	26.3	-2.0	18.0	-24.5
Morocco	-4.3	-4.9	-4.2	-3.8	-6.2	-2.0	-0.1	0.7	-1.8	-4.4	-6.9
Syria	2.3	-2.0	-2.7	-4.2	-4.4	-1.1	-3.0	-2.9	-2.9	-4.8*	n/a
Tunisia	-2.1	-2.2	-2.2	-2.2	-2.8	-2.6	-2.0	-0.6	-1.2	-1.0	-3.2
Turkey	n/a	-13.9	-10.0	-3.9	-0.3	0.0	-1.7	-2.4	-5.6	-2.7	-0.2*

Notes. \* IMF estimate; no data for the Palestinian Autonomy.

Source: IMF WEO database, October 2012.

Universal price subsidies are both costly and inefficient as tools to fight poverty (their main social policy justification). In reality, higher- and middle-income groups are the main beneficiaries of these subsidies. In addition, the subsidies have a devastating microeconomic and structural impact. They discourage producers of the subsidized energy and food products from increasing their output and quality parameters. They stimulate excessive and wasteful consumption, damage the environment, and hamper the development of renewable energy, etc. (see Bergasse, 2012 for the analysis of energy subsidies). Price subsidies should be replaced by

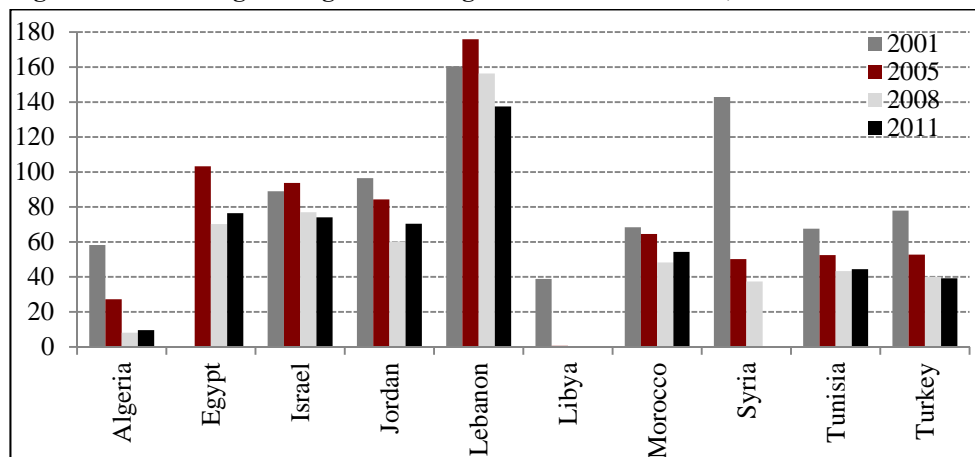
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(all but Israel, Palestinian Autonomy and Turkey) plus six Gulf states, Yemen, Iraq, Iran, Afghanistan, Pakistan, Djibouti, Sudan, and Mauritania (see IMF, 2011, p. ix).



targeted social safety nets, including targeted cash transfers, following the experiences of Iran, Jordan and Turkey.

**Figure 3. MED11: general government gross debt in % of GDP, 2001-2011**



*Note.* No data for the Palestinian Autonomy.

*Source:* IMF WEO database, October 2012.

#### **1.4. The Impact of the Arab Spring**

It is too early to assess the impact of the 2011-2012 Arab Spring on long-term economic policies and growth performance. Obviously, in the short term, the political turbulence caused a lot of damage in growth performance and macroeconomic stability, especially in countries which have suffered from violent conflict (Libya and Syria). Political instability also produced populist policy decisions. For example, the phasing-out of subsidies has been reversed in some countries as social unrest puts pressure on governments to offset the impact of surging global food and fuel prices, showing that once reforms have been conducted, they should not be considered irreversible (see IMF, 2011).

A review of the experience of countries that managed a successful transition to democracy suggests that growth declined by about 3% during the transition, but recovered the pre-transition rate within two years. Investment took about five years to recover (MENA, 2011, p. 2). The important lesson of this analysis suggests that with the right policies, the dip in growth rates being experienced in some MED11 countries can be temporary and that the long term growth trend can be resumed.

## **1.5. Drivers of Growth in MED11 Countries**

Econometric analyses of long-term drivers of economic growth in MED11 countries conducted by Couthino (2012) suggests the following conclusions:

- A convergence has been observed in growth across countries on both sides of the Mediterranean, i.e. between MED11 and MED4 (France, Greece, Italy and Spain) groups. This implies that, on average, countries with relatively low levels of GDP per capita have been growing faster than countries with high levels.
- Macroeconomic stability, as measured by low rates of inflation, has in general been rewarded with better growth performance. Deeper analysis of the determinants of inflation suggests that inflation is positively related to fiscal imbalances (hence the importance of containing the large fuel and food subsidies that strain many of the budgets in the region) and current account deficits.
- Efforts to reduce unemployment through additional public sector employment, either in civil service or in public enterprises, strain public finances, stimulate consumption and dampen productivity, thus generating upward pressure on prices and inflation that is harmful for economic growth. In addition, these policies substantially decrease the quality and effectiveness of civil service and public sector companies and stimulate nepotism and corruption. Thus, strategies to create employment will need to rely on improving internal and external competitiveness, which will depend on factors such as improving human capital, attracting foreign investment and increasing the openness of the economy to the outside world (see Sections 3, 4 and 7.4).
- Financial development as proxied by the initial level of capital account openness is robustly correlated with better growth performance (see Chinn and Ito, 2008, and Ayadi et al, 2011).
- Openness to trade is associated with better growth performance.
- FDI inflows stimulate growth. They are positively correlated with better institutions. Factors such as bureaucracy, corruption, but also information, the banking sector, and legal institutions are important determinants of inward FDI (see Bénassy-Quéré et al., 2007 and Section 4.4 of this paper).
- Infrastructure indicators such as the number of fixed telephone lines per 100 persons are also positively correlated with growth performance (see Section 6.2).
- Human capital proxied by secondary completion rates is insignificant and even has an unexpected negative sign (the same result holds if the average

years of total schooling are used instead). This is in line with the findings that returns from education in some analyzed countries are low, with young graduates often remaining unemployed (see Arbak, 2011; Sections 7.1 and 7.4 of this paper). When using the ratio of public expenditures on education to GDP, the coefficient becomes significant and positive. These last results are in line with the findings of growth studies that look at the detailed composition of public expenditure (see e.g. Bose et al., 2007).

In general, Coutinho's findings (2012) confirm that growth will be fostered by maintaining macroeconomic stability and openness to trade, investment, and FDI. A good business climate and a predictable macroeconomic environment are essential, as are developing financial markets, improving infrastructure and paying attention to the quality of human resources. While this growth agenda is not unique to the MED11 countries, the analysis has shown that each of the above variables should be addressed and that they are mutually supportive of a growth environment. Closer interaction with the EU would certainly assist in implementing the growth agenda, not only through the mobilization of additional resources to finance it, but also through greater trade and FDI openness and upgrading institutions in MED11 countries.

Growth is not the only objective of MED11 societies, as clearly shown by experience of the 2011-2012 Arab Spring. Persistent unemployment (see Section 7.1), growing income disparities (Section 7.2), an unequal level playing field in business, high levels of corruption and nepotism (Section 4.1), poor governance, the conspicuous consumption of a small elite, and the lack of political voice were prominent motivating factors for the Arab Spring activists. Economic growth can provide the resources to address major social challenges. Hence the new political leaders that will emerge from the Arab Spring, and those leaders that are adjusting their policy stance following the Arab Spring in neighboring countries should conduct growth-friendly economic policies.

## 2. Trade and Economic Integration

### 2.1. General Picture

Trade plays a crucial role in most of the analyzed economies which are relatively small (apart from Turkey which can be considered medium-sized) and often heavily dependent on energy and other commodity exports. Their relative under-industrialization and continuous high share of agriculture production in GDP (see columns 2 and 3 in Table 4) make their modernization prospects additionally dependent on free imports and investment openness. Indeed, as illustrated in columns 5 and 6 of Table 4, the share of both exports and imports in individual countries' GDP is considerable but it does not necessarily reflect the existing potential of increasing trade flows due to a strong protectionist legacy (see Section 3.2).

**Table 4. MED11 economies: structure by major sectors and the role of trade, 2007**

Country	Value added by sector (% of GDP)			Trade in goods and services (% of GDP)	
	Agriculture	Industry	Services, etc.	Exports	Imports
Algeria	8.2	61.1	30.7	46.8	23.4
Egypt	14.1	36.3	49.6	30.3	34.8
Israel <sup>#</sup>	2.7	30.2	67.1	43.9	43.9
Jordan	3.2	29.4	67.4	57.9	99.3
Libya <sup>~</sup>	17.0	23.0	59.0	..	..
Morocco	13.7	27.3	59.0	35.8	44.9
Syria	18.1	35.0	46.9	41.4	40.5
Palestinian Autonomy (2006)*	8.0	13.0	79.0		
Tunisia	10.4	29.6	60.0	54.1	56.5
Lebanon	6.4	24.0	69.6	25.3	49.9
Turkey (2006)**	8.7	28.3	63.0	22.1	27.2

Notes:

<sup>#</sup> Israel's value added per sector is taken from the CIA Factbook; values are for 2007 ;

<sup>~</sup> Libya's value added per sector is taken from the CIA Factbook; values are for 2004

\* Values for the Palestinian Authority are from CIA Factbook for 2006.

\*\* Value is PPP 2006;

data for other countries are taken from the World Development Indicators of the World Bank 2007.

Source: De Wulf, Maliszewska et al. (2009), Appendix 1, Table 1.

The product structure of merchandise exports differs strongly country by country. The exports of two countries – Algeria and Libya – are totally dominated by oil and natural gas. Fuels also play an important role in Syria's exports and less so – in Egypt. Other countries, including Egypt, represent a more diversified structure of exports.

Agriculture and food products are important export items in Syria, Morocco, the Palestinian Autonomy, and Egypt and, to a lesser extent, in Jordan, Lebanon and Turkey. Several countries, especially Jordan, Israel, Morocco and Egypt, have a strong export position in chemical products. Machinery and transport equipment play an important role in the exports of Tunisia, Turkey, Israel, Lebanon and Morocco. Finally, Tunisia, Turkey, Jordan and Egypt are important textile exporters (see Section 6.5). One should also remember about the role of service exports, especially the tourist industry (see Section 6.3).

The product structure of imports is less differentiated across the analyzed countries. Machinery, transport equipment and other manufactured goods dominate the imports structure everywhere in the region. In all countries but Turkey, food imports also play an important role. Finally, except for Algeria, Libya and Israel, fuel imports represent a substantial share of total imports.

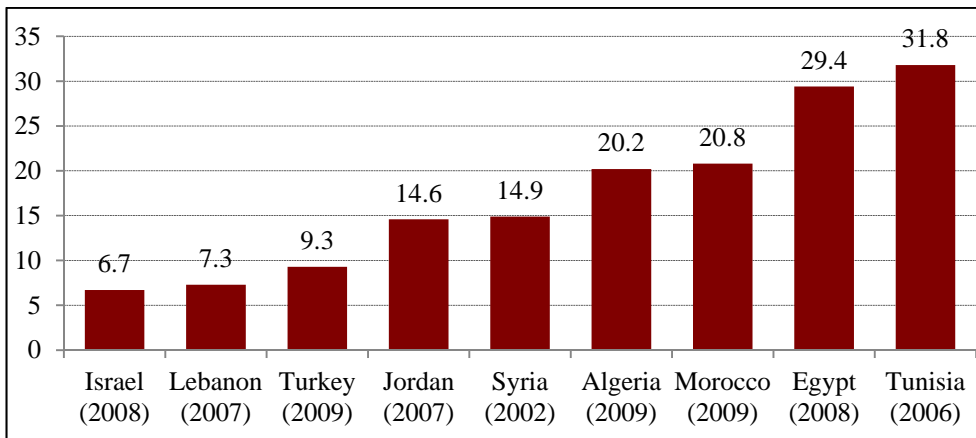
In terms of geographical structure, the EU is the major trade partner of the analyzed region. In 2007, the EU's share in MED11 exports accounted for 17.1% in Lebanon, 28.8% in Egypt, 29.9% in Israel, 43.0% in Syria, 43.6% in Algeria, 51.9% in Turkey, 71.9% in Morocco and 79.2% in Tunisia. Jordan and the Palestinian Autonomy are exceptions. The share of the EU's market in their total exports amounted to 3.2% and 5.2% respectively (in 2007). The former has large shares of exports to the Gulf countries, the US and the rest of the world while the latter trades mostly with Israel and through Israel. The US and other NAFTA countries are destinations for Algerian and Israeli exports. The Gulf countries are one of the main destinations for Lebanese and Syrian exports. The EU's share in MED11 imports was in the range between 22.3% in Egypt and 64.3% in Tunisia; in the case of Palestinian Autonomy, this share amounted to 7.8% of its total imports (see De Wulf, Maliszewska et al., 2009, Table 3, p. 46).

In spite of several intra-regional trade liberalization initiatives in the last decade, the role of intra-MED trade is still limited (6.9% of total exports and 5.8% of total imports in 2007), except for Palestinian Autonomy (92% for exports and 78% for imports). Intra-regional trade for Syria, Lebanon and, to a lesser extent, Jordan is slightly more than the regional average (De Wulf, Maliszewska et al., 2009, Table 3, p. 46).

## 2.2. Protectionist Legacy

MED11 countries remained relatively closed to the external world, including their near neighbors, for a quite a long time as a result of the import-substitution strategies of the 1970s and 1980s (see Section 2.2), trade and investment protectionism, current and capital account restrictions,<sup>5</sup> excessive government regulations, underdeveloped regional infrastructure, closed borders (for political reasons), restrictions to the movement of people, etc. In spite of some progress accomplished as a result of trade liberalization in the 1990s and 2000s, the average applied import tariff rate on manufactured goods remains high in most of the region (apart from Israel, Lebanon and Turkey – see Figure 4<sup>6</sup>).

**Figure 4. Average MFN tariffs applied by selected MED countries**



Source: Ghoneim, Peridy et al (2011), Annex 3.

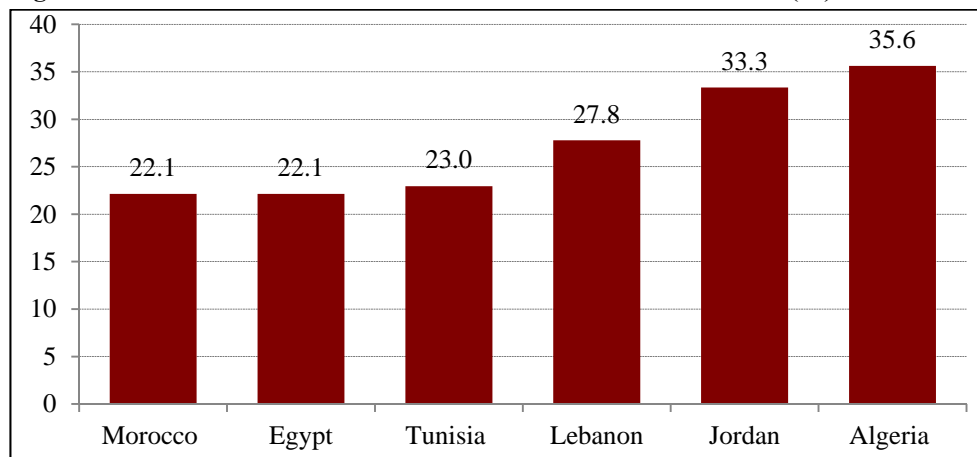
The Barcelona Process and the bilateral association and free trade agreements signed between the EU and individual MED11 countries have been primarily focused on tariff reduction and achieved little progress in the area of non-tariff barriers (NTB) and other obstacles to free trade. As these agreements have been concluded gradually since the mid-1990s and their agendas have varied country by country, the progress in import tariffs reduction differs among MED11 countries. Israel and Turkey have removed almost all tariff protection against EU imports.

<sup>5</sup> Until the early 2000s, most of the MED11 countries had inconvertible currencies, i.e. they continued current account restrictions and multiple exchange rates and did not meet the requirements of Article VIII of the IMF Articles of Agreement.

<sup>6</sup> Figure 4 reflects findings based on the latest available data, and probably overestimates the tariff rates that prevail in 2012.

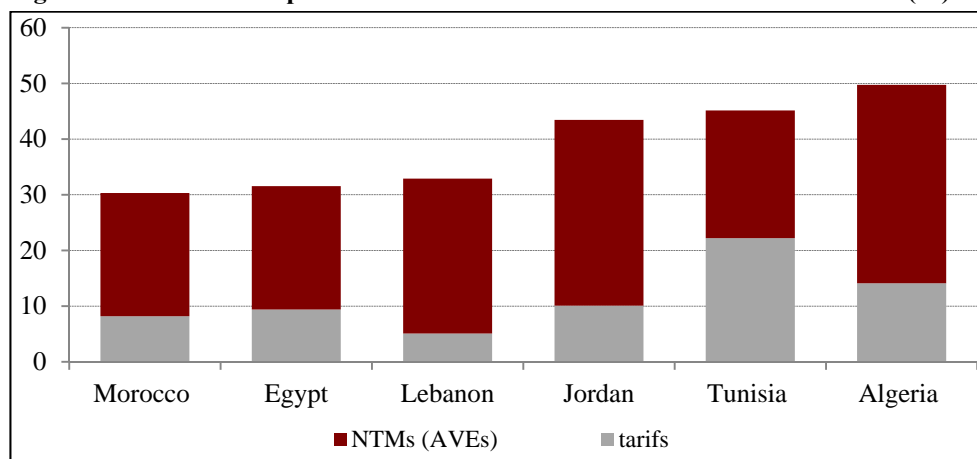
Morocco and Lebanon have also made significant progress, with small average tariffs applied to EU imports. On the other hand, Tunisia, Syria and Algeria show the highest tariffs (up to 18% for Tunisia), whereas Jordan and Egypt are in an intermediate position.

**Figure 5. An estimation of AVEs of NTBs in selected MED countries (%)**



Source: Ghoneim, Peridy et al (2011), Annex 3.

**Figure 6. Overall trade protection in selected MED countries: tariffs and NTBs (%)**



Source: Ghoneim, Peridy et al (2011), Annex 3.

Ghoneim, Peridy et al. (2011, Annex 3) estimated the tariff ad valorem equivalents (AVEs) of the NTBs using the recent methodology developed by Kee et al. (2009), which was applied in two stages. The first included an estimation of the quantity impact of NTBs on imports. Then, this impact was transformed into price

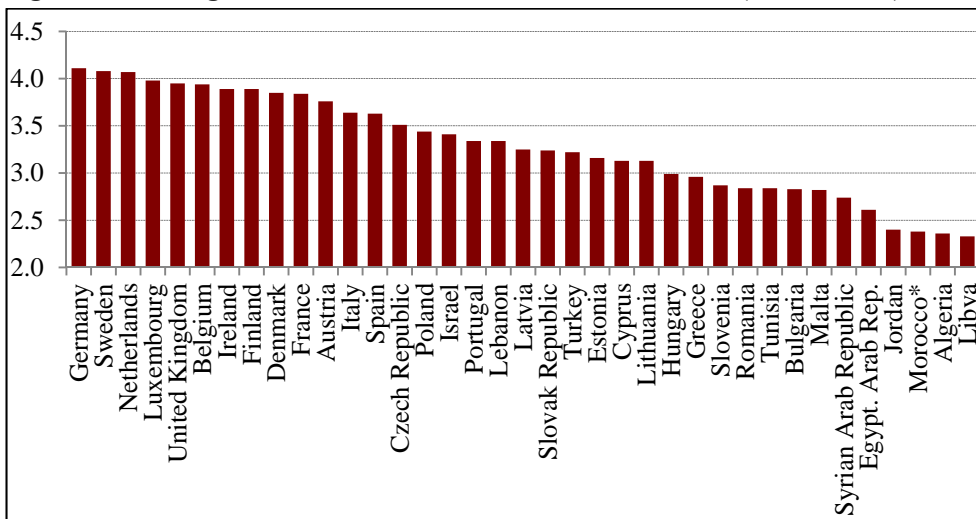
effects, using the import demand elasticities calculated in Kee et al. (2008). The data came from the TRAINS database, with eight groups of NTBs such as specific charges and taxes, administration process, financial measures, automatic licenses, non-automatic licenses and other quantitative restrictions, monopolistic measures as well as technical or quality regulations.

Figure 5 shows that NTB protection is strongest in Algeria and Jordan where it amounts to more than 33% in tariff equivalent. Conversely, Morocco, Tunisia and Egypt have the lowest AVEs (less than 25%). Figure 6 presents the overall level of protection, i.e. the sum of tariffs and NTBs, which looks very high especially in the cases of Algeria, Tunisia and Jordan.

### 2.3. Trade Logistics Barriers

Apart from protectionist policies (which manifest themselves in the form of tariff and non-tariff barriers), poor transport infrastructure and logistics are another barrier to trade.

**Figure 7. The Logistics Performance Index in the Euromed area (scores, 2010\*)**



Note. \*year 2007 concerning Morocco.

Source: World Bank (2011).

Ghoneim, Peridy et al. (2011) estimated transport costs based on Maersk statistics and the logistics performance index (LPI) of the World Bank (World Bank,



2011). The LPI is built as a weighted average of seven sub-indexes: (1) the efficiency of the clearance process by customs and other border agencies, (2) the quality of transport and information technology infrastructure for logistics, (3) the ease of arranging international shipments, (4) the competence of the local logistics industry, (5) the ability to trace and check international shipments, (6) domestic logistics costs, and (7) the timeliness of shipments in reaching their destinations. All of these are computed based on a worldwide survey of the companies involved in logistics services. Figure 7 suggests that the LPIs in the MED11 countries are considerably lower than those of the EU countries.

#### **2.4. Determinants of MED Trade Flows**

Based on the application of a specific gravity model with trade costs, Ghoneim, Peridy et al. (2011) estimated the impact of various factors (tariffs, NTBs, transport and logistics costs, cultural factors like common language and colonial legacy, etc.) on the imports of selected MED countries from the EU. The results suggest that the NTBs have a particularly detrimental impact on MED imports (particularly for Algeria and Egypt), followed by transport costs. The negative impact of tariffs on MED imports is also significant. Finally, the traditional trade gravity variables (GDP and cultural factors) provide the expected signs and are also significant.

A similar analysis for MED country exports shows that EU tariffs have no impact since their level is very low. As the EU's NTBs are lower than those of MED countries,<sup>7</sup> their negative impact on MED country exports is also lower. Finally, MED countries' exports are significantly reduced by their low LPI.

#### **2.5. Scenarios of Euro-MED Trade Liberalization**

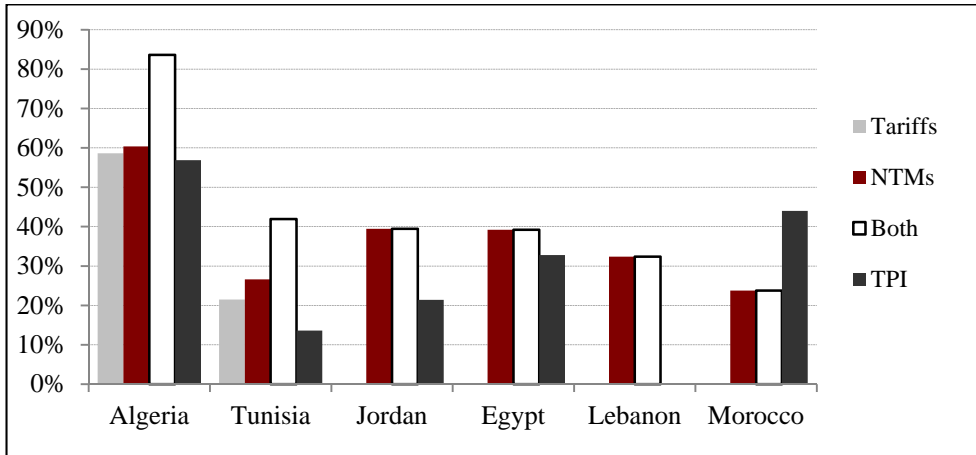
Ghoneim, Peridy et al. (2011) have developed four scenarios of further Euro-Med trade liberalization: shallow and deep integration, both in two variants - partial (pessimistic) and full (optimistic). Shallow integration refers to trade integration that is based on the reduction/elimination of tariffs. Deep integration assumes

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<sup>7</sup> Kee et al. (2009) estimate AVE with respect to EU imports at the level of 13.4%.

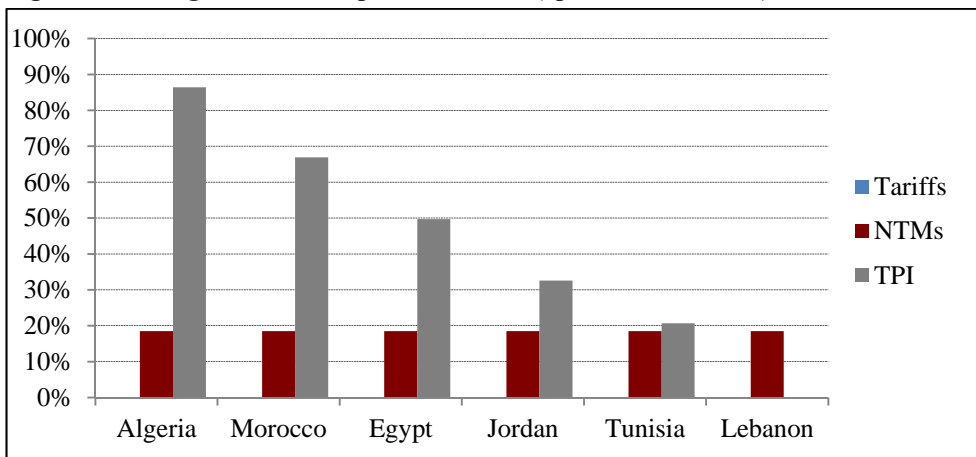
the elimination of non-tariff barriers and the reduction of various logistic barriers, in addition to tariffs removal.

**Figure 8. Change in MED's imports from the EU (optimistic scenarios), in %**



Source: Ghoneim, Peridy et al. (2011).

**Figure 9. Change in MED's exports to the EU (optimistic scenarios), in %**



Source: Ghoneim, Peridy et al. (2011).

Figure 8 presents the results of the full (optimistic) scenarios, which assume a complete removal of tariffs (shallow integration) or of both tariffs and NTBs (deep integration), respectively. In addition, the optimistic variant of deep integration assumes an improvement in the MED's LPI towards the 66% of highest performers, i.e. an LPI index equal to 3.05 (the level recorded in middle-income countries such as Mexico, Argentina, Chile and some EU new member states).

Figure 8 demonstrates the significant trade creation effects of deep integration for all MED countries, especially for Algeria (plus 60.4% of its current imports), Egypt, Jordan and Lebanon. The effects of shallow integration (only tariffs removal) are significant in the cases of Algeria and Tunisia (because of their initial high tariffs level) and less so for other countries. An improvement in trade logistics will contribute to substantial trade creation in all countries.

As seen from Figure 9, EU tariffs removal has no impact on MED countries' exports since they are already close to zero (under the existing trade agreements and the EU's Generalized System of Preferences). This means that shallow integration is already complete on the EU side. The potential of MED exports to increase due to the removal of the EU's NTBs is significant (18.5%) but limited by their current moderate level (see Section 3.4). However, a considerable exports increase is expected from the improvement in the MED's LPI. It can be greater for MED exports than MED imports because the initial level of export logistics performance is lower compared to import logistics.

Under the partial (pessimistic) scenarios which assume a 1% tariffs cut, a 1% reduction in the number of NTBs and a 1% increase in LPI, trade creation effects are marginal. In the case of NTBs, this means that trade is less sensitive to their intensity than to their existence. In other words, significant trade creation is expected to occur only if several NTBs are removed simultaneously. On the other hand, a 1% tariff reduction has a greater effect in countries with high tariffs (e.g., Algeria). No gain is expected for MED exports, since the EU has already removed its tariffs for imports from MED countries. Improvements in LPI would increase both the MED's imports and exports. But exports would respond much more favorably to logistics improvements because initial logistics barriers are much higher in the MED countries than in the EU.

## **2.6. Scenarios of Intra-Regional Integration**

For trade between MED11 countries, Ghoneim, Peridy et al. (2011) have developed scenarios similar to those elaborated in Section 3.5.

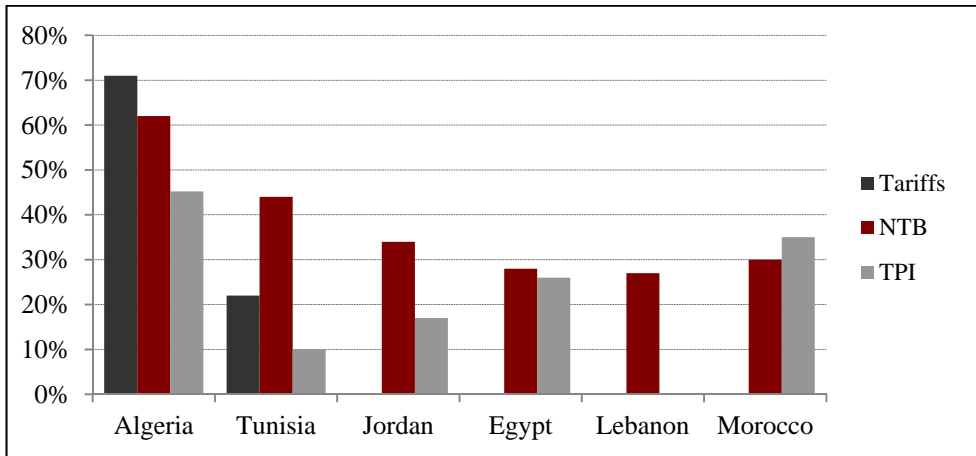
As tariffs between MED countries were phased out under the GAFTA (Great Arab Free Trade Area) agreements,<sup>8</sup> the process of shallow intra-regional integration can be assumed to be largely completed.<sup>9</sup>

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<sup>8</sup> With three exceptions: Algeria (which joined GAFTA but did not start removing its tariffs in 2005), Israel and Turkey (which both remain outside GAFTA).

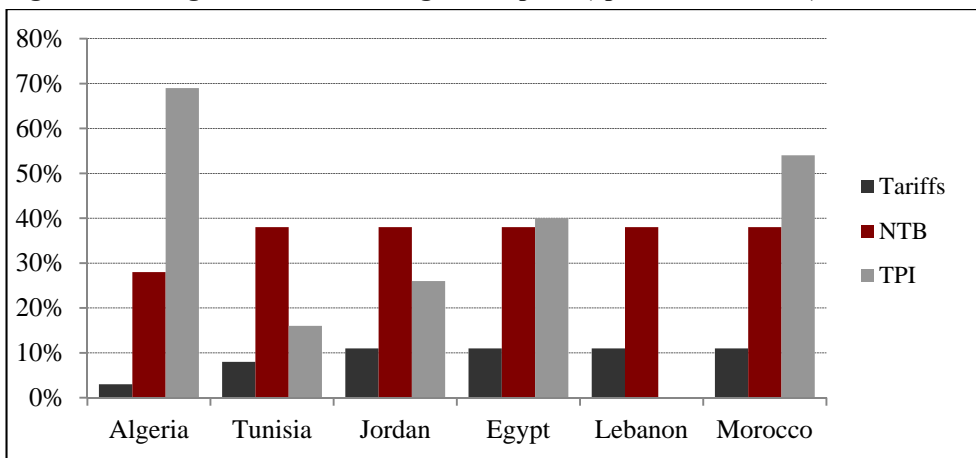
Hence the estimation results presented in Figures 10 and 11 suggest that tariff reduction will have no impact on MED imports, apart from Algeria and Tunisia. On the contrary, a reduction in NTBs can greatly help trade expansion under the optimistic scenario (by ca. 35%). An improvement in LPI will also lead to significant import and export increases, especially in Algeria due to its poor logistics performance.

**Figure 10. Change in MED's intra-regional imports (optimistic scenarios), in %**



Source: Ghoneim, Peridy et al. (2011).

**Figure 11. Change in MED's intra-regional exports (optimistic scenarios), in %**



Source: Ghoneim, Peridy et al. (2011).

<sup>9</sup> However, the previous tariff protection has been at times been replaced by additional NTB for specific products (Péridy and Ghoneim, 2009).

## **2.7. Policy Recommendations**

Mediterranean countries should complete shallow integration with their EU partners and amongst themselves as a means of capturing the remaining trade gains available. In particular, Algeria should make efforts to reduce its tariffs which currently remain at high levels.

Dealing with deep integration is a more difficult task. First, NTBs must be addressed in a comprehensive way, since the analysis has shown that the removal of only selected NTBs while keeping others provides very little gains. Consequently, each MED country should identify precisely all NTBs for each product and decide whether to remove them or not based on a cost-benefit analysis. Secondly, additional gains can be achieved by improving LPI (port infrastructures, logistics services, etc.).

Both the removal of NTBs and improving LPI are ambitious programs that may encounter many constraints from vested interests. They require a clear strategic vision, political commitment, and a well-tailored implementation plan. Financial cooperation between the MED countries and the EU could greatly assist in this process.

The example of the EU-Turkey Customs Union, which was supported by substantial financial and technical assistance from the EU and other international partners, could serve as a good example for other MED countries. It greatly helped put in place procedures that significantly reduced barriers to trade (standardization, testing, certification, inspection, accreditation and metrology). In addition, competition policies were strengthened and trade facilitation measures were introduced (Togan, 2012). The political impetus of creating a customs union and eventually joining the EU helped to overcome various obstacles and guided the modernization process. EU-Turkey trade expanded substantially, producing new jobs and income growth.

## 3. Private Sector Development and FDI

### 3.1. Indicators of Business and Investment Climate

In spite of several policy reforms in the 2000s (especially in Israel, Egypt, Tunisia and Algeria - see MENA, 2008, table 4.3, p. 90), most MED countries suffer from a poor business and investment climate as illustrated in various international surveys and ratings (Table 5).<sup>10</sup>

In the World Bank Doing Business 2012 report, most of the MED11 countries are ranked rather far from the top: from 71<sup>st</sup> (Turkey) to 148<sup>th</sup> (Algeria), out of the 183 countries covered by this survey. Only two countries, Israel and Tunisia, represent better performance levels and are ranked 34<sup>th</sup> and 46<sup>th</sup>, respectively (Doing Business, 2011).

**Table 5. Indicators of business climate in MED11 countries**

Country (No. of countries ranked) indicator	WBDB 2012 (183) rank	HFIEF 2012 (179) rank (score; category)	TI CPI 2011 (182) rank (score)
Algeria	148	140 (51.0; M/UF)	112 (2.9)
Egypt	110	100 (57.9; M/UF)	112 (2.9)
Israel	34	48 (67.8; ModF)	36 (5.8)
Jordan	96	32 (69.9; ModF)	56 (4.5)
Lebanon	104	90 (69.2; ModF)	134 (2.5)
Libya	n/a	176 (35.9; Repr)	168 (2.0)
Morocco	94	87 (60.2; ModF)	80 (3.4)
Palestinian Autonomy	131	n/a	n/a
Syria	134	139 (51.2; M/UF)	139 (2.6)
Tunisia	46	95 (58.6; M/UF)	73 (3.8)
Turkey	71	73 (62.5; ModF)	61 (4.2)

*Notes.* WBDB 2012 – World Bank Doing Business 2012; HFIEF 2012 – Heritage Foundation Index of Economic Freedom 2012; TICPI 2011 – Transparency International Corruption Perception Index 2011; ModF – moderately free, M/UF – mostly unfree, Repr – repressed.

*Source:* <http://www.doingbusiness.org/reports/global-reports/doing-business-2012>, <http://www.heritage.org/index/ranking>, <http://cpi.transparency.org/cpi2011/results/>.

<sup>10</sup> All these surveys reflect the situation which existed before the Arab Spring.

An equally bleak picture is provided by the Heritage Foundation Index of Economic Freedom 2012: only five countries (Jordan, Israel, Turkey, Morocco and Lebanon) are ranked “moderately free”. And only two of them, Jordan and Israel, represent a relatively decent performance (32<sup>nd</sup> and 48<sup>th</sup> ranks, respectively). None of the economies in the analyzed region are ranked ‘free’ or ‘mostly free’. Four countries, Tunisia, Egypt, Syria and Algeria, are classified as ‘mostly un-free’. Libya is considered a ‘repressed’ economy.<sup>11</sup>

The same concerns the 2011 Transparency International Corruption Perception Index, according to which MED countries are ranked between 5.8 (Israel, 36<sup>th</sup> position) and 2.0 (Libya, 168<sup>th</sup> position) on a scale of 1-10, where higher scores mean less corruption.<sup>12</sup> Apart from Libya, four other countries – Algeria and Egypt (both 2.9 and 112<sup>th</sup> position), Lebanon (2.5 and 134<sup>th</sup> position) and Syria (2.6 and 139<sup>th</sup> position) – belong to the group of heavily corrupted countries.

Although the average performance of the MED region is slightly better than that of the CIS or Sub-Saharan Africa, it is bad enough to discourage investment, hamper economic growth, and impede the eradication of poverty and inequality (see Section 7.2). Only Israel and, to a lesser extent, Jordan, Tunisia, and Turkey appear to be more friendly to private sector business activity and investment. Worse, according to both the Heritage Foundation and Transparency International’s surveys, the performance of most MED11 countries has deteriorated since the mid-2000s.

The World Bank study conducted before the Arab Spring (MENA, 2009) gives credit for legislation reforms in several MED countries but, at the same time, underlines a weak institutional framework for their implementation and arbitrariness associated with regulations’ enforcement, i.e., bureaucratic discretion, corruption, and unequal treatment of investors (MENA, 2009, pp.79 and next). Private entrepreneurs complain about the lack of a ‘...level playing field that favors some incumbent firms at the expense of new entrants and competitors’ (MENA, 2009, pp. 87-89). As a result, the average age of firms and their managers exceeds that observed in other regions (MENA, 2009, p.98-99). As a remedy, the MENA (2009) report suggests (i) continuing setting up the formal framework of reforms, (ii) bringing greater focus on the implementation of these reforms without favoritism and (iii) attaching greater importance to consultation with real representatives of the dynamic private sector.

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<sup>11</sup> <http://www.heritage.org/index/ranking>.

<sup>12</sup> See <http://cpi.transparency.org/cpi2011/results/>.

### 3.2. Financing Private Business

Credit is the lifeblood of private sector operations.<sup>13</sup> Table 6 suggests that, on average, credit to the private sector rose slightly over the decade of 2000s. Yet this average hides large differences across countries. In Algeria, Morocco, Syria and Turkey, credit to the private sector increased significantly. In Israel and Tunisia, it stabilized at an above average level while in other countries it dropped, at times very significantly (Egypt and Libya). Even where its level is relatively high and increasing, there are indications that it is directed mostly to large and well-connected firms at the expense of small and medium size enterprises (SMEs).

**Table 6. Domestic Credit to the Private Sector in MED11, % of GDP**

Countries	2001	2009
Algeria	8	16
Egypt	55	36
Israel	85	85
Jordan	76	72
Lebanon	86	74
Libya	24	11
Morocco	45	64
Syria	8	20
Tunisia	68	68
Turkey	15	37
MED11 Average	47	53

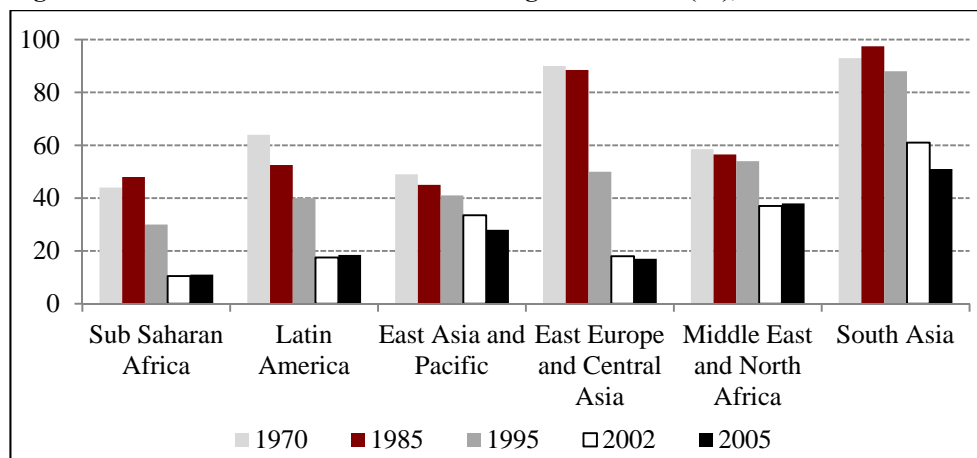
Source: World Bank Data Base (2001 and 2009), CIA World Factbook (2011), Woodward & Safavi (2012).

Anzoategui et al. (2010) studied the region's banking sector and found it suffering from a low degree of competition as compared to other regions. They also concluded that the situation did not improve between 1994 to 2008, blaming poor credit information and excessive restrictions on entry into the sector. The low level of competition is related to the high share of state-owned banks, as can be seen in Figure 12. Whereas in most other regions (with the exception of South Asia), the role of public ownership in the banking industry has systematically shrunk over the years, it remained relatively high in MENA and even rose slightly since 2002.

<sup>13</sup> This subsection draws partly from Woodward, Safavi & Kozarzewski (2012) and Woodward & Safavi (2012).



**Figure 12. Share of state banks in total banking sector assets (%), 1970-2005**



*Note.* MENA countries include Egypt, Jordan, Lebanon, Morocco, Tunisia and Yemen.

*Source:* Woodward, Safavi and Kozarzewski (2012).

The dominant role of state-owned banks gives the banks great discretion in credit allocation, which favors well-connected and well-established enterprises. Coupled with the lack of independent supervision of the financial sector, this situation hampers private sector growth. The suggested remedy would be to credibly reform the governance of the remaining state owned banks, further privatize and foster competition in the banking sector. All this should be underpinned by improved banking supervision (MENA 2009, pp. 109- 127).

Table 7 illustrates the role of the stock market as an alternative source of private sector financing (available to large and, sometimes, medium-size firms). While since the mid-2000s the regional MENA average remains in line with both the global average and the averages of other major regions (earlier, MENA underperformed compared to others), the situation in individual MED countries varies a lot. Jordan presents the highest market capitalization to GDP ratio of listed companies; Israel and Morocco are also at the top of the regional list. The role of the capital market seems to be smaller, in relative terms, in Lebanon, Tunisia and Turkey. There is no data for Algeria, Libya, and Syria but in all three cases the stock market plays a marginal role.

In almost all regions and countries presented in Table 7, the market capitalization of listed companies collapsed after 2007 as a result of the global financial crisis. However, Egypt recorded a four-fold decrease in this ratio between 2005 and 2011 which, most likely, reflects not only the impact of the financial crisis but also of the revolution and regime change in 2011.

**Table 7. Market capitalization of listed companies (% of GDP)**

Region/Country	1990	1995	2000	2005	2008	2011
<i>Interregional comparison</i>						
World	47.3	61.1	101.3	96.6	58.7	66.3
East Asia & Pacific	80.5	65.8	69.2	91.2	70.5	66.1
Europe & Central Asia	31.7	42.2	99.5	76.0	41.6	45.0
European Union	31.0	41.4	100.2	74.1	41.5	43.1
Latin America & Caribbean	7.7	23.0	31.9	41.0	31.1	42.1
North America	52.1	91.1	150.1	134.7	81.0	104.3
South Asia	10.5	29.0	25.5	58.8	45.0	48.7
Sub-Saharan Africa	n/a	126.5	89.7	128.6	n/a	111.0
MENA	n/a	24.5	29.2	118.5	46.9	47.8
<i>Individual MED countries</i>						
Egypt	4.1	13.4	28.8	88.8	52.7	21.2
Israel	6.3	37.9	51.3	89.7	66.7	59.7
Jordan	49.7	69.4	58.4	299.0	163.1	94.3
Lebanon	n/a	3.4	9.2	22.5	32.1	24.1
Morocco	3.7	18.0	29.4	45.7	74.0	60.0
Palestinian Autonomy	n/a	n/a	18.6	111.1	n/a	n/a
Tunisia	4.3	21.8	13.2	8.9	14.2	21.1
Turkey	12.7	12.3	26.1	33.4	16.1	26.1

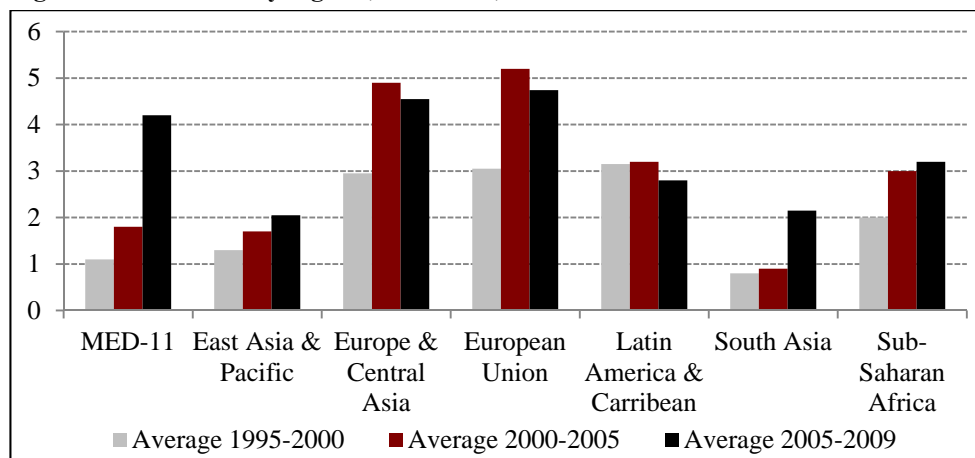
Source: [http://api.worldbank.org/datafiles/CM.MKT.LCAP.GD.ZS\\_Indicator\\_MetaData\\_en\\_EXCEL.xls](http://api.worldbank.org/datafiles/CM.MKT.LCAP.GD.ZS_Indicator_MetaData_en_EXCEL.xls).

### 3.3. Foreign Direct Investment

FDI is an important conveyer of technological innovation and management changes. It connects the new production centers to the world market and has important backward linkages to the local economy. Thus, it fosters growth beyond the FDI financed economic activity and, not least of all, adds to the local savings available for investment.<sup>14</sup>

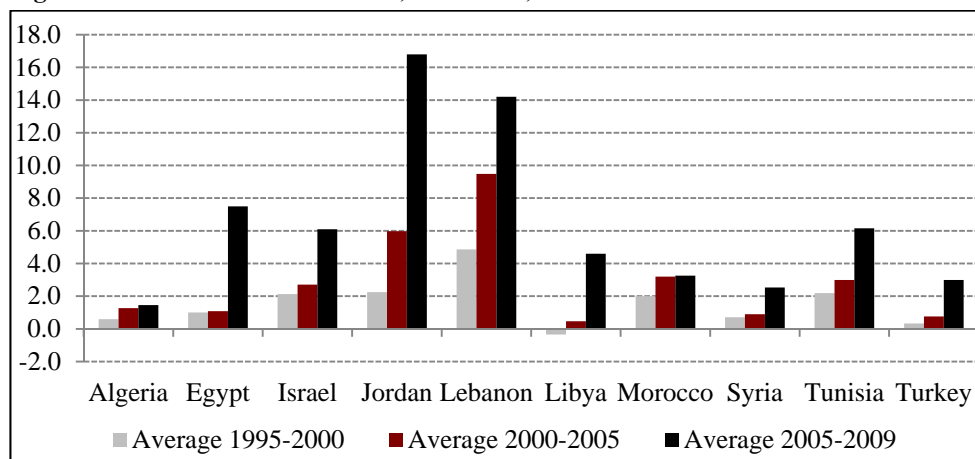
<sup>14</sup> Subsections 4.3 – 4.5 are based on Sekkat (2012), who provides an extensive overview of the literature which analyzes FDI impact on growth as well as an econometric evaluation of the factors that explain the development of FDI in the MED11.

Figure 13. FDI Flows by regions, 1995-2009, % of GDP



Source: UNCTAD (2009), *World Investment Report 2009* (online database).

Figure 14. FDI Flows as % of GDP, 1995-2009, MED11 countries



Source: UNCTAD (2009), *World Investment Report 2009* (online database).

Governments in the MED11 region have not always been keen to accept FDI. In the 1970s, the dominant strain of economic policy tended to favor import substitution over openness to the rest of the world and public ownership over private ownership (see Sections 2.2 and 5 for more details). This was reflected in very restrictive regulations pertaining to the foreign ownership of enterprises. Where FDI was permitted, regulations reserved high shares of total investment for domestic capital. It took many years to change this policy.

As seen in Figure 13, in 1995-2000 the MED11 still had the lowest FDI flows to GDP ratio (1.11%) of all regions except South Asia (0.68%). In 2005-2009,

however, the region exhibited one of the highest ratios (4.19%), just behind Europe & Central Asia (4.53%) and the EU (4.65%) and far ahead of the other regions.

There are nonetheless notable differences across countries (see Figure 14). In 2005-2009, Jordan and Lebanon, for instance, scored much better than others, particularly Algeria, which remained the most closed to foreign investors. In terms of dynamics, a similar picture emerges: Jordan and Lebanon show the highest increases (14 and 9 percentage points respectively) while Algeria shows the lowest increase (0.62 percentage point).

The global financial crisis of 2008-2009 and its second 'European' round of 2010-2012 diminished the size of capital flows from developed countries to emerging markets. In addition, the Arab Spring (2011-2012) also deteriorated the investment climate and prospects in a number of countries affected by revolutionary events (Tunisia, Egypt, Libya and Syria) which resulted in rapidly diminishing FDI inflows (see MENA, 2012, Figure 1.10, p.12). It remains to be seen whether those two factors will have a short term or longer term impact.

### **3.4. Drivers of Foreign Direct Investment**

Based on existing literature, Sekkat (2012) identified economic and institutional factors that might have an impact on FDI flows worldwide and in the MED region: level of GDP per capita and its rate of growth, quality of infrastructure, openness of the economy as measured by trade and foreign exchange regulations, export demand as reflected in the growth of trading partners, and the quality of human capital. Fiscal incentives that favor FDI have not been shown to have a significant effect on the location decision of multinational enterprises; rather, they have led to budget revenue losses and inefficiencies in public spending. Institutional factors that have been shown to impact FDI flows are the level of corruption in the country, different aspects of the quality of governance and the risk of political instability.

The results of the empirical analysis of Sekkat (2012) confirmed the statistical significance of the above-listed determinants and with the expected sign except for those pertaining to GDP growth and education, which proved non-significant. The coefficient of the per capita GDP was significant and negative, coherent with the interpretation by Edwards (1990) and neoclassical growth theory. The other estimated coefficients implied that greater openness of the economy, the availability

of infrastructure and better quality institutions are factors that increase a country's attractiveness for FDI.

### 3.5. Prospective Analysis: FDI Flows under MEDPRO Scenarios

Based on the coefficients estimated for the purpose of empirical analysis presented in Section 4.4, Sekkat (2012) developed four prospective scenarios for eight MED countries (Table 8).

These scenarios refer to four scenarios analyzed in other studies produced under the MEDPRO project, i.e., (I) Reference Scenario (until 2010), (II) Sustainable Development of an Enlarged 'EU-MED' Union, (III) Sustainable Co-Development of EU & MED Sub-Regions, and (IV) The Euro-Mediterranean Area under Threats (see Ayadi & Sessa, 2011).

**Table 8. FDI flows under four MEDPRO 2030 scenarios, in % of GDP**

Country	Observed (2005-09)	Reference	EU integration	Regional integration	Pessimistic
<i>Level (Percentages)</i>					
Algeria	1.37	1.28	1.51	1.44	1.03
Egypt	7.44	6.98	8.25	7.83	5.62
Israel	6.13	5.75	6.80	6.45	4.63
Jordan	16.71	15.68	18.53	17.60	12.63
Morocco	3.25	3.05	3.60	3.42	2.45
Syria	2.52	2.36	2.79	2.65	1.90
Tunisia	6.21	5.82	6.88	6.54	4.69
Turkey	2.94	2.76	3.26	3.10	2.22
<i>Change (Percentage points)</i>					
Algeria		-0.09	0.14	0.07	-0.34
Egypt		-0.46	0.81	0.39	-1.82
Israel		-0.38	0.67	0.32	-1.50
Jordan		-1.03	1.82	0.89	-4.08
Morocco		-0.20	0.35	0.17	-0.80
Syria		-0.16	0.27	0.13	-0.62
Tunisia		-0.39	0.67	0.33	-1.52
Turkey		-0.18	0.32	0.16	-0.72

Source: Sekkat (2012).

Under the Reference Scenario (continuation of past trends), the ratio of FDI to GDP decreases slightly in all countries but Jordan, where the decrease is relatively

important. Under the assumption that improvements are achieved with respect to GDP per capita, openness, governance quality and infrastructure, the second scenario (further integration with the EU) suggests an increase in the FDI to GDP ratio in all countries. The increase is highest (almost 2 percentage points) in Jordan and non-negligible in Egypt, Israel and Tunisia (above 0.6 percentage points). Under the third scenario (less integration with the EU but greater integration within the region), the increases are unsurprisingly less important than under the second scenario but remain non-negligible in Egypt, Israel and Tunisia (above 0.3 percentage points) and economically significant in Jordan (around 0.9 percentage points). Finally, the pessimistic scenario shows a decrease in all countries. The most affected economy is Jordan (-4 percentage points) followed by Egypt, Israel and Tunisia (around -1.5 percentage points). The deteriorations are far greater than the improvements expected under the most optimistic scenario (further integration with the EU). They are also much steeper than under the first scenario (i.e. the continuation of present trends).

Recent reductions in total world FDI flows (not taken into account in the estimate presented in Table 8) may have a contradictory impact on FDI flows to the MED region. On the one hand, there is a mechanical effect by which, other things being equal, higher world FDI translates into higher ratios of FDI inflows to GDP in each country. On the other hand, Méon and Sekkat (2012) suggest that higher world FDI might benefit countries with a weaker business climate more than those with stronger one.

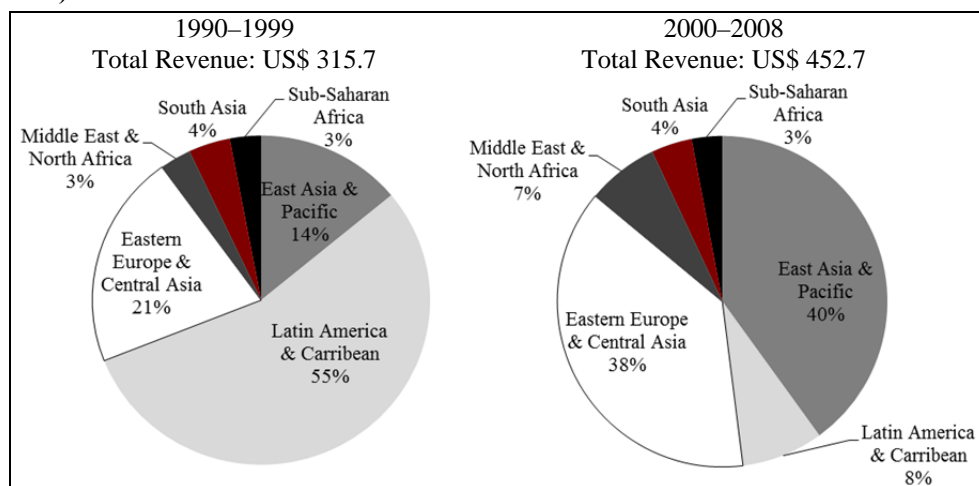
## 4. Privatization Policies

### 4.1. Regional Overview

All MED countries have ongoing privatization programs. Some of them were started in the 1980s as the part of national policies departing from asocialist/ statist past. Others are only in the early stages of implementation or are stalled for a variety of reasons.<sup>15</sup>

Privatization has made greatest progress in Israel, Jordan, Turkey and Tunisia while it lags behind in Libya, Syria and Lebanon. Progress made in Morocco and Egypt (where a large share of assets is in the hands of the military) falls somewhere in between. Progress in setting up the institutional and regulatory framework to ensure that privatization does not lead to monopoly operations also varies from country to country.

**Figure 15. Privatization Revenues by Region (% of total revenues for developing countries)**



Source: Woodward, Safavi & Kozarzewski (2012).

<sup>15</sup> This section is based on Woodward, Safavi & Kozarzewski (2012), Woodward & Safavi (2012) and series of country studies reported in the latter.

Compared to other regions (see Figure 15), the privatization performance of the MED countries appears very modest as measured by privatization revenues. In the 1990s, Latin America clearly took the lead, followed by Central and Eastern Europe and East Asia and the Pacific. The level of activity in other regions could be described as marginal. In the 2000s, the East Asia/Pacific and Eastern Europe/Central Asia regions moved into the lead, while the Latin America/Caribbean region was marginalized; the MENA region showed some improvement, but remained quite marginal in the overall picture. However, one should also bear in mind that this was a bigger piece of a bigger pie: total privatization revenues rose by 43% in the 2000s compared to the previous decade.

## **4.2. Privatization Progress In Individual MED Countries**

As available data on privatization is incomplete and hardly comparable country by country, any far-going regional generalization is very risky. Hence, this subsection will provide a brief country-by country overview of privatization programs and policies. It reflects developments that took place before the Arab Spring. The economic programs of the new governments in Egypt and Tunisia which have taken over from the previous regimes suggest further support to private sector development, including privatization.

### **4.2.1. Algeria**

A privatization law was passed in Algeria in 1995 in the context of an initiative to stimulate private sector development, but the process of privatization and enterprise restructuring only started in 2001. It resulted in the dissolution of more than 800 companies and in the redundancy or early retirement of more than 260,000 employees, accounting for 6% of the active population. Between 2003 and 2007, the privatization (partial or total) involved 417 smaller companies but did not affect the involvement of the state in the energy and finance sectors and in the bulk of the industry and services-related activities. The privatization program is hampered by the rule that foreign partners can purchase a maximum of only 49% of the company's capital. Also, the state has the right of first refusal on the sale of assets in the hands of foreign companies. Only the mobile telecom sector has been privatized, which stands in contrast with the experience of all other MED11 countries (except Libya and Lebanon) where the telecom sector is fully privatized.



#### **4.2.2. Egypt**

Over the past 20 years, Egypt, which had built a socialist model of economic development under Nasser, achieved a significant degree of privatization, selling off three quarters of its state-owned enterprises by 2010, mostly via the classic trade-sale, case-by-case method. Privatization revenues rose from the equivalent of USD4.7 billion in 1991-2000 to USD7.6 billion in 2001-2009 when 241 public enterprises were privatized. As of 2010, the Ministry of Investment (MOI) estimated that 147 enterprises remained in the public sector, i.e. one fourth of those slated for privatization (Lieberman, Nestor & Desai, 1997). Press reports suggest that the sale of public enterprises effectively ended in May 2010 (Egypt, 2010).

It should be noted, however, that the Egyptian military structures own and operate a large number of enterprises which traditionally are not classified as belonging to the public sector. The army's control over the economy has fluctuated over time. It began in the aftermath of the 1952 revolution/coup, which paved the way for the nationalization of private sector assets. It weakened in the 1970s with the economic policies aimed at taking Egypt off its socialist path but strengthened after the 1979 peace treaty with Israel when the army wanted to create jobs for many well-trained army officers. Through various subsidies and exemptions from some taxes, regulations, and labor laws, the state granted military-owned enterprises privileges not enjoyed by any other company in the public or private sectors.

The privatization program which started in the 1990s steered clear of military-owned enterprises. On the contrary, some of the privatization in state-owned enterprises went to the military (see e.g. Abul-Magd, 2011; Marroushi, 2011).

#### **4.2.3. Israel**

Israel, which had also followed a socialist path until the 1970s, embarked on a program of privatization in late 1980s. The program started by the selling minority packages of shares and the parceling off of inconsequential company branches, retaining government control over the most significant companies. Then the pace of privatization picked up, and, by 2009, 89 state companies had been privatized. Plans are under way to partially privatize the two remaining large state enterprises - Israel Aircraft Industries (IAI), and the Israel Electrical Company (IEC).

#### **4.2.4. Jordan**

Since 1999, Jordan has privatized many of its state holdings with total proceeds from the sales amounting to USD 1 billion. As of 2009, the infrastructure, tele-

communication, electric power, and transportation (airlines, urban transport, railways and ports) sectors have already been privatized by divestiture after “corporatization” (restructuring into corporate structure prior to privatization), but the water and sanitation sectors remain in state hands. The highest level of government ownership is in media (43.2%), followed by utilities and energy (33.7%), steel, mining and heavy engineering (21.04%), hotels and tourism (18.02%), transportation (15.96%), and textiles and clothing (14.95%). The smallest state shares are found in medical services, which have been totally privatized, followed by educational services (1.36%), real estate (2.57%), and chemicals and petroleum (2.78%). Private individuals rather than corporations were the main participants in the privatization process, with the exception of the transportation and real estate sectors, in which corporate ownership dominates.

#### **4.2.5. Lebanon**

Privatization was launched in the context of a debt reduction program of the 2000 budget. However, no privatization of major state-owned companies has materialized due to the unstable political environment. In telecommunication, the government still owns the assets, but private companies are managing the operations. In the water sector, several management contracts have been initiated beginning with Tripoli in 2003.

#### **4.2.6. Libya**

Several laws on the ownership and disposition of assets have been introduced and several simplifications of procedures for registering foreign companies have been implemented. The privatization of public enterprises has been initiated with the financial participation of sovereign wealth funds. Two of the five state commercial banks were turned over to international banks, with the transfer in 2007 of 19% of the capital of Sahara Bank to BNP Paribas and 19% of Wahda Bank to Arab Bank, as well as the merger of two state banks, Umma Bank and Joumhouriya Bank in 2008.

#### **4.2.7. Morocco**

Privatization in Morocco started in April 1988. Initially, a list of 114 public corporations slated for privatization was drawn up, of which 73 have been effectively

transferred; later, ten other public corporations were added to this list. Until 2010, total revenues amounted to the equivalent of ca. USD 18 billion. More than half of the transactions involved competitive bidding, one third was the result of direct allocation, 15% was sold through stock offering and less than 1% was acquired by the staff of the privatized entities. Sectors that were privatized included telecommunication, the tobacco monopoly, sugar refinery, port dredging, maritime transport (up to 100% of the total holding). Privatization attracted substantial amounts of FDI (mostly from France) and stimulated the operations of the Casablanca Stock Exchange, where about half of the total capitalization pertains to privatized enterprises. However, state ownership in many sectors is still substantial.

#### **4.2.8. Palestinian Autonomy**

Under pressure from international donors, numerous government assets were partially privatized in the 2000s (Khalidi & Samour, 2011, p. 8). While the Palestine Investment Promotion Agency's privatization strategy is to gradually phase out its existing equity holdings and to privatize most public enterprises, the priority is presently to put in place a competitive business environment to maximize economic benefits from ownership transfer.

#### **4.2.9. Syria**

Syria's privatization program has been limited by the government's desire to continue strict control over the economy and avoid open social dissent. As a result, the bulk of privatization activities have taken the form of joint ventures with the public sector, and/or opening the management of public companies to private operators. International investors have been reluctant to part take in Syria's privatization program as they are wary of the role of insiders and the remaining control of the state. Even though management contracts have been launched, government officials have insisted that '*...no privatization of state enterprises would take place during the tenth Five-Year Plan, which ran through 2010, or the coming eleventh Five-Year Plan, which runs from January 2011 through December 2015*' (U.S. Department of State, 2011).

#### **4.2.10. Tunisia**

Since it started in 1987, the Tunisian privatization has gone through three phases. From 1987 to 1994, it involved the privatization of enterprises operating in

purely competitive industries suffering from financial difficulties and requiring budget subsidies. These operations mostly concerned the service sectors (tourism, trade, agriculture and fisheries). About six firms were privatized annually. From 1995 to 1997, the program was targeted at businesses with a sound financial structure. With the establishment of a legal and institutional framework to improve the governance of privatization, the speed of this process accelerated and about 15 firms were privatized a year. Since 2008, the privatization of large successful companies such as cement, engineering industries and telecommunications has been undertaken. All in all, 219 companies have been privatized, 116 of which were privatized completely and the others were either partially privatized or liquidated.

#### **4.2.11. Turkey**

The first laws relating to privatization were enacted in 1984 and 1986 and they were periodically updated in later years. Privatizations between 1986 and June 2011 totaled 188 public companies (of which 23 were privatized in 2011). They earned USD42 billion in budget proceeds. Most involved a combination of public offering and block sale (48%) and asset sales (31%). The privatization process led to a complete state withdrawal from the following industries: cement, animal feed, dairy products, forestry products, handling and supply (catering), and distribution of petroleum products. State ownership in the following industries was reduced by over 50%: tourism, textile, iron and steel, ocean freight and meat processing. The government has also partly discontinued its activities in seaports, oil refineries, and banks.

### **4.3. Prospects of Privatization and Private Sector Development**

The recent revolutionary developments in the region make the future of privatization exceptionally uncertain. Political changes in individual countries have created a populist backlash in the short term (including controversies around the past privatization deals often considered non-transparent and favoring the cronies of the old regimes). However, this does not necessarily mean privatization policies will be abandoned in the longer term.

One of the possible political scenarios emerging as a result of the Arab Spring is a turn to a more Islamist policy. However, there is no evidence that this will re-

sult in policies harmful to the development of the private sector. On the contrary, the experience of Turkey under the relatively moderate Islamist Justice and Development Party (Turkish acronym: AKP) shows that rule by such a party can be pro-developmental in economic terms. The AKP model, in which institutional reform has been driven by the EU accession process, has become popular among moderate Islamist parties and movements such as the Muslim Brotherhood in Egypt.

Ignoring short-term turbulences, one can draw the following prospective scenarios (until 2030) in the area of private sector development and privatization:

- *Optimistic rapid development scenario*, corresponding to MEDPRO scenarios II and III (see Ayadi & Sessa, 2011). If peaceful democratic development takes place, with a decrease in corruption and the regulatory burden, then private sector development could take off in an explosive way. This would be signaled by significant increases in the Ease of Doing Business scores, significant progress in privatizing remaining state-owned enterprises, and a fall in the share of the informal sector in GDP. It could entail high rates of entry for new firms, dramatically improved performance of the banking sector in terms of lending to efficient private firms (instead of lending predominantly to insider firms), and diversification of the relevant countries' economies and exports. It would involve a further increase in FDI, and presumably greater integration with the EU and other world markets as well.
- *Reference scenario*, corresponding to MEDPRO scenario 1. Under this scenario, the Ease of Doing Business scores would remain essentially unchanged, further progress in privatization would be stalled, and FDI flows would also remain fairly stable. Such an outcome could be driven by economic policy inertia, which might result from the inability to generate a consensus around a clear political direction in the case of countries which have recently undergone revolutionary uprisings and no improvement in reform implementation.
- *Pessimistic regression scenario*, corresponding to MEDPRO scenario IV. Regression appears to be relatively unlikely for the region as a whole but may concern individual countries suffering from political instability or populist policies. A return to a statist or socialist development model seems unlikely; however, if the polity were to develop along despotic lines, and no leveling of the playing field that would allow new and small enterprises easier access to bank credit and benefit from better regulations took place, one could expect an increase in corruption, a deterioration in the business climate and a turn to nationalism and/or protectionism in economic policy. As a result, FDI could decrease, especially in non-oil and non-gas countries, and the share of the informal sector in GDP could increase.

## 5. Sectors of Particular Importance

The research agenda of WP5 of the MEDPRO project included an in-depth analysis of five sectors considered particularly important for the economic and social development of the MED region: transport infrastructure, information and communication technologies (ICT), tourism, agriculture and textile industry. Below we provide a brief summary of the major findings of these analyses.

### 5.1. Transport Infrastructure

Transport infrastructure plays a key role in the facilitation of trade in goods (see Section 3.3) and services, especially tourism (see Section 6.3), in determining domestic business costs, degree of labor mobility, etc. A lack of adequate infrastructure is a significant inhibitor to increased trade in MED11 countries. Bringing their transport infrastructure up to the standards comparable with countries of a similar per capita GDP will be costly but rewarding in terms of larger trade flows and higher GDP.

Carruthers (2012) compared the current quantities of six types of transport infrastructure in the MED region (paved roads, unpaved roads, railways, airport runways, airport passenger terminals, seaport container berths) with respective international benchmarks (average infrastructure densities for comparable countries or best international practices) and estimated the additional quantities needed to reach these benchmarks.

**Table 9. Additions to transport infrastructure for each MEDPRO scenario**

Type of infrastructure	Units	Reference Scenario	Common Development	Polarized Development	Failed Development
Paved roads	Km	174,436	307,145	301,234	118,918
Unpaved roads	Km	32,296	58,995	88,313	30,152
Railways	Km	4,274	16,452	4,709	2,246
Runways	Km	11	92	17	7
Passenger terminals	m <sup>2</sup>	888,062	976,869	888,062	732,652
Container berths	number	45	42	64	38

Source: Carruthers (2012).

**Table 10. Annual transport investment, as % of GDP**

Country/ Scenario	Reference	Common Development	Polarized Development	Failed Development
Algeria	2.1	4.5	1.7	1.4
Egypt	1.6	2.3	2.1	1.0
Israel	0.2	0.6	0.2	0.2
Jordan	1.5	2.6	2.0	1.0
Lebanon	0.4	1.2	0.4	0.4
Libya	1.3	4.3	4.0	1.7
Morocco	2.0	3.8	2.6	1.3
Syria	1.9	2.5	2.7	1.4
Tunisia	1.8	3.1	1.5	1.1
Turkey	0.9	2.1	1.3	0.7
Palestine	1.5	3.0	1.5	1.4
MED 11	1.2	2.4	1.6	0.9

Source: Carruthers (2012).

Table 9 presents the results of this estimation for each MEDPRO prospective scenario (see Ayadi & Sessa, 2011). The highest need for additional infrastructure will be for airport passenger terminals (between 52% and 56%), whereas the lowest need will be for more unpaved roads (between 7% and 13%).

**Table 11. Road and rail investment impacts on annual GDP growth (increase in GDP annual growth rate, percentage points)**

Country/ Scenario	Reference	Common De- velopment	Polarized De- velopment	Failed Devel- opment
Algeria	0.8	1.9	1.4	0.5
Egypt	0.7	1.3	0.6	0.3
Israel	1.2	0.5	0.0	0.0
Jordan	1.2	2.1	1.4	0.6
Lebanon	0.0	0.4	0.0	0.0
Libya	0.7	2.2	3.8	0.9
Morocco	1.4	1.6	0.6	0.3
Syria	1.7	1.6	0.6	0.2
Tunisia	1.5	2.4	0.3	0.2
Turkey	0.4	2.0	1.0	0.4
Palestine	0.8	1.9	1.4	0.5
MED11	0.7	1.7	0.9	0.3

Source: Carruthers (2012).

Carruthers (2012) also estimated the cost of additional infrastructure for all four scenarios. The investment (including maintenance) cost would be between 0.9% and 2.4% of GDP, although in some countries it would be higher - between

1.4% and 4.5% of GDP (see Table 10). He made tentative estimates of how much trade might be generated by improved infrastructure and how this might impact GDP (see Table 11). The impact on non-oil international trade would be substantial, but with differences between imports and exports. The overall trade balance of the MED11 region would improve by between 5.4% and 17.2%, although some countries would continue to have a negative trade balance.

## **5.2. Information and Communication Technologies**

Information and communication technologies (ICT) constitute the backbone of the modern economy and have a positive impact on economic growth (Qiang & Rossotto, 2009; Badran, 2011). The analysis carried out by Abbassi (2011) demonstrates that Arab countries, on average, lag behind other regions in terms of all major components of telecommunication infrastructure, especially in density of fixed telephone lines (9.4 per 100 inhabitants in 2010, as compared to 40.3 in Europe, 28.1 in Americas, 26.6 in the CIS, and 14.0 in Asia and Pacific; only Sub-Saharan Africa performs worse than the Middle East). The situation with mobile telephony looks better and is systematically improving and perhaps offers a possibility to close the gap created by the underdevelopment of fixed-line telecommunication, which globally is being taken over by mobile telephony. The density of internet users is only 40% of that prevailing in the Western Europe, half that of Eastern Europe, slightly higher than in the Asia and Pacific region but three times higher than in Sub-Saharan Africa.

However, the regional average masks large cross-country differences (Table 12). Israel represents the best record in fixed-line telephony and relative number of internet users and second-best record (after Libya) in mobile telephony. Libya is also ranked second in the statistics of internet users. Jordan, Tunisia and Algeria's relative numbers of mobile telephony subscribers are higher than the regional average but their performance in the sphere of fixed-line telephony and internet is much poorer.

The dominant role of state-owned monopolistic telecom operators, particularly in fixed line telephony, hampers the development of this sector. Yet, in recent years, most countries started to open up their markets to multiple players (including foreign investors) and privatize their telecom operators, greatly enhancing competition and increasing the number and quality of services and strengthening their regulatory institutions. This concerns internet services and mobile telephony,



but less so fixed-line telephony, which is still in the initial stage of the deregulation and privatization process in many countries (see Table 13).

**Table 12. Telecommunication infrastructure in MED11, 2009, % of population**

Country	Mobile telephony subscribers	Fixed telephony lines	Internet accounts
Algeria	92.6	8.6	2.4
Egypt	79.5	12.3	1.8
Jordan	101.5	8.4	4.1
Lebanon	59.8	20.5	9.3
Libya	146.3	16.5	12.0
Morocco	80.3	11.2	3.8
Palestinian Autonomy	53.2	9.3	2.9
Syria	48.2	19.2	4.1
Tunisia	93.5	12.3	4.0
Turkey	86.5	22.8	9.3
Israel*	111.8	40.0	22.1
Total	86.3	16.8	5.6

*Note.* \* By end of 2008.

*Source:* Abbasi (2011).

**Table 13. Status of competition in ICT in MED11 countries (2010)**

Country	Mobile telephony	Fixed telephony	Internet
Algeria	Competitive	Monopoly	Competitive
Egypt	Competitive	Monopoly	Competitive
Israel	Competitive	Competitive	Competitive
Jordan	Competitive	Competitive	Competitive
Lebanon	Controlled Duopoly	Monopoly	Competitive
Libya	Controlled Duopoly	Monopoly	Monopoly
Morocco	Competitive	Competitive	Competitive
Palestinian Autonomy	Competitive	Monopoly	Competitive
Syria	Controlled Duopoly	Monopoly	Competitive
Tunisia	Competitive	Monopoly	Competitive
Turkey	Competitive	Competitive	Competitive

*Source:* Abbasi (2011).

The future of the ICT sector in the MED11 countries will depend both on global technological progress in this industry and country specific factors such as business and investment climate, openness to competition and private sector, and quality of regulations.

### 5.3. Tourist Services

Tourism is an important sector in most MED11 economies except for Libya, as illustrated by its contribution to GDP (Table 14) and employment (Table 15).<sup>16</sup> Several countries, such as Lebanon, Jordan, Egypt, Morocco, Tunisia and, to a lesser extent, Turkey and Syria, are heavily dependent on tourist revenues and job creation in the tourist industry.

**Table 14. Tourism and travel contribution to GDP, as a% of total**

Country	1990	1995	2000	2005	2010	2011
Algeria	5.5	5.6	7.5	6.5	7.9	7.7
Egypt	8.8	10.2	11.4	15.7	17.5	14.8
Israel	7.8	8.4	8.3	6.7	8.2	8.0
Jordan	24.3	21.0	16.3	18.5	21.9	18.8
Lebanon	9.0	9.6	9.3	31.2	33.9	35.1
Libya	..	..	..	3.5	3.3	3.2
Morocco	10.4	10.3	12.3	14.9	19.4	18.9
Palestinian Autonomy	n/a	n/a	n/a	n/a	n/a	n/a
Syria	7.5	12.5	11.5	14.0	15.3	13.1
Tunisia	16.5	17.5	18.4	18.5	17.8	14.2
Turkey	7.9	10.5	9.9	11.4	10.6	10.9

Source: Lanquar (2012).

**Table 15. Employment in the tourist sector (as a share of total employment)**

Countries	1990	1995	2000	2005	2010	2011
Algeria	4.8	4.9	6.6	5.6	7.1	7.0
Egypt	7.4	8.6	9.6	13.0	15.4	13.1
Israel	9.5	10.1	10.1	8.2	8.8	8.6
Jordan	22.2	19.2	14.9	16.9	19.6	16.8
Lebanon	8.5	8.8	8.8	31.2	32.2	33.4
Libya	5.7	8.7	..	..	3.2	3.0
Morocco	8.9	8.9	10.6	14.7	17.3	16.8
Palestinian Autonomy	n/a	n/a	n/a	n/a	n/a	n/a
Syria	7.8	13.3	11.8	12.5	13.4	11.4
Tunisia	15.3	16.3	17.2	16.5	16.1	12.8
Turkey	5.3	6.4	5.4	7.7	8.1	8.0
MED11	9.5	10.5	10.6	13.8	13.5	11.0

Source: Lanquar (2012).

<sup>16</sup> This subsection is based on Lanquar (2011) and (2012).

In the 1990s and 2000s, the MED region recorded the highest growth rates in inbound international tourism, despite numerous security risks, natural disasters, rises in oil prices and economic uncertainties in the region. Domestic tourism in MED countries also increased rapidly. Even the 2008 financial crisis had no severe impact on this growth, which confirmed the resilience of MED tourism to various unfavorable factors. However, this trend came to an abrupt halt in early 2011 during the Arab Spring, but seems to be resuming in 2012 despite the economic slowdown in the EU, its main market.

The projection until 2030 developed by Lanquar (2012) for the four MEDPRO scenarios (see Ayadi and Sessa, 2011) predicts the further rapid development of this industry in the next two decades. Nevertheless, the general political and economic environment will matter a lot. In addition, climate changes may negatively affect the ability to provide tourist services, especially in coastal areas (Onofri & Nunes, 2012). Scenarios II and III offer the fastest growth in total number of tourists (more than doubling the total number of tourists in 2030 as compared to 2010) while Scenario IV offers the slowest one (an increase by ca. 50% during the same period).

## **5.4. Agriculture**

Agriculture is another sector of key importance in all countries in the MED region except Israel and Jordan.<sup>17</sup> As seen from Table 4 in Section 3.1, in 2007 its share in GDP creation exceeded 10% in 5 out of 11 analyzed countries: Syria (18.1%), Libya (17.0%), Egypt (14.1%), Morocco (13.7%) and Tunisia (10.4%). Its contribution to employment is equally important.

During the last decades, the active population in MED11 agriculture decreased at the slow pace of 0.2% per year. As a result, in the decade of the 2000s, the average annual regional productivity per one agricultural worker rose from USD2,300 to USD3,000, at constant 2000 prices. With the exception of Lebanon and Egypt, agricultural productivity is highly sensitive to weather fluctuations, in particular to the availability of rainfall, which can vary from year to year. The large investment in irrigation and equipment observed during the 2000s should somewhat limit this dependence. On the other hand, like tourism, agriculture is a sector which may suffer from climate changes in the long term. (see Section 6.3).

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<sup>17</sup>This subsection is based on Belghazi (2012).

Five countries, Turkey, Egypt, Morocco, Algeria and Syria, make up more than 91% of the total agricultural production in the MED11 countries (except Palestine and Libya), with Turkey alone accounting for about 39% of regional production. The MED11 production of cereal, roots and tubers exceeds their respective consumption. Animal production is on par with their consumption. On the other hand, MED11 countries experience massive shortages in vegetable oils and sugar.

MED11 agricultural exports concentrate on vegetables and fruits. Turkey is the sole country exporting significant amounts of cereals. The EU is the most important origin and destination region for MED11 agriculture trade, particularly for the Palestinian Autonomy, Israel, and the North African countries. EU exports to MED11 countries, mainly of cereals, face fierce competition from other regions. The bulk of EU agriculture exports go to Egypt, Algeria and Morocco.

MED11 agriculture policies are largely conservative. Domestic markets are heavily protected by tariffs. Governments support the agricultural sector with subsidies and domestic markets organization. Agricultural trade is not sufficiently included in the association and trade agreements between the EU and MED countries. The EU has applied selective protection depending on the country and the risk associated with its potential exports to the EU common market.

The prospective MEDPRO scenario I (see Ayadi & Sessa, 2011) assumes a continuation of trends observed during the last two decades: an increase of per capita production for all value chains, except cereals. Exports will decrease for fruits, vegetables and sea products and increase for animal products, sugar, edible oils and cereals. Absorption will increase for all products, mainly for fruits and vegetables and sea products. Imports of cereals, fruits and vegetables, sugar and edible oils and sea products will increase while animal product imports will decrease.

Scenario II will lead to an increase in production and imports and a bigger increase in exports and absorption. Production, imports and exports will increase for all value chains. The strongest increase of imports is expected for animal products and the strongest increase of exports is expected for fruits, vegetables and sea products. Domestic absorption will decrease for fruits and vegetables and increase for animal and sea products. The consumption of sugar and edible oils will remain stagnant. Scenario III is very close to Scenario II. The worst effects will come under Scenario IV: the agricultural sector will become inwardly oriented but the agriculture trade deficit will deteriorate. In Scenario IV, agricultural employment will show a small increase (due to a smaller productivity improvement), while it will decrease in the other three scenarios.

## **5.5. Textile Industry**

As discussed in Section 3.1, textile production and textile exports play an important role in six out of eleven of the analyzed economies (Tunisia, Morocco, Turkey, Jordan, Egypt and Syria). However, there are important differences in countries' positions in the value chain and their dependence on specific trading partners.<sup>18</sup> Whilst Egypt and Syria, 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. In their textile exports, four countries (Egypt, Morocco, Tunisia and Turkey) are largely dependent on EU markets. Jordan exports 85% of its textiles to the US and Syria exports 60% of its textiles to other MED11 countries.

The expiration of the WTO Multi-Fiber Arrangement (MFA) in 2005 had a negative impact on the relative competitiveness of MED exporters. Before 2005, the MED textile industry was protected against the competition of Asian low-cost producers through an import quota system.

Looking ahead, future opportunities include the lowering of non-tariff barriers, the modernization of the textile industry, higher demand for textiles from the EU and US and a shift up the value chain (e.g. towards technical textiles). Conversely, threats include a continuation of the poor business and investment climate, increasing competition from Asian countries, a further escalation of political tensions in the region and a lack of changes in the NTBs.

In MEDPRO Scenario I (see Ayadi & Sessa, 2011), the MED textile industry will likely need to focus on protecting itself from competition from Asian countries instead of modernizing the industry and moving up the value chain. Scenario II would allow MED countries to improve their Ease of Doing Business and TLI rankings based on deeper integration, engendering a flourishing textile industry. In Scenario III, MED textile production may possibly grow with the support of GCC countries. Intra-regional integration is also expected to lead to a larger regional trade volume. In Scenario IV, the escalation of political conflicts could have disastrous effects on industrial production in the region in general and on the textile industry in particular through disrupting trade flows.

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<sup>18</sup>This subsection is based on Haberl (2012).

## **6. Social Determinants of Economic Development**

Prospects of the economic development of MED11 countries will be also determined by factors other than those discussed in Sections 2-6. Many of them relate to social, environmental and political issues analyzed by other work packages of the MEDPRO project. Below we will try to briefly discuss a few major social challenges.

### **6.1. Demographic Factors, Labor Market And Migration**

In the last few decades, the demographic situation of the MED region has been determined by the high rate of population growth, limited progress in family planning, and rapid uncontrolled urbanization. As a result of the delayed and slow demographic transition, the region's population continues to grow at one of the highest rates in the world: between 2000 and 2011, it amounted to more than 2% annually in Arab countries, compared to about 1.2% for the entire world.

In spite of their gradual decline in the 1990s and 2000s, in 2008, fertility rates remained relatively high as compared to other regions (apart from Sub-Saharan Africa). However, they varied among countries: from 1.8 in Lebanon (the only MED11 country where the fertility rate is below the replacement level) to 5.0 in the Palestinian Autonomy (Groenewold, De Beer & Huisman, 2012).

Rapid population growth has also been associated with rapid urbanization which has led to the creation of visible enclaves of poverty and social exclusion in large metropolises such as Cairo, Damascus or Casablanca. The percent of countries' populations living in cities ranges from 43% in Egypt to over 80% in Jordan, Lebanon and Israel (PRB, 2008).

Even if one may expect a further decline in the region's fertility rates (three out of four MEDPRO scenarios predict such a decline – see Groenewold, De Beer & Huisman, 2012) and the pace of its population growth, the consequences of the past high fertility rates will be felt by domestic labor markets for quite a long time.

**Table 16. Total unemployment rates in MED11, % of labor force, age 15+, 2009**

Country	Total	Male	Female
Algeria	10.2	8.6	18.1
Egypt	9.4	5.2	22.9
Israel	7.5	7.6	7.5
Jordan	12.9	10.3	24.1
Morocco	10.0	9.8	10.5
Palestinian Autonomy	24.5	17.7	38.6
Syria	8.1	5.7	22.3
Tunisia (2008)	14.2	n/a	n/a
Turkey	14.0	13.9	14.3

Source: <http://kilm.ilo.org/kilmnet/view.asp?t=Table%209.%20Total%20unemployment%20%28by%20sex%29&I=K09&C=DZ||EG||IL||JO||LB||LY||MA||PS||SY||TN||TR|&Y=2008||2009||2010|&S=1|2|3>.

**Table 17. Youth unemployment in MED countries, % of labor force in age 15-24, 2007**

Country	Female	Male
Egypt	47.9	17.2
Israel	17.0	15.0
Jordan	47.9	23.7
Lebanon	21.5	22.3
Morocco	15.5	17.9
Palestinian Autonomy	42.6	34.0
Syria	49.1	13.1
Turkey	20.8	19.6

Source: [http://api.worldbank.org/datafiles/SL.UEM.1524.FE.ZS\\_Indicator\\_MetaData\\_en\\_EXCEL.xls](http://api.worldbank.org/datafiles/SL.UEM.1524.FE.ZS_Indicator_MetaData_en_EXCEL.xls), [http://api.worldbank.org/datafiles/SL.UEM.1524.MA.ZS\\_Indicator\\_MetaData\\_en\\_EXCEL.xls](http://api.worldbank.org/datafiles/SL.UEM.1524.MA.ZS_Indicator_MetaData_en_EXCEL.xls).

Unemployment rates remain at high two-digit levels (Table 16) even if labor market participation rates are relatively low in the MED11 region (see Table 20). They are particularly dramatic with respect to a young labor force (under 25 years old) as seen in Table 17. In the case of young females, they reach almost half of the labor force in Syria, Egypt, Jordan and the Palestinian Autonomy.

High unemployment results not only from demographic pressures but also from numerous other factors such as labor market rigidities, poor education, gender discrimination (the case of female labor force), a poor business and investment climate, restricted market entry for new firms, corruption, nepotism, etc.

Migration serves as one of the labor market buffers. It remains high and labor migrant remittances substantially contribute to the strengthening external positions

of several MED-11 countries, particularly Lebanon, Jordan and Palestinian Autonomy and, to a lesser extent, Morocco, Tunisia, and Egypt (see Table 18).

**Table 18. MED11: Migrant remittances in % of GDP, 1980-2011**

Country	1980	1985	1990	1995	2000	2005	2008	2011
Algeria	1.0	0.5	0.6	2.7	1.4	2.0	1.3	1.0
Egypt	13.4	13.6	11.9	4.9	3.0	5.3	5.3	3.5
Israel	1.8	0.8	1.4	0.7	0.3	0.6	0.7	0.7
Jordan	19.8	20.0	12.4	21.4	21.8	19.9	16.7	11.7
Lebanon	..	..	64.7	11.2	9.5	22.5	24.0	18.3
Libya	..	..	..	..	0.0	0.0	0.0	0.1
Morocco	5.0	6.8	7.0	5.3	5.8	7.7	7.8	7.1
Palestinian Autonomy	..	..	..	18.1	24.1	15.2	19.7	16.3
Syria	5.9	3.5	3.5	2.5	0.9	2.9	2.7	2.7
Tunisia	3.3	2.9	4.1	3.4	3.7	4.3	4.4	4.0
Turkey	2.2	1.9	1.6	1.5	1.7	0.2	0.2	0.1

Source: <http://unctadstat.unctad.org/TableViewer/tableView.aspx>.

Compared with unemployment rates in other major regions and groups of countries, MED11 countries perform particularly poorly and their prospects for the next couple of years look equally bleak. According to the forecast of the International Labor Organization, the unemployment rate in the MENA region will continue to exceed 25% of the labor force aged 15-24 in 2017 (ILO, 2012). Very high unemployment rates, especially among youth, must be considered a potential factor of social and political destabilization within individual countries, the region as a whole, and globally.

Based on the experience of other developing countries, the MENA (2012) report highlights the importance of prudent macroeconomic management, sound regulation and good governance as crucial preconditions for employment growth. In particular, it underlines that “*sound business regulation, as well as policies that facilitate trade, can catalyze the creation of enduring employment opportunities for those countries suffering high unemployment. However, when reforming, the devil is in the details and consistent implementation is critical for success. Overall our findings suggest that the solution to MENA’s employment challenge lies in good governance, and associated appropriate regulations and implementation thereof*” (MENA, 2012, pp.32).



## 6.2. Income Inequality

Faster economic growth in the 2000s also failed to produce more income equality in the region. As illustrated by Table 19 which is based on El Laithy's (2012) study, inequality remains high, one of the highest in the world. In all countries, the Gini coefficient exceeds 30 and in few (Turkey, Tunisia and Morocco) – even 40. The ratio of the richest to the poorest income quintile is also very high everywhere except Egypt where it amounts to less than 5.

Worse, inequality seems to have worsened in several of the MED11 countries: a phenomenon consistent with the one noted in a seminal contribution by Simon Kuznetz. According to Kuznetz (1955), in the process of economic growth, income inequality first increases and then decreases and thus follows a U-shaped curve. Even though he documented this trend over a long period of time, the factors he identified seem to work over shorter periods of time as well.

**Table 19. Income Inequality in MED countries**

Country	Year of Survey	Gini (expenditure)	Ratio richest /poorest quintile
Algeria	1995	35.3	6.12
Egypt	1990	32.0	4.71
	2004	32.1	4.60
Jordan	1992	43.4	8.44
	2006	37.7	6.29
Lebanon	2004	36.0	6.14
Morocco	1990	39.2	7.03
	2007	40.9	7.34
Syria	1997	33.7	5.32
	2004	37.4	5.67
Tunisia	1990	40.2	7.85
	2005	41.3	8.13
Turkey	1994	41.5	8.22
	2005	43.2	9.42

*Source:* El Laithy (2012).

A high level of income inequality usually indicates that there are various forms of discrimination, social exclusion and poverty (even in the case of high GDP per capita) in the society. Excessive inequality leads to social and political tensions and decreases the legitimization of the political regime as was seen during the Arab Spring. In social and economic terms, it can be interpreted as denying large groups of the population chances to participate, on equal terms, in the labor market, business activity, education and the consumption of other public goods and

wasting a substantial part of the country's human capital which negatively impacts growth prospects.

### 6.3. Gender Inequality

Gender inequality and gender discrimination is another serious challenge faced by most MED11 countries. For the purpose of our analysis which focuses on the region's economic development, two aspects of this complex and multi-dimensional phenomenon<sup>19</sup> have a fundamental importance: uneven access to education and the labor market.

**Table 20. Indicators of Gender Inequality**

Country	Population with at least secondary education (% ages 25+), 2010		Labour force participation rate (%), 2008	
	Female	Male	Female	Male
Algeria	36.3	49.3	38.2	83.1
Egypt	43.4	61.1	24.4	76.4
Israel	78.9	77.2	61.1	70.1
Jordan	57.6	73.8	24.7	78.3
Lebanon	..	..	24.1	74.8
Libya	55.6	44.0	25.1	81.1
Morocco	20.1	36.4	28.7	83.6
Palestinian Autonomy	..	..	16.7	72.4
Syria	24.7	24.1	22.0	82.1
Tunisia	33.5	48.0	27.7	74.2
Turkey	27.1	46.8	26.9	74.6

Source: El Laithy (2012).

The selected education indicators presented in columns 2 and 3 of Table 20 and Table 21 (in Section 7.4) suggest continuous female discrimination in access to education in MED11 countries with the exception of Israel, Libya and perhaps Syria.

Female labor market participation rates are very low in MED11 countries compared to female participation rates of about 50% in most low- and middle-income

<sup>19</sup> Which also includes the underrepresentation of females in political life, unequal civil rights, unequal status in marital and family law, and many other disadvantages. For a more in-depth analysis of this phenomenon see AHDR (2006) and El Laithy (2012).

countries and have increased only very slowly in recent decades. This situation results not only from limited access to education, but also from unfavorable legal, economic and cultural factors (MENA, 2004b; AHDR, 2006). In 2008, the female labor participation ranged from 16.7% in the Palestinian Autonomy to 38.2% in Algeria, while the average for the male labor force amounted to ca. 80% (Table 24). Israel was the only exception with the female labor participation rate of 61.1%.

## 6.4. Education

As illustrated in Table 21, illiteracy still remains a problem in several MED countries, especially in Morocco, Egypt and Tunisia.

**Table 21. Literacy rates in MED11 countries**

Country (year)	Adult total $\geq 15$	Young female 15-24	Young male 15-24
Algeria (2006)	73%	89%	94%
Egypt (2006)	66%	82%	88%
Israel	n/a	n/a	n/a
Jordan (2007)	92%	99%	99%
Lebanon (2007)	90%	99%	98%
Libya (2009)	89%	100%	100%
Morocco (2009)	56%	72%	87%
Palestinian Auton. (2009)	95%	99%	99%
Syria (2009)	84%	93%	96%
Tunisia (2008)	78%	96%	98%
Turkey (2009)	91%	97%	99%

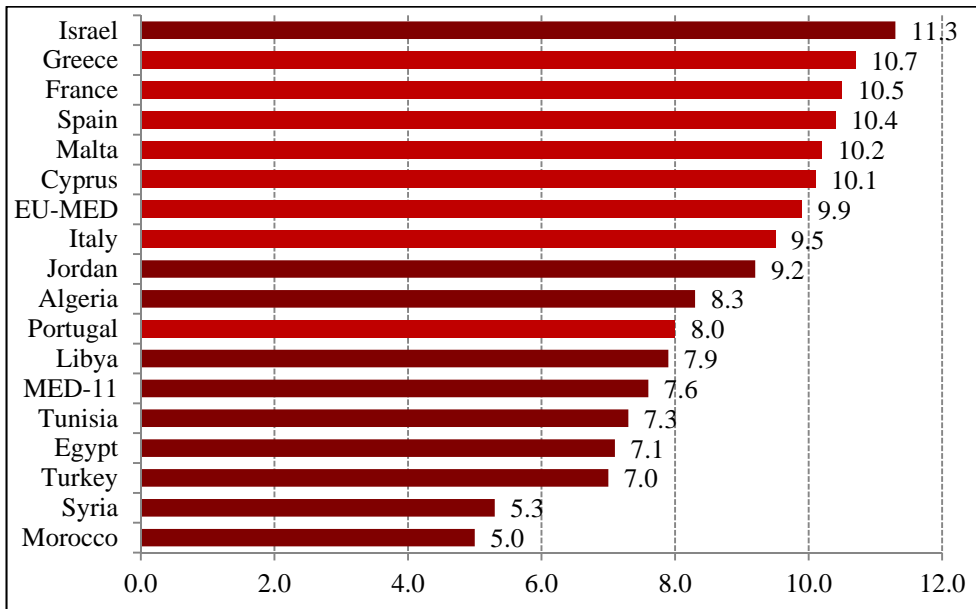
Source: [http://api.worldbank.org/datafiles/SE.ADT.LITR.ZS\\_Indicator\\_MetaData\\_en\\_EXCEL.xls](http://api.worldbank.org/datafiles/SE.ADT.LITR.ZS_Indicator_MetaData_en_EXCEL.xls), [http://api.worldbank.org/datafiles/SE.ADT.1524.LT.FE.ZS\\_Indicator\\_MetaData\\_en\\_EXCEL.xls](http://api.worldbank.org/datafiles/SE.ADT.1524.LT.FE.ZS_Indicator_MetaData_en_EXCEL.xls), [http://api.worldbank.org/datafiles/SE.ADT.1524.LT.MA.ZS\\_Indicator\\_MetaData\\_en\\_EXCEL.xls](http://api.worldbank.org/datafiles/SE.ADT.1524.LT.MA.ZS_Indicator_MetaData_en_EXCEL.xls).

As discussed in the previous section, women are particularly disadvantaged. The continuous high level of illiteracy among youth (15–24 year olds) means that large groups of girls and, to a lesser extent, boys remain excluded even from primary education.

However, most of those who have access to schools complete only a primary education. As illustrated by Figure 16, Moroccan and Syrian kids are particularly disadvantaged with the average schooling period of ca. 5 years. The quality of

education, apart from a very small number of elite schools and universities, is rather low (see AHDR, 2003) which is documented, among others, by poor results in international student tests (El Mahdi et al., 2011). Consequently, the quality of human capital in the region is below potential with negative consequences for economic development.

**Figure 16. Average years of schooling for adult population (ages 15+), 2010**



Source: Barro and Lee (2010), Arbak (2012).

The above assessment does not apply to Israel where education indicators exceed those of several EU countries.

## 7. Summary and Conclusions

The research results presented in this report point to key factors that have influenced the growth performance in the MED region and will continue to determine its development over the next twenty years. In spite of differences in individual countries' development levels and their economic, social, and political characteristics, there are some common lessons from the past which should be taken into consideration when shaping a region's future policies:

First, macroeconomic stability, underpinned by prudent fiscal and monetary management that ensures a low level of inflation and balanced budget, should be maintained.

Second, the benefits of an open economy should foster policies that aim to adhere to competitive exchange rates and low tariff and non-tariff barriers so as to ensure external competitiveness and better resource allocation.

Third, improving the business climate and governance should help attract domestic and foreign investment, unleash private sector activity, and help in job creation. Special attention should be paid to the effective implementation of reform measures. Governments would do well to continue their privatization policies and install a competent regulatory and supervisory framework.

The policies aimed at addressing these key challenges must take into account the specific circumstances of each MED11 country. For example, for some of them it will be important to stimulate economic diversification in order to decrease their dependence on hydrocarbons. Others can improve their attractiveness as tourist destinations.

However all countries will benefit from upgrading their infrastructure in order to improve their internal and external connectivity. This would enhance their prospects for domestic and international trade, from fine tuning their agricultural policies to improving their food security and ensuring that they are able to benefit from the ICT revolution. The latter will depend on an improved business environment, a privatized telecom sector, and a proper regulatory framework. Preparing the region to adjust to climate changes will also be a challenge and failure to do so would reduce the positive effects of economic reforms.

This report concentrates largely on economic issues. However the economic performance of any country is intended to improve the quality of life of its popula-

tion. In turn, the contribution which individuals can make to economic performance depends largely on their levels of health, education and labor participation, including that of females. Therefore, social policies and publicly provided social services should be assessed not only in terms of quality of life (level of human development) but also as the key determinant of economic development.

This study has also highlighted the importance of good governance in fostering economic and social outcomes. Hence the importance of building a democratic and secular state of rule of law and respecting civil rights and freedoms, without contradicting the dominant cultural and religious traditions of the region. The collapse of several authoritarian regimes in 2011-2012 as a result of the Arab Spring and its pro-reform impact on neighbors has created a unique window of opportunity to achieve this goal but, as the experience of revolutions in other regions demonstrates, it does not offer an automatic guarantee of success. Much will depend on individual countries' abilities to form stable governments, adopt democratic constitutions and other basic legislations, with sufficient institutional checks and balances, and to avoid the temptation of economic and social populism. The 2011-2012 experience of the first three countries which entered this path (Tunisia, Egypt and Libya) gives an indication that the transition to liberal and stable democracy with responsible economic policy will not be an easy task.

Apart from the large reform agenda in each individual country, MED11 countries must contribute to solving regional conflicts which requires better cooperation amongthemselves, within the broader MENA region and with other key strategic players such as the EU and US. Success in addressing such protracted conflicts such as those between Israel and its Arab neighbors or between Algeria and Morocco could unlock a huge cooperation potential in the region, providing a boost to its long-term development, through much larger intra-regional trade and incoming FDI and smaller defense/ security spending (the so-called peace dividend).

The major economic and political partners of MED11 countries, especially the EU, can support the development prospects of the region. Among the four MEDPRO prospective scenarios (see Ayadi & Sessa, 2011) the second one, i.e. the Sustainable Development of an Enlarged 'EU-MED' Union (or 'Mediterranean as One Global Player') seems to be the most beneficial in all aspects. Materialization of this scenario will not be easy and will require serious effort by both sides, i.e., the EU and its MED neighbors. Nevertheless, as the stronger partner (in economic and political terms), the EU bears special responsibility for its success or failure.

The initiative belongs to the EU in many important fields, for example, trade liberalization in some sensitive sectors (like agriculture and services), a more flex-

ible approach to incoming migration from the MED region, movement towards what this report refers to as ‘deep integration’, energy and environmental cooperation, cooperation in the area of education, science and culture. Such a policy could benefit from large-scale technical assistance to MED11 countries. This can be done within the existing framework of the European Neighborhood Policy, the Union for the Mediterranean, and bilateral association and deep and comprehensive free trade agreements. The initiatives should be carefully attuned to the new political and institutional initiatives in the region. The current financial and economic crisis in the EU should not deter new initiatives and enhanced resources to support the implementation of the ambitious goals of MEDPRO’s Scenario II.

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