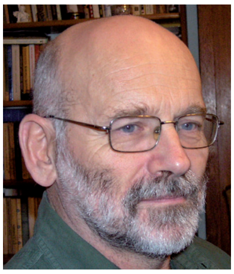


Economic and social challenges faced by Southern and Eastern Mediterranean countries[1]

Marek Dąbrowski and Luc De Wulf are both CASE Fellows. CASE - Center for Social and Economic Research, is an independent non-profit economic and public policy research institution founded on the idea that evidence-based policy making is vital to the economic welfare of societies.

Legacies of the past

Most of the Southern and Eastern Mediterranean countries (SEMC)[2] remain relatively backward in economic and social terms. Average GDP per capita is less than the global average. In 2010, it ranged from a high of nearly $30,000 in Israel to less than $5,000 in Morocco. The pace of the region's economic growth was not impressive for quite a long time, especially in the 1980s and early 1990s.

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

In the first decade of the 2000s, there was finally a visible improvement in terms of higher growth, lower inflation, fiscal deficits, and public debt levels in those countries which undertook market-oriented reforms. However, this did not fully compensate for the previous poor performance.

Per capita income growth has also been tempered by high population growth; the region's population has grown more than 2% annually as compared with 1.2-1.3% worldwide. As a result, economic growth has not been sufficient to reduce unemployment, which remains at more than 10% in most countries, with even higher rates for female workers. At 25% or more, the region´s youth unemployment is the highest rate in the world. Better education and labour market reforms could help in addressing this dramatic social challenge.

Persistent high unemployment, growing income disparities, an unequal playing field in business, corruption and nepotism, poor governance, the conspicuous consumption of a small elite, and the lack of a political voice led to widespread discontent, and, ultimately, to the Arab Spring. It is too early to assess the impact of the Arab Spring on long-term economic policies and growth performance. In the short run, political turbulence and populist policies have damaged growth performance and macroeconomic stability.

However, the experience of countries that went through political transitions suggests that countries can return to a growth trajectory in a few years if the correct policies are put in place. Specifically, economic growth benefits from macroeconomic stability (as measured by low inflation and balanced fiscal accounts), openness to trade, foreign investment (for which a good business climate and a predictable macroeconomic environment are essential), developed financial markets, good infrastructure and investment in human capital (if it is accompanied by good governance).

Maintaining fiscal stability

SEMC must continue reducing their fiscal deficits, which requires both expenditure and revenue adjustments. On the expenditure side, a reduction in price subsidies and a rationalization of public employment are the two most obvious priorities.

Large price subsidies to food, electricity and fuel continue to create a huge fiscal burden in several countries, especially Egypt (over 10% of GDP), Algeria, and Lebanon. In some countries, price subsidies have increased in the wake of the Arab Spring. They are both costly and inefficient in fighting poverty (their main 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, hamper the development of renewable energy, etc. Price subsidies should be replaced by targeted social safety nets, including targeted cash transfers. Countries that postponed or reversed reforms in this sphere should reconsider them as a priority task.

Increasing public sector employment, which often serves as another social policy tool, also has negative fiscal consequences and tends to keep wages low. It undermines the recruitment of the best candidates to public service thereby weakening the efficiency of service delivery. Private sector growth, not public sector employment, should stimulate job creation.

"Most of the MED countries, except for Israel and Tunisia, suffer from a poor business and investment climate"

Trade liberalization

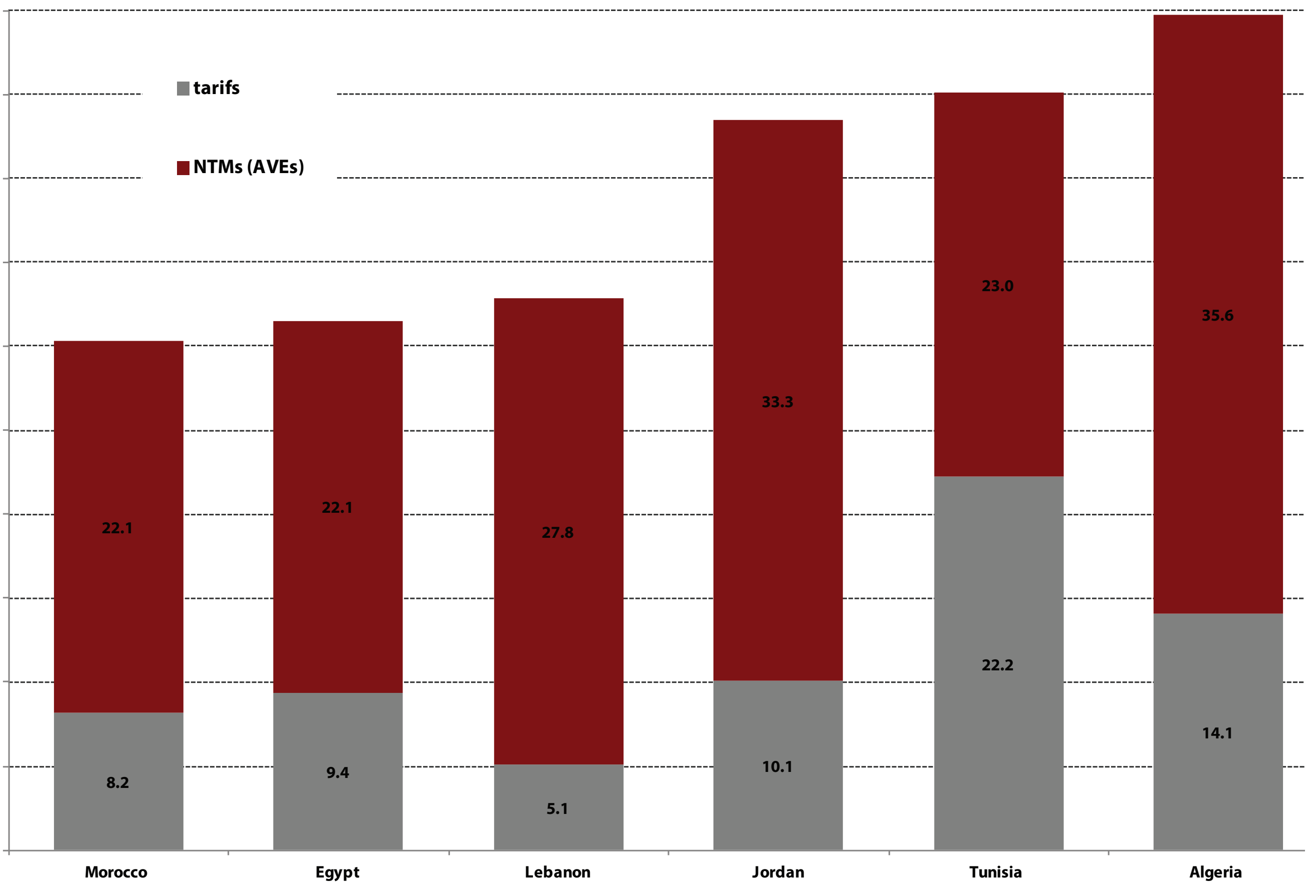
Trade plays a crucial role in SEMC, most of which are small and often dependent on energy and other commodity exports. Their relative under-industrialization and continuous high share of agriculture production in GDP make their modernization prospects dependent on duty-free imports, robust exports, and investment openness. The trade flows of most SEMC, except for Jordan and the Palestinian Autonomy, are concentrated on the EU. They may be boosted by removing tariffs, reducing non-tariff measures (NTMs), decreasing high transport costs and improving uncompetitive trade logistics. Trade in services also faces serious restrictions and removing these restrictions could lead to considerable trade expansion. The same concerns intra-regional trade, which is rather limited and often hampered by protracted political conflicts and closed borders.

Despite multilateral trade agreements sponsored by the WTO and the gradual implementation of the EU-MED Association Agreements (AA) and the Great Arab Free Trade Area (GAFTA), tariffs in several SEMC still constitute a significant barrier to imports, particularly of agricultural products (Figure 1).

The most serious NTMs include: insufficient harmonization of technical standards, sanitary and phyto-sanitary measures, restrictive competition and government procurement rules, inefficient custom procedures, and poor enforcement of intellectual property rights. Figure 1 demonstrates that the tariff *ad valorem* equivalents (AVEs) of the NTMs are consistently higher than the tariffs themselves.

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

Figure 1: Overall trade protection in selected SEMC: tariffs and NTMs, in %



Source: Ghoneim, Peridy et al (2011): Shallow versus Deep Integration between Mediterranean Countries and the EU and within the Mediterranean Region, CASE Network Reports, No. 96, Annex 3

If all tariffs were abolished, restrictive NTMs removed, and the TLI substantially improved, trade would expand substantially, especially in the countries with greater initial trade restrictions. MED exports to the EU would increase less than imports because the initial EU tariffs were close to zero and the EU's TLI is much better than the TLI of the MED region. Exchange rate adjustments may be needed to cushion excessive pressure on the current account. These policy changes would also foster growth in intra-regional trade.

Private sector development and privatization

Most of the MED countries, except for Israel and Tunisia, suffer from a poor business and investment climate as documented by the annual *World Bank's Doing Business* reports, the *Heritage Foundation's Index of Economic Freedom*, *Transparency International's Corruption Perception Index* and other international surveys and ratings. Even though several countries recently improved their business related legislation, its implementation suffers from weak institutions, bureaucratic discretion, corruption, and unequal treatment of investors. To improve the situation, each country should map out specific legal and regulatory constraints which impede private sector development, elaborate strategies to tackle them, and ensure the public monitoring of their implementation.

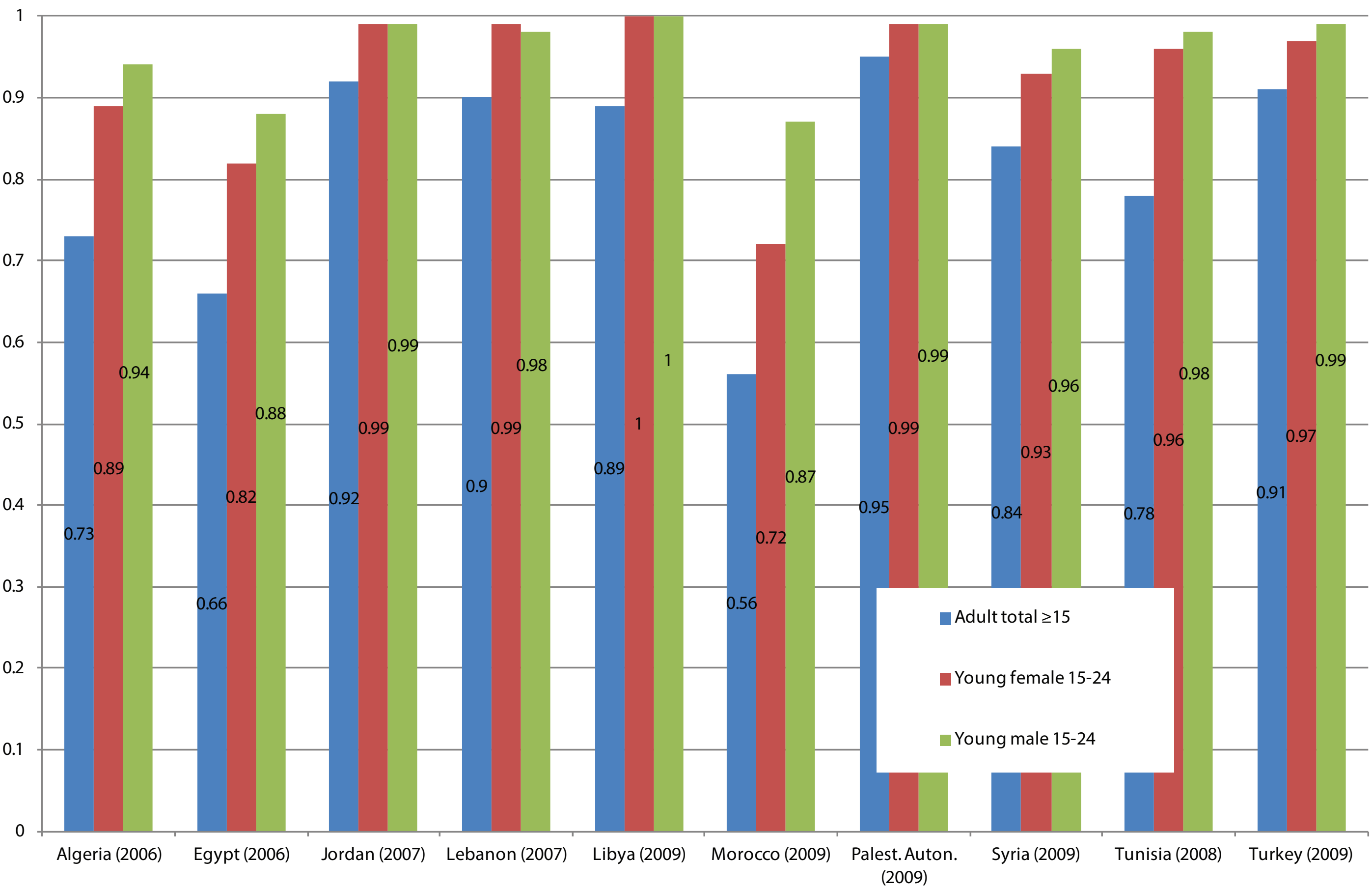
Banks in the region suffer from a low degree of competition as a result of excessive market entry barriers and the predominant role of public ownership. Credit allocation by state-owned banks is largely arbitrary and benefits large well-connected companies and discriminates against small and medium-size enterprises. Coupled with the lack of independent supervision of the financial sector, this situation hampers private sector growth. To improve private sector access to credit, countries should privatize remaining state owned banks and implement governance reforms. In addition, they must foster competition in the banking sector and improve banking supervision.

Some SEMC started privatization programs in the 1980s as part of policies departing from their socialist/statist past. Others are only in the early stages of implementation or the programs are stalled for a variety of reasons. In comparison with other regions, the privatization performance of SEMC is very modest. The regulatory framework for privatization needs to be strengthened to ensure full transparency.

Attracting foreign investment

In 1995-2000, SEMC had one of the lowest foreign direct investment (FDI) flows to GDP ratio (1.11%) as compared with other regions in the world. In 2005-2009, this changed and the region exhibited one of the highest ratios (4.19% of

Figure 2: Literacy rates in SEMC



Source: 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.MA.ZS_Indicator_MetaData_en_EXCEL.xls

GDP), just behind Europe & Central Asia (4.53%) and the EU (4.65%) and far ahead of the other regions. Since the Arab Spring, FDI flows have fallen off sharply.

To reverse this unfavourable trend, SEMC should improve the investment climate, for example, by eliminating barriers to trade and financial transactions, maintaining an exchange rate regime that ensures smooth adjustment to various shocks, improving infrastructure and governance, and investing in human resources to allow employers finding workers that are able to take on jobs created by modern manufacturing.

Investing in infrastructure

SEMC lag behind other middle income countries in their transport and telecommunication infrastructure, which hampers trade and economic growth. Efforts should be made to fill this gap, including mobilization of domestic resources and foreign aid, privatization of those subsectors (like the fixed-line telephony) which are still dominated by publicly owned monopolies, improving the environment for private sector operators, and strengthening competition.

Social challenges

SEMC are characterized by high levels of income inequality, with Gini coefficients above 0.3 (in Turkey, Tunisia and Morocco – they are above 0.4), which indicates the presence of various forms of discrimination, social exclusion and poverty. Excessive inequality leads to social and political tensions and decreases the legitimization of the political regime, which was what catalyzed the Arab Spring. In social and economic terms, this can be interpreted as denying large groups of the population the chance to participate, on equal terms, in the labour market, business activity, education, and consumption of other public goods and wasting a substantial part of the country's human capital.

Gender discrimination is another serious challenge. The region is characterized by uneven access to education and the labour market, the underrepresentation of women in political life, unequal civil rights, unequal status in marital and family law, and many other disadvantages. In 2008, female labour participation ranged from 16.7% in the Palestinian Autonomy to 38.2% in Algeria, while the average for the male labour force was ca. 80%. Israel was the only exception, with a female labour participation rate of 61.1%.

Illiteracy remains a problem in several MED countries; especially Morocco, Egypt, Algeria and Tunisia (see Figure 2). Continuous illiteracy among youth 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 or less and the overall quality of education in the region is widely considered as poor. Consequently, the quality of human capital in the region is below its potential, which has negative consequences for economic development. ■

ABOUT THE AUTHORS

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1. This article is based on authors' earlier publication in CASE Network E-Briefs No. 13/2012 – see http://www.case-research.eu/sites/default/files/publications/2012-13_Dabrowski%2C%20DeWulf.pdf and results of the EU Framework Program 7 funded project on 'Prospective Analysis for the Mediterranean Region (MEDPRO)'

2. SEMC include: Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestinian Autonomy, Syria, Tunisia and Turkey.