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The EU's neighbouring economies: emerging from the global crisis

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ABBREVIATIONS

AA	Association Agreement
AP	Action Plan
BIS	Bank for International Settlements
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
COM	European Commission
DoTS	Directorate of Trade Statistics
EBRD	European Bank for Reconstruction and Development
EFTA	European Free Trade Area
ENP	European Neighbourhood Policy
ENPI	European Neighbourhood and Partnership Instrument
EIU	Economist Intelligence Unit
EU	European Union
EURASEC	Eurasian Economic Community
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GCC	Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE)
GDP	Gross Domestic Product
GNI	Gross National Income
GSP	General System of Preferences
HDI	Human Development Index
ILO	International Labour Organisation
IMF	International Monetary Fund
MED	ENP Mediterranean Countries
MEI	Main economic indicators
MENA	Middle East and North Africa region
MFA	Macro-financial Assistance
NDF	National Development Fund
NEER	Nominal Effective Exchange Rate
NIP	National Indicative Programme
NPLs	Non-Performing Loans
OECD	Organisation for Economic Co-operation and Development
oPt	occupied Palestinian territory
PPP	Purchasing Power Parities
SMEs	Small- and Medium-sized Enterprises
SPPRED	State Programme on Poverty Reduction and Economic Development
UAE	United Arab Emirates
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
USD	US dollar
VAT	Value Added Tax
WB	World Bank
WDI	Word Development Indicators
WTO	World Trade Organisation

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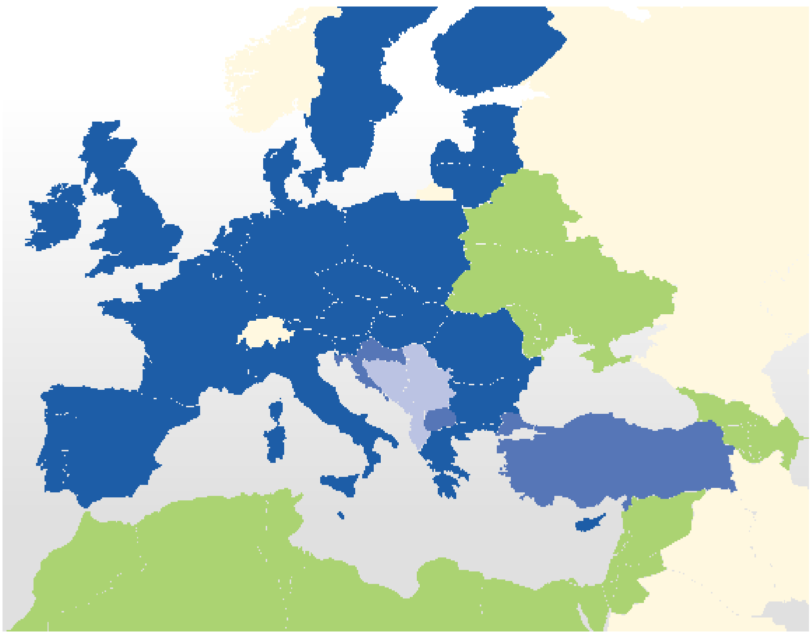
FOREWORD

In the aftermath of the global financial crisis the EU's neighbouring countries are facing new challenges. While the EU's eastern neighbours reached the trough of the crisis last year, many of them are experiencing a strong economic rebound from the recession that entails benefits as well as pitfalls. In contrast, economic growth in the southern neighbours of the EU slowed down, halving on average in comparison with the economic situation just before the crisis. But, growth remained positive on an annual basis during the global crisis, so that their return road towards the growth path that was achieved before the crisis is far less steep. National macroeconomic policies have adapted relentlessly during the crisis and seem for almost all countries to be heading towards less easing. Those challenges prominent before the crisis, such as the higher commodity prices in particular for energy and food, creating the risk of high consumer price inflation, are likely to reappear on the back of the resurgence of global economic growth. Nonetheless, the global crisis has impacted all countries and the vulnerabilities and risks to macroeconomic stability loom all the more so in the upward economic stage. In many countries, they are high fiscal debt stocks, sizeable government sectors, relatively weak private sectors, high unemployment rates, shallow financial sectors hampering the rise of economic activity and damage to welfare levels, and the lack of buffers. Vigilance is therefore the watchword, more than ever, and public finance reforms should be high up the agenda of policy makers, although it is hard to find the right timing for the implementation of fiscal tightening in order not to damage private sector developments.

Being part of the annual series of Occasional Papers on the EU neighbourhood policy, this paper reviews recent developments in the countries neighbouring the EU, in particular in the financial and monetary sector and in public finances. It contains three main parts. The *first* part analyses the welfare damage due to the global crisis at regional level, and reflects on the vulnerabilities of and risks to the economies in view of the financial crisis and global economic slowdown. The *second* part is divided into two regional sections, dealing with the EU's southern and eastern neighbours respectively. Both sections look at the main areas of reform, such as macroeconomic developments, trade and financial integration, business climate and governance. The *third* part contains country chapters, each of which gives an overview of the economy of one country. In addition to fiscal, financial and monetary issues, these chapters also contain country-specific information on labour market developments and social indicators.



The main focus of this publication is on countries that are part of the European Neighbourhood Policy (ENP) framework. The ENP encompasses the EU's immediate neighbours by land or sea, along the southern rim of the Mediterranean – Algeria, Egypt, Israel, Jordan, Lebanon, Libya, occupied Palestinian territory, Morocco, Syria and Tunisia – and the countries to the east of the EU which form the Commonwealth of Independent States – Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. Other countries analysed are Russia, Gulf Cooperation Council (GCC) countries – Saudi Arabia, the United Arab Emirates, Bahrain, Kuwait, Oman and Qatar – and Central Asia. Relations between the EU and Russia are governed by a strategic partnership and those with the GCC countries by a cooperation agreement. Central Asia is included for the first time in this analysis as this region has become a significant player in the world, in particular as far as the EU's eastern neighbours are concerned. The wider group of Mediterranean countries that take part in the restyled 'Barcelona Process: Union for the Mediterranean' but are not formally part of the ENP are occasionally included in the analysis, as are a number of other countries (such as EFTA-member Iceland and Kazakhstan). This broader scope is used to review the performance of the EU's neighbours against peers.

This Occasional Paper was written, under the guidance of Loukas Stemitsiotis and Andreas Papadopoulos, by Ronald Albers (thematic chapter, Lebanon, Moldova), Stylianos Dendrinos (Armenia, Israel, Libya), Alexandra Janovskaia (overview of the CIS, Georgia, Tunisia, Ukraine) Neil Kay (overview of the Mediterranean countries, Azerbaijan, Jordan, Morocco, occupied Palestinian territory, Syria), Marga Peeters (thematic chapter, Algeria, Egypt, GCC, editorial), Giedrius Sidlauskas (Central Asia) and Lúcio Vinhas de Souza (overview of the CIS, Belarus, Russia). Anne Juergens contributed to both regional overviews, in particular the sections on the business climate and governance. The authors are grateful for the comments of Paul van den Noord and Mary McCarthy.

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Part I

Thematic issues

1. THE WAY OUT OF THE CRISIS: LOOKING FORWARD

1.1. ADJUSTING TO THE CRISIS: POLICY DIRECTIONS

For the EU neighbour economies 2009 was a year of adjustment to the consequences of the global crisis. For the countries that were directly and heavily affected, it marked a period of further shaping policy responses to the crisis. This was particularly the case for several countries in the eastern neighbourhood, which sought international assistance to supplement domestic policy efforts. Eastern neighbours typically resorted to easing of monetary policies, often accompanied by exchange rate adjustments. As fiscal revenues shrank in the wake of the crisis, capital inflows and remittances dried up, the financial sector was hit by uncertainty, portfolio rebalancing and increases in risk premia, and fiscal stimulus measures added to public expenditure, current accounts had to adjust and fiscal deficits soared. In those circumstances, international assistance was often needed to ensure macro-economic stabilisation. A notable exception is Russia, which had sufficient buffers to fund domestic adjustment. But also countries that had escaped the worst of the direct impact, particularly in the southern Mediterranean, had to adjust to a fundamentally different economic environment. They adjusted policies in response to the differential impact on various sectors and industries in their national economies, but on the whole the emphasis there was on monetary easing and far less on the fiscal front. Eventually, however, in 2009 an economic slowdown did materialise among southern neighbours as indirect effects of the crisis passed through, and a fast rebound does not seem to be on the cards.

As the crisis worked its way through the global economic system from the advanced economies in which it originated, various rounds of adjustment occurred, showing up in trade and financial markets, in exchange rates, in portfolio shifts and changes in the size and direction of international capital flows and credit, in inflation and in public finances and debt dynamics. The impact on emerging and developing countries was shaped by factors such as the degree of trade and financial integration, the fiscal starting position, economic structure, and policy responses.([1])

Due to the large cross-country and cross-regional differences both the crisis impact and the policy actions differed widely among neighbour countries (the regional overviews in part II of this study and the country chapters in part III present a more detailed overview of key economic variables and policy measures, and specify as well economic reforms which fall outside the scope of this chapter to discuss in detail). This contribution focuses on the main policy challenges which neighbour countries face to overcome the crisis. It is argued that there is a compelling case for pursuing economic reforms targeted at enhancing potential

([1]) For an overview of transmission channels in these regions, see also *The Impact of the Global Crisis on Neighbouring Countries of the EU*, European Commission, European Economy Occasional Paper no. 48, 2009.

Table I.1.1:

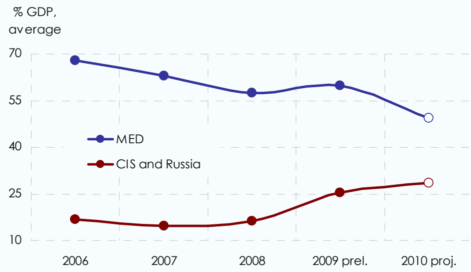
MED and CIS - Annual average GDP per capita in international US dollars	period	Mediterranean	CIS and Russia
growth	1994-2008	5.1	12.9
growth	1999-2008	5.6	16.3
growth	2004-2008	5.6	12.6
growth, excluding oil-exporting countries	2004-2008	5.3	14.5
growth, oil-exporting countries	2004-2008	5.7	11.3
level as % of the level in the EU-27	2004-2008	33	25
level as % of the level in the US	2004-2008	20	15
level as % of the level in Latin-America	2004-2008	94	69
level as % of the level in Developing Asia	2004-2008	263	193

Notes:
Mediterranean includes Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Syria and Tunisia.
The occupied Palestinian territory is not included due to lack of data.
CIS includes Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.
Oil exporting countries are Algeria and Libya (MED), Azerbaijan and Russia (CIS and Russia)
Developing Asia includes 26 countries, among which China and India.
Sources: IMF World Economic Outlook.

Box I.1.1: **Developments in public debt and deficits**

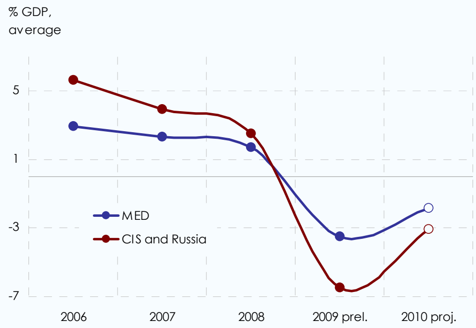
Public finances in the MED countries and the EU's eastern neighbours deteriorated significantly in 2009 (see graphs right). Especially in the latter region the public deficit was sizeable. However, the region's public finance stance had been in far better shape than the MED when the global crisis started, with relatively low debt levels thanks to multiple reforms over the last decade. As a consequence of worsening government balances and lower real and nominal GDP growth, aggregate debt levels in the neighbour economies rose in 2009 substantially, both in the east and in the south.

Government debt



As regional averages mask the underlying figures at national level, it makes sense to consider the range between the highest and lowest debt and deficit levels for each region (see graphs below).

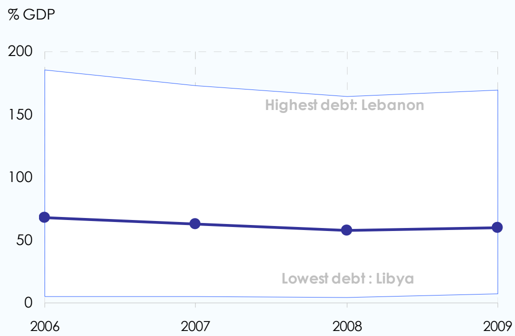
Government deficit



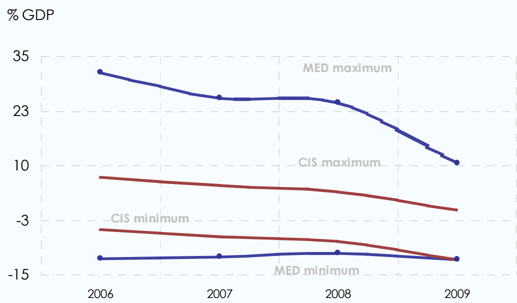
The dispersion in the public finance debt among the MED countries is large. In 2009, as in preceding years, Lebanon had the highest public debt ratio, exceeding 150% of GDP, while Libya had virtually no public debt. The latter is understandable in view of the abundant oil revenues in this relatively low populated country. The debt range for the CIS region (not shown here) is much smaller. Of the CIS countries, remarkably, oil-exporter Azerbaijan has the highest government deficits while Russia has often performed best in this respect over the past few year.

In sum, 2009 was a very bad year for all countries as public surplus countries faced a strong deterioration in government accounts, while public deficit countries saw their deficits increasing. For the years to come this means that reforms are needed to curb the upward trend of the government debt stock as a percentage of GDP. This can occur either via fiscal tightening, that is cutting government expenditures or expanding government revenues, or by conducting reform policies that support growth, or by a combination of both policies.

Government debt in the MED



Government balance

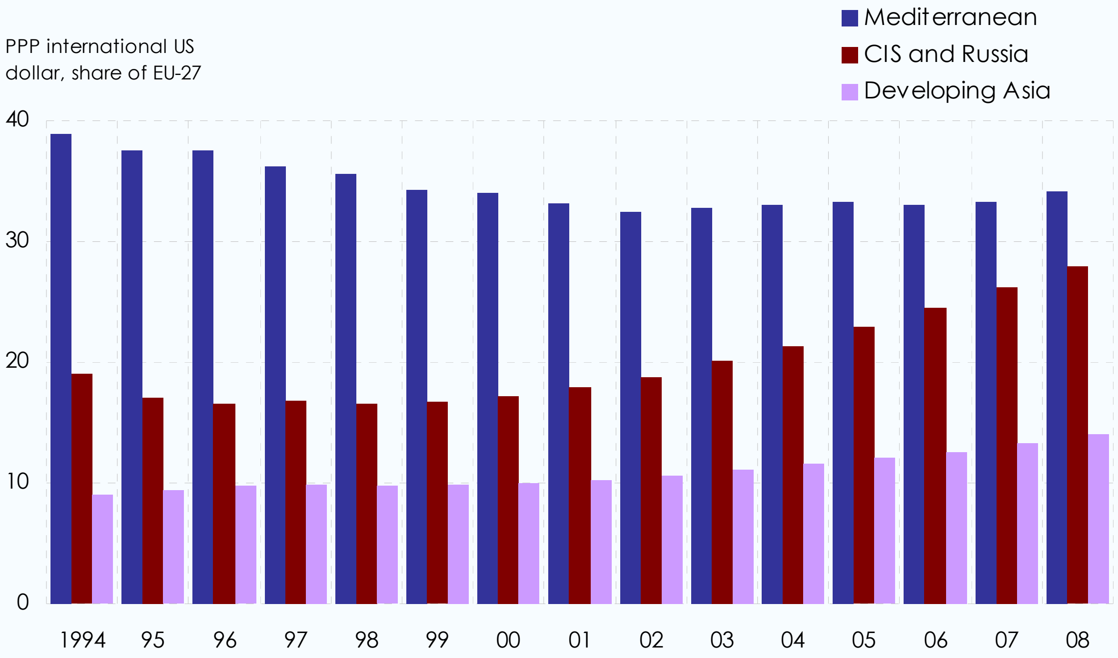


growth and softening the trade-offs that many countries faced in the recent period. Important lessons learnt from the global crisis are that growth and economic integration cannot be taken for granted and that the belief in the functioning of markets has been shattered to such an extent that the growth and development models used in the past are certainly up for fundamental reconsideration. For instance, eastern neighbour countries have clearly run into the limits of a growth model based on mobilising substantial foreign savings, which jeopardised financial, external and eventually fiscal sustainability. A major challenge for the Mediterranean neighbours is to find ways to overcome constraints in public spending and to create job opportunities and strengthen the business environment in order to address demographic pressures. But this need not mean that reforms should be slowed or reversed. An examination of the development of the relative income gap between neighbour and advanced economies rather suggests that they need to design policies aimed at realising growth potential.

Typically, policy responses in neighbour countries were not strongly co-ordinated, largely for lack of institutional co-ordination mechanisms that exist for instance in the European Union. But in any event, neighbour countries do face similar issues with respect to the design of exit strategies from the economic support measures that they put in place. Mutual co-ordination at regional level to avoid negative externalities is likely to remain a soft spot, as it was during the height of the crisis. At the present juncture, it seems that the thinking about exit strategies in neighbour economies is still developing. For each country, the urgency with which such strategies have to be devised also depends on the reliance on foreign assistance and on the budgetary starting position. Clearly, countries with larger fiscal buffers and less reliance on external support have more leeway to follow a gradual approach in adjusting stimulus measures.

This notwithstanding, the main challenge for neighbour economies will be to adapt to a post-crisis global economic environment in which external constraints to growth have become more stringent. The rapid economic expansion of the early 21st century is unlikely to be repeated in the years to come. Due to muted growth prospects in advanced economies, the scope for export-led growth aimed at those markets has diminished,

Graph I.1.1: **GDP per capita share of EU-27**



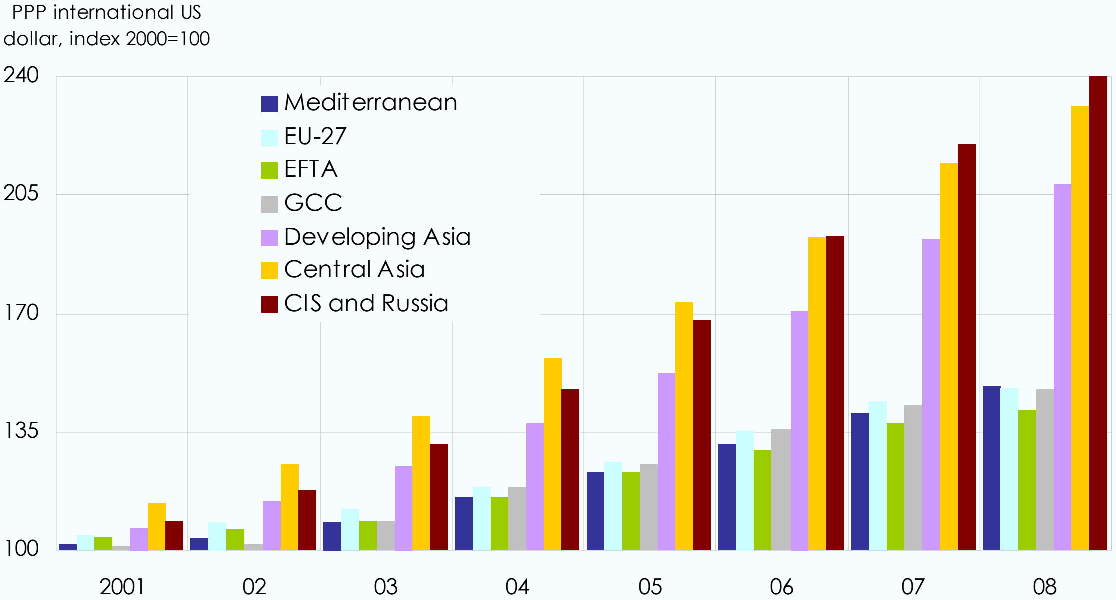
Source: IMF World Economic Outlook and own calculations.

although a reorientation of exports towards more rapidly growing emerging economies may offer compensation. Inflows of capital and credit will be more difficult to come by, and at a higher price, especially if recovery involves a progressive exit from accommodative monetary policies. And even if fiscal tightening could reduce the fiscal crowding-out effect on financial markets, heightened risk perceptions are still likely to be reflected in structurally higher risk premia. External and public debt has risen, increasing debt service and reducing fiscal space. A well-structured exit from fiscal stimulus might be positive and not only to ensure the sustainability of public finances. It might also help improve the internal allocation of resources and support structural adjustments that had been delayed in the stabilisation phase, thus contributing to restoring the confidence of foreign investors. Moreover, commodity prices have increased again, which on balance is positive for commodity exporters but signifies a deterioration in the terms of trade for commodity importers.

Against this background, neighbour countries arguably have to increase efforts to enhance domestic demand and increase productivity in order to continue to catch up with higher income regions. Hence the compelling case to continue implementing an ambitious reform agenda aimed at enhancing potential growth. In other words, perhaps the main lesson from the crisis for policy makers is not to loose sight of the benefits of well-managed international economic integration and not to back out of reforms that will bolster resilience, enhance conditions for foreign investment, and help develop a strong and sustainable growth trajectory. While the renewal of flows of foreign capital flows cannot be taken for granted, implementing ambitious reform agendas can help increase investment. A well-devised exit of public support from ailing industries could invite consolidation and improved resource allocation thus supporting innovation and productivity which in turn would boost the attractiveness to foreign investors to step in.

To be sure, costly lessons have been learnt about the devastating impact of macro-financial excesses that went unchecked for too long. In order to reap the lasting benefits of economic integration, a robust institutional and governance framework should safeguard macro-economic stability. But efforts to remain shielded from the vicissitudes of the global cycle by opting for protective or inward-oriented policies bear a high opportunity cost in

Graph I.1.2: **GDP per capita**



Source: IMF World Economic Outlook and own calculations.

terms of foregone catch-up. After all, the substantial and persistent relative income gap with advanced economies has been arguably the background to the long-standing policy agenda on development and growth strategies and reforms. The next section turns to this issue in more detail.

1.2. CREATING THE CONDITIONS FOR FUTURE GROWTH

According to the latest statistics for relative income levels approximated by purchasing power parity-adjusted GDP per capita, Mediterranean neighbour countries had an average GDP per capita of around 35 % of the EU-27 level in 2008 and 30 % of the euro area. For eastern neighbours (including Russia) the relative income level in terms of per capita GDP was still lower, at around 28 % of the EU-27 average and 24 % of the euro area average in 2008. Of course, per capita GDP is only a crude and incomplete measure of the much more encompassing notion of welfare. But in order not to digress unduly on the appropriate measurement of welfare (on which there is no consensus in the literature), the focus in this chapter is on relative GDP levels as an approximation which is often used. The substantial gap in measured income levels that neighbour economies have to bridge in order to come close to that in advanced economies sets the scene for a key challenge that policy makers in those countries face. It is to achieve sustainable catch-up to raise income levels and bring them closer to the best-practice frontier of advanced economies.

The development over time of the relative income gap by region reveals another important characteristic, which is not easily recognised if one focuses solely on recent developments. Graph I.1.1 shows the relative income level as a percentage of the EU-27 averages for the southern and eastern neighbours, covering a longer time period. For comparison, the chart includes figures for central Asia and for developing Asia, the latter region having shown rapid catch-up over the past few decades. Long-term trends in welfare levels and growth rates are presented in Box I.1.2 and give more details by country and on patterns over time; here the focus is on the long-terms trends in regional aggregates. Key growth figures are summarised in Table I.1.1.

Because growth had been very strong in Member States that joined the EU from 2004 onwards, comparisons of relative GDP per capita for the euro area probably offer a better basis for long-term comparisons. Graph I.1.2 provides this for the eastern and southern neighbours. The data illustrate quite clearly that between the early 1990s and 2008, the average relative income level of the Mediterranean neighbour countries stayed roughly the same compared to the euro area. The average masks important cross-country differences, such as the smoother catch-up of Tunisia over a longer period as well as the trend fall in the relative income level for Syria, but reflects the pattern observed for most countries in the region. By contrast, after the low-point reached directly following the early stages of transition and the problems caused by the Russian crisis, Russia and the CIS also enjoyed a long spell of rapid gains in GDP, from the late-1990s up until the crisis hit in 2008. Allowing for cross-country differentiation in the timing and extent of economic growth, this pattern holds for all eastern neighbours. Admittedly, the sheer depth of the recent crisis in the eastern neighbour countries shows that part of this catch-up was not sustainable but reflected an overextension, fuelled by mispricing of risk and ensuing misallocations of capital. Yet, on the assumption that the recovery that is projected for 2010 and beyond does materialise, Russia and CIS countries in the EU neighbourhood have caught up in relative terms in comparison with the EU and other advanced economies since transition began, and the crisis has wiped out only part of the gains.

By contrast, Mediterranean countries did not catch-up over a longer time period, despite the fact that their average relative income level is still higher than in the eastern neighbourhood. This also puts into perspective the relative resilience of Mediterranean countries to the crisis. Admittedly this was the case to an extent – although with some delay economic growth did slow down appreciably in that region as well. But one can also argue that apparently in the preceding period of rapid technological innovation (notably in ICT) and rapid globalisation, southern Mediterranean countries did not manage to reap the growth benefit. Tentatively, it may be the case that the lesser degree of global interdependence and the fairly slow progress in reforming economic structures partly helped shield them against the vicissitudes of the global cycle, but also penalised them in terms of a sub-par level of economic welfare.

The observed differences in per capita GDP are conditioned by a wide variety of factors, ranging from resource endowments, demographic developments and migration patterns, to public and private sector governance, infrastructure development, technology transfer and take-up, home and foreign investment levels, development of the financial sector and efficiency of financial intermediation, business climate, revealed or potential comparative advantages, openness of the economy, and a host of difficult-to-measure institutional and cultural characteristics. The regional chapters in part II complement the present narrative and illustrate in more detail several of the growth impediments pertinent to neighbour economies, and the policy challenges and actions that were taken in response. It goes beyond the scope of this chapter to account for the reasons behind the relative income gaps in any detail. However, it is clear that efforts are required to improve economic performance relative to the best-practice frontier. And in the neighbour economies, there seems to be ample potential to achieve this in the longer run, given improvements in the functioning of the economies concerned.

To the extent that one can hazard any conclusions on the basis of this rather broad overview, for all neighbour economies the preceding analysis seems to constitute a powerful plea not to give up on reforms, but rather to focus on those reforms that promise to entail a sustainable growth bonus. An overly cautious approach does not seem promising now that the external conditions have become much less favourable. Improving (international) governance, risk management and crisis resolution mechanisms will be critical to avoid the pitfalls of the past. Yet, the main policy lesson from the crisis may be that reforms to improve resource allocation and the functioning of the economy, to exploit comparative advantages, and to open up to other players in the world economy, still hold the promise of improved macro-economic performance.

With respect to policy frameworks and long-term strategies, lessons from the past will have to be learnt on how to avoid destabilising outcomes. In this respect, neighbour countries will depend on the outcome of the overhaul of the international financial architecture currently being negotiated. In any event, policy makers need to reflect on viable strategies to pursue. For instance, arguably growth models based on foreign inflows or overly relying on exports could be carefully reconsidered. It still makes sense to mobilise foreign savings to invest in projects that will help boost the domestic growth potential. This entails the development of a robust financial sector which can ensure an appropriate level of financial intermediation. That said, one lesson from the lead-up to the global crisis is that it is important for capital- or credit-importing countries not to exceed the absorption capacity for foreign funds. This involves avoiding excess inflows spilling over into unsustainable asset or property booms or domestic consumption, and ensuring the capacity to service external debt. As regards the role of exports, some of the neighbour countries boast industries which are heavily geared towards export markets, often in the EU (for instance Tunisian textiles or Ukrainian steel). With rather anaemic growth projected for some of the main export markets in the post-crisis economic landscape, economies in the region are well advised to adapt and not aim too strongly at export-led growth outside sectors in which they have comparative advantages. It is imperative to try and exploit fully comparative advantages. In some cases, this would encompass removing institutional and other barriers that prevents such exploitation, for instance trade monopolies or collusive practices. Reorientation towards strategic sources of growth does not imply that neighbour countries should become inward-looking, but rather it would mean develop domestic resources for growth and boosting intra-regional trade.

To summarise, there is a strong case for vigorously pursuing structural reforms as the external environment has become far less conducive to growth than it had been in the years preceding the crisis. But long-term structural challenges remain: sustainable public finances, price stability, poverty reduction and further development of the market economy in order to exploit the growth potential and bring about a permanent rise in living standards. Hence the challenge for policy makers is to review development strategies for their respective countries. As far as the outlook for the near term is concerned, history suggests that the CIS countries and Russia may be able to rebound relatively quickly thanks to the flexibility of their economies. In this regard, the relatively high degree of development of the financial sector in many of these countries can be conducive to the recovery provided that prudent policies to overcome the excesses of the past and to mitigate systemic risk in an internationally coherent approach are adopted. The countries in the Mediterranean neighbourhood have shown resilience to the immediate impact of external shocks that hit their economies during the crisis. However, the growth slowdown did affect them with a lag and removing economic and institutional rigidities will determine not only the strength of the rebound but in particular the prospects for longer-term welfare gains.

Neighbour countries now have to follow up on crisis measures that they have taken and redirect policies to some form of normality. The question of the design of 'exit strategies' is in essence a similar one to that facing advanced economies. The next section focuses on this issue.

1.3. EXIT STRATEGIES

In view of the massive funds invested in domestic policy stimulus and donors' support to counter the effects of the crisis and stabilise the economy and the financial sector, the question of how to exit the stimulus is the paramount policy issue for policymakers in all parts of the world. Debt sustainability (for both public and private debt) appears to have become the overriding constraint that dictates the need for consolidation and the unwinding of anti-crisis measures. Policy makers and indeed the population at large have to realise that the global economic and financial environment will be much more difficult than before the crisis.

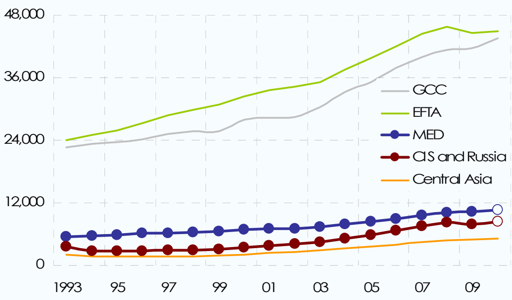
Recovery will not mean a return to the conditions that prevailed for most of the first decade of the 21st century. Those conditions were not sustainable but characterised a period of excesses building up. In the period ahead, growth will on the whole be lower, inflationary pressures are likely to be more persistent, risk aversion and risk differentiation will remain higher and risk premia are not expected to return to pre-crisis levels. Foreign investment and credit will be harder to come by. In addition, in a less conducive growth environment the quite substantial costs associated with ageing and climate change will be more difficult to cope with, especially for demographically challenged regions. In addition, the challenge arising from issues of social cohesion and distribution may well make it difficult to forge a political consensus to implement much-needed reforms. Clearly, the risk of withdrawing policy stimulus too soon has to be recognised. But from a longer-term perspective, the increase in debt levels, in the first instance but not only for the public sector, has been such that an adjustment in policies will be inevitable to ensure debt sustainability.

The size of the domestic and foreign stimulus measures in neighbour economies has arguably been greater in the east than in the south. This in part reflects the fact that several eastern neighbours resorted to international assistance, in contrast to their Mediterranean counterparts.

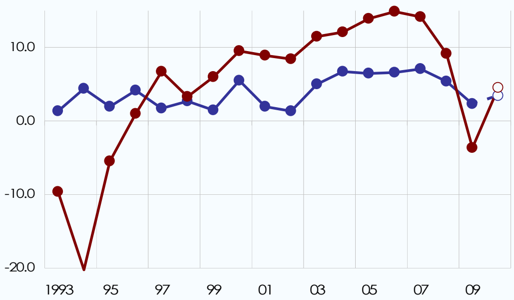
It is quite difficult to obtain a reliable estimate of the approximate size of the policy stimulus to address the impact of the crisis. This is partly due to the great disparity in neighbour countries' policies, economic characteristics and statistical frameworks. But it partly also reflects conceptual obstacles to estimating the effect of policy measures on the economy. For instance as regards fiscal policy in the neighbour countries it is quite difficult to break down the overall worsening in the headline fiscal balances into contributions due to purposeful stimulus measures, autonomous changes in tax policy and expenditure programmes, and the cyclical impact of the downturn (both due to lower real and nominal growth and to changes in GDP composition). Policy easing on the monetary and financial side is in principle somewhat more straightforward to gauge, particularly in terms of the lowering of policy interest rates and of reserve requirements. That said, for countries with exchange rate pegs the room for manoeuvre is essentially defined by the policies conducted in the country or region of the anchor currency. Also adjustments in exchange rates (or, for countries with exchange rate arrangements, the imported monetary easing via the central policy pursued in the countries of the anchor currencies) and the provision of liquidity or several forms of (state) guarantees for credit, loans and exports can be tracked. However, in practice the impact of changes in monetary and exchange rate policies on the real economy is blurred via differential impacts on lending rates and risk

Box I.1.2: Long-term trends in welfare levels and welfare growth rates

GDP per capita
PPP international USD, average across countries



Economic growth per capita
PPP international USD, y-o-y %, average across countries

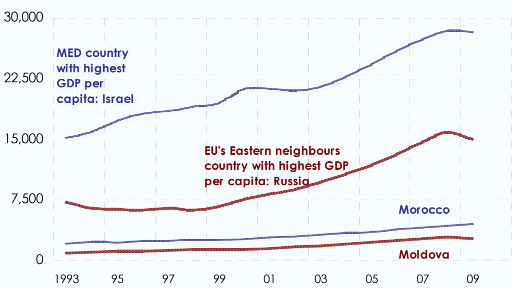


Source: IMF World Economic Outlook, own calculations.

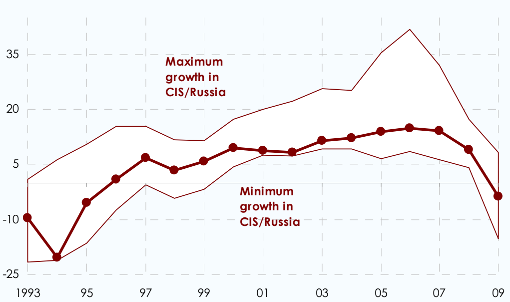
From the early 1990s until 2009, GDP per capita had been growing steadily and relatively strongly in the Mediterranean countries. In the CIS countries and Russia growth had been quite high after the first years of transition and the aftermath of the Russian crisis, from the late 1990s until 2008. On average, GDP per capita grew from 5 500 international USD in 1993 to 10 100 in 1998 in the MED and from 3 500 to 8 300 in the EU's eastern neighbour countries (see left-hand graph above). So GDP per capita almost doubled in 15 years. In 2009, a deep recession hit the EU's eastern neighbours, following a long period of high economic growth. In per capita terms, across these countries the economic contraction was 3.7%, while in the Mediterranean countries GDP per capita held up much better, growing 2.3% on average (see right-hand graph above). However, over the whole 16-year period examined here gains in the relative income levels of the MED and CIS and Russia still lagged behind in comparison with growth in other regions of the world, such as developing Asia, the GCC and the EFTA countries.

The average relative income levels (an incomplete measure of welfare as mentioned above), approximated by GDP converted at purchasing power parities (which correct for differences in price levels and thus make relative income levels more comparable), cover a wide range. This holds in particular for the MED, where Israel has a high relative income level comparable to several EU countries, whereas Morocco has the lowest (see the left-hand graph below). For the EU's eastern neighbours the range in relative income level is smaller, though still large, with Russia on the upper side and Moldova on the lower side of the distribution. Over the period examined, countries with the lowest starting level did not usually grow faster. For instance, among EU neighbouring countries Moldova tended to have the weakest growth in GDP per capita, while for many years GDP in Azerbaijan and Libya grew fastest thanks to their oil exports. Also, in the CIS and Russia the range in growth has been broad, even up to 30 percentage points (right-hand graph below).

GDP per capita
PPP international USD, minimum and maximum



Economic growth per capita CIS and Russia
PPP international USD, y-o-y %, minimum and maximum



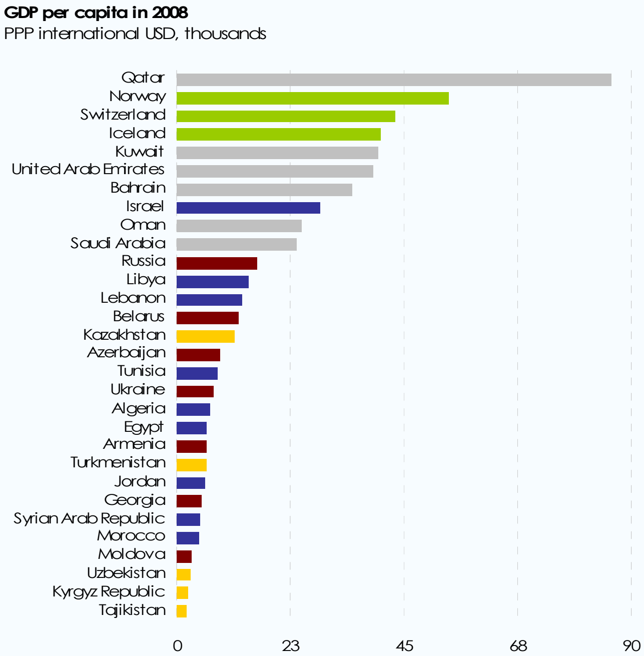
Source: IMF World Economic Outlook, own calculations.

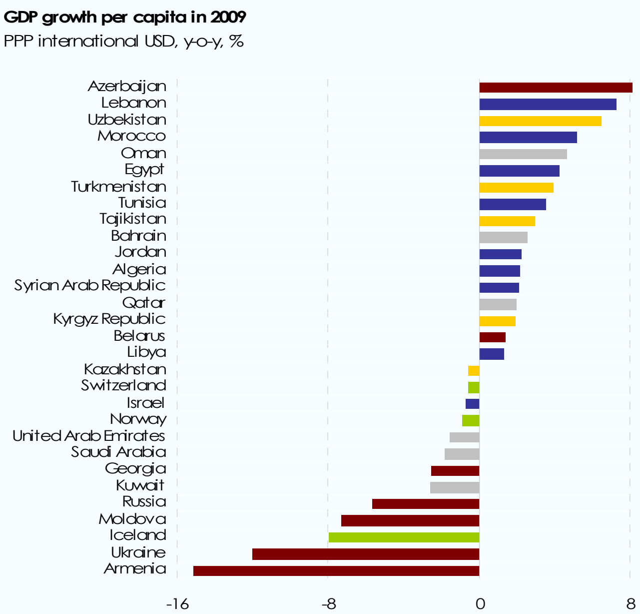
Note: Due to lack of data Palestine is not included in the analyses here.

(Continued on the next page)

Box (continued)

While, apart from Israel, the relative income levels of the MED and the EU's eastern neighbouring countries still lag well behind developed economies, the global crisis that started in 2008 and bottomed out in 2009 has impacted welfare levels in the EU's eastern neighbours much more than in MED countries. The large exposure of the financial sector in the EU's eastern neighbouring countries and the current account adjustments played a crucial role in the sharp drop in GDP (1). Armenia, for instance, suffered most with a contraction of GDP per capita of almost 16%, exceeding even the drop in Iceland (see the graph below). Ukraine ranked second. Azerbaijan, Lebanon and Morocco, by contrast, still grew strongly in 2009. (2)





Source: IMF World Economic Outlook, own calculations.

Nonetheless, history has shown that the CIS countries and Russia are able to catch up quickly thanks to the flexibility of their economies. Moreover, the relatively high degree of development of their financial sector is conducive for their economic growth, provided that prudent policies are adopted. Further lessons from the financial crisis can be drawn.

The MED countries have shown their resilience to the external shocks that hit their economies during the recent crisis, such as the drop in foreign trade. But their performances, on average, have shown to be modest. On the back of the global economic growth they could however benefit from economic expansion, not the least via further global integration.

1) See also *The Impact of the Global Crisis on Neighbouring Countries of the EU*, European Commission, European Economy Occasional Paper no. 48, 2009.

(2) See the regional overviews and country chapters in this Review for further details.

premia, credit volumes, write-downs and exchange rate movements.

But regardless of the amounts, authorities in the region have to devise exit strategies to partly or wholly unwind or redirect measures that were taken to address the global crisis. The quite diverse starting situation and institutional set-up across countries has to be taken into account. For several neighbour countries the fact that they did have a very articulated response strategy may make it more difficult to formulate a coherent exit strategy. Moreover, as noted above, policy responses in neighbour countries were typically not strongly co-ordinated. This was partly for lack of institutional co-ordination mechanisms at regional or international level and partly reflects the incomplete degree of regional integration, not least in the south. On the positive side, this also means that possible negative feed-back effects from international policy linkages are less of a concern in devising exit strategies. However, economic linkages still exist that do merit a critical reflection on international spillovers of national policy measures, even though these linkages probably are weaker than among the more closely integrated advanced economies.

A strong framework of international governance in financial markets and trade is indispensible to help guide strategy design. Certainly, tough lessons have to be learnt from the crisis. Improving the functioning and governance of financial institutions and financial markets and improving risk management and crisis resolution mechanisms at international level will be critical in this respect. In the aftermath of the crisis, intense efforts to address these issues are being made at international level, for instance in fora such as the G-20. Neighbour countries will have to adapt to international best practice in order to benefit from the overhaul of the global financial architecture that is currently being devised. Yet, most of the improvements in the functioning of the financial sector have to come from domestic reforms to improve its governance and functioning and increase the resilience of the financial sector to national and international shocks.

On the fiscal side, the emphasis will be on measures to withdraw crisis support in an orderly manner, duly timed. In the next phase, public finances have to be organised in a way that guarantees debt sustainability. Normalisation would mean a stronger emphasis on the quality and efficiency of public expenditure, with clear prioritisation. Unleashing growth potential by supporting and implementing welfare-enhancing structural reforms will ease the fiscal constraints. On the revenue side, the structure of taxation may have to be reconsidered to ensure a sufficiently broad fiscal base, while avoiding taxation becoming an impediment to growth and innovation. In terms of the planning and execution of fiscal strategies, well-designed fiscal rules can be an important lever in bringing about the changes and helping ensure that policies remain on a sustainable track. In several commodity exporting countries, perhaps most notably Russia, the deterioration in the fiscal deficit could be compensated by the surpluses that had been accumulated in previous years. Yet for the future, also countries with rich natural endowments have an incentive to work on strong budgetary rules in order to manage the consequences of the long-term depletion of resource and to prevent Dutch disease-type imbalances from developing.

Tailor-made solutions will have to be found in the first instance at country level. Benefitting from international experience and exchange of best practices can help to formulate policies that can mitigate or even address the debt sustainability constraints that are likely to become a major policy concern in the period ahead.

1.4. THE IMPACT OF PUBLIC FINANCES ON ECONOMIC GROWTH AND STABILITY

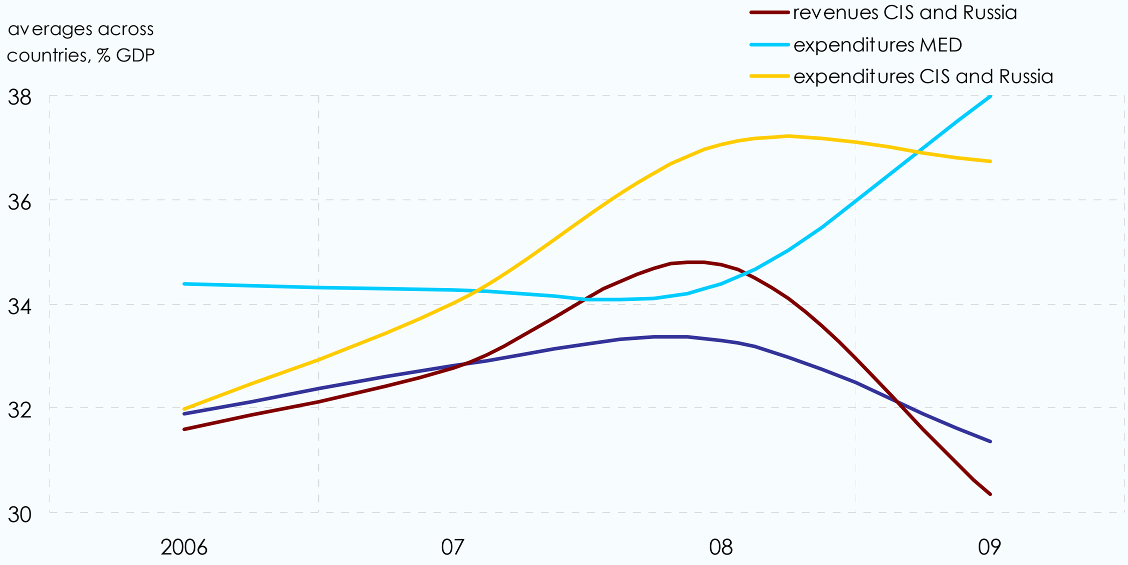
As regards exit strategies fiscal policies play a key role. Of course, the overall policy mix is important. But in several neighbour countries exchange rates constraints, developments in the financial account and/or a relatively less sophisticated financial sector circumscribe the room for manoeuvre for monetary and exchange rate policies (although there are some very important exceptions, such as Russia). So, arguably public finances play an essential role to overcome the crisis. Fiscal sustainability is one key issue. But as concerns the link between macro policies and long-term growth potential, the structure, governance and quality of public finances forms a critical nexus. There is a vast and rapidly developing literature on the quality of public finances and the impact of public finances on economic growth and stability([1]). It emphasises, for instance, the impact of public sector size on growth, and the importance of institutional quality and efficient public finance management on the efficiency of public spending.

The purpose of this contribution is not to revisit the debate, but rather to briefly touch upon key issues that have direct policy implications for EU neighbour economies. In this respect, three main issues can be identified.

The first issue concerns the effect of the relative size of public revenues, expenditures and debt on macro-economic performance. This covers for instance the sources of government funding, weight of taxation, pattern of expenditure, possible crowding-out of private investment, the optimal provision of public goods, and the various effects that credible and sustainable (or non-credible and unsustainable) fiscal positions can have on capital flows, risk premia, financial sector stability, exchange rate stability, and the credibility of the macro policies of authorities. These issues are all familiar ones, especially to the extent that sound public finances are a sign of credibility with international investors and financial markets. Experience with the recent global crisis has forcefully shown that emerging economies with a credible fiscal reputation and track record and/or a stronger fiscal starting position were able to weather the crisis better, to the extent that they could place and roll over debt easier and at more favourable interest rates. This pattern also pertains to EU neighbour countries, in particular those with relatively open economies. In several cases, specific circumstances led to an idiosyncratic policy response, with less binding fiscal constraints on anti-crisis strategies. Russia, for instance, was able to benefit from a large foreign reserve pool to finance policy stimulus. In Lebanon, the ample liquidity position of domestic banks provided a pool of funding for the government, albeit at high interest rates. Yet, in that latter country fiscal sustainability remains precarious given the large public debt. Commodity exporting countries were able to benefit from accumulated export proceeds to counter the crisis impact, aided by the rebound in commodity prices in the course of 2009. Relatively isolated economies, such as Syria, suffered a limited first-order impact of the global cycle but there the structural reform challenges and the relative underperformance vis-à-vis attainable potential growth remains substantial.

([1]) For an overview, see S. Deroose and C. Kastrop (*eds*.), The quality of public finances — Findings of the EPC Working Group, European Economy Occasional Papers **37,** March 2008.

Graph I.1.4: **Government revenues and expenditures**



Source: See country chapter Macroeconomic Indicator Tables

The second dimension concerns the structure of public revenue and expenditure and its impact on growth and stability. This covers sources of government funding, the weight of taxation, patterns of expenditure, debt management, and availability of monetary financing. Graph I.1.4 clearly reveals distinct patterns of public expenditure across regions. In the southern Mediterranean, expenditure ratios tend to be higher than among eastern neighbours, reflecting higher outlays on items such as public wages, defence, and education. Subsidies, for instance on basic food commodities and energy, still also tend to account for a substantial part of outlays. On the revenue side, there is a large reliance on indirect taxation, and quasi-rents from government monopolies. Eastern neighbour countries also have a revenue share of indirect taxes which is higher than in the EU, among other things reflecting impediments to assessing and taxing incomes and profits of households and enterprises. On the expenditure side, salary and interest expenses in the east are comparatively low, whereas transfers and (indirect) subsidies to (state-owned) enterprises account for a larger share than in the Mediterranean. It is beyond the scope of this contribution to examine these different patterns in detail, but some elements appear to be important for efficient and sustainable public finances. These include limiting the outlays on debt service and the importance of having a broad enough tax base so as to avoid stifling taxes that encourage evasion. Expenditures on distortive subsidies or transfers which hinder effective resource allocation, private sector initiative and innovation would also have a negative impact on long-term growth. By contrast, expenditures geared at supporting human capital formation, enabling smooth functioning of the labour market, and promoting efficient public services would yield a positive contribution.

The third, and arguably most difficult-to-fathom dimension is the governance and quality of public finances. Governance is an encompassing term, but essentially it covers institutional changes that go beyond the implementation of new regulations and structures. This stems from recognition that the quality of governance ultimately determines the impact of public finances on economic performance. For the EU neighbour countries, the issue of governance is essentially about public sector reform. This is not only about introducing legal frameworks, reforming audit systems and practice, and reinforcing the accountability and scope of action of management. EU best practices provide strong standards to assess performance and reform in these areas. ENPI instruments offer information, projects and funding to implement public sector reform. But the success of public sector reform and the positive effect on private sector development and macro-economic performance ultimately depends on the degree to which best practices are internalised by civil servants in their day-to-day work.

For all regions in the world, managing public finances during the recovery from the crisis and devising exit strategies to unwind crisis measures in an optimal way will be challenging. EU neighbour economies are no exception in this regard, although the severity of the downturn, fiscal starting positions and policy responses varied greatly from country to country. Hence, the reform challenges are also quite different in each case, but in all of these economies the reform challenge remains substantial. In any event, reform of economic structures – including public finances – to foster growth, to close gaps in economic performance, and to enhance macro-economic stability remains a must for neighbour countries to improve economic performance over the long run.

1.5. CONCLUSIONS

In view of the above, some tentative conclusions can be formulated that can help guide policies in adjusting to the post-crisis environment and constraints.

Certainly, tough lessons have to be learnt from the crisis. Improving (international) governance, risk management and crisis resolution mechanisms will be critical in this respect.

As far as the EU neighbourhood is concerned, there is a strong case for pursuing an ambitious reform agenda in the region in order to realise the growth potential and achieve catch-up. With the external environment far less supportive than it had been in the years preceding the crisis, reforms to improve resource allocation and the functioning of the economy, to focus on an efficient public sector and sustainable public finances, to attract investment, exploit comparative advantages, to open up to other players in the world economy, and to develop an appropriate degree of financial intermediation while mitigating stability risks, hold the key to of much-improved macro-economic performance.

As regards the policy mix, an appropriately timed exit from crisis relief measures is called for. The appropriate timing and modalities of the exit will depend on county-specific circumstances, taking into account parameters such as the risk of jeopardising nascent recovery, monetary conditions, and the fiscal room for manoeuvre.

On the monetary side, exit strategies will have to be defined in function of factors such as inflationary risks, the situation in the banking sector, developments in credit and currency markets, and (for countries with exchange rate targets) the constraints posed to the room for manoeuvre for monetary policy. Some neighbour countries may reconsider the design of their monetary and exchange rate regime as part of a longer-term strategy to overcome the effects of the global crisis.

Fiscal exit strategies should ideally be embedded in a robust fiscal strategy with a medium-term orientation, aimed at ensuring the sustainability of public finances. Among policy measures to heal public finances, enlarging the tax bases in a growth-optimal manner and changing the composition of government expenditures towards more investment in a broad sense (including in education, innovation, etc., which are not captured as investment in national account conventions) would raise growth potential.

In particular in the Mediterranean, but also in the EU's eastern neighbourhood, there is ample room for further intra-regional integration. In fact, the lack of it is one of the factors behind sub-optimal welfare levels. Enhanced trade integration can also help avoid an overly strong reliance of exports on a limited set of industries or export markets. In this regard, a stronger orientation of trade towards fast growing regions in the world will be called for.

Not only a higher degree of trade integration, but also a higher degree of financial integration can significantly accelerate economic growth in some economies, conditional on appropriate regulatory and macro policies that mitigate financial stability risks. Policies here have to be consistent with international best practice as currently being developed. With safeguards in place to help ensure financial stability, achieving and maintaining an optimal degree of financial integration will be beneficial for stimulating the realisation of growth potential and will be instrumental in boosting welfare levels in neighbour countries.

In order to address inflationary pressures, which are picking up on the back of the resurgence of global economic growth and commodity price inflation, policies should be geared towards diversifying the economies in the direction of agriculture and energy saving activities. The dismantling of collusive practices should also help improve price transparency and flexibility.

Finally, enhancing public governance would improve the potential for the economy to develop domestic sources of growth. Improvements to be targeted would be in particular regards public sector institutional reform, public finance management, and transparency.

Part II

Regional issues

1. OVERVIEW OF RECENT ECONOMIC, MONETARY AND FINANCIAL DEVELOPMENTS IN THE MEDITERRANEAN COUNTRIES

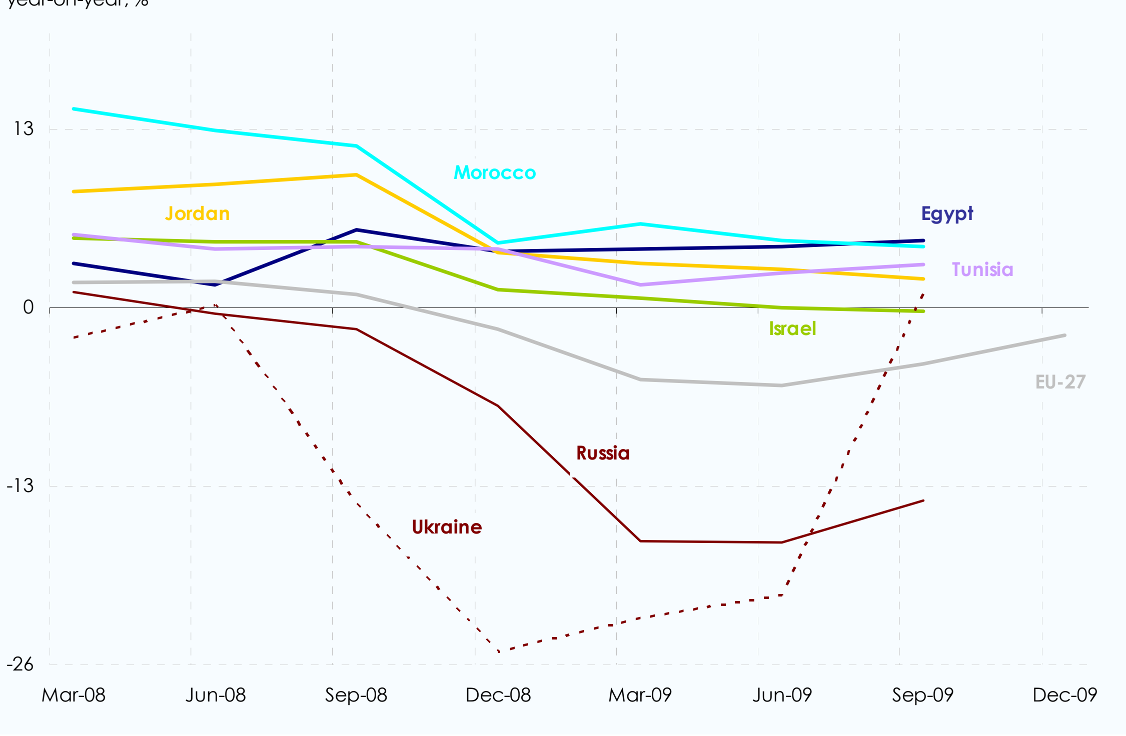
1.1. SUMMARY

Growth in the Mediterranean region was hit by the global financial crisis, mainly through external channels. Exports, inward investment, and remittances declined across the region causing governments and central banks to hastily erect fiscal and monetary policy responses. While the impact on individual economies varied, several factors meant that in general the effect of the crisis was weaker than in other regions, as GDP decelerated rather than contracted. Relatively narrow export bases and underdeveloped trade links in many countries, which have constrained long-term growth, muted some of the effect of a collapse in global demand. The fall in international commodity prices also temporarily offset the decline in exports in several of the oil-importers. In some cases, fiscal stimulus measures were applied to support economies through the downturn and helped avert a wider slow down. The agricultural sector, which is still an important source of employment in the Maghreb region, also compensated on account of a strong harvest. Finally, the region as a whole has limited exposure to international financial markets and structured financial products meaning that the domestic lending capacity of the largely bank-based financial system was not seriously impaired. Nevertheless, some of these factors are temporary and the region remains vulnerable to a continuation in the weak global environment.

The large oil-exporters were hardest hit by the crisis through the sharp decline in oil prices and a abrupt fall in inward investment, while governments responded decisively with expansionary fiscal policy, taking advantage of the fiscal space accumulated from budgetary surpluses over several years. Oil importers were hit less directly and, on the whole, the fiscal response was more limited.

After several years of high growth, real GDP moderated across the region as economies felt the

Graph II.1.1: **GPD growth on a quarterly basis**



indirect impact of the crisis through external channels. In the region as a whole, the impact of the crisis was first felt in the first quarter of 2009, while growth in most economies regained some momentum through the rest of the year. Export growth declined on account of falling global demand for mainly exported goods. Services were less affected although tourism revenues fell in some countries. Inward investment fell sharply on account of capital retrenchment in industrialised economies. Remittances also dipped as overseas employment prospects deteriorated. Although the fall in remittances, which still account for up to 20% of GDP in some countries, was less than anticipated at the start of the year given that unemployment in Europe, in general, rose less than feared. As exports and private sector investment dipped, the burden of growth shifted to private consumption which in most countries grew less strongly than in 2008 but held up reasonably well, averting a wider slowdown.

While the region felt the negative impact of the global economic crisis through several channels, there was also some succour in the reversal of international commodity prices which toward the end of 2008 had put significant pressure on the current account balances and public expenditure of oil-importers, leading in some cases to social unrest. Given the high concentration of food and fuel as a proportion of imports, the current account deficit of oil-importing economies on average narrowed in 2009, despite a dip in remittances. On the other hand, the large oil exporters, namely Algeria and Libya, saw significant trade and current account surpluses sharply curtailed, while oil-exporting economies approached 2009 from a stronger position given the sizeable accumulation of foreign oil revenue over recent years.

In addition to the financial crisis, the beginning of 2009 was also marked by the continuation of armed conflict in the Gaza region of the Occupied Palestinian Territory, highlighting the direct cost of conflict in human and economic terms, and the longer-term side-effect on the development of the surrounding region where military budgets still tie up a substantial proportion of government expenditure.

The Mediterranean region started to feel the impact of the crisis in the last quarter of 2008 and countries began to devise fiscal and monetary policy responses. While in certain cases governments took discretionary measures including increased capital investment and measures designed to support job creation and SME's, the response of fiscal policy was on the whole relatively muted, even in the case of oil-exporters where the room manoeuvre was far greater. Monetary policy started to be eased at the beginning of the year, in some cases central banks were obliged to reverse interest rate hikes, implemented during 2008, and lower reserve requirements as fears grew over the impact of tightening global liquidity and, in the case of countries adopting currency pegs, the pressure from external monetary easing. While the financial sectors of the region are generally well capitalized, in some cases governments took steps to secure their liabilities by, for instance, insuring bank deposits in order to bolster public confidence. However, on the whole monetary policy remained tighter than in most industrialised regions, notably Europe and the USA, given the lack of systemic problems in the domestic banking sector and the high sensitivity to inflation. This, in turn, alleviated some pressure on capital accounts during a period of falling investment. And it is notable that during the year, none of several currency pegs in the region came under significant pressure. Many stock markets in the region fell sharply at the end of the 2008 amid concern about the depth of the impact of the global crisis, but have partially recovered in 2009. In other cases, notably Lebanon and Tunisia, the declines were more moderate.

While the region held up reasonably well during 2009, it is also clear that the long-term structural challenges remain: sustainable public finances, price stability, poverty reduction and further development of the market economy in order to bring about a permanent rise in living standards. Although limited trade and financial sector linkages may have insulated the region in the short-term, they will also hamper the region from taking advantage of the second order effects of the crisis if the global recovery takes hold. In this respect, increasing trade links and developing new export opportunities remains as relevant as ever. In the medium-term, the region will also have to compete more keenly for FDI, as the supply of inward investment is likely to recover only gradually. In the case of oil-exporting countries, the possibilities for continuing to support the economy through public investment are greater while the limited fiscal space of most oil-importers means that there will be a greater need for private sector involvement such as PPP initiatives.

Despite the impact of the crisis, governments in the region continued with structural reform, and the weaker macroeconomic outlook facing the region should be used to expedite further reforms in 2010, in public finances and development of the market economy, much in the same way that surging inflation in 2008 led to the phase out of certain subsidies.

The main risks to the outlook for 2010 stem from the risk of a slow down in growth as the effect of domestic stimulus packages fades, particularly in countries with limited fiscal space where there is a risk of tightening public finances too soon, a weaker than forecast global outlook which would weigh on export sectors and domestic investment, and also the impact of a poor harvest in economies with large agricultural sectors in the Maghreb. For oil importers, the prospect of higher oil prices also poses a major risk. Should these factors materialise there is a risk of the impact of the crisis spreading to the wider economy, causing a slow down in private sector demand, rising unemployment and the write-down of financial sector assets through an increase of non-performing loans. While the region has withstood the crisis so far, it still remains vulnerable should the global outlook deteriorate.

1.2. MACROECONOMIC DEVELOPMENTS

Growth dipped on average across the region from around 5½% of GDP in 2008 to 3½% of GDP in 2009. While the region faired relatively better than other developing regions, avoiding a contraction in output with growth in the oil-importing countries partly supported by more a favourable foreign balance due to the much lower international commodity prices compared with 2008. Israel was the only economy in the region which suffered a short-term fall in output in the third quarter of 2009, based on current estimates, due to the greater export-oriented nature of the economy and stronger trade links with industrialised economies, while the economy is estimated to have registered mild growth over the whole year. The Lebanese economy grew most in the region, easily outperforming the regional average, at 7% of GDP on account of a strong rise in tourism, due to the improved security situation, and many expatriates obliged to return home to vote in national elections.

While the impact of the crisis was limited, due to the limited international exposure of financial sectors, the region nevertheless suffered sharp falls in exports, inward investment, remittances and in some cases a reduction in international grant aid. The large oil-exporters, Algeria and Libya, started to feel the impact of the crisis as early as the middle of 2008, due to decline in demand in the USA, while output in the region as a whole started to slow down in the final quarter.

Exports fell on average by an estimated 15% across the region in 2009. In particular, industrial exports, such as mineral based products, suffered sharp falls from the collapse in global demand. Other consumer oriented sectors, such as textiles and clothing, were all hit. The decline was, however, less than feared due to tourism revenues which held up better than expected and a high proportion of less cyclically sensitive exports such as food products. And in the case of Lebanon, export earnings increased driven by greater tourism receipts. Across the oil-importers, the decline in exports was in general more than offset by a sharp drop in imports, mainly on account of the reversal of international commodity prices.

The picture for tourism was mixed. While the number of tourists arriving in the region was similar to 2008, there was evidence that tourists spent less, for example in Morocco, leading to modest declines in tourism revenue. In other countries, for example, Lebanon and Syria, tourism revenue continued to grow due in part to the perception of an improved security situation. Tourism as an industry continues to gain ground in many countries both as an important source of jobs, for example employing around 25% of the workforce of Lebanon, and foreign currency, for example in Syria where it has the potential to substitute for oil revenues.

Remittances across the region dipped in response to deterioration in the employment market in Europe and the USA. Falls were particularly pronounced in Egypt while the drop was less marked in most of the region. This was on account of the employment market in Western Europe holding up better than expected as well as heavy government stimulus's in the GCC region which supported employment.

Inward investment declined on account the problems in the financial sector in the USA and Europe and shrinkage in regional oil earnings in the GCC countries. This led to a shortage of investment for new projects, particularly large PPP initiatives. Part of recycled oil wealth has been channelled into real estate sectors during the recent period. In this respect, the decline in investment may have triggered some corrections in real estate prices, for example in Jordan. Across the Mediterranean region, foreign direct investment is estimated to have declined by around 25% in 2009. While new inward investment declined in most of the region, there was no evidence of capital flight, with no devaluations of the several currency pegs in the region. In most cases increases in capital expenditure by governments compensated for much of the decline in FDI, leading to either stable or increased levels of gross fixed capital investment in 2009 compared to 2008.

While the impact of the crisis was clearly felt in external channels, it did not undermine domestic demand. Private consumption growth is estimated to have moderated in nearly all countries, but held up reasonably well due to a stable employment market, in general only modest declines in remittances and in some countries supportive fiscal policy. Across the region, private consumption still grew on average by around 4% in 2009, compared to 5.5% in 2008, and is set to rise gradually over the medium-term.

The fiscal policy response to the crisis was in general muted while oil-exporters saw large shifts in public finances. In Algeria, the estimated government deficit for 2009 is 10.8% of GDP compared to a surplus of 9% in 2008, driven by the government's USD 150bn, five-year infrastructure programme. In Libya government finances registered a mild deficit following consistent large surpluses including an estimated 24.6% of GDP in 2008. This was almost entirely driven by a collapse in oil revenues while government expenditure was allowed to remain at previous year levels.

In the oil-importers, the fiscal response was more muted while in most cases still accommodative of economic activity as the level of government spending was at least upheld despite falling revenue. In addition to allowing automatic stabilisers to operate, in some cases, already programmed capital expenditure was brought forward. For example, in Egypt the government accelerated current spending commitments including investment in water and sanitation projects, as well as expenditure on roads, bridges, ports and railway development. Expenditure on schools and the health sector was also increased as well as programmes to promote exports and further development of industrial zones. Capital spending was also substantially increased in Jordan. However, in general fiscal policy was applied lightly, in view of the indirect impact of the crisis and relatively high levels of public debt which left less room for manoeuvre.

While public debt is relatively high in the oil-importers, governments have still been able to finance their deficits through established sources: FDI, remittances, international aid and official lenders. With the exception of Lebanon, there was no bond issuance through the year and in general government borrowing in the region did not come under strain.

While fiscal policy was constrained in many countries, monetary policy was eased throughout the region reflecting liquidity concerns, given the sharp fall in inward investment, and the greater room for manoeuvre given lower international commodity prices and monetary easing in Europe and the USA. Interest rates were reduced throughout the region, in many cases reversing the trend in 2008, and reserve requirements were also lowered in some cases, for example, Jordan and Morocco, in a further effort to boost liquidity.

Inflation started to decline at the end of 2008. This was on account of falling food and fuel prices, which carry a larger weight of the CPI basket than in industrial economies, but also due to the strong base effect of soaring inflation in many economies in 2008 due to high commodity prices and the consequent phase out of food and energy subsidies in some countries, for example Syria and Jordan. This lead to sharp falls into deflation in many countries by the middle of 2009. Average inflation over the year is estimated to around 3% for the region, compared to around 7% in 2008. This excludes Egypt where the CPI only moderated to 12%, sustained by a strong increase in government consumption. However, inflation remains higher in most of the region than in its main industrial trading partners and real effective exchange rates generally appreciated in 2009, in many cases underpinned by currency pegs, which may drag on export growth in 2010.

While the financial sector has limited exposure to international financial markets, it also faced the crisis from a relatively strong position due to domestic factors. A combination of strong regulation and conservative lending practices mean that as a whole the sector is well capitalized. In most countries capital adequacy ratios are at or above the Basel II requirement level of 12%. A few governments took measures to guarantee 100% of banking sector deposits to shore up public confidence in the bank-dominated financial sector at the start of the crisis, but throughout 2009 there have been no failures of major financial institutions in the Mediterranean region. The rate of non-performing loans varies widely across the region, from around 15% in Tunisia to about 5% in Jordan. Having recently fallen due to the strong economic environment and stricter financial sector regulation, rates remained broadly stable in 2009.

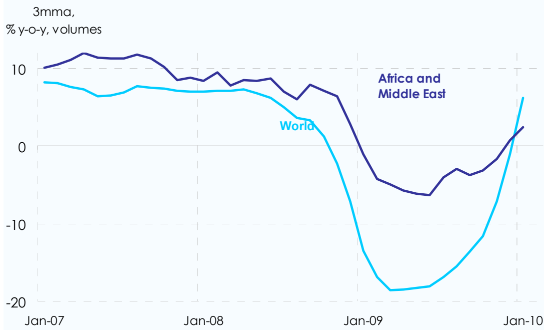
Unemployment stayed broadly flat, in general, and fell in some countries. In particular, unemployment continued falling in Morocco and Algeria, partly on account of strong hiring in the agricultural sector due to the strong harvest, which more than compensated for job losses in industrial export-oriented sectors such as textiles and clothing. The exception was Israel which recorded an increase in unemployment from 8% in 2008 to 9.7% in 2009 on account of the relatively large industrial sector and high concentration of cyclically sensitive technological exports. Despite slackening employment markets in Western Europe and the neighbouring GCC region, there was no large-scale reverse migration.

On the whole, the region is set for a moderate growth outlook given the limited fiscal space of oil-importers to apply further stimuli and the lack of potential in the external side of the economy to take advantage of a recovery in global demand. The scope for monetary policy will also be limited due to potential for interest rate rises in the regions main trading partners, higher commodity prices, slowly increasing inward investment, and the constraint of maintaining currency pegs. Hence, the growth outlook is forecast to be weak, with real growth projected to grow at a similar rate to 2009 at around 3½% of GDP in 2010.

1.3. TRADE AND FINANCIAL INTEGRATION

While world trade in goods contracted by 14% in the global recession of 2009, trade in the Middle East and North Africa contracted by far less.([1]) This is due to the fact that the MENA countries had to contend with a slowdown and not a recession, so their levels of imports remained relatively high. Nonetheless, their exports fell sharply in comparison with previous years. It is expected that, in 2010, trade in the MED will return to almost the same rate of growth as before the global crisis. Economic growth in the developing countries and Asia will reach its potential, but growth in the GCC may still remain sluggish.

Graph II.1.2: **Trade of goods by the MED countries**

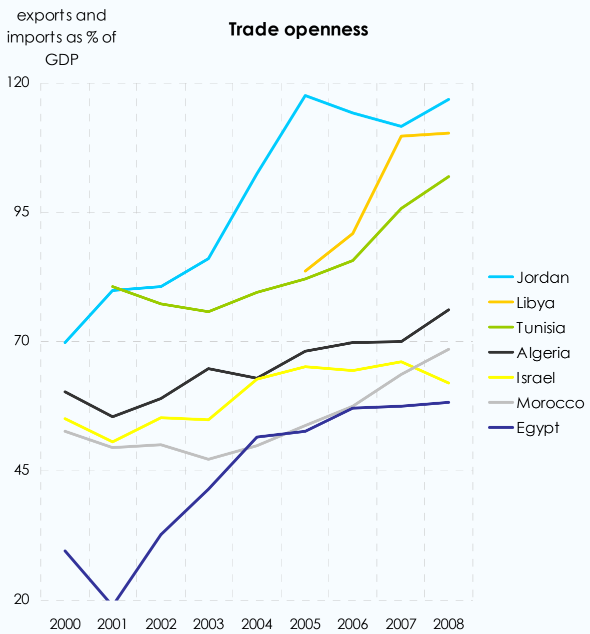


Source: CPB Bureau of Economic Policy Analysis.

Trade is a crucial engine of economic growth. Countries that are well-integrated in the region or worldwide benefit from the trading of goods and services across country borders because they mutually derive a comparative advantage from this practice. In comparison with other countries in the world, some of the MED countries still have ample room to increase their degree of trade openness

([1]) According to the monthly World Trade Monitor of the CPB Netherlands Bureau for Economic Policy Analysis, that measures trade as the average of nominal exports and imports on the basis of up to date national information and short-term econometric models for those countries that have no timely data.

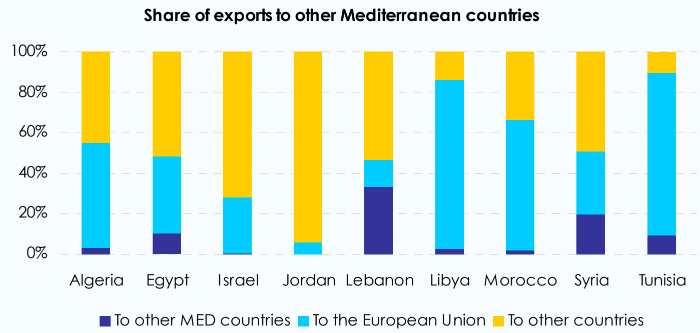
Box II.1.1: **Intraregional trade in the MED**

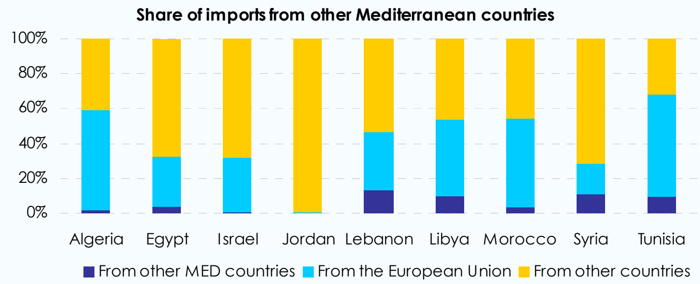


Source: IMF DoTs, ECOWIN Reuters, own calculations.

Although the degree of trade integration in the Mediterranean has not yet reached its full potential, most Mediterranean countries have become much more integrated in recent years (see graph right). Taking the nominal exports and imports of a country as a percentage of the country's nominal GDP as a measure trade integration, Jordan and Libya are the most integrated countries. The total of their revenues received from their exports and imports of goods has actually exceeded their nominal GDP since 2004 and 2007, respectively. Even Egypt, which has the lowest level of trade openness according to this measure, has more than doubled its openness, from 20% to more than 50%, in recent years.

Given the conducive effect of trade on GDP, these higher degrees of trade integration are commendable. However, regional trade integration has remained remarkably low. Apart from Lebanon and Syria, which have considerable bilateral trade, no other Mediterranean country exported more than 10% of its exports to the other Mediterranean countries in 2008 (see graph on export shares below). The shares of imported goods from the region are even lower (see graph below on import shares). The main reason for importing a lot from other regions, such as the Europe, Asia, the US and the Middle East, is the availability of high-tech industrial products, or food products or commodities that are not easily available in the Mediterranean region. Given the complementary nature of the economic activities in this MED region (textiles, rice and other basic agricultural products, commodities), there is ample room for more cross-border trading in the MED. Boosting trade can feed economic growth and eventually provide more opportunities to create jobs.





Source: IMF DoTS, own calculations.
Note: In percentages of total exports and imports, respectively, of 2008.

Box II.1.2: **Financial integration, FDI and remittances of the MED**

The financial sector in most of the Mediterranean countries has considerable room for further development. While it is true that the MED countries have been sheltered from the global financial crisis due to their low degree of integration into the global financial markets, it is also true that many MED countries have missed opportunities in the past and will miss potential opportunities in the current global upsurge, because of non-existent or fairly shallow stock and bond markets, and their banking sectors in particular. Using efficient and effective financial intermediation as a means of ensuring a better channelling of funds from national and international savers to productive investments and consumption in the country will help to accelerate economic growth.

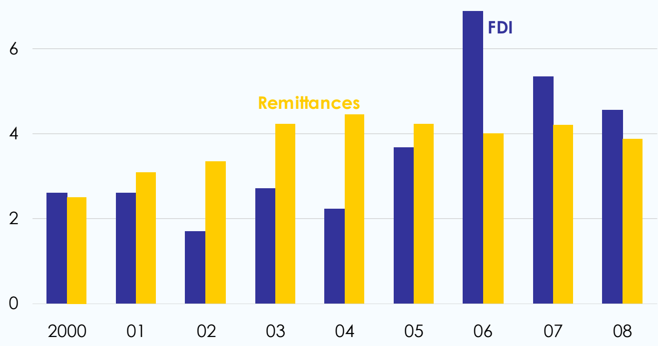
Financial integration

	Algeria	Egypt	Israel	Jordan	Lebanon	Libya	Morocco	Syria	Tunisia
2000	19	28	25	138	127	32	33	88	30
2001	18	28	30	127	115	42	32	98	28
2002	18	33	33	123	117	75	30	104	31
2003	17	39	38	113	141	77	27	117	31
2004	12	45	33	109	148	81	27	102	35
2005	10	53	38	102	145	93	26	83	29
2006	12	54	45	125	166	118	30	73	36
2007	11	47	39	115	160	113	30	64	38
2008	5	31	23	80	145	82	20	44	25

Note: Financial integration is measured as the total cross-border bank assets and bank liabilities as a percentage of nominal domestic GDP.
Source: BIS, IMF and own calculations.

Stock and bond markets can grow, and the banking sector, too, can be deepened and broadened. The banking system is dominated by state banks in some countries, that is a drain on the government budget. Easier access to credit for (starting) companies and households is important going forward, with a view to the further development of the private sector.

MED - Inward FDI and inward remittances
% of GDP, simple average



Note: oPt not included due to lack of data.
Sources: UNCTAD, IMF, World Bank, own calculations.

As banking sector activity is relatively shallow at the national level the degree of financial integration is also low. Measuring financial integration, similar to trade of goods' integration, by the imports and exports of bank loans at foreign banks in relation to the national GDP, ratios are obtained as presented in the table above. It follows that there is considerable variety across the MED countries. Jordan and Lebanon have cross-border banking assets and liabilities that exceed their GDP. On the contrary, Algeria has an extremely small amount of bank assets and liabilities at foreign banks. Moreover, although not surprisingly, the global financial crisis caused a drop in financial integration in 2007 and 2008. Inward FDI also dropped significantly in 2007 and 2008 (see graph). Thanks to the Gulf economies, which employ many people from the MED the inflow of remittances remained substantial. On average, FDI continued to top 4% of the GDP of the MED, with remittances only a little less.

(see box II.1.1). As a reaction to the sharp falls in exports owing to the global recession, some of the MED countries have even taken more protectionist measures to protect their own national industries or economic sectors. While some of these measures were to some extent isolated movements, their ability to trigger a protectionist wave across the MED region should not be underestimated.

During 2009, MED countries continued to implement the provisions of the Association Agreements, including the dismantling of tariffs on industrial products under the Free Trade Agreements (FTAs). Although liberalisation of the trade in goods will not be achieved with all partners in 2010, a critical mass of industrial and agricultural liberalisation will be completed by that date, while agreed dismantling schedules will continue to be implemented later. As of today, two countries - Tunisia and the oPt - have a fully effective and implemented FTA with the EU; tariff dismantling continues in other MED countries reducing every year the level of tariff protection.

The ultimate objective of the EU is to establish a fully-fledged EuroMed regional FTA by 2010, which will involve expanding the coverage into other areas, such as services and investment, further liberalisation for (processed) agricultural and fisheries products, and the establishment of a dispute settlement mechanism. To date, bilateral negotiations on the liberalisation of services and the right of establishment have been launched with Egypt, Israel, Morocco and Tunisia, but they are progressing at different rates. Negotiations on agricultural, processed agricultural and fisheries products have been concluded with Egypt and Israel, and are continuing with Morocco and Tunisia. Discussions are under way to start negotiations in the areas of industrial standards and conformity assessment with the aim of negotiating Agreements on Conformity Assessment and Accreditation (ACAAs) so as to encourage industrial integration and give MED partners a stake in the internal market.

1.4. BUSINESS CLIMATE

Over the last five years, countries in the Mediterranean region have made progress in fostering a business environment and strengthening the application of horizontal enterprise policies ([1]). Some of the best performing countries have been Egypt, Jordan, Morocco and Tunisia have been among the best performing countries to have adopted and implemented a horizontal enterprise policy conducive to improving the business environment, although, enterprise policy is less advanced in other countries of the region. In some cases, the transition from industrial policy is still ongoing or remains fragmented.

Some of the biggest improvements on a regional have been achieved in reducing the amount of capital required to start up a business and making it easier to launch a business through one-stop shops, as well as reducing the administrative burden of paying taxes, while progress on increasing the flexibility of employment regulation has been slower.

In terms of comparative global competitiveness ([2]), there are wide differences across the region. With the exception of Israel, which is in the highest group, all economies of the region are classified by the World Economic Forum (WEF) as either ‘efficiency driven’ (Jordan, Tunisia) or in ‘transition’ (Algeria, Egypt, Libya, Morocco and Syria). Tunisia is the highest ranked economy (40th) behind Israel (27th) based primarily on the efficiency of its government institutions while labour market rigidity, similar to the majority of countries in the region, is a weak factor. This reflects rigid employment regulations and wage-setting processes as well as high taxes and a low participation of women in the workforce. In the WEF’s rankings, Algeria jumped more than any other country, by 16 places to 84th, while this appears to be more a reflection of comparative macroeconomic stability in the context of the global economic crisis than specific

([1]) *Report on the implementation of the Euro-Mediterranean Charter for Enterprise* is a joint publication of the European Commission, the OECD, and the European Training Foundation. It was completed in mid-April 2008.

([2]) The Global Competitiveness Report is an annual report of the World Economic Forum covering 133 economies. The Report includes the ENP Mediterranean countries except Lebanon. The report is based around a Global Competitiveness Index, which is a large composite index that measures a wide range of features such as institutions, infrastructure, innovation, business sophistication, market size, technological progress, financial market sophistication, labour market efficiency, goods market efficiency, higher education and training, health and primary education and macroeconomic stability.

reform measures. Egypt rose by eleven places to 70th, reflecting further development of the financial market and upgrades to its infrastructure.

Despite the advancement of most countries in the WEF's league table, several common structural challenges remain, including restricted access, large and inefficient government bureaucracies, comparatively inflexible labour markets, heavy tax regulation and in some cases high tax rates ([1]) ([2]). A relative paucity of expenditure on research and development and a small scientific and engineering workforce also continues to restrict innovation.

1.5. PUBLIC INSTITUTIONS AND GOVERNANCE SYSTEMS

Governance consists of the institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them.([3]) Institutions are the carriers of good governance in a country, the role of which goes beyond the legal framework A country's development in the public and socioeconomic sector significantly affects its macroeconomic performance. The more transparent the country's public administrations and the more accountable the political elites are in the eyes of citizens, the greater the chance of boosting economic growth and successfully introducing economic reforms. Thus the question of governance and public institutions is considered to be an important factor for the country's competitiveness in the global economy.

([1]) Paying Taxes 2009, The Global Picture, International Financing Corporation, the World Bank and Pricewaterhousecoopers.

([2]) Corporate tax rates still tend to be relatively high in the Mediterranean region, in particular in Algeria and Tunisia. In 2009, Morocco reduced the rate of corporate income tax from 35% to 30% while Jordan lowered corporate income tax in early January 2010 to 14% for all industries except telecommunications and financial services. Also, Tunisia made filing and paying taxes easier by expanding on-line payment options.

([3]) The World Bank Group: Governance Matters 2009

There are a number of indices and studies which measure governance in a country. In the framework of the European Neighbourhood Policy several key areas are addressed([4]). Other indicators from the World Bank([5]), the Transparency International([6]) and Global Competiveness Report of the World Economic Forum([7]) also show the development of governance.

One set of indicators assessing governance is the World Economic Forum's Global Competitiveness Index (GCI)([8]), which was introduced in the previous section. "Institutions" is one of the dimensions measured, including sub-indicators, such as public trust in politicians, judicial independence and transparency of policymaking. The factors showing institutional efficiency while doing business are the efficiency of government bureaucracy, corruption, as well as policy and government stability.([9]) Another characteristic for governance and the quality of public service are the Worldwide Governance Indicators([10]), provided by the World Bank.([11])

([4]) COM (2009)188 – Communication from the Commission to the Council and the European Parliament, Implementation of the ENP in 2008.

([5]) World Bank: Worldwide Governance Indicators 1996-08.

([6]) Global Corruption report 2009.

([7]) The World Economic Forum's GCI Report 2008-09.

([8]) GCI is produced by the WEF and measures the overall competitiveness of a nation on over 100 indicators grouped into 12 pillars covering areas such as institutions, macroeconomic stability, health and education, labour and financial markets as well as issues related to inequality, gender bias, mobile phone and internet subscribers, etc. The rankings are based on the Executive Opinion Survey completed by top management business leaders around the world. GCI 2009-10 is available for 134 countries, and for all but Lebanon and the oPt in the MED region.

([9]) GCI "The most problematic factors for doing business", whereby from a list of 15 factors, respondents were asked to select the five most problematic and to rank those from 1 (most problematic) to 5.The results were then tabulated and weighted according to the ranking assigned by respondents. Relevant factors for governance are: corruption; inefficient government bureaucracy; policy instability; government instability/coups.

([10]) Data from the WGI research project.

([11]) Kaufmann D., A. Kraay, and M. Mastruzzi 2009: Governance Matters VIII: Governance Indicators 1996-08.

The indicators measure six dimensions of governance: voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, rule of law and control of corruption.([1]) The countries are rated according to their percentile rank in comparison to all other rated countries. Percentile rank indicates the percentage of countries worldwide that rate below the selected country. Higher percentile values indicate better governance ratings.([2])

Israel, although it is the top GCI-ranked country of the MED region, is doing less well on the institutions-scale (56th). Despite the fact that public and private institutions are recovering, the assessment of them is that they are still relatively weak, in particular with respect to the capacity of government to ensure security (69th) and the efficiency of government operations (51st). Within the Worldwide Governance Indicators (WGI) of the World Bank, political stability is rated as Israel's weakest dimension, ranking only in the 10th-25th percentile, meaning the likelihood of government being overthrown by unconstitutional in violent means is fairly high. Nevertheless, the country obtains a high ranking for independence of the judiciary (15th) and efficiency of the legal framework (23rd). Accountability of the government is average in Egypt, ranking in the 50th percentile. Other factors, such as government effectiveness, regulatory quality and rule of law rank Egypt clearly above all other countries of the region, among 30% of best performing countries in the world.

Algeria is the bottom player when it comes to institutions, ranking 115th out of 133 countries. The burden of government regulation appears to be rather high, and there is insufficient transparency of public policy-making (both in 126th place). Regulatory quality, accountability, as well as political stability sets Algeria among the world's last ¼th of the countries. In rule of law, Algeria is within the last 1/3rd of the world's total. This means, that the implementation of sound policies and regulations, as well as the risk of governmental coups are fairly high. Nevertheless, government effectiveness is the best dimension of governance in Algeria, according to WGI, listing the country among 50% of best performing countries.

Jordan is the clear winner in the GCI institutions' ranking, occupying the 25th position. Despite the fact that government bureaucracy appears to cause inefficiency problems, very high ranking is achieved on fighting organised crime (8th), reliability of police services and business cost of crime and violence (both 17th). Also the burden of government regulation is considered to be rather low (18th). Jordan is among the upper 60th percentile of world's best performing countries in government effectiveness, quality of regulation and rule of law, falling to the 30th percentile in the dimension of political stability and accountability.

Tunisia has also achieved a GCI institutions' ranking of 35 with the second best overall ranking of the region (40th). The country's efficient government institutions (15th) remain its main strength, along with a high level of security (23rd) and an educational system that ensures a good quality of education (29th). An impressively positive assessment of wastefulness of government spending (5th) goes along with a high public trust in politicians (16th) and favouritism in decisions of government officials (18th). This is also reflected by the WGI, where Tunisia ranks clearly among 40% of best governed countries, within all dimensions. The only exception is the accountability and voice, where Tunisia only manages the last 1/4th of all countries, showing problems with participation, inclusion and political freedoms.

Lebanon is a country, which according to WGI is second best of the region (after Israel), when measuring political participation and guarantee of freedoms, although still leaving only 30% of all other countries behind. It is the bottom player within the dimension of political stability, due to the recent bilateral and inner tensions. Regulations,

([1]) The indicators cover 212 countries and territories for 1996, 1998, 2000, and annually for 2002-2008. The governance indicators aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The indicators are based on several hundred individual variables measuring perceptions of governance, drawn from 35 separate data sources constructed by 33 different Organisations from around the world.

([2]) For instance, a percentile rate of 75% indicates that an estimated 75% of the countries rate worse and an estimated 25% of the countries rate better than the country of choice.

effectiveness of the government, as well as rule of law leave Lebanon within the 40^{th} percentile.

The GCI institutions' rankings of Egypt (56th), Syria (57th), Morocco (64th) and Libya (67th) still show some weaknesses, especially concerning auditing and reporting standards in Syria (124^{th}), Libya(114^{th}) and Morocco (95^{th}), transparency of public policy-making in Syria (116^{th}) and Libya (111^{th}), as well as favouritism in decisions of government officials in Egypt (81^{st}). The latter has a rather high ranking in fighting organised crime (15^{th}), though not as well as Syria, ranked 5^{th} on this issue. Fighting crime is overall positive in Syria and Libya, ranking 2^{nd} and 11^{th}, respectively, on business cost of crime and violence. The WGI indicates that Morocco is better performing of the three, concerning in voice and accountability, political stability, government effectiveness, regulatory burden and rule of law. Here Morocco performs better than 40% of the total, including oPt, Egypt, Syria and Libya. The latter two are placed within the world's worst performing 10% in this dimension. Libya, nevertheless, is more stable than 70% of all other countries, earning the top placement in the region. Other governance dimensions place Libya within the lower $1/3^{rd}$ of total, Syria ranking roughly similar, only doing worse on the scale of government regulation, being last in the region.

The occupied Palestinian territory ranks among the last 20% of all countries within the dimension of voice and accountability, regulatory quality and rule of law. Dimensions of political stability and government effectiveness have been affected by instable government, military tensions and violence within the country, along with dependence of public institutions on these tensions, thus turning down the quality of governance. Therefore oPt is only among the last 10% within these dimensions.

Corruption in the public and private sector can be shown in practice of domestic firms and multinationals paying bribes in order to secure public procurement contracts. Such practices can be encouraged by or met with cooperation from civil servants or political leaders.([1]) "Control of corruption" is one of the dimensions on governance measured by WGI, capturing perceptions of the extent to which public power is exercised for private gain. The Corruption Perceptions Index (CPI)([2]) produced by Transparency International, ranks countries in terms of the degree to which businesspeople and country analysts perceive corruption to exist among public officials and politicians. The score varies between 1 and 10, better results show higher scores.

Corruption is more diversified between the MED-region countries, found to be a problem for doing business and good governance in Morocco, Libya, Egypt and Algeria in the Global Competitiveness Report. Israel is a clear winner of the Mediterranean group of countries, scoring 6.0 on the CPI in 2008 and being among the upper 25% of best performing countries, according to WGI, leaving 75% behind.

Other countries of the region are scattered between the ranking of 5.1 for Jordan and 2.1 for Syria on the CPI 2008, with Tunisia on 4.4, Morocco on 3.5, Algeria on 3.2, Lebanon on 3.0, Egypt on 2.8 and Libya on 2.6 ranking. World Bank's WGI sets the countries nearly in the same order, Jordan and Tunisia are within the 60^{th} percentile, Morocco, Algeria and Egypt within the 30^{th} and Libya, Lebanon, Syria and oPt within the 20^{th} percentile. According to TA, corruption among these countries is marked strongly by the unique style of governance found throughout the region, being deeply rooted in the political infrastructure of the state, the institutional infrastructure of the public sector, and develops as a result of the relatively limited opportunities for public participation.([3])

([1]) Transparency International "Global Corruption Report 2009"

([2]) CPI draws on thirteen different polls and surveys from eleven independent institutions, using data published or compiled between 2007 and 2008. The data sources include the Asian Development Bank, the African Development Bank, the Bertelsmann Transformation Index, the World Bank's Country Policy and Institutional Assessment, the Economist Intelligence Unit, Freedom House's Nations in Transit, Global Insight, IMD International World Competitiveness Center, Merchant International Group, Political and Economic Risk Consultancy and the World Economic Forum.

([3]) Transparency International "Global Corruption Report 2009"

1.6. CONCLUSIONS AND POLICY ISSUES

The MED region has weathered the global economic crisis so far. The region has felt the indirect impact of the crisis through external channels, goods and services exports, inward investment, and remittances. Growth has decelerated throughout the region while a contraction has been averted by supportive fiscal and monetary policy as well as the significant impact of lower international commodity prices which has temporarily improved the trade balance in many oil-importers, and helped sustain growth in private consumption.

The region still remains vulnerable should the global outlook continue to be weak or deteriorate. While fiscal policy was used to support demand in 2009, with the exception of the oil-exporters, it would need to be tightened in the near term to put public finances back on a sustainable path, by engaging in a process of fiscal consolidation and by relieving some of the significant debt burden of several countries. Monetary policy also looks set to be tighter as inflationary pressures are gradually re-emerging. Hence there is still a risk of a further slow down in growth as the effect of domestic stimulus packages fades, and exports and investment take time to recover. For oil importers, the prospect of a swift increase in oil prices also poses a major risk.

Should these factors materialise, the impact of the crisis could spread further, causing a slow down in domestic private sector demand, a rise in unemployment and the write-down of financial sector assets through an increase of non-performing loans.

Given the constraints on monetary and fiscal policy, greater emphasis will have to be placed on structural policy going forward, in order to foster growth as the region emerges from the crisis. Many countries in the region have proceeded with structural reforms in 2009 and this impetus should be stepped up in 2010. This includes the objective of further streamlining public expenditure, including subsidies, in order to provide more room for growth enhancing expenditure, such as on education, and encourage private sector development. Also, the region still has potential to improve many aspects of governance which would further leverage the effect of growth enhancing expenditure.

Table II.1.1:
Mediterranean countries - Main economic indicators

Real sector	2006	2007	2008	2009	2010
Real GDP growth (domestic currency, % change)				prel.	proj.
Algeria	2.2	3.0	3.0	2.1	3.9
Egypt	6.8	7.1	7.2	4.7	4.9
Israel	5.2	5.3	4.1	0.5	2.5
Jordan	8.0	6.6	5.6	3.1	3.0
Lebanon	0.6	7.5	8.5	5.5	2.5
Libya	5.9	6.0	3.8	2.1	5.4
Morocco	7.8	2.7	5.6	2.5	5.0
oPt	-4.8	-1.2	2.3	5.5	6.5
Syria	5.1	4.2	5.2	2.9	2.9
Tunisia	5.5	6.3	4.6	3.1	4.0
MED Region (GDP at PPP)	*4.8*	*5.3*	*5.4*	*3.4*	*3.7*
Nominal GDP (EUR billion)					
Algeria	93	98	119	117	
Egypt	88	100	111	138	
Israel	115	120	138	142	
Jordan	11	12	14	15	
Lebanon	18	18	20	23	
Libya	43	49	66	44	
Morocco	52	55	61	65	
oPt	4	4	4	5	
Syria	23	29	36	36	
Tunisia	25	26	28	28	
MED Region (total)	*471*	*510*	*597*	*612*	
GDP per capita (EUR)					
Algeria	2866	2973	3572	3448	
Egypt	1239	1371	1490	1815	
Israel	16858	17337	19379	19713	
Jordan	1816	1989	2336	2317	
Lebanon	4350	4450	4859	5587	
Libya	7208	8023	10567	6973	
Morocco	1692	1759	1921	2079	
oPt	946	947	881	1177	
Syria	1171	1400	1694	1663	
Tunisia	2448	2550	2707	2735	
MED Region (simple average)	*4060*	*4280*	*4941*	*4751*	
Inflation (% change)					
Algeria	2.5	3.5	4.5	5.6	5.3
Egypt	4.2	11.0	11.7	16.2	11.3
Israel	2.1	0.5	3.8	3.6	2.9
Jordan	6.3	5.2	3.8	2.7	2.5
Lebanon	5.6	4.1	10.8	1.1	2.4
Libya	1.4	6.2	10.4	2.5	4.5
Morocco	3.3	2.0	3.9	1.8	2.3
oPt	3.8	2.7	9.9	2.5	3.0
Syria	10.0	3.9	15.7	3.8	7.9
Tunisia	4.5	3.2	5.0	3.7	3.4
MED Region (simple average)	*4.4*	*4.2*	*7.9*	*4.4*	*4.6*

(Continued on the next page)

Table (continued)

Social indicators	**2006**	**2007**	**2008**	**2009**	**2010**
Unemployment rate (%)				**prel.**	**proj.**
Algeria	12.3	13.8	11.3	10.2	9.9
Egypt	11.0	10.3	8.9	9.1	9.4
Israel	7.7	7.3	6.1	7.9	7.6
Jordan	13.2	13.1	12.7	13.5	13.6
Lebanon					
Libya					
Morocco	9.7	9.8	9.5	9.2	9.8
oPt	23.6	22.0	23.9	23.6	20.1
Syria	8.3	8.4	8.6	9.2	9.7
Tunisia	14.3	14.1	14.2	14.7	15.1
MED Region (simple average)	*12.5*	*12.4*	*11.9*	*12.2*	*11.9*
Fiscal sector					
General government budget balance (% GDP)					
Algeria (Central Government)	13.6	11.8	9.0	-7.8	-5.2
Egypt	-9.2	-7.7	-7.8	-6.9	-8.0
Israel	-1.4	-0.8	-2.8	-5.7	-4.7
Jordan	-7.0	-7.9	-9.6	-11.9	-10.8
Lebanon	-11.2	-10.8	-10.0	-10.5	-9.5
Libya	31.4	25.5	24.6	10.6	15.8
Morocco	-2.1	0.2	0.4	-1.0	-2.2
oPt					
Syria (Central Government)	-3.5	-3.1	-1.9	-7.0	-4.9
Tunisia (Central Government)	-3.0	-2.9	-1.2	-3.3	-5.3
MED Region (simple average)	*1.4*	*0.9*	*0.3*	*-4.6*	*-3.7*
Total gross public debt (% GDP)					
Algeria	23.8	19.0	15.1	18.6	19.8
Egypt	90.4	80.2	70.2	72.8	71.0
Israel	84.4	78.1	76.8	79.9	80.9
Jordan (Net Public Debt)	69.6	67.5	60.5	70.3	73.2
Lebanon	180.0	168.0	160.0	162.0	160.0
Libya	5.4	4.9	4.3	7.3	7.3
Morocco	66.6	63.7	55.6	53.6	51.8
oPt					
Syria	34.0	28.7	25.4	31.8	32.5
Tunisia	53.7	50.0	47.5	48.7	49.0
MED Region (simple average)	*67.5*	*62.2*	*57.3*	*60.6*	*60.6*
External sector					
Current account balance (% GDP)					
Algeria	25.2	23.6	19.6	3.2	0.7
Egypt	2.5	0.4	-0.8	-1.9	-0.3
Israel	5.3	2.5	1.2	3.5	2.2
Jordan	-10.6	-17.7	-11.7	-6.2	-5.3
Lebanon	-5.6	-7.1	-11.4	-11.3	-10.5
Libya	44.6	40.7	40.7	16.8	23.5
Morocco	2.0	0.3	-6.4	-3.3	-3.8
oPt	-8.0	-0.8	3.8	-2.6	-2.4
Syria	2.7	1.1	-1.4	-2.8	-2.4
Tunisia	-2.0	-2.6	-4.3	-2.8	-2.9
MED Region (simple average)	*5.6*	*4.0*	2.9	*-0.7*	

(Continued on the next page)

Table (continued)

Foreign direct investment (net, % GDP)	**2006**	**2007**	**2008**	**2009 prel.**	**2010 proj.**
Algeria	1.5	1.0	0.6	0.7	
Egypt	5.6	8.1	7.5	3.6	3.7
Israel	-0.1	1.2	0.9	2.4	1.2
Jordan	22.1	11.5	11.8	8.5	8.5
Lebanon	11.9	7.5	8.9	8.0	
Libya	2.6	1.1	-2.0	2.1	2.0
Morocco	3.1	2.9	2.3	3.3	
oPt					
Syria	2.7	2.8	4.2	3.7	3.2
Tunisia	3.2	6.0	5.3	3.1	3.2
MED Region (simple average)	*5.8*	*4.7*	*4.4*	*3.9*	
External vulnerability					
External public debt (% GDP)					
Algeria	4.9	3.8	3.0	3.4	2.0
Egypt	17.6	14.9	12.9	13.9	13.8
Israel	22.3	19.8	16.1	15.0	14.5
Jordan	53.9	50.6	33.8	33.1	31.4
Lebanon	89.5	84.6	80.8	84.8	
Libya	8.7	9.1	8.9	17.0	17.0
Morocco	26.3	24.7	22.7	21.9	20.4
oPt					
Syria	19.9	17.0	14.1	14.6	13.4
Tunisia	58.1	53.9	53.7	52.5	52.3
MED Region (simple average)	*33.5*	*30.9*	*27.3*	*28.5*	

Note: See the country articles for the sources and clarifications.

2. OVERVIEW OF RECENT ECONOMIC, MONETARY AND FINANCIAL DEVELOPMENTS IN THE EU'S EASTERN NEIGHBOURS

2.1. SUMMARY

The 2008-2009 global recession was showing signs of easing in most EU's Eastern neighbours by the fall of 2009. In any case, for the majority of them, 2009 will count as one of the worst years since the "transition recession" in the early 1990s.

This section outlines the region-wide macroeconomic developments and the changes in structural policy areas observed during 2009, and the expectations for 2010. The chapter concludes by discussing the relevant elements of an "exit strategy" for the region.

2.2. MACROECONOMIC DEVELOPMENTS

Average **GDP growth** in the EU's Eastern neighbours collapsed from 8.3% in 2008 to an almost mirror image of -8.0% in 2009, a remarkable 16.3% change in a single year. The downturn in 2009 makes the region the worst performer on the planet, with a contraction a whole order of magnitude greater than the global one (global GDP in 2009 fell by an estimated -0.8%). Only two countries escaped open recession (oil-rich Azerbaijan and the always surprising Belarus –respectively, the fourth and third largest Eastern neighbouring economies). Among the others, several had double digit or quasi double digit contractions (Armenia and Ukraine, both with around -15%, and Moldova, with -9%). Russia, one of the ten largest economies in the planet, and bigger than the whole rest of the ENP economies put together, saw a GDP contraction of -7.9%. A limited recovery is expected for 2010, with the **regional GDP set to increase by around 3.5%** (which, in any case, implies a difference of 11.3% between the 2009 and 2010 performances).

Almost a decade of robust growth in **per capita GDP** was interrupted in 2009, when it fell by 16% y-o-y in euro terms, due to the combined effect of negative GDP growth and large depreciations in exchange rates. The long term trend is expected to reassert itself in 2010, due to the return to growth and the stabilisation of nominal exchange rates, with a growth rate above 5%.

The **increase in unemployment** initiated in 2008 continued in 2009, partially reversing the gains observed throughout the 2000s. The average unemployment rate in the seven countries of the area increased from above 6% to above 7% (with the usual exceptions, Azerbaijan and Belarus, with effectively formal full employment). **Growth resumption in 2010 shall bring unemployment again below the 7% mark.**

As foreseen in last year's review, the fall in domestic demand components observed in 2008 and 2009 together with the exchange rate depreciations led to an **increase of the relative importance and a change of the sign of the external demand component for GDP**: in 2009, it became positive in Russia for the first time since the early 2000s (the same had happened in Ukraine already in 2008), while in Belarus a notable reduction of its traditionally negative contribution was observed.

The average regional government balance in 2009 swung sharply into deficit, falling from 2.5% to 6.2% of GDP (albeit the previous surpluses largely reflected the Russian performance). All countries (bar Belarus) showed deficits last year, but, of course, the regional figure was again dominated by Russia (with almost 80% of the "regional" fiscal deficit), where the 6% deficit was *fully* financed by the fiscal reserves accumulated in its oil funds (designed exactly for this purpose). With growth resumption and higher commodity prices, the deficit is to more than halve in 2010, but fiscal retrenchment is set to remain a key policy question for several countries in the region.

The average **regional government debt** increased significantly in 2009, from 16.3% of GDP in 2008 to above 25.1%, but the GDP-weight average barely budged, increasing from 9% to 10.4% (very low by EU or OECD standards), reflecting the fact that the large Russian deficit was totally financed by its own resources. The average stock of debt is foreseen as still nudging upward in 2010, but its GDP-weighted value will fall, again due to Russia.

Box II.2.1: **EU Support to neighbouring countries in response to the crisis**

European Union has set up a crisis response instrument to assist non-EU countries in cases they face exceptional external financing needs in the balance of payments that are to a large extent – notably in the recent crisis – exogenous. Macro-financial assistance (MFA) is intended to support countries which have strong political and economic links with the EU – ranging from potential membership to partnership – and are facing substantial residual financing needs in the context of stabilisation programmes supported by financing from the IMF and other multilateral or bilateral donors. The extent of the assistance is based on clearly identified (by the IMF) external financing needs, over and above resources provided by other International Financial Institutions (IFI's). MFA function is therefore complementary to financing from IMF and other IFI's and to macroeconomic conditionality of the respective programmes. In particular, MFA has supported efforts by recipient countries to stabilise their economies and bring about economic reforms and structural changes. In close coordination with the IMF and the World Bank, it has promoted policies that are tailored to specific country needs with the overall objective to stabilise the financial situation and to put the economy to a sustainable growth path.

By its nature the assistance is exceptional, short-term, and is based on ad-hoc legislation. It can take the form of medium-term loans and/or grants depending on the level of development and on the debt sustainability of the recipient country. Loans are raised by EU borrowings (AAA credit rating) on the market and then are extended to the recipient country with similar financial terms. Grants are financed by the EU budget. The release of MFA is made in successive tranches and is conditional upon:

- Satisfactory macro-economic performance measured by the respect of agreements with the IMF (programmes on track)
- Structural reforms: structural adjustment criteria, consistent with agreements with IMF/WB and reflecting EU priorities (e.g. reform in macroeconomic policy framework, public finance management and fiscal reforms, enterprise restructuring and business environment, financial sector reform or specific sectoral issues)

MFA operations implemented from 1990 until 2009 committed over 6.7 billion euro, distributed as follows:

- 1.4 billion for the Western Balkans,
- 1.2 billion to the Newly Independent States
- 0.9 billion for the Mediterranean countries
- 3.3 billion for Central and Eastern Europe (now members of the EU)

More recent MFA operations implemented from 2002 until 2009 committed over 1 050 million euro including 430 million euro in straight grants. MFA funds were distributed as follows:

- 635 million for the Western Balkans,
- 335 million to the Newly Independent States
- 80 million for the Mediterranean countries

Since the outbreak of the economic crisis, the EU has received a large number of requests for MFA. In the last months of 2009, the EU's Council of Ministers decided to provide MFA to Armenia, Bosnia and Herzegovina, Georgia, and Serbia. The implementation of the four operations started between late 2009 and early 2010. European Commission is also preparing proposal for support to three more countries of the region – Belarus, Moldova and Ukraine.
The IMF capacity to help countries with financial difficulties has been considerably increased by EU Member States and other IMF members. The EU committed in 2009 to provide EUR 125 billion to the IMF, which represents 35% of the increase in the IMF's lending capacity from USD 250 billion to USD 750 billion.

As foreseen last year, the economic contraction brought **average inflation** strongly down, from 14.0 % in 2008 to 6.7 % in 2009, with the effects of the region-wide devaluations fully counteracted by the downturn. This is set to continue in 2010.

Regarding **exchange rates**, the regional average nominal one experienced a depreciation of around 30% between the onset of the crisis in mid 2008 and end January 2010, but this masks both significant country and time differences. The Azerbaijani currency (which seems to have behaved effectively like a peg) actually experienced a slight appreciation during this period, while the Ukrainian one lost almost two thirds of its value (by far the deepest depreciation in the region, albeit as pointed out above, this seems to have helped in supporting a significant external adjustment). Time-wise, most currencies experienced significant falls around late 2008/early 2009, roughly stabilising afterwards (and with the Russian rouble actually appreciating by over 14% between January 2009 and January 2010). A potentially positive effect from the crisis is the introduction of more flexible exchange rate regime in some countries the region (more or less floating in Russia and Ukraine, a more balanced peg in Belarus), given that fixed regimes led to the accumulation of external financial liabilities.

The dynamics of average **interest rates** in the region followed a similar pattern to the one observed around the world: a significant fall as a reaction to the downturn, from around 12.3% in mid-2008 to around 7% in early 2010 (or a over 42% fall). Nevertheless, there are important differences in this pattern, **linked to the exchange rate regime**. First, in Russia, in the immediate onset of the crisis in mid 2008, rates were actually raised to defend the peg, only starting to come down in April 2009, after a more flexible exchange rate regime was introduced (they have fallen by a third since). This is believed to have contributed to the intensity of the downturn there (see the Russia chapter). A similar process happened in Ukraine, where rates started falling even later, around May 2009. Finally, also in Belarus, rates were raised starting mid-2008 until early 2009 and were only reduced, and just marginally, in November 2009 (this country still pursues a basket peg).

In the region there are **stock markets** of significance only in Russia and Ukraine. They lost (as measured by the MICEX and PFTS indexes) respectively 75% and 77% of their values between the highs of mid-May 2008 and the lows of October 2008. They have rebounded strongly since, also due to the liquidity created by the largest centrals banks on the planet to combat the crisis (foreign investors are major players in both markets), with gains of 164% and 204% between their lows and mid-February 2010 (which still represents a fall of 31% from their 2008 highs).

The traditional contrast in terms of **trade performance** between the energy exporters (Azerbaijan and Russia, with very significant surpluses) and importers (large deficits) remained, which is reflected in the simple average of the region (with a trade deficit of around 10% of GDP in both 2008 and 2009) and the GDP weighted ones (with surpluses of around 7% of GDP in both years, reflecting the size of the Russian trade surplus). 2010 shall see a reduction of the average regional deficit (and an increase of its GDP-weighted surplus). Only Ukraine escaped the stylised description above during the recession. The very large GDP fall and currency depreciation led to the largest expenditure switching effect among the Eastern neighbours, with a trade deficit of -8.1% in 2008 turning into a -1.7% trade deficit is 2009.

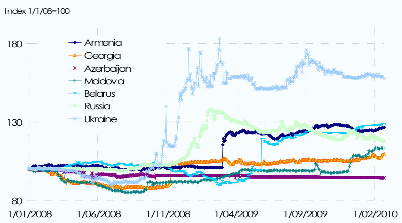
The Eastern neighbours **current account** position reflects the same dichotomy as described above. Equally, the simple average showed a worsening between 2008 and 2009 (from -5.3% of GDP to -4.9%), while the GDP-weighted shows a fall of the surplus in the same period, from 4.9% to 2.8% of GDP. ([1]) The pattern is expected to continue in 2010, with Azerbaijan and Russia still having surpluses, and the others having deficits (also worsened by a significant fall of remittances from the EU and Russia to some of the countries in the region that are largely dependent on that, namely, Moldova, Georgia and Armenia). Again, Ukraine, and for the same reasons as above, defies this typology: its current account improved from a large deficit of -7.2% of GDP to -1.5%.

([1]) Albeit the current account deficits of both Georgia and Moldova actually experienced significant reductions in 2009, so here the fall of the surpluses in Azerbaijan and Russia actually drives the outcome.

Box II.2.2: **Fiscal and monetary policy response during crisis**

The real sector in the majority of the European neighbourhood countries in the East was hit very hard by the global financial and economic crisis. A pattern of limited and selected fiscal policy reactions with more active monetary and exchange rate policies has emerged. A significant fiscal stimulus has been used by only two countries: Russia and Georgia. In Russia, a sizeable financial package financed out of the Oil Stabilisation Fund amounting to 6% of GDP was announced for 2008-2010. It has been used for fresh capital injections into the banking system as well as for wage and pension increases. In Georgia, public spending has been financed to a large extent by the international donor community and was mainly related to managing the consequences of population displacement and damaged infrastructure after the military conflict with Russia in 2008. In other Eastern Partnership countries, additional fiscal stimulus has been practically absent due to a very limited fiscal space. Fiscal support has been restricted to capital injections into the banking systems. In Ukraine, for example, bank recapitalisation in 2009 amounted to 2.8% of GDP. The majority of countries struggled to preserve the level of public expenditure due to a significant fall in tax revenues, a paramount regional phenomenon present even in Azerbaijan, the only country in the region with a positive real GDP growth in 2009. Preserving the public expenditure was considered a priority: social spending and public sector wages and pensions constitute a large share of national budgets. However, in a number of countries - among them Moldova, Azerbaijan and Armenia – fiscal policies had been pro-cyclical as significant expenditure cuts had to be implemented in 2009.

Exchange rate against the USD (against currency baskets for Russia and Belarus)



Source: ECOWIN Reuters.

While the room for manoeuvre in fiscal policies has been limited to bank recapitalisation, monetary and exchange rate policy instruments were used more actively. A common trend in the monetary policy already in the late 2008 - early 2009 was a substantial monetary easing through lowered reserve requirements that was expected to provide banks with easier access to liquidity. Refinancing rates were mostly used to support the real sector: they were lowered in Ukraine, Moldova and Georgia. The common trend in exchange rate policies has been an increased level of flexibility: the overwhelming majority of countries reduced their interventions in setting exchange rates thus flexibilising their de-facto exchange rate regimes against the US dollar or against a currency basket (Russia and Belarus). Defending the currency against strong devaluation pressures would have resulted in a sizeable loss of foreign exchange reserves. While before the crisis, exchange rates against the US dollar, the dominant foreign currency in the region, have followed a slight appreciation trend, since autumn 2008 all currencies but the Azeri manat lost a substantial part of their value in a successive wave of devaluations. Ukraine and Georgia allowed their national currencies to depreciate already in late 2008, with currencies losing around 50% and 15% of their respective value over the last three months of 2008. Belarus let its currency to depreciate in January 2009 by 20% against a currency basket, Armenia in March by 20%, and Moldova in December 2009 by around 10%. Russia had three devaluations between November 2008 and February 2009 with its national currency loosing more than 1/3 of its value against the USD/EUR currency basket. While the Russian rouble has regained a part of its value since then, currencies of other countries in the region have remained stable or devaluated further during the course of 2009. Since the beginning of the global crisis, the currencies of Ukraine, Belarus and Moldova lost 70%, 30 % and 34% of their value, respectively, while Georgia and Armenia lost around a quarter of their currency's value. Exchange rate devaluations have contributed to inflationary pressures through higher import prices (e.g. Ukraine, Belarus) while they also increased vulnerabilities of the banking sectors in countries with a high share of foreign currency denominated liabilities (Ukraine, Moldova, Georgia). Azerbaijan has been the only country in the region that opted for preserving exchange rate stability at the expense of a significant loss in its foreign currency reserves: the country continued its policy of an informal currency peg and kept its exchange rate stable towards the USD.

As foreseen last year, **net FDI** flows in the EU's Eastern neighbours almost halved, falling from 7.4% of GDP to 4.2%, a figure expected to remain roughly the same in 2010.

The **average external indebtedness** of the countries of the region (public and private debt) increased from 30% of GDP in 2008 to around 40% in 2009, and is again at a similar level in 2010. Nevertheless, the GDP-weighted average actually fell between 2008 and 2009 (from 31% to around 27%), largely due to the deleveraging of banks and firms in Russia (financed with hard currency from the central bank's reserves). The figure is particularly worrying for Ukraine, where it is expected to be close to 100% of GDP in 2010.

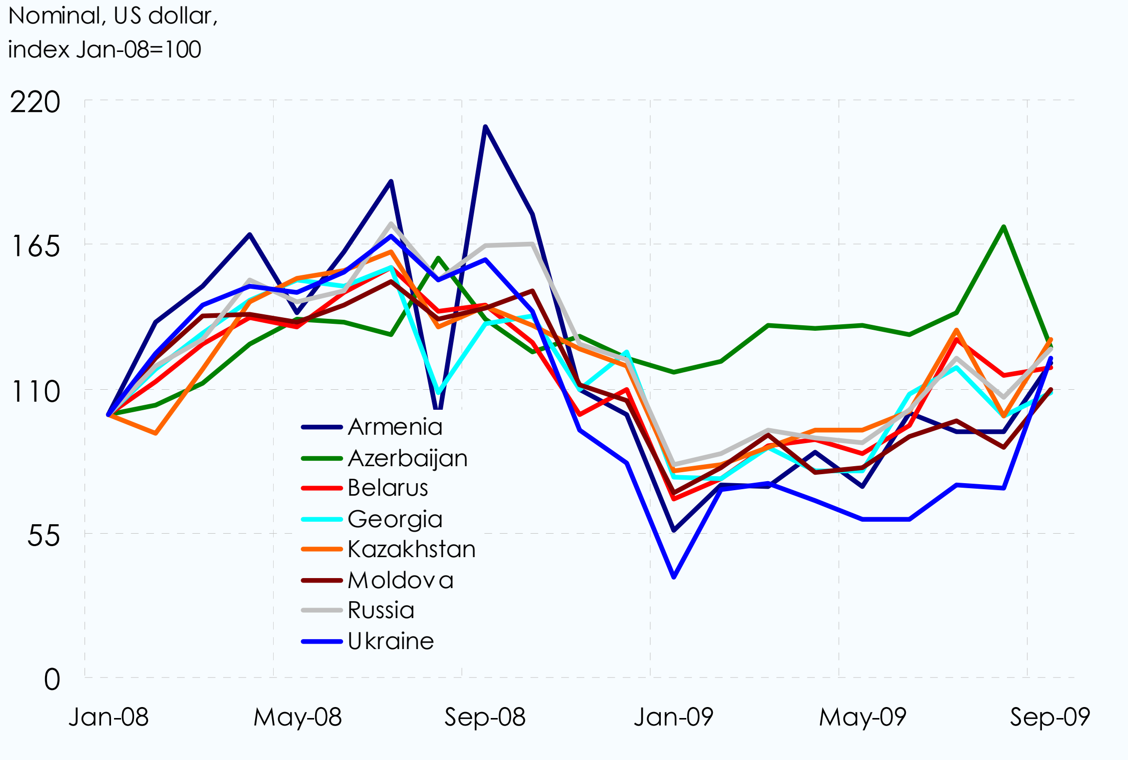
2.3. TRADE AND FINANCIAL INTEGRATION

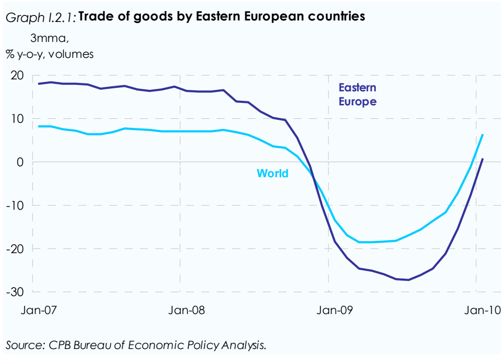
Concerning **trade**, even with the crisis, the EU is still the single largest trading partner of all the countries of the region (see Box 1.2.2).

The only exception remains Belarus, which has an FTA with Russia, complemented by the EURASEC Customs Union (see Box 1.2.3), and is over-reliant on Russia for imports, due to its role in the trade of some Russian energy products. As a matter of fact, across the region, Russia is a more important source of imports than an external market for exports. As an innovation in our analysis, we have this year introduced a chapter on Central Asia: given the integration of the largest Central Asian economy, Kazakhstan, in the EURASEC Customs Union, this chapter also briefly deals with that region (see Box 1.2.4).

In any case, Russia is rather close to the share of the EU in some of the other countries (notably for Armenia and Ukraine, and, in Central Asia, for Kazakhstan, this last one due to its role as a conduit for trade with China to the other countries in Central Asia and also to Russia itself). It is equally noteworthy to see that the EaP aggregate is itself an important market for the region, usually surpassing both China and the US (and, in the case of Georgia, equally Russia).

Graph II.2.1: **Export dynamics**

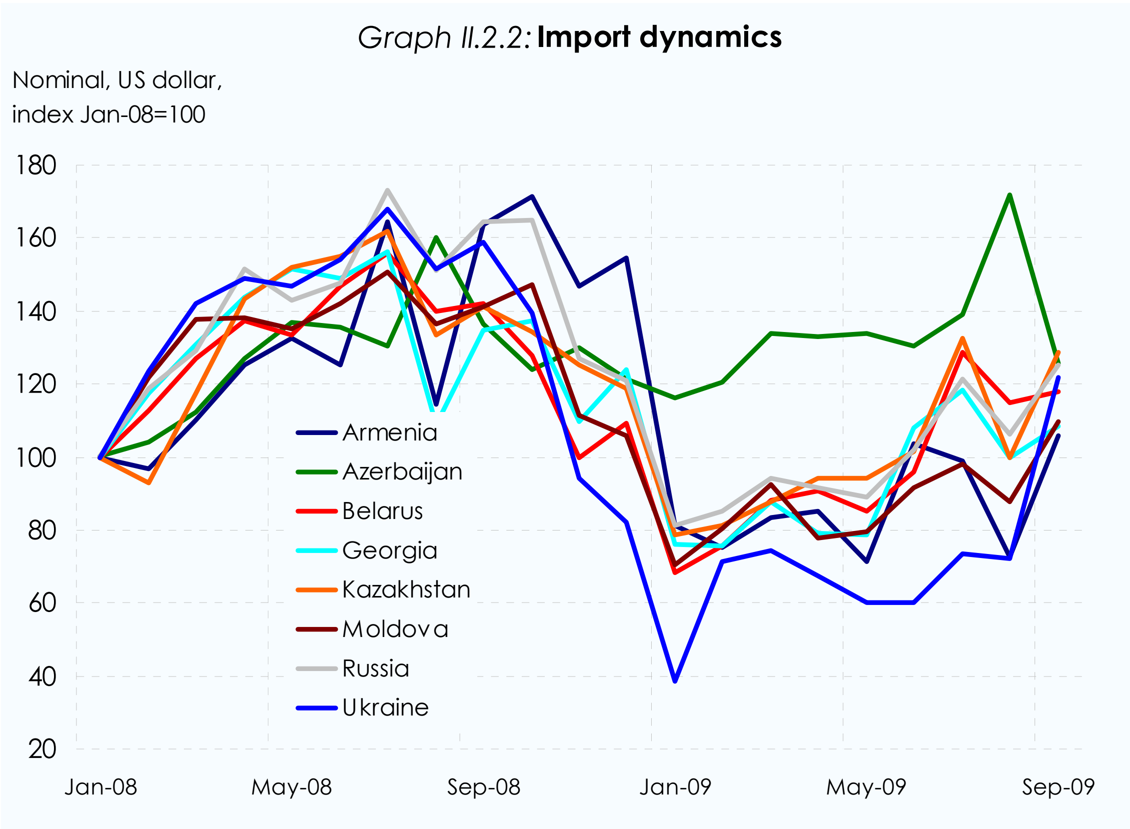




As a matter of fact, most analysis (for instance, based on so-called "gravity" trade models) tends toconclude that the region "overtrades" with itself (this conclusion holds including or not Russia in the relevant aggregates). This implies that trade diversification away from the region (for instance, even stronger trade ties with the EU) would be welfare improving for the EaP countries (which is supported by the several ongoing efforts for trade liberalisation towards the EU, namely FTA+ negotiations with Ukraine, talks with Armenia and Georgia, etc). On the other hand, most analysis tend to conclude that Russia "overtrades" with the EU, so it would be potentially welfare-improving for that country to diversify away from EU (by, for example, correcting its apparent "undertrading" with China). ([1])

Specific regional and product trade patterns are also apparent. *China* is a particularly relevant partner for Central Asian, while, beyond the trade partners indicated in Box 1.2.1, *Turkey* is the third most important trade partner for Georgia (after the EU and the EaP), *India* is a significant export market for Azerbaijan, Ukraine and Belarus (as is also Brazil for this country), while *Morocco* took over half of all Moldova exports during the first three quarters of 2009, whereas Kazakhstan and Uzbekistan are significant import partners for Ukraine (due to their role in energy trade). As concerning trade specialisation, most of the analysis indicates that the CIS countries broadly are more competitive in sectors related to natural endowments and some types of manufactures.

([1]) For a recent analysis of this subject, see Shepotylo, O. (2009), "Export Diversification across Industries and Space: do CIS countries Diversify enough?", n° 20, Discussion Papers, Kiev School of Economics..



More precisely, the estimation of a Revealed Comparative Advantage (RCA) index shows that the CIS have RCAs in items like food, beverages, crude materials, mineral fuels and specific manufactures (mostly related to natural-resources abundance).([1]) This varies by country, by market and by period: for example, Russia globally has RCAs in the *manufacturing* sectors of Leather and Wood and their Manufactures, Fertilisers, Organic and Inorganic Chemicals, Iron and Steel, Non-metallic Mineral Manufactures and Power Generating Equipment. Nevertheless, albeit Russia's overall RCA worsened throughout the 2000s, its RCAs towards the other CIS improved significantly in this period and is much broader (as a matter of fact, towards the CIS Russia shows RCAs in *most* manufacturing sectors). ([2])

The total trade (imports plus exports) of the EaP countries plus Russia with the EU-27 decreased sharply in 2009, due to the strong contraction of the EU economy: from €348 billion in 2008, it fell to €202 billion (January-November). The share of the region in total external EU-27 trade fell to 9.7% in 2009, from 12.2% in 2008, making this region the third most important external trading partner of the EU, after the United States and China. As over 80% of this total trade was with Russia, just by itself this country would still be the 3rd. most important trade partner of the EU.

From the top of the cycle to the bottom of the contraction (roughly, from July 2008 to January 2009), total trade fell by almost 60% for the countries in the region, as commodity exporters were particularly hit by the global downturn (see Box 1.2.2). Some of these countries managed to have either balanced falls of imports and exports (Russia) or greater falls of imports (Belarus, Moldova and Ukraine) which underpinned an external adjustment process. With the onset of a stabilisation in trade flows and an increase in commodity prices from January 2009 onwards, nominal total trade recovered by over 66% between January and November 2009. This, in any case, was still just 67% of its value in July 2008.

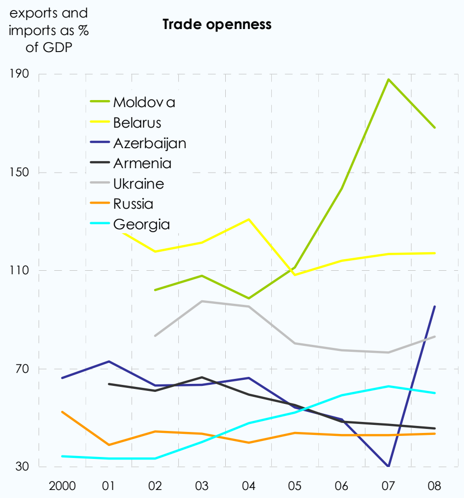
([1]) See Freinkman L. *et al*. (2004), "Trade Performance and Regional Integration of the CIS Countries", World Bank Working Paper n° 38, and Lücke, M. and Rothert, J. (2006), "Central Asia's Comparative Advantage in International Trade", Kiel Economic Policy Paper n° 6.

([2]) See Garanina (2008), "What Beyond Oil and Gas?: Russian Trade Specialisation in Manufactures", BOFIT DP n° 23.

While the Eastern neighbouring countries are on average trade-wise rather open economies, it is not necessarily true that the degree of openness was positively related to the degree of sensitivity to the global crisis (which holds even if the real channel was an important transmission channel of the crisis). Their degree of trade openness (measured by the sum of imports and exports to the nominal GDP) was on average 127% in 2007, falling to 92% in 2008 (a drop caused by a single country, Azerbaijan, who exports essentially oil products, and having had an openness rate of almost 400% in 2007, which fell to a "mere" 116% in 2008 with lower oil prices). GDP weighted, the figures are, respectively, 98% and 60% (again, Russia dominates this average, and as all large, continental economies its openness ratio is smaller). The largest openness ratios in 2008, all above 100%, are found in Azerbaijan (spared by the crisis), Belarus (with a far better performance than the regional average) and Moldova (almost as strongly affected as Ukraine), while the lowest openness ration (round 40% is in Russia) a country that was significantly affected by the crisis.

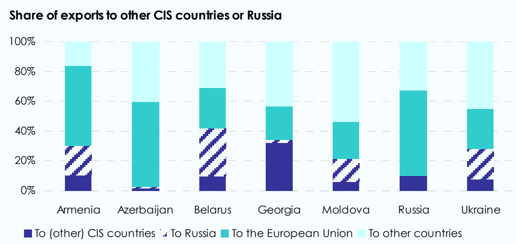
The **banking sector** in the Eastern neighbours has improved considerably since the difficult days of late 2008, early 2009. The financial channel was the main initial crisis conduit, but massive liquidity support by the monetary authorities, including in foreign currency (notably, by the Central Bank of Russia, see Russia chapter) and by international financial institutions seem to have prevented a systemic crisis, while at the same time allowing a mostly orderly reduction of the external exposure of the banks in the region. No major bankruptcies were observed in the regional financial system, and the bank systems remained well capitalised by international standards, even increasing their capital cushions as 2009 progressed (the capital adequacy ration rose from just below 13% by mid-2008 to above 16% by end November 2009 in Russia, from 17.5% to 19% during the same period in Belarus and from around 11% in Ukraine in July 2008 to 13% by September 2009). Non-performing loans indeed rose significantly across the region (from 0.7% in mid 2008 to 1.7% by end 2009 in Belarus, from 1.5% to 5.2% in Russia, and from 3% to 9.6% in Ukraine, the most affected country), but seem in overall terms largely manageable.

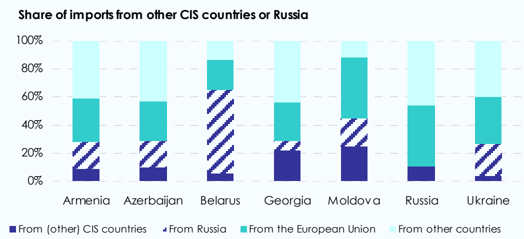
Box II.2.3: **Intraregional trade in the CIS and Russia**



Source: IMF DoTs, ECOWIN Reuters, own calculations.

Trade integration allows countries to use their comparative advantages and is thus growth inducing in the medium-term. According to the measure of trade integration that is the sum of imports and exports in the country's GDP, an important dichotomy emerges among the CIS countries. In the 2000s, the countries with a relative low level of trade integration have been the three Caucasus countries and Russia. In these countries, trade represents 40-60% of GDP. Countries with a high level of trade integration are Ukraine, Moldova and Belarus but they still differ substantially from each other, as Ukraine's trade integration since the early 2000s has been at 85% of GDP, while Moldova and Belarus have trade shares that have been substantially higher, at 130% and 120% of GDP, respectively. A common trend has been that since the early 2000s for all countries but Armenia and Russia the trade integration has been growing, albeit at a different pace. The fastest growth can be reported for Moldova and Azerbaijan. Some countries like Belarus, Moldova and Azerbaijan have a high level of volatility in their annual trade integration figures which is characteristic for small economies that are either highly dependent on a limited number of trading partners (Belarus) or on a limited number of traded commodities (Azerbaijan).





Source: IMF DoTS, own calculations.
Note: In percentages of total exports 2008 and imports 2008, respectively.

While according to the baseline assumption trade integration is good for medium-term growth and welfare, in the CIS, rather than being a proxy for competitive strength, high levels of trade integration often mask either a lack of diversification (as is the case for the energy exporting Azerbaijan and Russia) or a dependence on imports (Armenia and Georgia import goods that amount to 40% of GDP, while Moldova's import share is at 85% of country's GDP). Such import dependence is translated into significant trade deficits and cannot be considered as welfare increasing in the medium-term. The only two countries with a relatively important export sector and a balanced trade performance are Belarus and Ukraine. The CIS intraregional trade remains low; even before the fall in trade flows in 2009 the average of import and export shares represented 30% of total trade in 2008. Intraregional trade lacks diversification as it is strongly dominated by the trade links most CIS countries have with Russia. Apart from Georgia trade integration with Russia is at least twice as big as trade integration with all other CIS countries. Georgia and to a lesser extent Moldova are the only countries in the region that have a more diversified intraregional trade. A part of the explanation for the limited intraregional trade is a low export capacity, a similar export structure that focuses on agricultural products and raw materials and a low purchasing power. Yet another part of the explanation is the lack of trust and in some cases political tensions.

Box II.2.4: **Financial integration, FDI and remittances**

One way of measuring the degree of financial integration is by accounting for the share of country's banks' assets and liabilities with foreign financial institutions expressed as a share of country's GDP. According to this measure, EU's eastern neighbours have a relatively low level of financial integration. In the 2000s, among the countries with the highest level of financial integration have been Russia and Moldova: the assets and liabilities of their banks in foreign banks represented 26% and 21% of GDP, respectively. Azerbaijan's and Ukraine's average financial integration has been at 16% and 18% of GDP, while that of Armenia, Georgia and Belarus has been very low: at 11, 14% and 8% of GDP, respectively. While most countries experienced an increase in their degree of financial integration during the last decade, in Ukraine the trend has been strongest. Already since 2007 Ukraine's banking system has caught up with Moldova and Russia and was leading, with bank assets and liabilities with foreign financial institutions standing at 31% of GDP in 2008. In practically all countries in the region the level of financial integration declined in 2008.

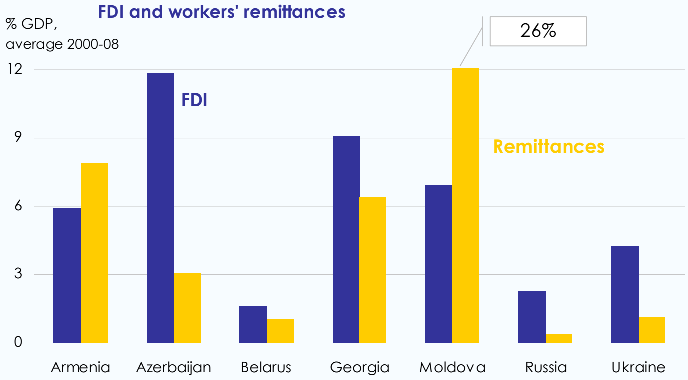
Cross-border assets and liabilities of banks, % of GDP

	Armenia	Azerbaijan	Belarus	Georgia	Moldova	Russia	Ukraine
2000	12	13	6	15	21	23	5
2001	12	20	7	15	18	21	5
2002	12	17	6	12	15	21	8
2003	13	16	7	19	18	25	10
2004	12	23	7	13	17	25	15
2005	10	19	7	9	17	32	25
2006	15	14	8	12	25	33	29
2007	10	15	16	15	30	32	35
2008	5	10	10	15	26	19	31

Source: BIS, IMF and own calculations.

While cross-border banking assets and liabilities are low, EU's eastern neighbouring countries are relatively well integrated into the world economy and thus exposed to external shocks through foreign direct investment and remittances flows. Not surprisingly, Russia and Ukraine attracted most investment in the region: since 2000, USD 22.3 billion and USD 4.4 billion per year, respectively. As a share of GDP, FDI inflows have also been sizeable in other countries of the region with the exception of Belarus. Azerbaijan and Georgia have been leading in FDI attraction with annual average FDI inflows of 12% and 9% of GDP, respectively. Moldova and Armenia have followed with FDI inflows representing 7% and 6% of GDP, respectively. Remittances have played a less important role than the FDI inflows but – at 6.5% of GDP per year (simple average) – they still have been considerably higher than those in the MED EU neighbouring countries, for example. Since 2000, Russia and Ukraine attracted most remittances in the region: USD 2.7 billion and USD 1.4 billion per year, respectively. As a share of GDP, remittances have become a very important source of additional income for Moldova: for the period 2000-2008, they amounted to around 26% of country's GDP with a peak in 2006 when they reached 35% of GDP. In Armenia and Georgia, for the same period, remittances have been much lower but still reached 8%, and 6% of GDP, respectively. In 2008 has been the first year when due to the global economic crisis the growing trend in remittances was reverted.

FDI and workers' remittances



Source: IMF WEO, UNCTAD and own calculations.

2.4. BUSINESS CLIMATE

The relevance of the structural indicators section in this year ENP review is due to the relationship between crisis and reform efforts. Crisis may arguably produce an opportunity to introduce additional reforms that could otherwise be considered difficult in normal times. On the other hand, crisis may equally induce a rollback of reforms, at least in some areas. Given this perspective, how did the EU's eastern neighbours fared during the "great recession"?

As happened last year, if one uses the **World Bank's 2010 Doing Business,** the average quality of the business environment in the seven Eastern neighbour countries has actually improved, so the crisis has not stopped reforms. From 78 in 2009 it reached 72 in 2010 (the Doing Business is a decreasing index, with 1 indicating the country where doing business is easier). This is a figure actually better than in 4 EU member states (Poland, the Czech Republic, Italy and Greece), which is an indication that such indexes should be used with a degree of care.

Also Georgia improved further its already very high position, from 15$^{th.}$ to 11$^{th.}$ spot (which would make Georgia a better place to do business than, for instance, all but three of the EU member states). Two of the worst hit countries in the region, namely, Moldova and Ukraine, also improved somewhat their positions (albeit Ukraine remains the worst performing Eastern neighbour, at 142$^{th.}$ place out of 183). The country that was spared by the global recession, Azerbaijan, actually saw a roll bank of this investment climate indicator, falling from 33$^{th.}$ to 38$^{th.}$, and therefore reversing some of the impressive gains from the previous year. The regional giant, Russia, remained stable at 120$^{th.}$ place. Therefore, at prima face, the crisis may have been used for a reinvigoration of the reform process, at least in some of the countries in the region.

Concretely, which changes were observed in individual policy areas? Still using the "Doing Business", in Armenia, Moldova and Belarus it became easier for entrepreneurs to **start a new business** (in Belarus, massively so, as the country improved its ranking from 97 to 7 place, very close to Georgia's 5th), while in Azerbaijan, Georgia, Russia and Ukraine the reverse was true (the worsening was huge in Russia, which collapsed from 65 to 106, and that without any apparent significant legal changes in that country). **Dealing with permits** also improved significantly in Belarus, while worsening markedly in Armenia, with limited changes on the others. **Employing workers** became easier in Belarus and Ukraine, worsening in all the others.

Registering property also became notably less complicated in Belarus, while **getting credit** became more difficult across the region, as an effect from the crisis (bar in Russia, which is perhaps linked to the size of the policy response in that country). **Protection of investors' rights** remained largely at around the previous level across the region (bar in Ukraine, were it improved but from a very low basis) while **paying taxes** became easier in Georgia, Moldova and Russia. **The costs of trading across borders fell** in Armenia and Georgia (perhaps peculiarly, as this happened in spite of the continuous trade embargoes faced by Armenia from both Turkey and Azerbaijan, and given the sharply reduced trade relations between Russia and Georgia which were pointed up above).

Finally, the level of **enforcement of contracts** remained largely stable, but it is worthwhile to stress that regional performance in this criterion is significantly better than the EU average, while on the other hand **closing a business** became somewhat costlier throughout the region.

Once again, this average masks very significant relative positions and dynamics amongst the countries, which also enables one to look at the areas (and countries) that use the crisis as an opportunity to reform. From this point of view, Belarus was the country in the region that used the most the crisis as an opportunity to reinvigorate reforms, as it again improved significantly its relative position (jumping by an impressive 27 places, which means a cumulative improvement of 62 positions in just two years, reaching the 58th. spot). ([1])

([1]) This conclusion also comes from the use of the "veteran" among the structural reform indicators for Eastern European countries, the EBRD's "Transition Indicator" (TI). This index is made up of individual components, and observed improvements in a larger number of those components during the crisis years (namely, on privatisation, enterprise restructuring, price liberalisation and banking sector reform). On the other hand, the TI did not indicate any liberalisation reversals in the region. privatisation, enterprise restructuring, price liberalisation and banking sector reform). On the other hand, the TI did not indicate any liberalisation reversals in the region.

Box II.2.5: **The EURASEC**

The Treaty on the Establishment of the Eurasian Economic Community (EURASEC) was signed on 10 October 2000 by the presidents of five CIS countries: Belarus, Kazakhstan, Kyrgyzstan, the Russian Federation and Tajikistan. Uzbekistan joined the organisation in 2006, while Uzbekistan suspended its membership in December 2008. Additionally, Armenia, Moldova and Ukraine have "associated status" to the EURASEC. Its original building block lies in the treaty for a customs union between Belarus, Russia and Kazakhstan, signed on 29 March 1996. Arguably the main aim of the EURASEC is the ultimate (re)constitution of a customs union and later a single economic space between its members, all former parts of the Soviet Union.

Discussions about the creation of such a common economic space between the four largest CIS economies (Russia, Ukraine, Belarus, and Kazakhstan) resulted in an agreement of principle towards that aim signed on 23 February 2003. However, the political developments observed Ukraine in 2004 (compounded by Ukraine's WTO accession in 2008 and ongoing negotiations for a DFTA+ with the EU) have so far limited Ukraine's involvement in this process. Therefore, in a meeting on August 16, 2006 a decision was taken to establish a customs union within the EURASEC framework, with only Belarus, Kazakhstan and Russia as initial members (while other EURASEC members would join when their economies would be ready).

This decision received a significant boost in mid-2009, when, in a surprise announcement, Belarus, Kazakhstan and Russia declared that they would aim for a joint WTO accession after the constitution of a customs union between those three countries. The introduction of a common customs tariff schedule and the elimination of non tariff barriers between those three countries were slated for 1 January 2010. Remarkably, given the complexity of such tasks, this deadline was actually achieved. Nevertheless, some very important elements, for instance the division of customs revenues between the three states, are to be completed by mid 2010 only. Additionally, its is unclear what –if any– significant economic gains can arise of this process (that in spite of a study by the Russian Academy of Sciences that shows equivalent gains in the order of several hundred billion of USD), as the economies were already largely trade integrated (via the tariff free intra-CIS trade and the FTA Belarus-Russia).

As result of this harmonisation, for Belarus, 7% of the line tariffs would increase and 18% decrease (namely, increases on meat products, metals, motor cars and decreases on apparel, footwear, machinery and mechanical appliances and pharmaceutical substances). For Kazakhstan, 10% of the tariffs would increase while 45% would decrease (increases on means of transport, wood, refrigerating equipment, pharmaceutical preparations, electro-mechanical domestic appliances, footwear and apparel and decreases on agricultural products, hides and skins, optical medical or surgical instruments and appliances). Lastly, for Russia, 14% of the tariffs would increase while 4% would decrease (namely, increases on meat products, yeast, some articles of apparel and clothing accessories and decreases on fruit concentrates, baby food, materials for photography, wool and fabrics, pharmaceutical substances, parts of footwear, electro-mechanical appliances).

Finally, and potentially very importantly, a so called "Anti-Crisis Fund" was established under the EURASEC on 4 February 2009. The stated aims of this fund are to a) to grant loans and stabilization credits and b) to fund interstate investment projects. Initially capitalised with USD 10 billion, not a single disbursement has yet been made of this fund, as its operational rules are still being developed. It is unclear who the potential beneficiaries would be, what would be the terms and what –if any– conditionalities could be attached to the operations (no document describing legal framework concerning the fund is apparently available at the EURASEC website), but it seems that at least the EURASEC members (both full and associate) would be able to submit requests. Some statements indicate that decisions concerning the first disbursements could be announced as soon as late February 2010, and those could be granted to non-full EURASEC members (so, observers members, like Armenia, Moldova or Ukraine).

Additionally, the **taxation** framework should obviously be seen as an important part of the overall investment climate. Using as a measure of that another index of that prolix index producer, the World Bank, namely its "Paying Taxes" indicator, in terms of the **easiness of paying taxes**, the region average improved significantly between 2010 and 2009, from the 140th. position to the 128th. (this is a decreasing index, with 1 indicating where it is easier to pay taxes), albeit this is still in the bottom third of the distribution. That was due to significant improvements in Georgia (the "friendliest" tax location in the region) and Russia, but the region still has the worst performer globally (namely, Belarus, at 183rd. spot). Nevertheless, it could be pointed out that those countries listed as "easiest" tax locations by this indicator (Maldives, Qatar, Hong Kong, the UAE, Singapore) may also be less charitably classified as sharing some features of a so-called "tax heaven". The regional position concerning **number of tax payments** also became better (from 128th. to 119th.), and equally due to a significant reduction of those in Russia (the regional champion in this respect) and Georgia, while stagnating at 152nd. in terms of the **time to comply** with taxes (and that in spite of another significant improvement in Russia, which was counteracted by worsenings in Azerbaijan and Georgia). Finally, the average **total tax rate** of the region advanced too (from 109th. to the 95th. spot), due to the better positions of Georgia and Moldova (and as a remark, the average regional tax rate is not significantly higher than that in the EU). All in all, the crisis year also resulted in an improvement of the taxation framework in the region.

2.5. PUBLIC INSTITUTIONS AND GOVERNANCE SYSTEMS

In order to secure the functioning of markets and the whole macroeconomic policy mix, a stable system of governance and public institutions needs to be established. In case of non-transparent institutions and decision-making process, corruption, dependence of the judicial institutions on the government, as well as overregulation of the market can lead to malfunctioning of the political and economic development of the country. Both **macroeconomic performance and global competiveness** of a country can be negatively affected by that.

The Global Competiveness Report of the World Economic Forum([1]) measures some of the aspects which make up the governance of a country, through an aggregate index called "Global Competitiveness Index" (GCI). The most important actors for governance are **public and private institutions**, since they are responsible for the policy measures affecting the economic environment of a country.

Among eastern neighbours only Armenia, Azerbaijan, Georgia, Russia and Ukraine were ranked in 2009. In this group, the best performer in 2009 was Azerbaijan, with the 51th. spot, up from the 69th. in last year's report, at the same time as Armenia and Georgia experienced no changes in their relative positions, and while both Russia (the best performer of the group last year) and Ukraine suffered a significant worsening of their relative position. Therefore, the relationship crisis/reform here seems to work in the opposite direction of the previous section, but there is an endogeneity matter with the GCI: as includes **macroeconomic performance** among its components, those countries that faced worst economic downturns are automatically penalised in the aggregate index, and vice versa. Also, the **policy instability** criterion could also lead to higher rankings for countries with less frequent or less open democratic procedures.

How do eastern neighbours fare at the individual component of the index? In **Azerbaijan**, the ranking in the **institutions** criterion is 55 (rather surprisingly, this country is the regional best performer in terms of institutional framework). The **burden of government regulations** also improved, with a rank of 14th. out of 133. This raised the **public trust in politicians** rank, as well as belief in **good governance**. According to the GCI-ranking **policy instability** seems to be the least of its institutional problems: the country has been run by a family dynasty since its independence. On the other hand, the worst elements in Azerbaijan were **corruption** and **inadequately educated workforce**.

Russia fell to the 63rd. spot, from 51st. in 2009. The country is seen as struggling with **corruption** and **inefficient government bureaucracy**. Relatively

([1]) The World Economic Forum's Global Competitiveness Report 2008-2009.

worse results are shown in the items **judicial independence, burden of government regulation, transparency** and **efficiency of government policy making**, as well as of the **legal framework** and **ethical behaviour of firms and corporations**. Russia's ranking at the **institutions** criterion is 114.

Ukraine also fell to 82nd from last year's 72nd. The country is plagued by **policy instability**, caused by continuous tensions between the government and the president, and by other institutional weaknesses (of course, as in Russia, the index fall was also related to its uninspiring economic performance). Ukraine ranks in the regional bottom on the **institutions** criterion, with 120.

Concerning Georgia, it has remained stable on the 90th position for the last 3 years (noteworthy, this is much lower than its overall ranking in the "Doing Business" indicator, where it is the "regional champion"). Due to the crisis with the Russian Federation in August 2009, the item **government instability** had a large impact on the index, which also affected the **policy instability** component. **Corruption** is not perceived as a major problem, but is still mentioned among the problematic factors for doing business. More similarly to the "Doing Business" indicator, Georgia occupies a remarkable rank of 3rd. in the **burden of government regulation** criterion. Unfortunately, the **judicial independence** is on the other hand within the last quartile of the set of countries, ranking only 117th. Its ranking on the **institutions** criterion is 72.

Armenia ranks 97th, the lowest from the group (and 95th. on institutions), which is the same as last year (on the other hand, the country has the third best position in the region in the "Doing Business" index). **Institutions**' problems appear to be embedded within the **efficiency of legal framework**, as well as overall **judicial independence** of the country. Furthermore, there seems to be a low level of **good governance among firms**, which are performing neither efficiently nor transparently. This explains the low assessment of Armenia on **corruption**, which is listed as the most problematic factor for doing business in the country. The **inefficiency of government bureaucracy** is also a negative factor in that perspective.

Corruption, or at least the perception of it, as already indicated above, is an equally important part of the governance system of any country. Another gauge of it is provided by the Transparency international "Corruption Perceptions Index". Using the 2009 index as reference, their average is still in the lower third of the distribution, albeit the figure actually improved slightly when compared with 2008 (the rank fell from 125th. to 121th.: the index decreases with a lower perception of corruption). The regional best performer is still Georgia (position unchanged), but the regional improvement is due to significant gains in two countries, Moldova, which climbed 20 spots to 89th. place, and Belarus, which climbed 12 spots to 139th. The others either worsened (Azerbaijan and Ukraine) or stagnated (Russia), and are all now effectively within a similar range (143 for Azerbaijan, 146 for both Russia and Ukraine).

2.6. CONCLUSIONS AND POLICY ISSUES

The crisis has shown that globalisation and financial deregulation can have short term costs, but the policy response to this is **to design frameworks that would soften the impact of shocks, without compromising the long-term benefits from integration.**

From this point of view, it is positive that **no major liberalisation reversals** have been observed in the region, including on the trade field, ([1]) and that at least some of the countries (notably, the long time regional laggard, Belarus) seem to have used the opportunity provided by the crisis to introduce deeper structural reforms. Nevertheless, it is necessary that **liberalisation reforms resume**. This is especially relevant for the two largest regional economies, Russia and Ukraine, given their relatively low rankings.

The need for **a consistent policy mix** was strongly emphasized by the crisis, and indeed led to policy

([1]) The 2008-2009 recession did not generate the feared global backlash in trade liberalisation, in spite of some punctual and temporary restrictive measures. In the region, that even happened in spite of the facts that three of the Eastern neighbours (Azerbaijan, Belarus and Russia) are not yet WTO members and despite some temporary restrictive measures introduced by Ukraine and Russia.

changes. This is equally relevant in the **"exit strategy" phase** of the crisis.

For instance, **harder exchange rate regimes**, seen as one of the origins of the accumulation of external imbalances (one of the underlying causes of the crisis), have been replaced in some countries by more flexible frameworks. This has allowed for the necessary adjustment to proceed in a smoother fashion, and, therefore, this development should continue. Also, the **withdrawal of the additional monetary liquidity**, an important element of the monetary part of the "exit strategy", has, in some cases, began. This process will have to intensify, albeit in a careful and staggered fashion, in the medium term.

Equally important, the fiscal part of the "exit strategy" would need to include **a process of fiscal consolidation, so as to allow long-term fiscal sustainability.** Additionally, the crisis enhanced the relevance of **robust fiscal institutions**.

Most of the countries in the region (with the possible exceptions of oil-rich Azerbaijan and fiscally conservative Belarus) would have to carefully consider **the necessary process of future fiscal consolidation,** which, again, must be done in a progressive fashion. International institutions (the EU, the IMF) may provide useful benchmarks and support for the countries in the region for this process, beyond the intra-regional sharing of experiences itself. ([1])

Here, it is worthwhile to mention the case of Russia: its fiscal framework, specifically designed to counteract fiscal shocks linked to commodity prices, worked as planned. The large headline deficit was fully absorbed by the accumulated fiscal funds, and virtually no additional sovereign indebtedness (domestic or external) was incurred by the country. Also, its existing "Medium Term Expenditure Framework" enables the government to signal already to the domestic economic agents a progressive and staggered withdrawal of the fiscal stimulus (see Russia chapter).

Finally, concerning the **regulatory and supervisory reforms of the international financial system**, this remains very much work in progress, at global level linked to the **future implementation of G20 commitments**. It is nevertheless reassuring to see that, even with the significant shock from the crisis, the commitment towards financial integration was upheld, by both the countries and by international banks. None of the international banks active in the region left any of the countries, and most significantly recapitalised their operations across the region. ([2])

([1]) As an example of this dimension, the World Bank has recently created in Moscow, with the support of the Russian Government, a center for the sharing of regional experiences in the field of Public Finance Management (PFM).

([2]) As a matter of fact, studies indicate that, when faced with the crisis, more internationalised countries faced lower costs of access to capital markets (as an example, Russia re-capitalised its banking system with public funds, while Ukraine was able to shift the adjustment costs to the foreign banks operating in the country).

Box II.2.6: **Central Asia**

Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan forms Central Asia – a landlocked region rich with the hydrocarbon and other mining resources. Kazakhstan is by far the biggest country by the territory and the size of the economy([1]), while in Uzbekistan lives almost a half of regions' population. Region has a limited water supplies and a rather rough terrain, which have to sustain a large share of population dependent on agriculture. Five countries are differently endowed despite proximity. Smallest and poorest mountainous South East countries - Kyrgyz Republic and Tajikistan, have little natural resources, except for a largely untapped hydropower. They, however, can potentially control part of the water supplies to the hydrocarbon rich Northern and Western downstream countries – Kazakhstan, Turkmenistan and Uzbekistan. In turn, upstream countries largely rely on gas and oil rich downstream countries for energy supplies. In addition, countries depend on the regional transit routes to get an access to export markets.

The progress in market reforms is uneven. In most countries economic activities are still heavily directed by the state despite the attempts to restructure the impoverished economies by introducing market reforms after the disintegration of the Soviet Union. As a result, private sector share in the economies ranges from 75% in Kyrgyz Republic to just 25% in Turkmenistan([2]). Countries have dominating executive branches of power, which impose administrative measures and direct economic activities. State involvement in the different sectors actually advanced in 2009, because governments orchestrated economic activities responding to a global recession and financial turmoil. States also maintain strong presence in the banking sectors, which are generally underdeveloped and often employed to channel credit to the preferential sectors.

Revenues from the hydrocarbon exports empowered resource rich countries to sustain high public investment levels resulting in strong economic growth. Rigid regulations, however, depress business and investment climates, thus restraining the development of the private businesses, especially outside the hydrocarbon sector. Consequently, population remain dependent on the state support, while benefits of high growth do not translate in to swift alleviation of the poverty. Trade barriers remain prominent. Corruption is still a systemic problem. Agricultural sectors, which employ a bigger part of population in some countries, remained unreformed for a long time resulting in low productivity and dependence on state support. Job opportunities are lacking resulting in massive migration for the temporary jobs in Russia and Kazakhstan.

Kazakhstan, Turkmenistan and Uzbekistan used the significant fiscal and external surpluses accumulated from hydrocarbon exports to shield their economies from the global recession and financial turmoil. Kyrgyz Republic and Tadzhikistan lacking such resources had to rely on prudent fiscal policies, while anti-crises spending had to be supported by concessional financing. Four countries let their currencies depreciate to buffer external shocks. Inflation was a serious problem for most countries during the years of economic boom. Inflation pressures subsided since the boom ended and domestic demand weakened, but in some countries inflation remains close to double digits. The regional economic cooperation is very weak despite of the regional interdependence on access to water, energy resources and export markets. Russia is still most important neighbouring economy for the region, but China shows great interest in supplies of gas and oil from the Central Asia, thus region starting to benefit from the geographic diversification of the hydrocarbon exports.

([1]) Kazakhstan accounts for 57.6% of region's GDP in PPP terms, World Bank data of 2008
([2]) EBRD, Transition Report 2009

Table II.2.1:
CIS countries - Main economic indicators

Real sector	2006	2007	2008	2009 prel.	2010 proj.
Real GDP growth (domestic currency, % change)					
Armenia	13.3	13.7	6.8	-14.4	2.0
Azerbaijan	34.5	25.0	10.8	9.1	9.7
Belarus	9.9	8.2	10.5	0.0	2.0
Georgia	9.4	12.3	2.3	-3.9	2.0
Moldova	4.8	3.0	7.2	-6.4	2.0
Russia	7.4	8.1	5.6	-7.9	3.5
Ukraine	7.3	7.9	2.1	-15.1	2.7
CIS Region (GDP at PPP)	*6.5*	*8.0*	*8.3*	*-8.0*	*3.5*
Nominal GDP (EUR billion)					
Armenia	5	7	8	6	6
Azerbaijan	17	21	32	38	46
Belarus	29	33	41	31	31
Georgia	6	7	9	8	
Moldova	3	3	4	4	3
Russia	788	942	1150	897	1032
Ukraine	86	104	123	84	
CIS Region (total)	*934*	*1118*	*1367*	*1068*	
GDP per capita (EUR)					
Armenia	1584	2081	2524	1921	1982
Azerbaijan	1959	2495	3625	4351	5122
Belarus	3018	3368	4271	3237	3302
Georgia	1415	1679	1987	1774	
Moldova	757	902	1160	1091	979
Russia	5521	6628	8099	6326	7264
Ukraine	1848	2255	2678	1846	
CIS Region (simple average)	*2300*	*2773*	*3478*	*2935*	
Inflation (average anual % change)					
Armenia	2.9	4.4	9.0	3.5	3.7
Azerbaijan	11.4	19.7	15.4	1.4	6.9
Belarus	7.0	12.1	13.3	10.0	8.0
Georgia	9.2	9.2	10.1	1.7	3.0
Moldova	12.8	12.4	12.8	-0.2	6.2
Russia	9.7	9.1	13.3	9.0	7.5
Ukraine	9.1	12.8	25.2	15.9	10.3
CIS Region (simple average)	*8.4*	*10.0*	*14.2*	*6.7*	*6.5*
Social indicators					
Unemployment rate (%)					
Armenia	7.2	6.7	6.3		
Azerbaijan	1.0	0.9	0.8	1.0	1.0
Belarus	1.2	1.0	0.8	0.9	1.0
Georgia	13.6	13.3	16.5	16.5	
Moldova	7.4	5.1	4.0	5.5	
Russia	6.9	6.1	7.7	8.1	7.5
Ukraine	6.8	6.4	6.4	8.8	10.0
CIS Region (simple average)	*6.3*	*5.6*	*6.1*	*6.8*	*4.9*

(Continued on the next page)

Table (continued)

Fiscal sector	2006	2007	2008	2009	2010
General government budget balance (% GDP)				prel.	proj.
Armenia (Central Government)	-2.1	-2.2	-1.3	-7.5	-5.8
Azerbaijan	-4.6	-6.2	-7.2	-8.6	-4.5
Belarus (Central Government)	1.4	0.6	-0.8	0.0	-1.5
Georgia	-3.0	-4.7	-6.3	-9.2	-7.4
Moldova	-0.3	-0.2	-1.0	-6.9	-6.5
Russia (Central Government)	7.4	5.5	4.1	-6.0	-2.5
Ukraine	-1.4	-2.0	-3.2	-8.6	-6.0
CIS Region (GDP weighted)	*5.6*	*3.9*	*2.5*	*-6.2*	*-3.0*
Total gross public debt (% GDP)					
Armenia	18.7	17.4	15.9	37.4	44.1
Azerbaijan	7.7	6.4	4.1	4.3	2.9
Belarus	11.0	11.6	19.0	20.0	22.0
Georgia	28.9	22.9	26.6	40.5	47.8
Moldova	29.2	26.8	21.3	30.9	36.9
Russia	5.4	5.1	7.1	7.1	7.0
Ukraine	15.7	12.9	19.9	35.4	38.6
CIS Region (simple average)	*16.7*	*14.7*	*16.3*	*25.1*	*28.5*
Monetary sector					
Degree of monetisation (M2/GDP, %)					
Armenia					
Azerbaijan (M3/GDP)	19.1	22.0	22.3	19.7	21.2
Belarus (M3/GDP)	22.1	24.8	21.9	21.3	22.0
Georgia (M3/GDP)	19.5	23.7	22.3	24.1	25.8
Moldova	27.9	34.5	34.6	34.1	
Russia	33.4	40.1	32.4	30.0	35.0
Ukraine					
CIS Region (simple average)	*24.4*	*29.0*	*26.7*	*25.8*	
Dollarisation in bank deposits (%)					
Armenia	52.3	39.6	27.7		
Azerbaijan					
Belarus	29.1	30.5	31.0	30.0	30.0
Georgia	69.0	65.0	64.0	83 (2)	
Moldova	49.1	43.3	31.3	43.8	
Russia	27.1	24.1	36.1	30.0	28.0
Ukraine					
CIS Region (simple average)					
External sector					
Trade balance (% GDP)					
Armenia	-14.0	-17.3	-22.3	-23.5	-24.8
Azerbaijan	36.9	46.1	47.1	22.0	30.0
Belarus	-4.5	-9.0	-9.6	-14.0	-9.0
Georgia	-23.9	-26.8	-52.3	-22.5	-24.5
Moldova	-48.2	-53.3	-52.8	-36.6	
Russia	14.3	9.9	9.4	8.4	9.5
Ukraine	-2.8	-5.7	-8.1	-1.7	0.1
CIS Region (simple average)	*-6.0*	*-8.0*	*-12.7*	*-9.7*	*-3.1*

(Continued on the next page)

Table (continued)

Current account balance (% GDP)	**2006**	**2007**	**2008**	**2009**	**2010**
Armenia	-1.4	-6.4	-11.5	-13.7	-13.0
Azerbaijan	27.0	34.2	22.7	9.2	7.5
Belarus	-1.8	-5.0	-8.2	-10.0	-7.0
Georgia	-15.1	-19.7	-22.7	-12.2	-14.2
Moldova	-11.4	-15.3	-16.3	-9.0	-9.5
Russia	9.8	5.9	6.3	3.5	4.0
Ukraine	-1.5	-3.7	-7.2	-1.5	0.1
CIS Region (simple average)	*0.8*	*-1.4*	*-5.3*	*-4.8*	*-4.6*
Foreign direct investment (net, % GDP)					
Armenia	7.0	7.6	7.8	3.1	3.5
Azerbaijan	36.9	5.6	7.2	6.2	7.4
Belarus	0.4	3.0	3.6	2.0	2.5
Georgia	15.3	16.4	12.2	7.1	7.9
Moldova	7.4	11.2	11.8	6.4	
Russia	3.2	3.6	3.5	0.5	1.5
Ukraine	5.3	6.4	5.5	3.9	
CIS Region (simple average)	*10.8*	*7.7*	*7.4*	*4.2*	
External vulnerability					
External debt (% GDP)					
Armenia (public)	18.8	14.0	13.3	33.4	39.3
Azerbaijan (public)	9.6	10.3	5.7	4.5	3.8
Belarus (public plus private)	18.5	27.9	24.6	30.0	30.0
Georgia (public)	22.3	18.0	20.9	31.8	37.6
Moldova (public plus private)	74.1	64.2	56.0	65.9	
Russia (pubic plus private)	31.7	35.8	28.9	25.0	23.0
Ukraine (pubic plus private)	49.7	54.0	54.5	85.4	85.3
CIS Region (simple average)	*32.1*	*32.0*	*29.1*	*39.4*	*36.5*
Real effective exchange rate (2004=100)					
Armenia	9.1	15.2	11.6		
Azerbaijan	115.6	119.9	128.2	164.2	
Belarus	73.4	72.3	71.2	65.0	
Georgia (y-o-y, %)	3.7	1.4	8.4	0.5	
Moldova	102.1	96.3	95.4	103.2	
Russia	163.0	173.0	184.0	175.0	
Ukraine	*110.2*	*115.5*	*117.1*	*127.6*	

Note: See the country articles for the sources and clarifications.

Part III

Country analysis

1. ALGERIA

- ***Economic growth in Algeria reached 2.1% in 2009 only. The fall in oil prices in the wake of the global economic and financial crisis depressed oil revenues and resulted in a government deficit after many consecutive years of budget surpluses.***

- ***Inflation remained high, which is remarkable in view of the fact that global food prices fell in the wake of the economic slowdown and the price controls and heavy food subsidises. Import restrictions or speculation in the food supply chain will have to be reduced in order to bring inflation down.***

- ***Algeria could benefit from WTO accession. Integration in the Maghreb region and further global integration, in line with the Association Agreement with the EU, will potentially lead to more and cheaper trade and therefore higher economic growth in Algeria.***

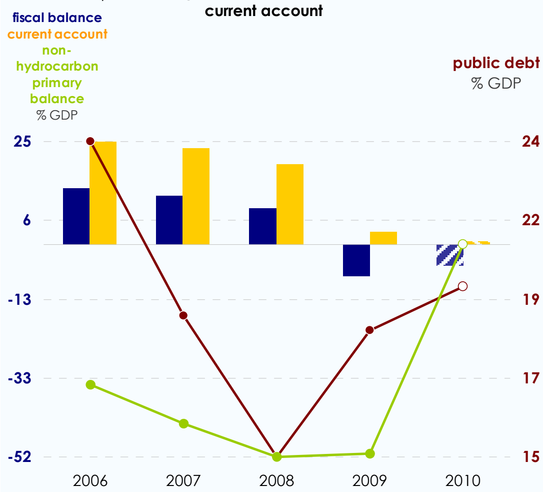
Macroeconomic and financial developments

Algeria has every potential to be a wealthy country. As an OPEC member with high oil revenues, with twin surpluses for years in a row, combined with a relatively high average educational level and a literacy rate of 70 %, a high welfare level for each citizen is within reach. However, average GDP per capita was in the peak year 2008 only 3 200 euros. Moreover, the national income distribution is highly skewed as the poverty rate is still high, with 45 % of the population living below the poverty line.

Admittedly, the Algerian real economy was hit hard by the global crisis. Falling global commodity prices and the high dependence of the Algerian economy on oil and gas depressed government revenues during 2009. **Economic growth** reached only 2.1 % in this year. The expectations are that it will accelerate in 2010 to 3.9 %.

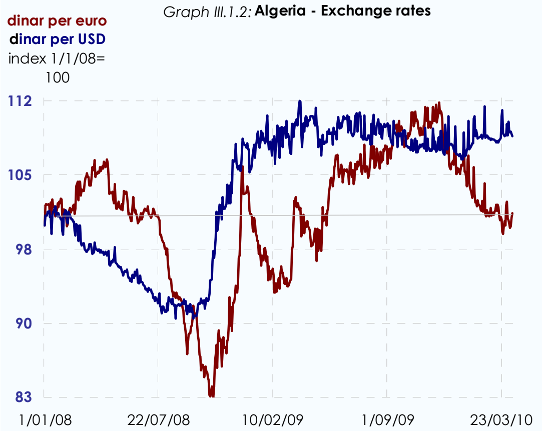
The overall government balance dropped sharply in 2009, after coming down already sharply in 2008 to 9% from a surplus of almost 14% of GDP

Graph III.1.1: **Algeria - Fiscal balances, public debt, current account**



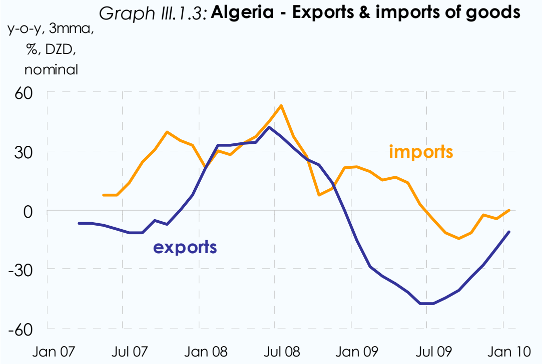
Sources: EIU, IMF and own calculations.

Graph III.1.2: **Algeria - Exchange rates**



Sources: ECOWIN Reuters.

Graph III.1.3: **Algeria - Exports & imports of goods**



Note: Includes only trade with the EU and US due to lack of data.
Source: IMF DoTS.

in 2006. After years of strong surpluses it recorded a deficit of almost 8% of GDP. The trend of expansionary fiscal spending will continue in 2010. But, due to the increase in global commodity prices on the back of the resurgence of global growth the government balance is expected to become positive again in 2010.

The Growth Consolidation Plan for 2005-09, which is basically a **public investment** programme, will be pursued in 2009. There may be further wage rises for civil servants to retain skilled staff, in particular in the security services. These additional expenditures are one reason why the non-hydrocarbon primary deficit remained at excessively high levels of around 50 % of GDP in 2008.

The ***Fonds de Régulation des Recettes*** (FRR) was intensively used for financing the budget. Apart from direct financing of the non-hydrocarbon deficit, as a sub-account of the government at the central bank, it allows for the amortisation of government debt. Budgetary receipts from oil when the price is above the equivalent of USD 37 per barrel (previously USD 19 per barrel) flow into the fund, as do taxes on profits generated by foreign partners. In view of the sharp decline in oil prices, and the higher deficit, the accumulation of funds in the FRR has slowed down.

Higher food prices kept on pushing total inflation upward. Despite earlier tightening of **monetary policy** by the Central Bank of Algeria, inflationary pressures remained possible due the intensification of speculation in the supply chain and the imposition of import restrictions. The inflation level is high for Algeria, where prices of many goods and services are subject to government intervention.

The **exchange rate** regime remained a managed float with no pre-announced path, giving the central bank discretion to intervene in the foreign exchange markets. The sharp decline in world oil prices and the increasing uncertainty in the financial markets affected the Algerian currency. Since October 2008 the dinar has been on a sharp depreciating trend vis-à-vis the US dollar as well as vis-à-vis the euro (see graph III.1.2) but stabilised at the end of 2009. Despite numerous interventions in the exchange market to support the Algerian currency, foreign exchange reserves kept on increasing, albeit at a much slower pace.

The **current account** remained positive in 2009, despite the drop in energy prices and the global demand fall. Exports started falling mid 2008, in line with the sharp slowdown of the US economy, but are on the rise again since mid 2009 (see III.1.3.). The current account is expected to remain low in 2010 due to negative carry over effects.

The official **external debt** deteriorated little in 2009, but is still at an exceptionally low level of little more than 3% of GDP. This solid external debt position, along with the foreign exchange reserves of 80% of GDP, form solid buffers to accommodate shocks.

The banking sector and the bond market in Algeria is shallow and there is no stock market. This, in addition with the low degree of **financial integration** means that the private sector lacks easy access to funds for financing their projects. Cross-border banking is likewise very low, with bank loans from abroad at only 1 % of GDP (see Table III.1.1). Cross-border banking even diminished before the global crisis. Economic growth opportunities are missed through the underutilisation of these financial channels.

Risks and outlook

The main vulnerability of the Algerian economy remains the **low diversification of economic activity**. The high dependence on oil and gas, and sluggish progress in private sector development, are hampering economic development and consequently job creation.

As a reaction to the recent sharp global economic slowdown Algeria may suffer from more protectionist measures. Algeria runs the risk of missing ample opportunities to create growth and jobs if its degree of financial and trade integration stagnates or even decreases. The in July 2009 introduced new measures under the new budget law (see next section) are harmful, as the newly introduced provisions will deter foreign investors, make it more difficult to do business in Algeria and be detrimental to efforts to diversify the economy away from its dependence on hydrocarbons.

As poverty in Algeria is still high and GDP per capita is extremely low in view of the abundant revenues obtained during the last few years, Algeria lags behind its peer countries. Protectionist measures, such as constraints on foreign companies in Algeria, entail a cost for growth. International cooperation, opening of markets and continuing the privatisation processes could accelerate economic growth in Algeria. A higher growth path is within reach, but requires financial markets to be broadened and deepened for the optimal channelling of funds to the economy.

Along with the risk of protectionism, there remain the negative effects of heavy government intervention. The lack of **transparency** in government institutions and government policy making, as well as the lack of public availability of timely and consistent national statistics, prevents public checks and balances that are needed for the government and its policies to perform effectively. To mention but one of the basic needs, national accounts data should be made publicly available, in a timely fashion and on a quarterly basis. The government's accountability to the public depends, among other things, on these statistics.

The economy is also liable to remain faced with high inflation that keeps purchasing power low, which in turn is not conducive to economic growth. Investments in agriculture will be needed to tackle the problem of the increasing demand for food and the low domestic supply.

At the same time, to alleviate the government's' heavy burden of **food and energy subsidies**, there is a need to move to more effective targeting of subsidies to the poor and to review price ceilings on food and energy. This would provide the fiscal authorities with room for manoeuvre in discretionary spending, to stimulate growth and create jobs.

Policy reforms and measures

Government efforts to liberalise the economy have been relatively small-scale and piecemeal in the near term. In the recent past there has been a marked change in the government's attitude towards foreign investors in that measures were taken to grant the government first refusal in the sale of Algerian assets by foreign investors. Restrictions to FDI were introduced under the ***Loi de Finances Complémentaires*** 2009 (LFC 2009, a mid-year supplementary budget law) on 26 July 2009. These measures include *inter alia* the following provisions:

- limitations on foreign ownership in that minimum Algerian shareholding is 30% for import companies, 40% for auxiliaries of maritime transport and 51% for other companies. The 40% shareholding for auxiliaries in maritime transport applies to all the companies installed Algeria (so not only to new investment) with a two years delay to abide with this provision of the LFC 2009 ;

- new import measures stipulating the use of letters of credit and import certificates for import payments have been introduced recently.

In line with the roadmap of 2008, as a follow-up to the Association Agreement, Algeria is preparing for **WTO accession**. WTO membership will enable Algeria to establish stronger trade relationships, not only globally but first and foremost with its geographical neighbours. It will also allow it to lock in domestic reforms. In particular, the areas of services and energy need specific commitments.

Social development and poverty

Despite its healthy public finances in the past, Algeria has ranked poorly on human development indicators. Life expectancy at birth is just 72, adult illiteracy exceeds 30 % of the population, more than 25 % of the population does not enrol in education, GDP per capita is relatively low and more than 5 % of the population will not reach the age of 40.

The level of unemployment is still high. According to the official figures, it has fallen significantly from a peak of almost 30 % in 2000 to 10.2 % at the end of 2009. According to unofficial figures the unemployment rate is far higher, at even 30 %. A point of concern remains that most newly created jobs are temporary and are therefore not sustainable. Government youth employment and investment plans should help relieve poverty through a careful distribution of public expenditure. Structural reforms should lead to a more diversified private sector.

Table III.1.1:

Algeria - Main economic indicators	2006	2007	2008	2009	2010
Real sector				prel.	proj.
Real GDP growth (domestic currency, % change)	2.2	3.0	3.0	2.1	3.9
Real GDP non-hydrocarbon (% change)	5.6	5.8	6.0	6.0	
GDP (dinar, billion)	8521	9306	10051	10090	
GDP per capita (EUR)	2866	2973	3572	3448	
GDP per capita (USD)	3598	4070	5228	4796	
GDP nominal (EUR, billion)	93.4	98.1	119.3	116.6	
GDP nominal (USD, billion)	117.3	134.3	174.6	162.1	185.7
Inflation (average, %)	2.5	3.5	4.5	5.6	5.3
Social indicators					
Recorded unemployment (officially registered, %)	12.3	13.8	11.3	10.2	9.9
Youth unemployment (%)					
Population (million)	32.6	33.0	33.4	33.8	
Fiscal sector					
Total revenues (% GDP)	43.0	42.7	44.8	33.0	
Total expenditure (% GDP)	29.4	30.9	30.8	43.8	
Government balance (% GDP)	13.6	11.8	9.0	-7.8	-5.2
Non-hydrocarbon primary balance (% GDP)	-34.5	-44.0	-52.1	-51.4	
Gross government debt (% GDP)	23.8	19.0	15.1	18.6	19.8
Monetary sector					
Credit to the economy (% change)	7.1	13.8	16.0		
Money and quasi money (% change)	18.7	23.1	24.1		
External sector					
Trade balance (% GDP)	29.1	25.5	24.1	2.5	
Current account balance (% GDP)	25.2	23.6	19.6	3.2	0.7
Import cover of reserves (months)	29.1	32.2	36.3		
Net FDI (% GDP)	1.5	1.0	0.6	0.7	
External vulnerability					
Gross external debt (% GDP)	4.9	3.8	3.0	3.4	2.0
Gross official reserves (USD, billion, e-o-p)	77.8	108.5	143.5	134.4	
Financial sector					
Exchange rate (dinar per USD, average)	72.2	69.0	64.0	71.6	
Exchange rate (dinar per EUR, average)	90.7	94.5	94.1	99.8	
Real effective exchange rate (% change, e-o-p)*	-0.3	-0.5			
Cross-border banking (% GDP)					
External liabilities	2.4	1.9	1.4	1.7**	
External assets	9.9	8.9	4.0	4.2**	
External loans	2.3	1.7	1.2	1.4**	
External deposits	9.7	8.6	3.9	4.1**	

* Increase (or decrease) reflects appreciation (or depreciation) of the Algerian dinar. ** September 2009.

Note: Assumption for the Brent oil price per barrel is USD 35 in 2009.

Sources: Algerian authorities, IMF, EUROSTAT and own calculations.

2. ARMENIA

- ***The impact of the economic crisis was very deep for the Armenian economy. GDP contracted by 14.4% in 2009, led by a sharp decline in the construction sector.***

- ***The authorities acted promptly by implementing a set of reforms including the return to a floating exchange rate regime and measures to maintain financial stability.***

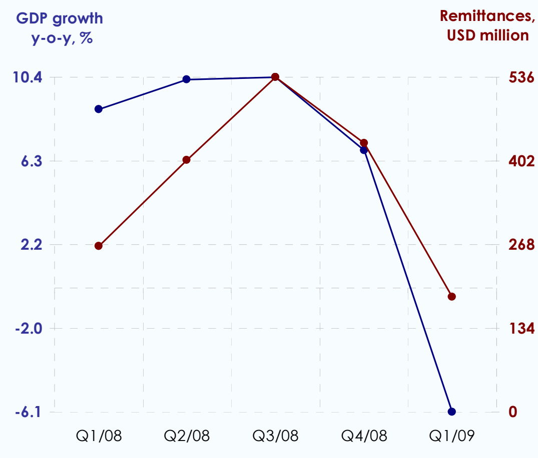
- ***Foreign-financed capital spending helped the country to accommodate the fall in tax revenues and preserve social spending. However, public debt more than doubled in 2009, calling for a reduction of the budget deficit in 2010 and the development of a sound debt strategy.***

- ***Oligopolistic structures continued to be dominant in many sectors of the economy.***

Macroeconomic and financial developments

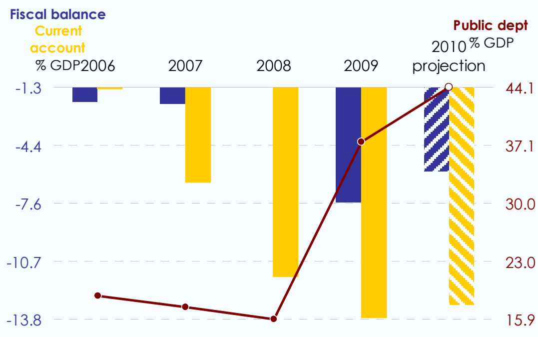
The global economic downturn and particularly the rapid deterioration of the Russian economy had a deep impact on the Armenian economy in 2009. Economic activity, which had started to fall since the last quarter of 2008, contracted by around 14.4% in 2009, representing a massive turnaround compared to the strong growth rates of previous years. This was the result of the slump in the construction sector, which shrank by around 38%, as an immediate consequence of the reduction in remittances by around 30%, and of the strong contraction of industrial output by around 10% following the drop in metals prices. The authorities acted rapidly, adopting appropriate measures to mitigate the effects of the sharp downfall in output. In March 2009, they reverted to a fully floating exchange rate regime allowing a de facto devaluation of the Armenian dram by around 22% against the euro and the USD. This step helped to improve competitiveness without threatening financial stability as the negative effects of the devaluation were largely absorbed. At the same time they reached an agreement with the IMF for a Stand-by Arrangement totalling USD 830 million, while they secured additional funding from other multilateral and bilateral donors (including a

Graph III.2.1: **Armenia - GDP growth and remittances**



Source: IMF, Central Bank of Armenia.

Graph III.2.2: **Armenia - Fiscal balance, public debt, current account**



Sources: Armenian authorities, IMF, EU staff calculations.

Graph III.2.3: **Armenia - Exchange rates**

Sources: ECOWIN.

USD 500 million loan from Russia) to meet the increasing fiscal and external financing needs. The European Union also decided in November 2009 to provide Macro-financial assistance to Armenia amounting to €100 million, part of which will be in grants (€35 million). Fiscal policy was appropriately supportive to the economy with expenditure plans focusing on wide-ranging anti-crisis measures, increasing foreign-financed capital spending and protecting social spending. Partly through external borrowing, the authorities accommodated largely the approx. 15% fall in tax revenues without cutting significantly social expenditures, while taking into account financing constraints and debt sustainability concerns. As a result the fiscal deficit reached 7.5% of GDP and public debt 37% of GDP in 2009.

Monetary policy eased and the Central Bank of Armenia lowered its policy rate gradually from 7.75% in April to 5% in September 2009 to contribute to the recovery of the economy. It also injected dram liquidity through various channels, including purchases of government securities and increasing the maturity of its repo operations, to boost credit growth. However, due to weaknesses in the transmission mechanism, bank lending rates remained high (at 15%-18%), triggering additional action by the authorities such as lending to targeted SMEs and sectors through the Central Bank and commercial banks of credit resources provided by Russia and other donors/creditors. Part of the weakness in the transmission mechanism is attributed to the high deposit dollarisation, which remained at around 70%. Thus, the rate of credit expansion moderated significantly to 13% in 2009 compared to 40% in 2008.

Average inflation remained relatively low at around 3.5% on the back of weak demand despite the depreciation of the Armenian dram in March 2009. However, end-period inflation was already 6.5% in December 2009 and it became worrisome in February 2010 reaching 9.4% as a result of the rise in international prices of raw materials and food products, the oligopolistic structure of import trade, and the pick up in aggregate demand. The Central Bank raised the refinancing rate from 5% (the rate since September 2009) to 5.5% in January and to 6% in February 2010.

External trade turnover contracted by around 28% in 2009. Export revenue contracted by around 37%, influenced by the drop in prices of metallurgical products, while imports contracted to a lesser extent by around 26%. Remittances are estimated to have been cut by nearly one third, in dollar terms. As a result, the current account deficit is estimated to have widened to 13.7% of GDP in 2009. Combined with the collapse in FDI, this raises serious concerns about the competitiveness of the Armenian economy.

Risks and outlook

The economy is expected to record a moderate recovery of around 2% in 2010, supported by a rebound in services, agriculture, industry and mining. Nevertheless, the economic outlook will depend heavily on developments in the Russian economy.

Fiscal policy will remain expansionary — albeit to a lesser extent than in 2009 — and the fiscal deficit will continue to be financed from external resources. Provided that expenditures remain contained, increasing tax collection in line with the moderate economic recovery is expected to shrink the fiscal deficit to around 6% of GDP in 2010. Public debt will continue to rise as a result of the large external borrowing in 2009 and 2010. The public debt to GDP ratio is expected to reach 44.1% in 2010, with the external component reaching 39.3% of GDP. Rapid debt accumulation calls for fiscal consolidation in the years ahead along with improvements in debt management.

Inflation, which peaked at 9.4% in February 2010, will be challenging to be contained as movements in the refinancing rate have only a limited impact, given the inadequately developed domestic money market and the high dollarization rate. Also, any adverse exchange rate conditions and the imminent increase of the natural gas prices by 40% could make inflation containment efforts even more difficult.

Despite the increase in metals and minerals prices — Armenia's main exports — since the second quarter of 2009, there is limited evidence of a recovery in physical demand, aside from restocking. However, improvements in physical demand, as a result of governments' fiscal packages, will support prices in 2010 and provide a boost to economic activity. Domestic demand will also benefit from the return to growth of Armenia's main trade and investment partner, Russia, in early 2010, following a contraction of 7.9 % in real GDP in 2009. This is expected to lead to higher remittance inflows, along with a rise in investment and access to credit, although at much lower levels than before the economic crisis. In such a case the current account deficit could narrow slightly to 13 % of GDP in 2010.

Policy reforms and measures

Based on external financing the authorities' plan to face the crisis included increasing capital spending, cutting maintenance expenditures, preserving social spending and channelling credits to the economy. At the same time, the fiscal structural reform agenda advanced through improvements in VAT refund processing and introduction of e-filling of tax returns for large taxpayers while changes to the presumptive taxation regime for tobacco and fuel are to be introduced. Implementation of risk-based audits in VAT processing is to be enacted in 2010 along with closer monitoring of large businesses. Two regional taxpayers' services centres have been established in 2009 with the aim to increase them to five in 2010.

Plans for further streamlining and automation of electronic filing, reporting and information sharing are being prepared in 2010 but their exact time of implementation will depend on the fiscal situation and the availability of the respective resources. The above-mentioned plans, along with the broadening of the tax base to small businesses and the effective implementation of tax law in large businesses, will be crucial for the improvement of the tax/GDP ratio above the level of 16 % where it stood in 2009. Since the beginning of 2010 tax inspectors are to be based in the accounting departments of large businesses in an effort to combat tax evasion even though this measure is liable to increase the incidence of corruption.

Given the rapid accumulation of public debt, the greater part of which is external, strengthening of the medium-term debt management strategy is necessary. This strategy should be combined and supported by resuming the medium-term expenditure framework, which was de facto abandoned in 2009 due to the extraordinary economic conditions.

The banking sector is stable and overcapitalised despite the fact that its profitability decreased in 2009 due to the depreciation of the Dram. The Central Bank of Armenia is strengthening prudential regulation and crisis preparedness. Stress tests are conducted each month and the Deposit Guarantee Fund will increase its coverage considerably in 2010. The Central Bank is considering measures such as raising the risk weights for USD-denominated assets to restrict banks' reliance on a single source of funding and to improve the dollarisation ratio, which was above 70 % in February 2010. Despite the liquidity in the banking sector lending rates remain high (around 18 %), continuing to impede growth prospects.

Social development and poverty

The impact of the economic crisis in terms of employment was not dramatic for the Armenian economy. The average unemployment rate rose to 6.9 % in 2009 from 6.3 % in 2008. The government ring-fenced social expenditures to protect the poor and increased social allowances, including pensions, by 18 % in nominal terms in 2009. However, as a result of the economic contraction in specific sectors and the currency depreciation poverty rates rose around to 28 % in 2009 from 23.5% in 2008. The expected rise in retail natural gas prices by nearly 40 % in 2010, and the significant inflationary pressures which appeared in the first quarter of 2010 could raise the poverty rates even further. The authorities are working closely with the World Bank to develop a strategy to further strengthen the targeting of social safety nets, which will help to protect the poor, while enhancing the efficiency of social spending.

Restructuring the pension system will be an important step in 2010, with the introduction of private pension accounts to be financed by workers contributing 5 % of their salaries every year, to which the State pledges to add an equivalent sum. However, many issues important for the implementation phase, such as licensing of the management funds, capital requirements, investment schemes and insolvency compensation, are not easy to be determined as the securities market is not yet sufficiently developed in Armenia.

Table III.2.1:

Armenia - Main economic indicators	2006	2007	2008	2009	2010
				prel.	proj.
Real sector					
Real GDP growth (domestic currency, % change)	13.3	13.7	6.8	-14.4	2.0
GDP nominal (Dram, billion)	2656	3149	3646	3116	3215
GDP nominal (EUR, billion)	5.1	6.7	8.2	6.1	6.3
GDP nominal (USD, billion)	6.4	9.2	11.9	8.6	8.8
GDP per-capita (EUR)	1584	2081	2524	1921	1982
GDP per-capita (USD)	1983	2857	3691	2689	2756
Inflation (average)	2.9	4.4	9.0	3.5	3.7
Social indicators					
Unemployment (off. registered, average, %)	7.2	6.7	6.3		
Poverty rate (% population)	26.5	25.0			
Income inequality (Gini, %)	36.9	33.8			
Population (million)	3.2	3.2	3.2	3.2	3.2
Fiscal sector					
Total revenues (including grants, % GDP)	18.0	20.1	20.0	20.5	21.0
Total expenditure (% GDP)	20.0	22.4	21.8	28.0	26.8
Central govt. balance (% GDP)	-2.1	-2.2	-1.3	-7.5	-5.8
Gross public debt (% GDP)	18.7	17.4	15.9	37.4	44.1
share of foreign currency debt (% GDP)	16.5	14.0	13.3	33.4	39.3
External sector					
Current account balance (% GDP)	-1.4	-6.4	-11.5	-13.7	-13.0
Trade balance (% GDP)	-14.0	-17.3	-22.3	-23.5	-24.8
Remittances (net inflows, private USD million)	960	850	1062	733	794
Remittances (% GDP)	15.0	9.2	8.9	8.5	9.0
Foreign direct investment (net, in USD million)	450	701	929	263	305
Foreign direct investment (net, % GDP)	7.0	7.6	7.8	3.1	3.5
External vulnerability					
External public debt (in million USD)	1206	1449	1577	2701	3191
External public debt (% GDP)	18.8	14.0	13.3	33.4	39.3
Debt service ratio (% of exports of goods and services	3.9	2.9	3.1	6.5	7.7
Gross reserves (excl. gold, USD million)	1072	1659	1407	1910	1861
In months of next year's imports	3.6	4.2	4.7	6.1	5.6
Financial sector					
Exchange rate (DRAM per EUR, average)	521.2	467.8	447.3	506.8	506.8
Exchange rate (DRAM per USD, average)	416.0	342.1	305.8	362.1	364.6
Real effective exchange rate (%, + denotes apprecia	9.1	15.2	11.6		
Human development	1995	2000	2005	2006	2007
Human development index	0.693	0.738	0.777	0.787	0.798

Sources: IMF, EIU, Armenian authorities.

3. AZERBAIJAN

- ***Following exceptionally rapid growth over the last four years, GDP growth decelerated to 9% in 2009 on account of the fall in external demand for oil and decline in inward investment.***

- ***The government deficit expanded to 8% of GDP, as revenues plummeted and the government supported the economy with increased capital spending and higher social expenditure.***

- ***The external demand shock for oil has underlined the need to diversify the economy away from the hydrocarbon sector as a key policy objective.***

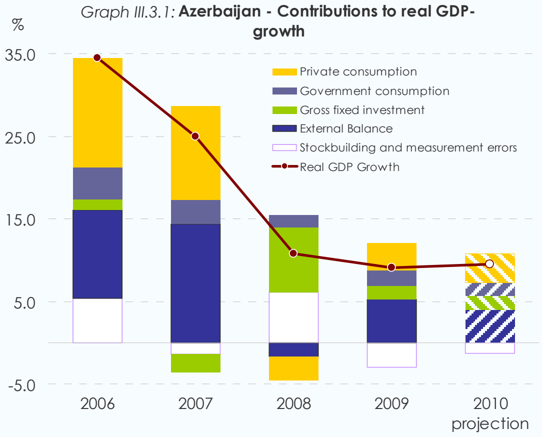
Macroeconomic and financial developments

Following strong growth in 2008, of 11% of real GDP, the rapid expansion of the economy moderated in 2009 to 9% of GDP, due to the impact of the global economic crisis, although Azerbaijan was much less affected than other countries in the region. This is the slowest growth rate for a decade in one of the world's fastest growing economies.

The global crisis mainly affected exports, through waning energy demand, and investment given major problems in the main industrialised economies and heightened risk aversion toward emerging markets. On the other hand, long-term energy export contracts and an expansionary fiscal stance cushioned the impact of the short-term external demand shock. On account of the crisis, export growth more than halved, compared with 2008, but still reached just over 9% in 2009. While remittances fell sharply similar to other developing economies, they account for a relatively minor proportion of GDP, around 3%, compared to other economies in the region and are not an important source of foreign currency.

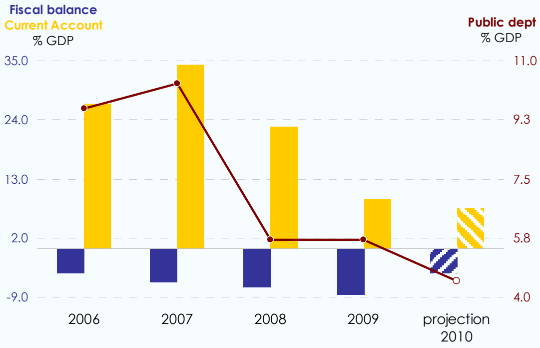
Foreign direct investment declined sharply during the first half of the year, by 63%, particularly on account of the deterioration in the UK economy which is the origin of almost half of foreign investment in Azerbaijan. However, gross fixed

Graph III.3.1: **Azerbaijan - Contributions to real GDP-growth**



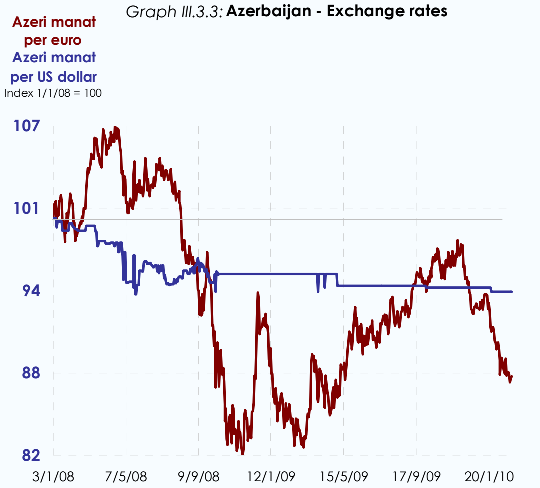
Source: Commision services.

Graph III.3.2: **Azerbaijan - Fiscal balance, public debt, current account**



Sources: IMF, WB and Azeri authorities.

Graph III.3.3: **Azerbaijan - Exchange rates**



Source: Ecowin Reuters.

investment growth still reached 5% in 2009 supported by domestic sources which still account for 80% of investment. This was in part due to an increase in government capital spending on large infrastructure projects funded by transfers from SOFAZ (State Oil Fund of the Republic of Azerbaijan).

The industrial sector, which accounts for almost half of GDP, expanded by an estimated 6% compared with 2008. The relatively small services sector, which makes up approximately 30% of GDP, continued to grow strongly, mainly driven by hotels and restaurants, and the communications sector, by an estimated 21% compared to 2008, while growth in the small agricultural sector slipped from 6% in 2008 to about 3% in 2009.

Despite the external demand shock for oil, the hydrocarbon sector of the economy still provided the main impetus of growth, expanding by 14% in 2009, compared to far weaker expansion in the non-oil sector of around 3%. This was in part due to a contraction in the construction sector as building firms responded anxiously to price falls in real estate after a period of robust rises, by postponing new projects.

While a stronger slow down was feared at the start of the year, the partial recovery in oil prices in the second half of 2009 has been supportive of growth. In addition, total gas production is estimated to have risen by around 20% in 2009 compared to 2008 due to the resumption of output at the significant Azeri-Chirag-Guneshi (ACG) oil- and gas fields, which suffered technical problems at the end of 2008.

Inflation plummeted in 2009 due to the base effect of very strong inflation in 2008, the decline in international commodity prices, and a strong fall in monetary growth rates. Following six months of deflation up to June, the CPI rose gradually during the second half of the year. Average annual inflation for 2009 is estimated at 2%. This helped support private consumption, which grew by 8% in 2009 compared to 10% in 2008, as nominal wages rose by around 9% in 2009 providing a rise in real incomes. In addition, private consumption was supported increased government social expenditure on public sector wages and pensions. Official recorded unemployment remained at approximately 1% on average in 2009.

The government's 2009 budget targeted higher social spending and capital investment compared with 2008. Revenue was constrained due to the impact of lower oil prices given that the State Oil Company of the Azerbaijan Republic (SOCAR) is the main contributor to the state budget. While expenditure has been lower than in 2008, it has been supported by transfers to the state budget from the State Oil Fund of the Republic of Azerbaijan (SOFAZ). Excluding these transfers, the budget deficit for 2009 is estimated to be 9% of GDP.

The Central Bank took significant measures to loosen monetary policy and ease liquidity conditions as restricted access to global capital markets and falling deposits obliged the banking sector to scale back lending. The CBAR reduced the refinancing rate by 13 percentage points, to 2%, and reduced the reserve requirement on banks to 5%. The Manat remained stable against the US dollar, at Manat 0.8: US$1, even as oil prices fell, supported by central bank intervention. After declining by nearly 20% at the beginning of 2009, foreign currency reserves stabilised during the later part of the year.

The Azeri financial sector remained largely insulated from the global turbulence due to a strong capital base and limited links with the international financial sector. At the start of 2009, the aggregate capital of the banking sector stood at EUR 1.3 billion, or 4 % of GDP, and its aggregate assets roughly doubled to EUR 8.7 billion (28 % of GDP).([1]) Foreign lending comprises 18% of domestic bank assets. Nevertheless, the CBA raised collateral requirements from 120 % to 150 % at the end of 2008 as a precautionary measure, against the risk of a sharp correction in property prices, which has grown swiftly over the recent period. Property prices fell on average by around 20% in 2009 compared to 2008, gradually stabilising through the second half of the year.

The substantial current account surplus, which rose to 35% of GDP in 2008, fell to 13.5% of GDP in 2009 due to the fall in oil and gas prices while this

([1]) One state-owned bank and 45 privately owned banks as well as 94 non-bank credit entities were registered in Azerbaijan as of January 1 2009. Half of the banks (23) have foreign shareholders: 7 banks have a foreign ownership share of 50 to 100 % and 14 banks have a share of 50 % or less.

is expected to recover in 2010 as international demand regains momentum. In 2009, Azerbaijan's gross official reserves and oil fund assets reached USD 17.3 billion (EUR 11.8 billion), about six times the size of the public external debt.

Risks and outlook

Azerbaijan's high reliance on hydrocarbons([1]) remains the economy's major vulnerability, while the current global outlook means that there is little risk of this weakness being exposed in the medium term, and the hydrocarbon sector is set to expand further due to increasing investment. About $10 billion is expected to be invested to increase production in the vast Azeri-Chirag-Gunashli oil fields in the Caspian Sea as well as an estimated $20 billion for the second phase of the development of Azerbaijan's biggest gas field, Shahdaniz. In 2009, Azerbaijan retained its previous standing of 38 in the World Bank Doing Business 2010 report, having been named the top reformer in 2008. While the regulatory environment is supportive of investment in the oil sector, there are fewer investment opportunities in the non-oil sector of the economy. Diversification of the economy into manufacturing and services remains a long-term challenge.

While the hydrocarbon sector is likely to underpin low levels of public debt, 4% of GDP in 2009, for the medium term, the unresolved dispute with Armenia over Nagorno-Karabakh still poses a further political risk to economic stability.

Policy reforms and measures

The Azerbaijan parliament passed several amendments to the law on pensions gradually taking effect from January 1st 2010. The male retirement age will be incrementally raised from 62 to 63 years by 2012, and the female retirement age, from 57 to 60 years by 2016. In the context of the draft 2010 budget, submitted in November 2009, the government proposed a number of tax changes including a reduction in the rate of tax on company profits from 22% to 20% and lowering the maximum rate of income tax from 35% to 30%. A system for electronic submission of tax invoices became operational on 1 January 2010.

In the context of expanding the non-oil related economy, the government announced further support for the agricultural sector. A government owned joint-stock company was established in 2009 for the import of livestock to be leased at preferential rates to farmers. The government also held preparatory talks at the end of the year for the establishment of a specialized privately owned agrarian bank to help develop the sector.

Social development and poverty

The official unemployment rate remained very low at 1%. The Ministry of Labour and Social Protection reported that 46,000 people applied to the Service in 2009 out of which roughly 10% received unemployment benefits. The Ministry of Labour continued its policy of holding labour fairs, which in 2009 were held in 57 cities and districts advertising around 25,000 vacancies with around a third of them taken up. The Ministry of Labour is also jointly implementing a programme of social rehabilitation of prisoners with the Ministry of Justice to boost their employment prospects.

Faced with the prospect of rising local unemployment, in February 2009 the government increased the one-off payment that employers are required to make to hire a foreign worker as well as the charge for extending the term of permit for such workers.

The poverty rate dropped to 11% in 2009 compared with 13.2% in 2008. The government's main target on the UN Millennium Development Goals is to eradicate poverty to 10% by 2015. Given that poverty is concentrated in rural areas, where 44% of the population live, the government is aiming to increase the agricultural sector to 10% of GDP by 2015.

([1]) The oil sector provides around 95% of country's total export earnings, 50% of its GDP and around 60% of its budget revenue.

Table III.3.1:

Azerbaijan - Main economic indicators	2006	2007	2008	2009	2010
				prel.	proj.
Real sector					
Real GDP growth (domestic currency, % change)	34.5	25.0	10.8	9.1	9.7
GDP nominal (EUR, billion)	16.7	21.5	31.5	38.3	45.6
GDP nominal (USD, billion)	21.0	29.4	46.4	53.6	63.8
GDP per capita (EUR)	1959	2495	3625	4351	5122
GDP per capita (USD)	2468	3418	5328	6091	7171
Inflation (e-o-p)	11.4	19.7	15.4	1.4	6.9
Social indicators					
Unemployment rate (officially registered only)	1.0	0.9	0.8	1.0	1.0
Life expectancy at birth (years)		70.0			
Adult literacy (% ages 15 and older)		99.5			
Domestic population	8.5	8.6	8.7	8.8	8.9
Fiscal sector					
Total revenue (% GDP)	22.8	23.0	30.9	17.1	18.7
Total expenditure (% GDP)	27.4	29.2	38.1	25.7	23.2
Budget balance (% GDP)	-4.6	-6.2	-7.2	-8.6	-4.5
Net public debt (% GDP)	7.7	6.4	4.1	4.3	2.9
Monetary sector					
Domestic credit to private sector (% GDP)	13.3	17.6	19.3		
Broad money (M3) (% change)	86.3	71.4	44.0	-0.3	32.3
Degree of monetisation (M3/GDP, %)	19.1	22.0	22.3	19.7	21.2
External sector					
Current account balance (% GDP)	27.0	34.2	22.7	9.2	7.5
Trade balance (% GDP)	36.9	46.1	47.1	22.0	30.0
FDI inflows (% of GDP)	36.9	5.6	7.2	6.2	7.4
External vulnerability					
Total external debt (% GDP)	28.2	22.3	19.2	17.5	17.5
Public external debt (% GDP)	9.6	10.3	5.7	4.5	3.8
Total international reserves (% of GDP)	12.5	14.8	14.1	10.1	8.8
Financial sector					
Short-term interest rate	10.4	9.2	10.1	12.2	11.5
Lending rate	17.9	19.1	19.8	20.2	19.6
Exchange rate (local currency per EUR, average)[2]	1.15	1.24	1.12	1.19	1.11
Exchange rate (local currency per USD, average)[2]	0.87	0.85	0.80	0.80	0.80
Real effective exchange rate (% change)	6.3	8.7	8.8		

Sources: Azeri authorities, IMF, WB and own calculations.

4. BELARUS

- ***Belarus experienced a very sharp deceleration in growth, but a recession was avoided***
- ***The EURASEC common customs tariff was implemented surprisingly fast***
- ***Real prospects for a joint WTO Accession with Russia and Kazakhstan?***

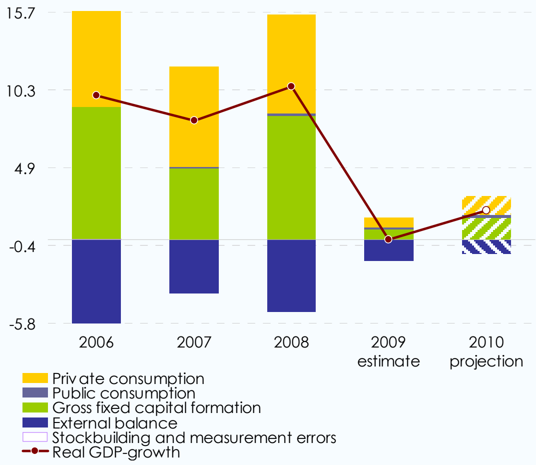
Macroeconomic and financial developments

Belarus, the second largest Eastern Partnership (EaP) economy after Ukraine([1]), had an impressive economic performance during most of the 2000s: average annual growth in the period 2001-08 was 8.3 %. Nevertheless, the global economic crisis that spread from developed to emerging markets during the second half of 2008 caught up with it in 2009: **growth** is expected to fall from an impressive 10 % in 2008 to stagnation in 2009, with a predicted rebound in 2010 of around +2 %.

This reflects the crisis in all main economic partners of the very open Belarusian economy (exports plus imports fell to around 100 % of the Belarusian GDP in January-November 2009, from over 120 % in 2008): Russia, the EU and Ukraine, whose economies experienced significant contractions in 2009. At any rate Belarus had a rather better performance in that year than its partners did. Russia experienced a fall in GDP of almost -8 %, the EU -4 % and Ukraine -15 %.

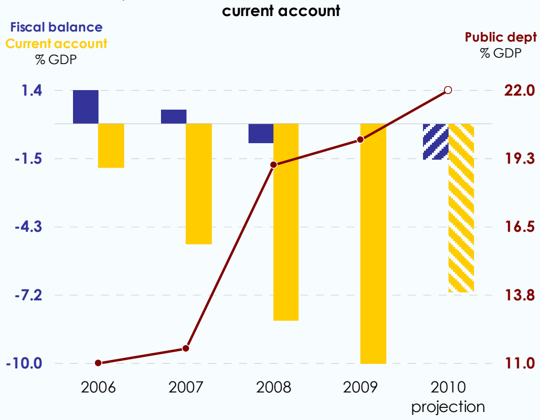
While GDP held up in the face of the crisis – the figures for December 2009 show a performance of +0.2 % (down from +10 % in December 2008) – some industrial sectors reflected the slowdown much more than others: the December 2009 industrial production of the fuel sector (over 21 % of total industrial output) was down by over 9 %, while machinery (responsible for 19 % of industrial production), fell by more than 13 %.([2])

Graph III.4.1: **Belarus - Contributions to real GDP-growth**



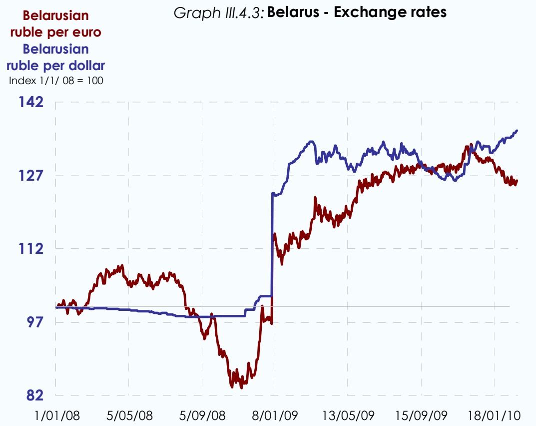
Source: Ministry of Statistics and Analysis of Belarus.

Graph III.4.2: **Belarus - Fiscal balance, public debt, current account**



Source: Ministry of Statistics and Analysis of Belarus.

Graph III.4.3: **Belarus - Exchange rates**



Sources: ECOWIN Reuters.

([1]) Belarus has around 22 % of the EaP's 2009 estimated PPP GDP, while Ukraine has roughly 55 %.

([2]) These falls were partially compensated by a significant expansion of the chemical/petrochemical industry, the third most important industrial sector in Belarus..

As in several countries of the EaP region, this led to an IMF programme. Signed in December 2008, it was initially worth USD 2.5 billion (later increased in June 2009 by an additional USD 1 billion).

The main vulnerability of Belarus lies in its **weak external position**, as its hard currency reserves cover only around a month and a half of imports, at USD 5.6 billion by end 2009 from USD 2.6 billion, or four weeks of imports, in mid-2009. The increase reflects the disbursements of IMF and World Bank loans. Moreover, the country is almost completely dependent on imports for its energy needs. The **trade deficit** increased very sharply as early as 2007, as oil and gas price shocks hit the economy. It virtually doubled from 4.5 % of GDP in 2006 to around 9 %, approaching 11 % of GDP in 2008 and reaching close to 20 % in early 2009. This was because exports fell much more than imports in the worst months of the crisis. However, as 2009 progressed, partly as a result of the IMF-mandated currency devaluations, the situation improved somewhat, with the January-November 2009 **trade deficit** reaching 14.3 % of GDP (or USD 6.4 billion).

Still on the subject of the trade deficit, it is worth noting the specific nature of Belarusian trade relations, as, uniquely among EaP countries, Belarus still has Russia as its main trade partner: Russia was responsible for 59 % of its January-December 2009 total imports, and for 32 % of its exports (or more than 47 % of its total trade). This means that Russia was responsible for 140 % of the Belarusian trade deficit. In other words, while Belarus has trade surpluses with its other major trade partners – the EU and the rest of the CIS – this is overtaken by its deficit with Russia.

This is linked to Belarus' special economic relations with Russia, and chiefly with its **energy sector**: not only does Belarus still receive natural gas at somewhat below 'market rates'([1]) but – and more importantly in economic terms– it also still benefits from specific arrangements in the refined oil trade. Russian oil companies that exported refined crude from Belarus were effectively able to evade Russian export fees. According to the terms of the Russia-Belarus customs union, which precedes the current EURASEC arrangement (see below), Belarus imported crude oil from Russia duty-free, but did not charge export duties on refined oil products at the same level as Russia's, and did not transfer the corresponding revenue to the Russian budget. There have been several complaints by the Russian Government over the years claiming that Belarus was in breach of its legal obligations, as already in 1995 a treaty stipulated an 85-15 % split of export duty for Russia and Belarus respectively. Remaining problems with oil duties led to another prolonged dispute between Russia and Belarus starting in December 2009 and not solved until late January 2010 when an agreement was reached on keeping a large amount of oil imported duty-free (aimed at domestic Belarusian consumption). In any case, it has been estimated that the full end of subsidized oil trade has the potential to increase the already very high Belarusian trade deficit by as much as USD 1.8 billion, and will also affect budget revenues from 2010 onwards.

The **budgetary data** for 2008 indicate a budget surplus of almost 1.5 % of GDP, due to an increase in revenues to 51 % of GDP (almost two percentage points above 2007). The IMF-agreed aim for 2009 was a balanced budget (although there is a margin for a relatively small deficit in 2010). **Inflation** grew to 13.3 % in 2008, but further increases in 2009 were moderated by the economic slowdown, even considering the pass-through effects of the currency devaluations. Consequently, CPI inflation by December 2009 had fallen to 10.1 %. Belarus consistently has one of the lowest official **unemployment** rates in Europe, at a mere 0.9 % in December 2009.

Risks and outlook

The main risks for the very open Belarusian economy stem from the overall status of the global economy, and from a potential sagging of the

([1]) Unlike other CIS countries, the maintenance of this situation was made possible via the partial sale in 2007 of state-owned BelTransGaz to Gazprom. BelTransGaz is the owner and operator of the remainder of the gas transit network in Belarus (beyond the Yamal-Europe pipeline, which Gazprom already owned). See Vinhas de Souza, L. and Lysenko, T., 'The Effects of Energy Price Shocks on Growth and Macroeconomic Stability in Selected Energy-Importing CIS Countries', in Economic Review of EU Neighbour Countries, Occasional Paper No 30, June 2007, European Commission, Brussels, pp 3-23.

political commitment to continue with structural reforms as the global crisis abates. The new privatisation law and the Privatisation Agency (agreed with the IMF and partially designed by the World Bank) will provide an early test case. In the longer term, Belarus is faced with the task of developing a sustainable growth model which does not rely on preferential access to the Russian market or subsidised energy prices.

Policy reforms and measures

Belarus, Kazakhstan and Russia are aiming for a Customs Union within the framework of the Eurasian Economic Community (**EURASEC**) and have announced a joint WTO entry bid (see Regional chapter). It is unclear which significant economic benefits – if any – could be derived by Belarus from this process, given that it already has an FTA with Russia (Kazakhstan is a marginal trade partner), as it would result in a further concentration of its trade relations with that country.

On 31 December 2008, an agreement was announced on an **SBA between the IMF and Belarus**. The SBA conditions go beyond sheer macro stabilisation, aiming at significant structural reform and liberalisation components. The worsening of the economic situation led to an augmentation of the loan by USD 1 billion, which was approved on 29 June 2009. The programme now totals 587 % 'exceptional access' of the quota, one of the largest in the region.

In spite of the augmentation the IMF programme implies **an external funding gap** for Belarus of around USD 900 million, after the IMF loan and **a single-tranche USD 200 million 'Development Policy Loan' (DPL) from the World Bank** (approved on 1 December 2009 and already fully disbursed in the same month). This funding gap (i.e. external needs after the multilateral institutions, the IMF and the WB, have been taken into account) would have been partially covered by the final tranche of a second 'economic stabilisation' loan from Russia (worth USD 500 million). This loan was expected in 2009, but it was frozen by Russia amidst several overlapping rows between Belarus and Russia, including trade disputes about meat and dairy exports. Comments by Russia indicate that this loan will not be disbursed at all, although recourse to the EURASEC anti-crisis fund (see Regional chapter) may be possible.

The liberalisation reflected in the IMF programme is the continuation of a cautious economic opening-up process initiated earlier. As an example of this improvement, the World Bank's 2010 Doing Business report (which uses 2009 data) shows that Belarus further improved its relative position significantly by 24 places in a single year, from 82nd to 58th ([1]).

After years of restrictions, EU-Belarus relations have been evolving rapidly since the decision of the 13 October 2008 General Affairs and Economic Relations Council for a progressive re-engagement with Belarus. This was confirmed by the GAERC Council decision of 17 November 2009, which, among other things, invited the Commission to prepare a joint interim plan for reforms inspired by the ENP Action Plans (effectively a sort of 'shadow' AP). A draft plan was prepared in January 2010. Also, the participation of Belarus in the 'Eastern Partnership' framework further enhances the scope for engagement with the EU.

In connection with the developments described above, already on 23 June 2009 a letter was sent by the Minister of Finance of Belarus asking for a **macro-financial assistance (MFA) programme for Belarus**. The Commission is considering submitting to the Parliament and Council a proposal for an MFA for Belarus. Moreover, on 10 June 2009 the Minister of Finance of Belarus wrote a letter asking for **the EIB lending mandate to be extended** to include Belarus. This is expected to be included in the mid-term review of the EIB's external lending mandate, planned for the second half of 2010.

In addition, a more ambitious **EBRD country strategy** for Belarus was approved by the EBRD (with Commission support) in December 2009. This strategy includes greater involvement of the EBRD in more sectors of the Belarusian economy and significant support for the expected increase in privatisation.

([1]) According to the 2010 ranking of this index, doing business in *6 EU member states* (Spain, Luxembourg, Poland, Czech Republic, Italy, Greece) is more problematic than in Belarus.

Table III.4.1:

Belarus - Main economic indicators	2006	2007	2008	2009	2010
Real sector				prel.	proj.
Real GDP growth (domestic currency, % change)	9.9	8.2	10.5	0.0	2.0
GDP nominal (EUR, billion)	29.4	32.7	41.0	30.8	31.4
GDP nominal (USD, billion)	36.9	44.8	60.3	45.2	
GDP per-capita (EUR)	3018	3368	4271	3237	3302
GDP per-capita (USD)	3808	4619	6281	4761	
GNI per-capita (PPP, current prices, USD)					
Inflation CPI (%, end of period)	7.0	12.1	13.3	10.0	8.0
Social indicators					
Unemployment (%)	1.2	1.0	0.8	0.9	1.0
Population (million)	9.7	9.7	9.6	9.5	9.5
Fiscal sector					
Total revenue (% GDP)	48.2	50.0	52.1	48.0	44.0
Total expenditure (% GDP)	46.9	49.4	52.9	48.0	45.5
Central government balance (% GDP)	1.4	0.6	-0.8	0.0	-1.5
Gross domestic public debt (% GDP)	6.5	6.3			
Gross public debt (% GDP)	11.0	11.6	19.0	20.0	22.0
Monetary sector					
Private sector credit (% change)	52.4	52.4	59.7	12.7	
Private sector credit (% total credit)	74.9	93.0	79.0	78.0	
Broad money (M3, %)	39.3	35.9	15.0	15.0	
Degree of monetisation (M3/GDP, %)	22.1	24.8	21.9	21.3	22.0
Dollarisation in bank deposits (%)	29	30	31	30	30
External sector					
Current account balance (% GDP)	-1.8	-5.0	-8.2	-10.0	-7.0
Trade balance (% GDP)	-4.5	-9.0	-9.6	-14.0	-9.0
FDI (net, % GDP)	0.4	3.0	3.6	2.0	2.5
Import cover (months)	0.7	1.8	1.0	1.5	
External vulnerability					
External debt (public plus private, % GDP)	18.5	27.9	24.6	30.0	30.0
Gross reserves (excluding gold, USD, million)	1383	4200	2865	5600	7000
Reserves/M3 (%)	16.3	44.5	46.0	25.0	
Financial sector					
Short-term interest rate (%)	12.9	10.4	12.0	13.5	
Exchange rate (rouble per EUR, end of period)	2812	3167	3143	4106	
Exchange rate (rouble per USD, end of period)	2140	2150	2137	2863	
Real effective exchange rate (2000=100)	73.4	72.3	71.2	65.0	

Sources: Belarus Ministry of Statistics and Analysis, NBRB, UNDP, WDI, IMF and Commission.

5. EGYPT

- ***Thanks to three fiscal stimulus packages and adequate monetary policy to stimulate economic growth, the Egyptian economy has been faring quite well during the global crisis. In fiscal year 2009 GDP growth decelerated to 4.7% after three years of growth around 7%.***

- ***Economic growth in fiscal year 2010 is expected to reach almost 5%. On the back of faster growth, there is a risk that consumer price inflation may return to the levels reached before the global crisis.***

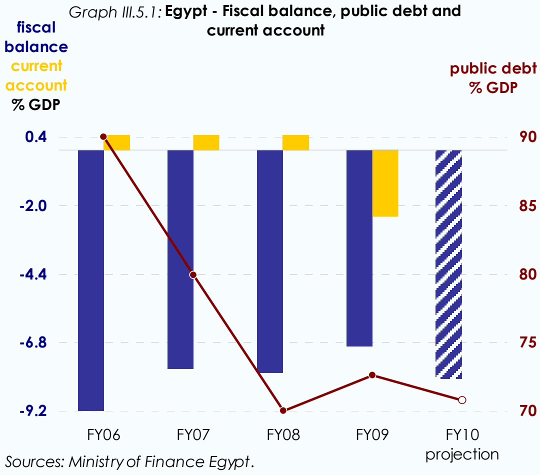
- ***Key priority is to maintain macroeconomic stability, first and foremost by striving for fiscal sustainability. In this respect, further structural reforms to increase the tax base and reduce government consumption will help to reduce the fiscal deficit.***

Macroeconomic and financial developments

In FY09 the **real economy** was affected by the global crisis via the external trade and services channels, but also via the channel of the capital account. In line with the sharp drop in world trade, exports of Egyptian goods slowed down. But in addition, income from tourism and the Suez Canal negatively impacted the Egyptian economy. On top of this, inward FDI and inflows from foreign portfolio investors fell significantly in FY09 in comparison with FY08. The Cairo and Alexandria stock exchange lost more than 50% of its market value. Reforms in the Egyptian banking sector stalled, due to the lack of funds in the international banking market, being another shock hitting the **financial side** of the Egyptian economy.

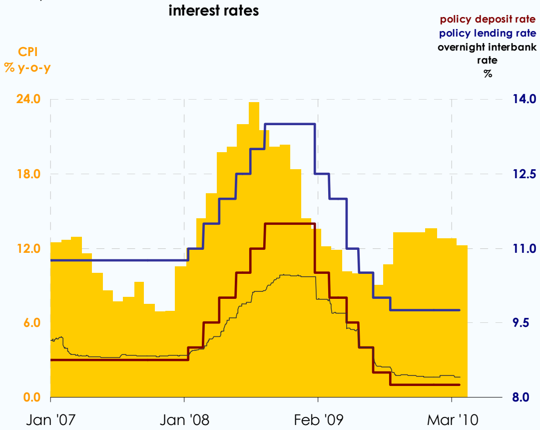
While **economic growth** was mainly fuelled by investment and exports of goods and services in the years before 2009, private and government consumption were the main drivers in FY09. For the time to come, Egypt can grow faster on the back of the global recovery, provided that the private sector and foreign inflows pick up again and take over the stimulating role from government spending.

Graph III.5.1: **Egypt - Fiscal balance, public debt and current account**



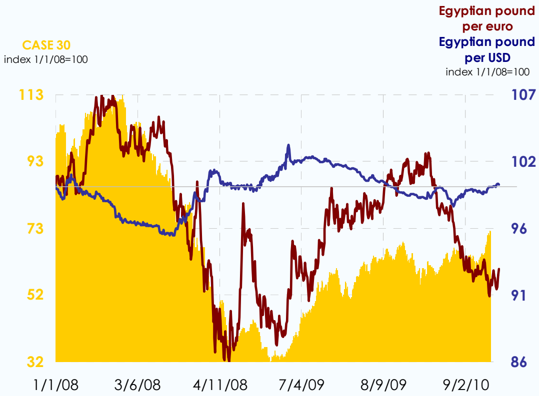
Sources: Ministry of Finance Egypt.

Graph III.5.2: **Egypt - Consumer price inflation and policy interest rates**



Sources: CAPMAS and Central Bank of Egypt.

Graph III.5.3: **Egypt - Share prices and exchange rates**



Sources: ECOWIN Reuters.

With the benefit of hindsight, the **fiscal and monetary** authorities can be said to have anticipated timely and adequately the negative effects of the foreign shocks that hit the Egyptian economy. The fiscal stimulus packages, though being partly planned government investments that were accelerated, but also the rapid monetary policy easing gave consumers confidence and sufficient leeway for the private sector.

Although **gross government debt** is still high at 73% of GDP, general government public finances have deteriorated only slightly in view of the three fiscal stimulus packages and lower economic growth. Reforms in tax collection have been fruitful. Moreover, the general government debt was on a steeply declining path when the crisis started. The government kept itself to the commitment of a government budgetary deficit of around 7% of GDP in FY10 and is on track for further fiscal consolidation, which initially would mean a gradual reduction of the deficit to 3% of GDP in FY11. The replacement of energy and food subsidies by targeted income support that started in FY08 is still ongoing. The eventual phasing out of subsidies, though politically extremely difficult, is still needed to strengthen government debt sustainability and reduce the vulnerability of the economy to shocks. Improving the structure of public spending by reducing the share of the government wage bill, interest and subsidies in total expenditures remains a priority.

On the back of the economic slowdown **consumer price inflation** came down to a minimum of 9% y-o-y in August 2009, which is 15 percentage points less than a year earlier when it soared due to the high global food and fuel prices. In line with the deceleration of inflation, the central bank lowered its policy rate from 11.5% to 8.25%. But, while inflation started to increase again after August 2009 the central bank kept its rates on hold. This accelerating inflation faces the central bank with the dilemma of choosing between fighting inflation (and increasing rates) or stimulating economic growth (not increasing rates). The increasing inflation may further threaten the economy (see the section on risks and outlook and graph III.5.2).

High **unemployment** remains a serious concern. Close to 9% of the labour force is unemployed. The relatively high population growth is one reason for persistent unemployment. Also, a surge in wages has hampered the creation of jobs. Job creation is essential for absorbing the continuing high annual inflow into the labour force and the pool of existing unemployed. Youth employment is high, even among males.

After several years of surplus, the **current account** became negative in FY09. Revenues from tourism, private transfers, remittances and the Suez Canal no longer compensated the trade deficit. Net FDI more than halved from 7.5% of GDP in FY08 to 3.5% in FY09. The negative current account and lower foreign direct investments pushed the balance of payments into deficit in FY09.

Cross-border banking decreased in FY09 (see the lower part of Table III.5.1). External assets fell from 18.7% of GDP to 14.9%, so money was repatriated via the banking system from foreign banks to Egypt. External liabilities fell also, from 11.9% to 9.2%. In sum, Egypt remains a creditor to other countries as regards bank claims. In comparison with developed economies, cross-border banking is still moderate.

The currency regime is a managed float. The central bank pursued an inflation targeting regime, but started to manage the float more strictly when the global crisis started. The weights used mimic the currency composition of the foreign exchange reserves. Volatility in the Egyptian exchange rate increased at the end of 2008, in line with international financial markets. In support of the Egyptian pound, the central bank intervened occasionally in the foreign exchange market. Nonetheless, **official foreign exchange reserves** remain stable, at more than 15% of GDP.

Risks and outlook

For the years to come, Egypt will have to remain vigilant in order to maintain **macroeconomic stability**. While the main risk before the global crisis was high fiscal spending on food and energy subsidies, it is now essentially **fiscal sustainability** that is most at stake. Ongoing reforms, such as VAT, can help to keep the deficit under control. Another commendable policy reform is the removal by the Egyptian government of all fuel subsidies for the industrial sector by 2010. Also, wheat prices will be brought to global price levels gradually, with the first step being the setting of minimum prices, and more competition will be allowed on the monopolised food market.

Furthermore, the state of the **external imbalances** is a vulnerability in the Egyptian economy. The balance of payments deficit, in combination with the internal imbalance of the large government sector, could make the economy more indebted and potentially less attractive for foreign investors.

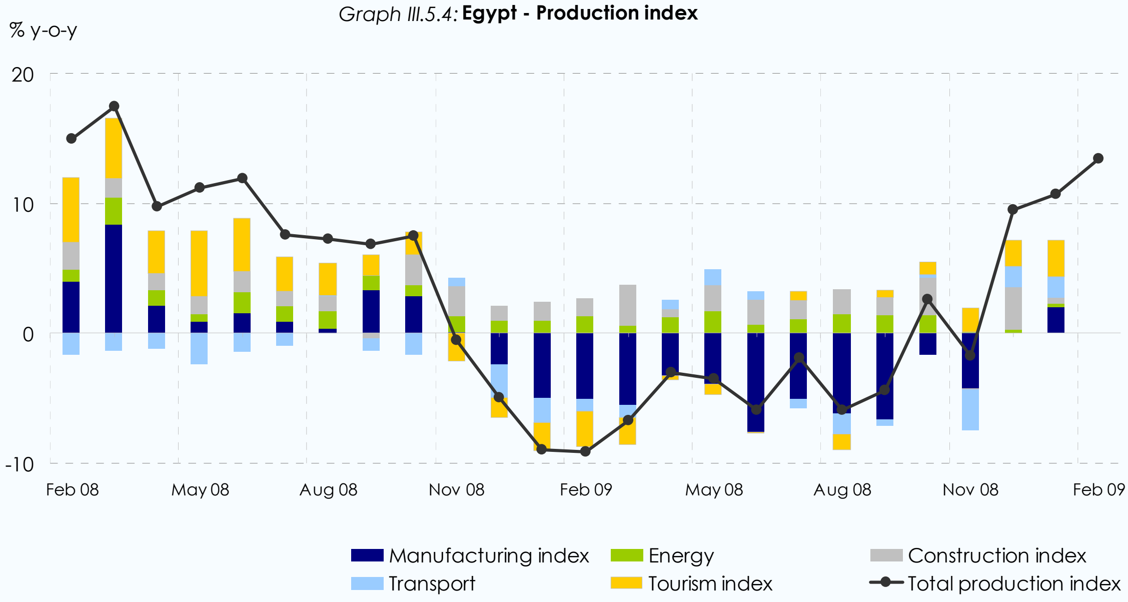
Policy reforms and measures

Although politically very difficult, a commendable policy reform would be the removal by the Egyptian government of all fuel **subsidies** to the industrial sector by 2010. Wheat prices will be brought to global price levels gradually, with the first step being the setting of minimum prices. This food price policy change has the potential to bring new employment opportunities, reduce food supply-side inefficiencies and eventually lead to the abolition of food subsidies.

The **pension and health insurance systems**, the National Investment Bank and Social Insurance Funds, are being restructured to separate them from government. This should lead to a more accurate calculation of government debt. The restructuring of short-term debt financing into longer-term financing and the successful issuing of bonds on the international markets are other commendable achievements.

Egypt is still largely a cash-based economy, where only 10% of the population and 18% of SMEs have a bank account and mortgage loans and consumer credit are still embryonic. Public banks account for around 50% of the domestic banking sector in terms of assets and the State is the owner of the largest banks in Egypt. So, a liquidity crisis would burden the government directly. The average deposit-to-loans ratio is still high, at 50%, and the Egyptian interbank market functions on a limited basis. Therefore, **financial sector reform** is a key issue. Broadening and deepening of the financial sector is needed in order to build an efficient and well-functioning market sector, where households and companies can easily find access to funds from intermediaries such as commercial banks, and in order to give more room for manoeuvre for capital instead of current spending by the government. **Strengthening of the financial regulatory framework** is in progress, in agreement with international arrangements and current reforms in the international framework (Basle II), in order to maintain financial stability. The EU-Egypt Action Plan, adopted in 2007 in the framework of the ENP, still provides a good framework for deepening economic and trade relations.

Graph III.5.4: **Egypt - Production index**



Sources: Ministry of Economic Development of Egypt, ECOWIN.

Table III.5.1:

Egypt - Main economic indicators	FY06*	FY07	FY08	FY09	FY10
Real sector				prel.	proj.
Real GDP growth (domestic currency, % change)	6.8	7.1	7.2	4.7	4.9
GDP (Egyptian pounds, billion)	618	731	863	1047	1240
GDP nominal (EUR, billion)	88	100	111	138	
GDP nominal (USD, billion)	107	130	163	188	
GDP per-capita (EUR)	1239	1371	1490	1815	
GDP per-capita (USD)	1508	1790	2187	2483	
Inflation (consumer price, average)	4.2	11.0	11.7	16.2	11.3
Social indicators					
Unemployment (off. registered, average, %)	11.0	10.3	8.9	9.1	9.4
Life expectancy at birth (years)	70.2	70.7	71.6		
Adult literacy (% ages 15 and older)	71.4				
Domestic population	71.3	72.9	74.4	75.9	77.4
Income inequality (Gini, %)		34.4			
Human development index	0.613	0.659	0.708		
Fiscal sector					
General government revenues and grants (% GDP)	28.5	28.1	28.8	27.6	18.1
General government expenditures (% GDP)	36.2	33.4	35.4	34.1	26.1
General government balance (% GDP)	-9.2	-7.7	-7.8	-6.9	-8.0
General government primary balance (% GDP)	-3.5	-2.4	-3.0	-2.8	-2.4
Gross public debt (% GDP)	90.4	80.2	70.2	72.8	71.0
Monetary sector					
Total liquidity (% change)	13.5	18.3	15.7	8.4	9.4**
Dollar/Euro/other currency-isation (% broad money)	24.4	23.2	20.8	20.1	18.6**
Credit to private sector (%)	8.5	12.3	12.6	5.1	3.8
Loan to deposits non-government sector (%)	61.9	56.3	55.4	55.6	53.9**
External sector					
Overall balance (% GDP)	3.0	4.0	3.3	-1.8	
Current account balance (% GDP)	1.6	1.7	0.5	-2.3	
Trade balance (% GDP)	-11.2	-12.5	-14.4	-13.4	
FDI (net, % GDP)	5.6	8.1	7.5	3.6	3.7
Remittances (% GDP)	4.6	4.8	5.1	4.1	
Import cover of reserves (months)	5.8	5.3	6.7	5.8	5.8
External vulnerability					
External public debt (% GDP)	17.6	14.9	12.9	13.9	13.8
Gross reserves (USD, billion)	25.6	31.4	33.8	34.2	
Financial sector					
Official discount rate (end-of-period, %)	9.0	9.0	10.0	9.0	8.25***
Lending rate (avg, less than one year loans, %)	12.7	12.6	12.2		
Exchange rate (LE per EUR, average)	7.2	7.5	8.1	7.6	
Exchange rate (LE per USD, mid FY)	5.75	5.72	5.50	5.51	
Real effective exchange rate (%, + is apprec.)	8.1	4.4	3.0		
Stock market (CASE-index, % change FY)	-1	63	26	-56	
Cross-border banking					
External liabilities (% GDP)	14.7	15.4	11.9	9.1**	
External assets (% GDP)	39.6	31.2	18.7	14.9**	
External loans (% GDP)	10.6	11.6	9.6	6.9**	
External deposits (% GDP)	39.4	31.1	18.6	14.7**	

*FY06 is the fiscal year running from July 2005 until June 2006. **Sept '09. ***April '10.

Sources: CAPMAS, Central Bank Egypt, Ministry of Finance Egypt, IMF, EUROSTAT, EIU, BIS, own calculations.

6. GEORGIA

- ***Georgia's economic contraction in 2009 has been a consequence of reduced capital inflows and a subsequent fall in consumption and investment.***

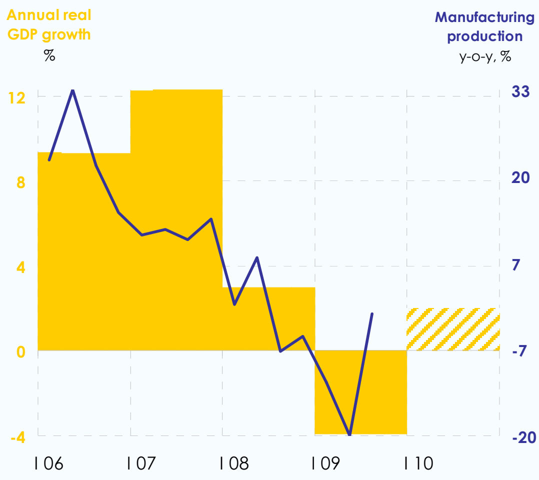
- ***Contraction in economic activity could partially be offset by public investment projects financed with significant support from multilateral and bilateral international donors.***

- ***With more than half of the population living below the poverty line, the Government needs to step up its efforts in poverty reduction.***

Macroeconomic and financial developments

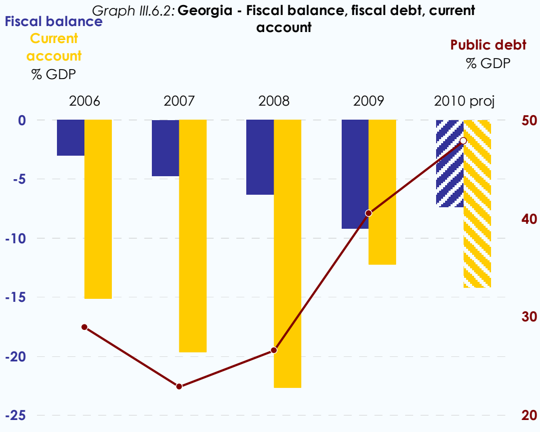
The global financial and economic crisis strongly affected Georgia and thus further exacerbated the economic downturn caused by the military conflict with Russia that occurred in August 2008. In the first half of 2009, real GDP dropped by 8.5% continuing the contraction that started in the third quarter of 2008. The economic contraction was driven by the decline in domestic demand caused by a tightening of bank credit, a fall in remittances and in foreign direct investment inflows which subsequently led to a decline in output and consumption. Economic sectors especially hit have been manufacturing and construction. The first signs of economic stabilisation appeared in the third quarter of 2009 but this has been partially due to the low statistical base: economic slowdown became apparent in the third quarter of 2008. Thus, the recovery has been only very tentative. For 2009 as a whole, real GDP is forecasted to contact by 3.9%. As a result of the economic slowdown average inflation fell dramatically from 10% in 2008 to 1.7% in 2009. A slight increase in inflation to 3.5% at the end of 2009 can be interpreted as one of the first signs of a tentative economic recovery.

Graph III.6.1: **Georgia - GDP and production**



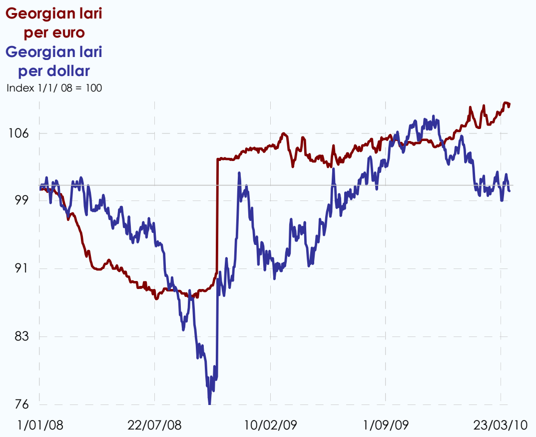
Sources: National Statistical Office Georgia and Commission.

Graph III.6.2: **Georgia - Fiscal balance, fiscal debt, current account**



Sources: IMF, Georgian authorities, Commission.

Graph III.6.3: **Georgia - Exchange rates**



Sources: ECOWIN Reuters.

The country's external imbalances were somewhat reduced in 2009. The large current account deficit decreased from around 23% of GDP in 2008 to 12% of GDP in 2009. The strong rebalancing was driven by the trade balance adjustment: exports and imports of goods and services declined by 16% and 30%, respectively, thus reducing the trade deficit from around 30% of GDP in 2008 to 23%. 2009 was also marked by a strong decline of capital inflows: in comparison to 2008, worker remittances declined by more than 20% to USD 0.5 billion, while FDI inflows more than halved going from USD 1.5 billion to USD 0.8 billion.

Both the country's fiscal position and its public debt position deteriorated in 2009. The budget deficit reached 9.2% of GDP. The widening of the general government deficit was mainly due to a contraction in fiscal revenue caused by the recession. It was financed through the external financial assistance of the International Financial Institutions (IFIs) and bilateral partners and by issuing domestic Treasury bills. As far as public debt is concerned, several years of strong growth and prudent debt management in early 2000s had significantly reduced Georgia’s public debt and thus the country's external vulnerability. Public and publicly guaranteed external debt fell from 50% of GDP in 2000 to about 18% of GDP in 2007. Yet, this declining trend stopped in 2008: external public debt increased to around 21% of GDP in 2008 and to 32% of GDP in 2009. Higher external borrowing provided funding for public infrastructure rehabilitation and social spending projects.

As regards monetary and exchange rate policy, the central bank legislation was amended in spring 2008 to make price stability as the NBG’s core objective. This was to be achieved by introducing a monetary policy framework of inflation-targeting. However, from August 2008 the National Bank of Georgia (NBG) resumed its interventions on the foreign exchange market to limit the depreciation of the lari. In early November 2008, under pressure from the markets, the authorities allowed the exchange rate to depreciate against the US dollar by around 17%. Since March 2009, the authorities have allowed for greater exchange rate flexibility. The National Bank holds regular foreign currency auctions to prevent the exchange rate from fluctuating too much but the practice of almost daily interventions has been abandoned.

The global financial crisis had adverse repercussions on the country's financial intermediation. Before the crisis Georgia's financial sector was growing at a fast pace: domestic credit expanded from around 27% to 31% between 2006 and 2008. Since late 2008 household deposits and bank lending have fallen considerably. In summer 2009, the share of non-performing loans increased to more than 18%. Trust in the lari declined further: in 2009 the share of domestic deposits held in foreign currency increased to 83% from 64% in 2008. The NBG took a number of anti-crisis measures to increase liquidity and restore confidence in the banking sector by lowering reserve requirements and reducing the refinancing rate. However, monetary policy instruments have only had a limited impact due to the central role of the foreign currency in domestic financial transactions. Thus, rather than the National Bank's refinancing rate it is the domestic interest rate on the USD that has influenced the economic activity. In 2009, the high domestic lending rate of 23% on an annual basis kept domestic lending low and thus hampered economic recovery. In 2010 domestic lending is expected to remain low. Thus, the two biggest challenges for the national monetary authorities remain rebuilding the trust in the national currency in order to regain the use of monetary policy tools and reviving credit lending to the private sector in order to stimulate economic activity.

In September 2008, to improve the country's balance of payments position and to contribute to a more stable macro-economic policy framework, the International Monetary Fund (IMF) approved an 18-month Stand-By Arrangement (SBA) for Georgia worth USD 750 million. The programme was frontloaded and enabled Georgia to draw USD 250 million from the Fund in the first instalment. In 2009, Georgia drew an amount equivalent to USD 410 million: USD 187 million in March, USD 148 million in August and USD 75 million in December 2009. During the third review approved by the IMF Board in August 2009, the SBA was extended until June 2011 and the financing package increased by about USD 424 million bringing the whole SBA programme to USD 1.17 billion. The European Commission pledged up to EUR 500 million for 2008-2010. Multilateral donors include the ADB, the EBRD, the EIB and the World Bank Group, while the largest bilateral donors to Georgia are the US and Japan. The overall donor pledge for the post-war period amounts to USD 4.5 billion.

Risks and outlook

Economic prospects for 2010 are not over-optimistic. Economic contraction is expected to stop but the forecasts assume only low real growth of around 2%. A real recovery is only expected for 2011. Foreign direct investment (FDI), the driver of growth in the early 2000s, will recover only slowly and remain below the two-digit levels of the early 2000s. Exports will grow, but they will be outpaced by imports, which collapsed in 2008. The fiscal stimulus is expected to be maintained in early 2010 and to be slowly phased out as the economic recovery takes hold.

Policy reforms and measures

Since the 2003 Rose Revolution Georgia has made significant progress in a number of legal and regulatory reforms. The tax system has been simplified and public finance management brought closer into line with international practices. Customs regime has been liberalised, while important anti-corruption measures have been taken and the regulatory business environment has substantially improved. However, in several areas, notably trade-related like protection and enforcement of intellectual property rights, competition, food safety and technical barriers to trade, Georgia's progress in approximation with the EU and international laws and standards remained limited. The economic crisis that started with the August 2008 war and was further fuelled by the global economic slowdown meant that the pace of legislative and regulatory policy initiatives slowed down in late 2008 - early 2009 as more urgent issues such as accommodating the immediate needs of internally displaced persons were on the government's policy agenda. However reforms efforts revived in the second half of 2009 with a number of new initiatives being put on the table.

Social development and poverty

According to the United Nations' Human development index, which measures monetary and non-monetary dimensions of human development Georgia is ranked 89th among 182 countries worldwide and has a medium level of human development. Although its income per capita is quite low even by regional standards - it is below USD 5 000 in PPP, - the country enjoys a high life expectancy at birth of 71.6 years and claims 100% adult literacy. Despite certain improvements in the 2000s, after the dramatic fall of the early 1990s, GDP per capita did not recover to its pre-transition level in the period 1990-2007 and its prospects do not look very promising: Georgia's GDP per capita has grown on average by only 1.8% a year, which is as much as Belgium or Austria and is not enough to allow the country to catch-up with the EU countries in the near future.

Poverty is a widespread in Georgia, with 30% of the population living on less than USD 2 a day and more than half of the population living below the national poverty line. In terms of relative income poverty, during the early 2000s, 23.4% of the population lived below the national poverty line. According to the IMF Poverty Reduction Paper, in 2003 52% of the population lived in poverty and 15% in extreme poverty. As in all transition countries, economic inequality increased. While the top quintile of the population accounts for 30.6% of overall consumption, the bottom quintile's share of consumption is only 1.9%. This puts Georgia's Gini coefficient, the central international measure of relative income inequality, at a level comparable with that of the US. Several factors have contributed to the high poverty and increasing inequality. Among them are a high unemployment rate of around 15% of the labour force and low real wages.

As far as non-monetary poverty is concerned, around 5% of the Georgian population lives in extreme poverty with almost 7% of the population vulnerable to death at an early age, 1% of population without access to clean water and 3% of small children not having sufficient nutrition. Health care and a social safety net are crucial in contributing to the non-monetary dimension of human development, yet both are considered as poor in Georgia. A targeted social assistance programme introduced in 2006 covers around 16% of the population, but the level of assistance is low. Regional inequality is also significant, rural areas being the most disadvantaged. Gender inequality is considered to be relatively low, but is rising due to a lack of appropriate child care provisions.

Table III.6.1:

Georgia - Main economic indicators	2006	2007	2008	2009	2010
Real sector				prel.	proj.
Real GDP growth (domestic currency, % change)	9.4	12.3	2.3	-3.9	2.0
GDP nominal (EUR, billion)	6.2	7.4	8.7	7.8	
GDP nominal (USD, billion)	7.8	10.2	12.8	10.7	
GDP per capita (EUR)	1415	1679	1987	1774	
GDP per capita (USD)	1764	2312	2909	2442	
GDP per capita (PPP current prices USD)	4041	4671	4869	4747	
Inflation (period average)	9.2	9.2	10.1	1.7	3.0
Social indicators					
Population (million)	4.4	4.4	4.4	4.4	4.4
Unemployment rate (ILO definition)	13.6	13.3	16.5	16.5	
Poverty rate (% population)1		54.5			
Inequality (Gini index consumption/ income)		40.8			
Life expectancy at birth (years)		71.6			
Human development index		0.778			
Fiscal sector					
Total revenue (incl. grants) (% GDP)	26.7	29.3	30.7	29.4	28.5
Grants			3.0	2.6	2.5
Total expenditure (% GDP)	29.8	34.0	37.1	39.0	35.8
Current expenditure			28.5	30.0	27.9
Capital spending and net lending			8.6	9.0	7.9
General government balance (% GDP)	-3.0	-4.7	-6.3	-9.2	-7.4
Gross public debt (% GDP)	28.9	22.9	26.6	40.5	47.8
Monetary sector					
Domestic credit to private sector (% GDP)	19.7	27.1	30.2		
Broad money (M3) (% change)	39.7	49.7	5.7	2.0	13.0
Degree of monetisation (M3/GDP, %)	19.5	23.7	22.3	24.1	25.8
Foreign currency deposits in bank deposits	69.0	65.0	64.0 83 (2)		
External sector					
Current account balance (% GDP)	-15.1	-19.7	-22.7	-12.2	-14.2
Trade balance (% GDP)	-23.9	-26.8	-29.8	-22.5	-24.5
Exports of goods and services	32.9	31.1	28.7	28.9	32.3
Imports of goods and services	56.8	57.9	58.3	48.9	54.2
Foreign direct investment (net, % GDP)	15.3	16.4	12.2	7.1	7.9
Import cover of reserves (months)	1.8	2.2	3.3	4.1	4.0
External vulnerability					
External public sector debt, period end (% GDP) (4)	22.3	18.0	20.9	31.8	37.6
Public external debt service ratio (3)	7.2	3.5	3.4	6.2	6.4
External debt, period end (% of GDP)	34.6	35.7	42	55.1	61
MLT external debt service in percent of exports		11.9	16.0	23.8	25.0
Gross reserves (USD million), period end	931	1361	1480	2109	
Reserves/M3	0.6	0.6	0.5	0.8	
Financial sector					
Interest rate on over-night interbank loans (period ave	9.5	7.4	10.0	4.0	
Market rate of interest on loans (period average)	18.4	18.8	21.9	22.6	
Exchange rate (lari per EUR, average)	2.2	2.3	2.2	2.3	
Exchange rate (lari per USD, average)	1.8	1.7	1.5	1.7	
Real effective exchange rate (% change)[4]	3.7	1.4	8.4	0.5	

[1] Below the national poverty line 2000-2006.
[2] Data for the first three quarters of 2009. [3] External debt service as % of exports of goods and services.
[4] REER is calculated as a weighted average of Real Exchange Rates of 12 main trade partner countries.
Sources: IMF, UN, Georgian authorities and Commission.

7. ISRAEL

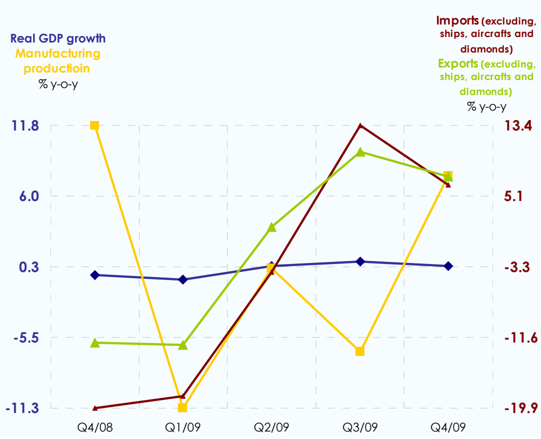
- ***Israel weathered the global economic crisis relatively well and was the first advanced economy to stage a recovery in 2009.***
- ***The banking sector proved resilient and along with effective monetary and fiscal policies shielded GDP, which rose 0.5% in 2009.***
- ***Despite the positive macroeconomic performance, incidences of poverty, income disparity and low-paid jobs are high.***

Macroeconomic and financial developments

The export-oriented economy of Israel was one of the least affected by the economic and financial crisis despite its high integration with the US and European economies. The composition of trade, the absence of housing or bank credit booms, the high household savings rates and the specific policy responses helped Israel to minimise the impact of the crisis in the economy, which was technically out of the recession from the second quarter of 2009. The negative effects of the global crisis, like the decline in exports, the soaring of risk premiums and the tightening of credit standards were felt but not to a dramatic extent. The reduction of the public debt and the structural reforms of recent years as well as the decisive easing of fiscal and monetary policy shielded GDP growth in 2009, which recorded an increase of 0.5% compared to 4.1% in 2008. As a result of the economic slowdown, unemployment rose to 7.9% from the historic low of 6.1% in 2008.

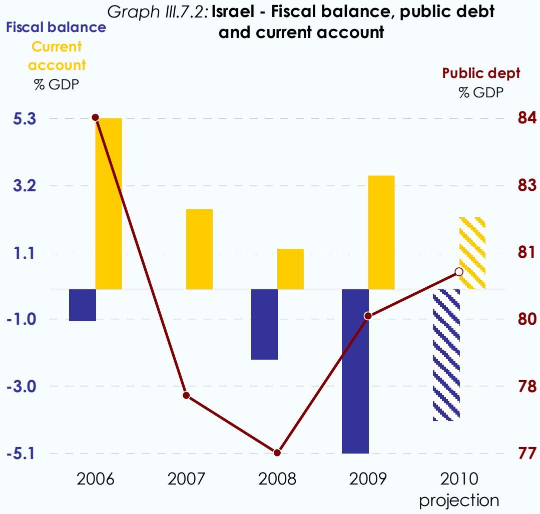
Fiscal policy was expansionary during 2009, reflecting the financial cost of the war in Gaza, the setting up of an inclusive (0.7% of GDP) economic stimulus plan and the use of automatic stabilisers. The earlier well-established framework of fiscal rules – comprising ceilings on deficits and on the growth of real spending – was abandoned appropriately to accommodate the fiscal easing while the government adopted a two-year (2010-2011) budget. Thus, despite the fact that tax revenues were stabilised at the end of 2009, the public deficit rose to around 5% of GDP in 2009 while public debt is expected to approach 80% of GDP.

Graph III.7.1: **Israel - Real sector and trade in 2009**



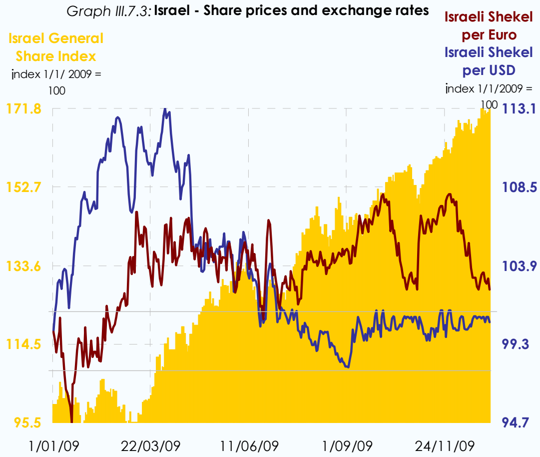
Sources: CBI, TASE and CBS Israel.

Graph III.7.2: **Israel - Fiscal balance, public debt and current account**



Sources: IMF and Ministry of Finance Israel.

Graph III.7.3: **Israel - Share prices and exchange rates**



Sources: CBI, TASE.

Monetary policy was eased decisively by the Bank of Israel, which reduced policy interest rates (from 2.5% in summer 2008 to 0.5% in April 2009), resorted to quantitative easing and intervened in the foreign exchange market through programmed purchases of USD which were replaced later by discretionary purchases. The latter move raised some concerns about the credibility of the exchange rate policy under the free floating exchange rate regime. Against the background of an expansionary monetary policy, in August 2009, the Central Bank of Israel responded to higher than expected inflation (3.3%) and became the first developed-economy central bank to raise its policy interest rate (from 0.5% to 0.75%) since the onset of the global financial crisis. In December 2009 and January 2010, it continued to tighten monetary policy by raising its key discount rate by 25 basis points each time (to reach 1.25%). Inflation in 2009 remained above the upper limit of the Bank of Israel's 1-3% target band. However, stripping out seasonal factors and taxes and surcharges, the annual rate of inflation was 2.6%, near the midpoint of the inflation target range. Although the economy was set to weaken, Israel's relatively robust external position gave some support to the shekel, despite the central bank's continued purchase of foreign-exchange reserves to prevent the shekel's appreciating. The shekel dipped sharply around April 2009 amid a steep fall in emerging-market currencies, and then rebounded again in July 2009, raising concerns among Israeli exporters but contributing to the disinflation efforts of the Central Bank. As a result of the comfortable level of its foreign exchange reserves position (USD 60.6 billion in December 2009) Israel reached an agreement with the IMF to provide upon demand a loan, up to around 800 million USD, that would be paid from Israel's foreign exchange reserves.

Both exports and imports fell since the beginning of 2009, due to the economic crisis in Israel and world wide, but as a result of the improvement in the terms of trade and real depreciation of the shekel during the year, the decline in exports was more moderate (16.4%) than that in imports (24.3%). The most notable fall in imports was in investment goods (producer durables) in the first semester; this trend reversed when the recovery of the economy began. Export activity was mainly based on exports of services and of electronic components while exports of goods excluding diamonds and electronic components remained sluggish, particularly in the first quarters of 2009. As a result, the trade account recorded a surplus of 2.1% of GDP in 2009 while the current account surplus widened to around 3.5% of GDP.

Due to its prudent lending practices and its limited foreign exposure, the banking sector remained solid during the global crisis. Credit to the private sector increased by only 1.2% in 2009. Provisions for non-performing loans increased from 0.3% to 0.8% of total loans but the non performing loan ratio remains at only 1.5%. The non-bank financial sector was severely affected by the sharp fall in corporate bond (14%) and equity (45%) markets, the peak in risk premiums and some re-scheduling of corporate bond debt. Nevertheless, the various emergency financial sector support initiatives remained in place at the end of 2009, even though their use by the banks was limited.

Risks and outlook

With its output, consumption and confidence being restored already in 2009, Israel is a global exit frontrunner. However, even though the economic outlook for 2010 is positive, it depends on the growth of potential output of major economies, which is quite uncertain. Beyond 2010, a significant reduction in the growth of global output is likely to reduce Israel's medium-term growth potential.

Given the uncertain economic environment the execution of fiscal policy in 2010 will be important and challenging. Although the fiscal deficit is expected to be decreased to around 4% of GDP it is highly dependent on the uncertain economic situation. In any case, fiscal policy in 2010 should be aimed at delivering considerably lower deficit outturns than the expected ceilings if economic growth proves to be strong while at the same time being ready to make necessary adjustments or further fiscal consolidation if downward scenarios materialise and financing conditions prove challenging. In this context, the adoption of fiscal rules targeting reduction of the public debt in the medium-term taking into account the cyclicality of the economy will be appropriate for fiscal policy.

Additional challenges for 2010 will be the restoration of exports, imports and fixed investments, which despite the output growth in

2009 are far from their pre-crisis levels, and unemployment which increased to around 7.9% from 6.1% in 2008. Given the expected economic recovery and despite the withdrawal of the unconventional monetary measures and the rise of interest rates, inflation could be a point of concern if it remains long above the upper limit of the inflation targeting framework.

Policy reforms and measures

From the onset of the global crisis, the government mobilised a programme of financial and credit support initiatives which remained in place at the end of 2009, even though their use by banks or firms was limited. The programme consisted of seed capital of NIS 1.1 billion to support corporate issues for solvent firms facing debt rollover difficulties, guarantees amounting to NIS 12 billion for bank's capital increases and guarantees of NIS 2.6 billion to small and medium-sized firms. Despite the resilience of the banking sector, the temporary closure of the corporate bond market during the peak of the crisis and the decline of several insurance companies' solvency ratios below their regulatory standards call for improvements in the supervision of these institutions and markets in their risk management practices. The authorities launched procedures for taking various actions to strengthen the content of supervision, including establishment of a financial stability unit in the Bank of Israel, proposals by experts and regulators to strengthen due diligence practices, bond structures, remuneration arrangements, and investment portfolio guidelines. The authorities are also taking measures to strengthen the long-term credibility of the inflation targeting regime by preparing a new law for the Bank of Israel. This law will aim to increase independence, establish a monetary policy committee and a separate management committee to manage the bank's administration.

The government adopted in mid-2009 a two-year budget to cover both 2009 and 2010 which incorporated discretionary expansionary measures and anticipates a 3% increase in real spending in 2009 relaxing the 1.7% ceiling of the relevant fiscal rule.

As a partial offset social security contributions and VAT were raised (VAT by 1% to 16.5%) with a plan to be reversed in 2010. Tobacco and gasoline excise were permanently increased. Additional spending curbs are to be implemented from 2011 to offset the spending increases of 2009.

Social development and poverty

Despite the strong growth of recent years, the benefits were not shared equally and social policies are faced with deep socio-economic cleavages characterised by high poverty and low employment. Overall household poverty is around 20% compared with the OECD average of 11%. While the poverty rate for the general Jewish population is around 10%, it is particularly high among the 20% of the population who are Arab-Israelis, whose poverty rate is around 50%, and the 8% of ultra-Orthodox Jews, whose poverty rate is around 60%. Poverty is attributed to poor education and low labour force participation of large segments of the population but it is also exacerbated by the high degree of earnings disparity and the incidence of low-paid jobs which is very high in Israel. In 2008 the child poverty rate of 34% was also worrisome, indicating that 783.600 children were below the poverty line. The authorities are trying to raise low employment levels and to support low-income earners by expanding targeting programmes such as the 'Lights for Employment' and the 'Earned Income Tax Credit' respectively. However, adjustments and additional funding would be needed to boost the effectiveness of such programmes along with better outcomes on education, and better enforcement of labour laws. Further strengthening of the redistribution power of the tax/benefits system will be essential as employment fell in 2009 and given the high debt reduction target, social expenditures are not expected to increase significantly (in 2007 they were already low at 15.8% of GDP, 6% below the OECD average).

Table III.7.1:

Israel - Main economic indicators

	2006	2007	2008	2009 prel.	2010 proj.
Real sector					
Real GDP growth (domestic currency, % change)	5.2	5.3	4.1	0.5	2.5
GDP nominal (NIS, billion)	641	674	725	775	830
GDP nominal (EUR, billion)	115	120	138	142	152
GDP nominal (USD billion)	144	163.9	201.4	206.7	218
GDP per capita (EUR)	16858	17337	19379	19713	20967
GDP per capita (USD)	21176	23749	28369	28704	30127
Inflation (period average)	2.1	0.5	3.8	3.6	2.9
Social indicators					
Unemployment	7.7	7.3	6.1	7.9	7.6
Poverty rate (% of households)	20.0	20.5	18.5	18.4	
Population, annual growth rate (%)	1.5	1.5	1.5	1.5	1.5
Human development index	0.930	0.935			
Life expectancy at birth, annual (years)	80.5	80.7			
Adult literacy rate (% aged 15 and older)	97.1	97.1			
Gini index (%)		39.2			
Population (million)	6.8	6.9	7.1	7.2	7.3
Fiscal sector					
Central govt. revenues (% GDP)	35.2	35.4	31.6	29.1	29.8
Central govt. expenditures (% GDP)	36.2	35.4	33.8	34.2	33.9
Defense expenditure (% GDP)	7.9	7.9	7.9	7.9	7.9
Central govt. balance (% GDP)	-1.0	0.0	-2.2	-5.1	-4.1
General govt. balance (% GDP)	-1.4	-0.8	-2.8	-5.7	-4.7
Total public debt	84.4	78.1	76.8	79.9	80.9
Monetary sector					
Domestic credit to private sector (change %)	4.3	6.7	9.2	-0.6	
Broad money (M3, % change)	7.4	12.9	8.0	15.2	
Narrow money (M1, % change)	13.7	15.3	14.1	57.8	
External sector					
Current account balance (% GDP)	5.3	2.5	1.2	3.5	2.2
Trade balance (% GDP)	0.6	-1.7	-1.3	2.1	-0.9
Foreign direct investment (net, % GDP)	-0.1	1.2	0.9	2.4	1.2
Foreign reserves (billion USD)	29.4	28.4	42.7	60.6	64.7
External vulnerability					
Gross reserves (excl. gold, USD billion)	29.1	28.4	42.7	62.6	64.7
External debt (% GDP)	22.3	19.8	16.1	15.0	14.5
Financial sector					
BOI policy rate (average, %)	5.1	3.9	3.7	0.8	
Lending rate of bank credit (average %)	8.1	6.9	6.6	4.2	
Exchange rate (local currency per USD, average)	4.5	4.1	3.6	3.8	
Exchange rate (local currency per EUR, average)	5.6	5.6	5.3	5.5	
NEER (period average)	0.4	3.9	11.4		
REER (period average)	0.0	1.8	12.3		
Terms of trade (2000=100; index)	-1.4	-2.2	1.6	11.2	

Sources: IMF, Ministry of Finance of Israel, Bank of Israel, CBS, EIU.

8. JORDAN

- ***After the recent period of robust growth, GDP growth moderated to 3% in 2009 on account of the indirect impact of the global economic crisis.***

- ***The government deficit expanded to around 12.5% of GDP both on account of a fall in tax revenue and an increase in capital spending. The current account deficit is set to narrow to -6.5% of GDP largely driven by the decline in fuel and food prices.***

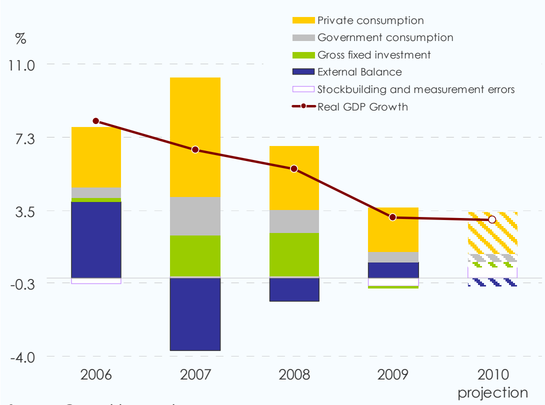
- ***A key challenge will be to reign in government expenditure to stem the rise in government debt while absorbing the pressures of a rapidly growing population.***

Macroeconomic and financial developments

Growth in the Jordanian economy moderated during 2009. Despite an increase in government capital spending, gross fixed capital formation contracted due to a sharp decline in FDI from surrounding Arab states, as oil earnings shrunk. The slowdown affected growth in a number of sectors, particularly export industries, construction and real estate. Private consumption growth is predicted slowed from 3.8% in 2008 to 2.5% in 2009, driven by a slackening labour market and falling remittances.

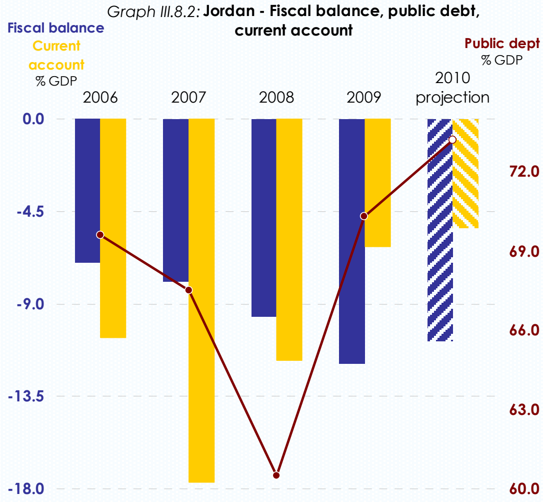
Imports fell markedly due to the reversal of international commodity prices and the slowdown in consumer spending. Exports were restrained primarily by the economic slowdown in the US, Jordan's main trading partner, although rising demand from neighbouring Iraq partially compensated. Export earnings declined by 20%. The current account deficit fell from 11.9% of GDP in 2008 to around 6% of GDP in 2009, helped by an increase in the services balance, and despite a fall in remittances in the region of 15% compared with 2008.

Graph III.8.1: **Jordan - Contributions to real GDP-growth**



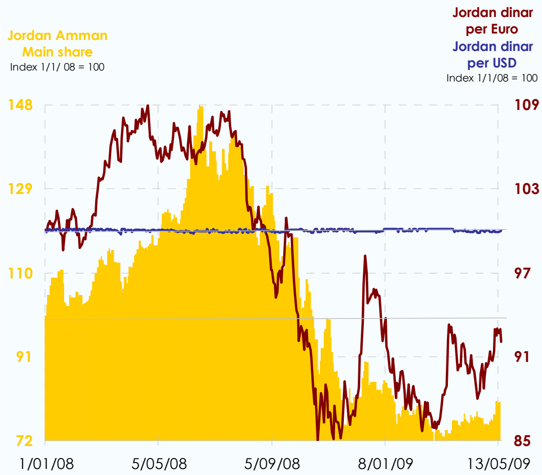
Source: Commision services.

Graph III.8.2: **Jordan - Fiscal balance, public debt, current account**



Sources: EIU and IMF.

Graph III.8.3: **Jordan - Share prices and exchange rates**



Sources: ECOWIN Reuters.

Registered unemployment remained stable at around 12.5% due to the large number of migrant workers in the sectors most affected by the slow down.

Inflation rose swiftly during 2008 on account of soaring fuel and food prices, the weakening dollar to which the Jordanian dinar is pegged, and the removal of fuel subsidies which exposed the population to higher utility costs. However, consumer prices have since fallen sharply reflecting the reversal in commodity prices and the strengthening dollar. Inflation has declined since Q3 2008 with the CPI falling into negative territory in Q2 2009. Annual average CPI for 2009 was 1.7% compared to 14.9% in 2008.

In 2009, the fiscal deficit expanded to 11% of GDP, compared to -9.6% of GDP in 2008, excluding grant aid. Public finances were placed under pressure due to the slowdown in economic activity and structural tax measures leading to a fall in revenues. The prior abolition of food subsidies in 2008 and cuts to non-essential current expenditure made room for an increase in capital expenditure. In 2008, the authorities made progress on reducing Jordan's debt-to-GDP level due to the special buy-back agreements signed with bilateral creditors and the Paris Club. The burden of government debt is, however, set to rise to above 60% of GDP in 2009 and thus potentially surpass the legislative ceiling, triggering spending cuts in 2010.

Jordan's banking sector has not been seriously affected by the global economic crisis. The country's 23 banks, which adopted the Basel II Accord in 2008, have benefited from recent growth in the corporate sector and have limited exposure to international property and equity markets. The absence of sophisticated financial instruments and the limited scale of most of operations, has insulated the sector against short-term instability. Nevertheless, the government guaranteed all private sector deposits to ensure confidence in the sector.

Interbank lending rates rose toward the end of 2008, in response to which the government guaranteed all bank deposits until the end of 2009. While local banks had very limited exposure to the financial turmoil in the US, spreads between the Central Bank's policy rate and the lending rates of domestic commercial banks widened in the first half of 2009, given the increased risk environment and decline in inward investment.

Monetary policy was eased to support investment and increase liquidity. The Central Bank of Jordan (CBJ) cut interest rates three times up to April 2009 bringing the benchmark rate to 5.25% (the lowest since August 2005). At the same time, the CBJ reduced banks' reserve requirements by 1 percentage point to 7% (compared with 10% in October 2008) in order to boost liquidity. Banking sector soundness indicators remained favourable. The banking system's capital adequacy ratio is well above the Basel II 12% requirement and recently conducted stress tests([1]) indicate limited risk to interest rate and liquidity shocks, and interbank contagion. While the rate of non-performing loans is relatively low, it increased to from 4% in 2008 to 6.5% in 2009. Further scope for monetary scoping is, however, limited, given that the CBJ is expected to maintain the dollar-dinar peg at the current level.

Risks and outlook

While lower international commodity prices and an expansionary fiscal policy will help to sustain the somewhat vulnerable Jordanian economy, output growth is expected to remain subdued for the near future, with the economy predicted to grow at 3% of GDP in 2010 given still weak external demand, only a gradual recovery in the level of inward investment and tightening fiscal policy.

The Jordanian economy is forecast to grow at a similar rate in 2010 as inward investment re-gathers momentum. The Jordanian government has targeted a much reduced deficit of -6.5% of GDP for 2010 which appears ambitious given the weak global economic climate and recent legislative changes whereby the level of personal and corporate income tax was reduced at the start of 2010. This would make the achievement of the target heavily dependent on cuts in capital expenditure which if too deep may lead to a slow down in growth.

Despite a reduction in the current account in 2009, the Jordanian economy is still vulnerable to a

([1]) IMF FSAP update mission

reduction in grant aid, a slow down in inward investment, or a swift rise in commodity prices. In this respect, the expansion and diversification of a relatively narrow export base remains paramount.

The dinar's peg with the USD has supported monetary confidence during the crisis. Foreign reserves have been maintained at healthy levels, having recovered swiftly after the buyback of Paris Club debt.

Policy reforms and measures

The Jordanian government implemented a tax reform in January 2010 to reduce the level of income and corporate taxation. The reform of personal and corporate income tax is estimated to reduce revenues by about 1% of GDP. On personal income tax, the number of tax rates will be reduced from four to two (7% and 14%) with the maximum tax rate falling from 25% to 14%. The main corporate tax rate has been reduced to 14% while there are still higher rates for financial institutions and telecommunications companies. While the reform brings greater harmonisation to income tax rates, it may have to be counterbalanced by other tax measures in the short term as revenues remain under pressure. At the same time as the new tax law was approved, legislation was also approved to harmonize tax administration, in particular income and sales tax record-keeping requirements; filing requirements; audit procedures; administrative and judicial appeal procedures, and collection procedures.

The Jordanian government is continuing with a programme of public finance management reform. The concepts of result-oriented budgeting (ROB), a GFSM 2001-compliant budget classification and chart of accounts, GFMIS (Government Financial Management Information System) and an MTEF (Medium Term Expenditure Framework) for the years 2008-2010 are being introduced, as well as an amended debt law, which provides for a ceiling of debt-to-GDP of 60%. The MTEF spans 3 years and includes setting a partial ceiling of expenditures for each ministry according to priorities and national objectives.

A series of regulatory bodies have been created in several sectors: telecoms, energy, civil aviation and public transport. Supervision of the banking sector has also risen in response to the global financial crisis including greater cooperation with foreign supervisory agencies and onsite inspections of overseas subsidiaries of domestic banks. Jordan has been successful in attracting strong FDI inflows but further efforts will have be made to attract and widen the sources of inward investment as the economic environment remains weak and competition for global investment intensifies. In this respect, the Jordanian authorities have sought to expand inward investment sources, including South Korea and China.

Social development and poverty

Despite strong growth in recent years, unemployment is expected to rise to 13.5% by the end of 2009. This is partly due to the presence of a large number of foreign workers in expanding sectors of the Jordanian economy, such as manufacturing, telecommunications and construction, as well as a rapidly expanding population with a demographic profile in which 70% of the population are under the age of 30. The government is aiming to boost employment in SME's by instigating a development and employment fund, while a more sustainable reduction in youth unemployment will require increased investment in education and further market reforms. In this respect, Jordan has continued to improve the environment for business development. Jordan ranked 100 out of 183 economies in the 2010 Doing Business Report, improving by four ranks from 2009. Jordan's improvement was mainly due to improvements in regulations dealing with construction permits, trading across borders and enforcing contracts

The official poverty rate is 14.5%. The Jordanian authorities are adopting a local development approach to poverty reduction co-ordinated by a central committee. A draft social security law aims to reform the pension system by dissuading early retirement and raising the retirement pension. It will also introduce universal social security insurance for all workers by 2011, as well as maternity and unemployment allowances. A large house-building initiative aimed at low-income families, comprising 120,000 units over five years, was launched in February 2009.

Table III.8.1:

Jordan - Main economic indicators

	2006	2007	2008	2009	2010 proj,
Real sector					
Real GDP growth (% change)	8.0	6.6	5.6	3.1	3.0
Inflation (consumer price, year average)	6.3	5.2	3.8	2.7	2.5
GDP per-capita (EUR)	1816	1989	2336	2317	2466
GDP per-capita (USD)	2558	2802	3290	3263	3473
GDP (Jordanian dinar, billion)	10.5	11.7	14.2	15.6	15.6
GDP (EUR, billion)	10.5	11.7	14.2	14.6	15.8
GDP (USD, billion)	14.8	16.5	20.1	20.6	22.2
Social indicators					
Unemployment (off, registered, average, %)	13.2	13.1	12.7	13.5	13.6
Domestic population growth (%)	2.3	2.3	2.3	2.3	2.3
Human development index	0.769	0.77			
Population (in million)	3.4	1.7	3.3	3.2	1.6
Fiscal sector					
General government revenues, excl, grants (%GDP)	30.5	30.1	27.5	28	27.4
General government expenditures (% GDP)	37.5	38	37.1	39.9	38.2
General government balance, incl, grants (% GDP)	-7.0	-7.9	-9.6	-11.9	-10.8
Net public debt (% GDP)	69.6	67.5	60.5	70.3	73.2
External and Monetary sector					
Broad money (% change)	14.1	10.6	17.3	7.1	7.7
Current account balance, incl off. transfers (% GDP)	-10.6	-17.7	-11.7	-6.2	-5.3
Trade balance (% GDP)	-33.9	-39.0	-35.5	-26.8	-25.3
FDI (net, % GDP)	22.1	11.5	11.8	8.5	8.5
Remittances (% GDP)	15.3	15.5	14.7	14.0	14.0
Import cover of reserves (months)	5.1	4.7	5.8	5.2	4.8
External vulnerability					
External public debt (% GDP)	53.9	50.6	33.8	33.1	31.4
Gross reserves (USD, billion)	7.0	7.9	8.9	11.4	11.7
Financial sector					
Exchange rate (JOD per USD, period average)	0.71	0.71	0.71	0.71	0.71
Exchange rate (JOD per EUR, period average)	0.94	1.04	0.99	1.05	0.98
Real effective exchange rate (% change, + is apprec,)	0.6	-2.5	5.5		

Sources: Ministry of Finance Jordan, IMF, World Bank, EIU and Commission

9. LEBANON

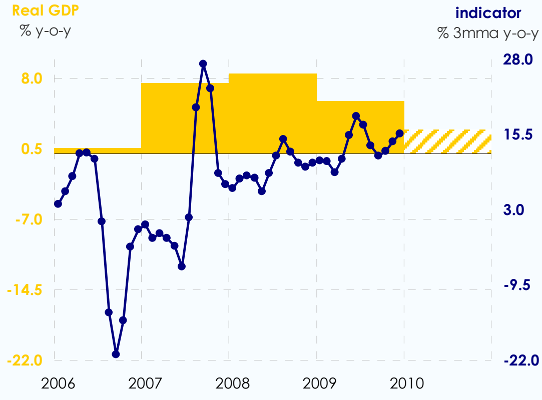
- ***In 2009 economic growth remained fairly strong against the background of a difficult global environment.***

- ***Capital inflows boost bank balance sheet and reserves and help sustain buoyant conditions in financial services and construction. By contrast, traded sectors negatively affected by the crisis.***

- ***Public finances remain vulnerable in view of high deficit and debt.***

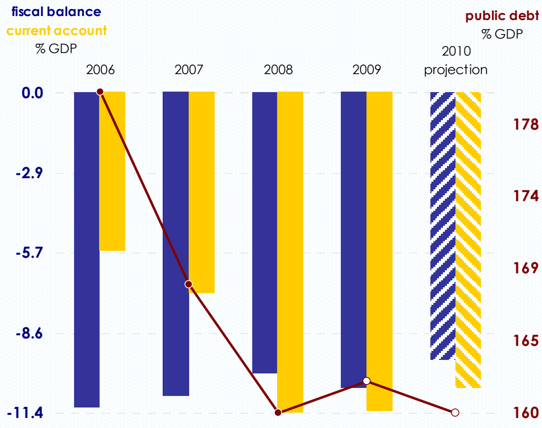
- ***Limited progress in structural reforms reflects uncertain political situation.***

Graph III.9.1: **Lebanon - GDP-growth and coincident indicator**



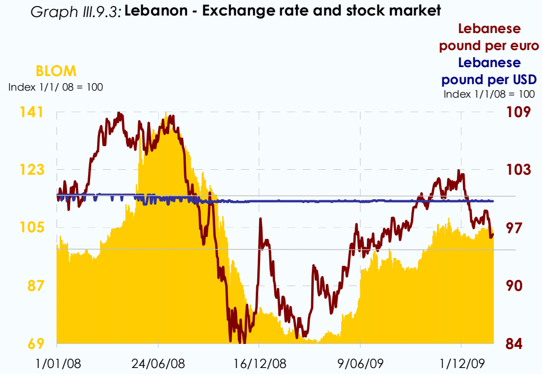
Source: ECOWIN and Lebanese authorities.

Graph III.9.2: **Lebanon - Fiscal balance, public debt, current account**



Sources: Ministry of Finance Lebanon, IMF, WB and Commission.

Graph III.9.3: **Lebanon - Exchange rate and stock market**



Sources: ECOWIN Reuters.

Macroeconomic and financial developments

The latest economic indicators show a quite robust performance of the Lebanese economy in spite of the global financial crisis. Real GDP growth is estimated at 5.5% on average in 2009, from 8.5% in 2008. Leading indicators show expansion of activity into the last quarter of 2009. This to no small degree reflects the fact that the financial sector proved remarkably resilient to the politically uncertain environment, with a government of national unity only formed towards the end of 2009, and the global crisis. The high number of visitors from abroad around the elections also boosted domestic expenditure. For several industries the negative impact of the global financial crisis was increasingly felt towards end-2008, in the first instance via external transmission channels. Trade volumes decelerated from the beginning of 2009 onwards, mirroring the slowdown in major trading partners, notably Arab countries and the countries in the European Union, which account for around 50 and 17 percent of Lebanese exports respectively. Persistent high interest rate spreads to international benchmarks kept financing costs up. Moreover, from the second half of 2008 onwards, remittance inflows fell back in view of the slowdown in countries where Lebanese expatriates had been working.

But several other factors acted in support of the economy. Inflationary pressures abated sharply from the latter part of 2008 onwards, as commodity and global trade prices fell. Consumer price inflation as measured by the CPI fell from more than 10% in 2008 to around 1% in 2009. In addition, despite a clear negative impact of the crisis on tradeables industries (exports contracted by 18%) the Lebanese banking system has so far been quite resilient. Lebanese banks have long-standing experience in operating in a strained economic and political environment, have had high liquidity buffers, limited exposure to structured products under long-standing prudential directives by the central bank supervisors, and have not borrowed heavily on international markets – if only because of Lebanon's impaired investor status. Relatively high deposit interest rates helped attract funding inflows in the aftermath of the global financial crisis, partly reflecting regional portfolio shifts in a relative flight to yield and certainty. Share prices also recovered from the trough in spring 2009, in line with global trends.

Thus, Lebanon registered substantial capital inflows. Deposit inflows were sustained despite a continued fall in interest rates and were partly diverted into real estate but did not translate into an acceleration in domestic credit growth to the private sector. The strong surge in financial inflows helped push reserves to record levels, further bolstering the credibility of the exchange rate peg. Deposit growth helped domestic banks (who are the largest creditor group to the government) absorb high-yielding government bonds, even though the weakness of lending opportunities and the excess of remunerated liquidities impacted negatively on bank profitability. This was partly mitigated by the government borrowing beyond its needs, as reflected by the growing gap between the gross and net public debts. Ample liquidity enabled extending state borrowing to longer maturities in the yield curve (5-year T-bills in Lebanese pounds and 5 and 15-year Eurobond issues that were finally launched early December 2009, yielding 5.875 and 7% respectively).

On the back of moderating growth, the current account deficit is broadly stabilised in 2009, at around 11% of GDP. The total external debt ratio declined only moderately in the last few years, to 187% of GDP in 2009. The elevated external debt ratio goes hand in hand with a high public deficit and debt. Despite buoyant fiscal revenue (up by around 20%) on the back of strong economic activity, the government budget balance (including grants) is expected to have broadly stabilised at around 10% of GDP in 2009, partly reflecting substantial increases in pension outlays and other government expenses. Total public expenditure increased by around 15%, of which is a large part is going to service the public debt. The relatively high interest rate spreads which helped support capital inflows, is thus weighing on the government budget. International support did help alleviate the pressure on public finances. This included the first tranche of grants and loans (€15 and €25 million respectively) under the EU macro financial assistance (MFA) facility (payments were made in December 2008 and May 2009 and will be primarily used for debt reduction).

Risks and outlook

In 2010 real GDP growth is expected to slow down to slightly above 2%, in response to the fading out of several factors that supported growth in 2009, such as financial portfolio shifts and the strong surge in tourist receipts in the run-up to the parliamentary elections. The high cost of credit will weigh on private consumption and investment spending. Inflation would pick up moderately to 2.4 on average in 2010, largely in response to rising commodity prices. Key fiscal ratios are not expected to improve markedly, whereas the deficit on the current account is projected to remain at around 10% of GDP.

Despite the overall resilience of the Lebanese economy to global headwinds in 2009, the economic situation remains vulnerable on several counts. Apart from political risks and the general uncertainty on the strength of the global upswing, these relate to the high public and external debt, the reliance on just a few sectors to provide the bulk of growth, uncertainty about the persistence of foreign inflows in a situation where banks continue to have maturity mismatches, and possible inflation risks also in view of rising commodity prices. Some downside risks to economic growth are further posed by possible base effects related to.

Direct financial stability risks are mitigated by the current strong reserve base, substantial gains in deposits, and continued high liquidity ratios in the banking sector, factors which also boosted the credibility of the currency peg. The sustainability of financial flows and diversification of assets remain important challenges, however. The fiscal situation remains vulnerable and a source of ongoing concern. Ample liquidity in the financial sector so far helped sustain demand for government bonds, but a slowdown in deposit growth with commercial banks could tighten financing conditions for the government. But in the absence of reforms the narrow tax base limits the scope to improve the structural fiscal balance and to reduce the large public debt overhang. Government finances remain exposed to deteriorating overall economic conditions.

Policy reforms and measures

Implementation of the reform agenda outlined in the Paris III programme stalled against a background of deep political divisions and consequent paralysis of legislative activity in the run-up to the June 2009 parliamentary elections and during the protracted subsequent negotiations on forming a new government.

Still mainly as a reflection of the long-lasting political stalemate, no meaningful progress was made on key reforms such as changing the heavily subsidised electricity subsidy system and passing the draft laws on WTO-related issues, pension reform, capital market reform and public procurement. Large privatisation projects, notably for mobile telephony and electricity supply, have been put on ice, reflecting ongoing uncertainty about market conditions. A 25% stake in the national air carrier MEA, held by the central bank, was announced to be floated in 2010.

More generally, many impediments to a conducive business climate remain unresolved. Hence, the ranking of Lebanon according to several business climate measures remained poor in comparison with regional peers, which made progress in recent years. The central bank progressed in improving operating procedures in financial services and adopting International Financial Reporting (IFRS) standards [check and update concrete measures]. In view of the large weight of the financial sector in the Lebanese economy, international agreements on actions to improve oversight and reduce systemic risk in the global financial sector will have an impact in the years to come. Against this background the Banque du Liban and IMF agreed to have a new Financial Stability Assessment in 2010. This would be valuable to identify vulnerabilities in the Lebanese financial system and to benchmark against new standards of oversight that were being implemented internationally. The high interest rates charged by commercial banks on domestic loans reflect the high spreads against international interest rate benchmarks that support deposit and reserve inflows. Spreads are in part mirroring risk premia and heavy government borrowing. However, the ensuing high interest rates hinder lending to domestic industries, in particular small and medium-sized enterprises.

With respect to public finance management, progress with improving budgetary planning and control has been limited. This concerns measures aimed at improving budget formulation and execution as well as plans to improve cash management and implement a single treasury account.

With the new government in place, it is crucial that the authorities proceed with reviving the stalled reform agenda. This with a view to make growth in the country less dependant on a few industries only, such as finance, and to develop growth potential in other sectors. Despite relatively favourable macro-economic developments in the last year, the fiscal deficit and public debt remain high and progress with fiscal consolidation to reduce the hefty burden of public debt service remains a key priority to ensure sustainability.

Social development and poverty

The latest available figures of Ministry of Social Affairs and the United Nations Development Program date back to 2004. It was estimated that nearly 28% of the population (approximately 1 million Lebanese) qualified as poor, with 8% (300 000 individuals) living in extreme poverty. The crisis on the whole led to an increase in income inequality, which the September 2008 minimum wage rise could only partly mitigate. The need for social safety nets need is thus increasing in view of the rise in inequality. Since taxes weigh largely on consumption, lower income strata face a relatively high tax burden.

Table III.9.1:

Lebanon - Main economic indicators

	2006	2007	2008	2009 prel.	2010 proj.
Real sector					
Real GDP growth (domestic currency, % change)	0.6	7.5	8.5	5.5	2.5
GDP (Lebanese pounds, trillion)	33.8	37.7	44.2	49.3	52.8
GDP (EUR, billion)	17.8	18.2	19.9	23.5	24.2
GDP per-capita (EUR)	4350	4450	4859	5587	5751
Inflation (consumer price, average)	5.6	4.1	10.8	1.1	2.4
Social indicators					
Life expectancy at birth (years) [1]	71.5				
Adult literacy (% ages 15 and older) [2]	86.6				
Resident population (million) [1,2]	4.1	4.1	4.1	4.2	4.2
Income inequality (Gini nom. consumption, %) [2]	37.0				
Human development index					
Fiscal sector					
General government revenues, incl. grants (% GDP)	25.1	24.4	24.8	26.2	13.0
General government expenditures (% GDP)	36.3	35.2	34.7	34.2	35.7
General government balance, incl. grants (% GDP)	-11.2	-10.8	-10.0	-10.5	-9.5
General government primary balance incl. grants (%GDP)	1.7	1.8	1.4	1.1	1.1
Gross public debt (% GDP)	180	168	160	162	160
Monetary sector					
Broad money (% change) [3]	8.7	13.3	14.2	18.2	
Commercial bank assets (% GDP)	331	329	322	347	
Degree of monetisation (M4/GDP, %)	250	254	248	262	
Dollarisation of deposits (%)	76.2	77.3	69.6	64.5	
External sector					
Current account balance, incl. official transfers (% GDP)	-5.6	-7.1	-11.4	-11.3	-10.5
Trade balance goods and services (% GDP)	-13.5	-18.2	-18.7	-16.0	
FDI (net, % GDP)	11.9	7.5	8.9	8.0	
Import cover of reserves (months)	6.6	4.9	7.7	9.7	
External vulnerability					
External debt (% GDP)	199	194	187	187	
External public debt (% GDP)	90	85	81	85	
Gross reserves (EUR, billion)	15.5	14.4	17.6	24.9	
Financial sector					
Government's Eurobond rate (marginal)	7.5	8.7	8.6	8.0	
Two-year T-bill yield	8.7	8.7	8.4	6.7	
Exchange rate (L£ per EUR, period average)	1894	2066	2218	2095	
Exchange rate (L£ per USD, period average)	1508	1508	1508	1508	
Real effective exchange rate (% change, + is apprec.)	2.2	-4.6	1.3		
Stock market index	1185	1502	1178	1319	

[1] 2005

[2] 2004

[3] Resident population, except those living in Palestinian refugee camps

[3] Defined as M4 (currency in circulation plus resident and non-resident deposits plus T-bills held by non-banks).

Sources: Ministry of Finance Lebanon,Banque du Liban, IMF, World Bank and Commission.

10. LIBYA

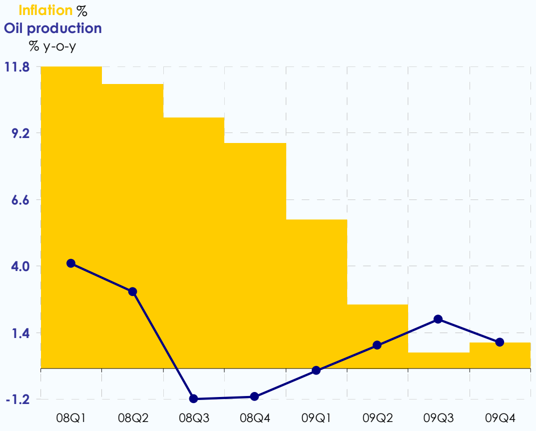
- ***The impact of the global crisis on Libya was mild and limited to a decline in oil revenue.***
- ***However, fiscal and external balances shrank markedly highlighting Libya's overdependence on oil price shocks.***
- ***Progress in macroeconomic policies was significant but development of the private sector economy remains a challenge.***

Macroeconomic and financial developments

The global economic crisis had only a mild impact on the Libyan economy. The main reason for this was the lack of exposure of domestic banks to the global financial system and the presence of liquidity arising from the recycling of oil revenues. In addition, Libya's foreign assets consisted mainly of foreign reserves and of bank deposits abroad, which meant that they were sheltered from turbulences in global equity markets. Nevertheless, GDP declined in 2009 to around 2.1%, broadly due to an expected 1.5% reduction in oil production. However, major public expenditure on infrastructure projects, mainly on construction utilities and transport, helped to sustain non-oil growth at around 6%.

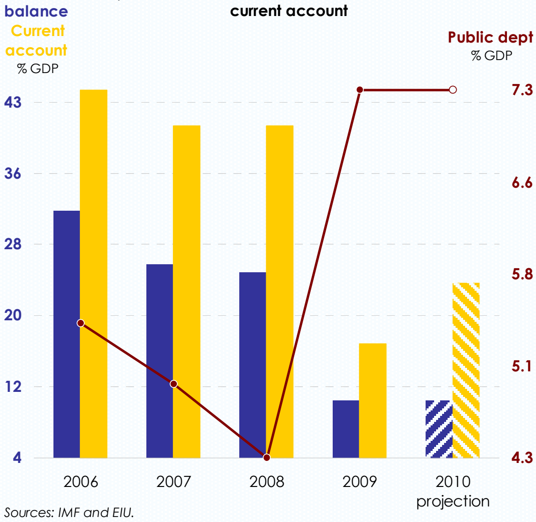
Fiscal surplus narrowed significantly in 2009 as a result of the lower average oil prices, leading to revenue loss. Public expenditures were slightly reduced as the government decided to delay some projects and to reduce some subsidies. Nevertheless, wage expenditures grew by around 14% with the return to the civil sector of public employees who were about to be transferred to the private sector as part of a plan that was later abandoned. Further spending under the Wealth Distribution Programme (WDP), which was launched in March 2008 to distribute part of the oil wealth to the population and to reduce the size of the government, has been put on hold over concerns about its potential impact on inflation and the provision of basic public services. Also significant is the higher expenditure on external grants to African lower-income countries as part of Libya's strategy to increase its influence in many African countries.

Graph III.10.1: **Libya - Inflation and oil production**



Source: EIU.

Graph III.10.2: **Libya - Fiscal balance, public debt and current account**



Sources: IMF and EIU.

Graph III.10.3: **Libya - Exchange rates**

Sources: ECOWIN Reuters.

Inflation fell to an estimated average 2.5 % in 2009 from 10.4 % in 2008 as the domestic demand and commodity prices decreased. The lower food prices were particularly important in cutting inflation as Libya imports around 90 % of the food products it consumes. In response to the moderate economic slowdown, the Central Bank of Libya reduced the interest rate on its discount facilities and CDs. The former was reduced by 100 basis points (to 4 %) and the latter by 75 basis points (to 1.75 %) in April 2009. Lending rates turned positive in 2009 with the decline in inflation.

The Libyan dinar weakened during December 2009 and January 2010, having strengthened since March, and inflation accelerated. The dinar is pegged to the SDR and is managed through tight official controls. Libya's huge stocks of foreign reserves — USD 103 billion at the end of December 2009 — mean that the authorities will be able to defend the exchange-rate regime should there be any pressure on the currency in the near future.

Libya's current account is dominated by hydrocarbons, which account for 95 % of total exports. As a result of the fall in oil prices and the stable level of imports, sustained by demand for inputs for infrastructure projects, current account surplus narrowed to around 16.8 % of GDP in 2009 from some 40.7 % of GDP in 2008.

Risks and outlook

Libya's economic growth and financial position are expected to strengthen in 2010 as a result of the global economic recovery, the ongoing upgrade of the infrastructure and the projections for higher oil prices. In that case, overall GDP growth could reach 5 % and the fiscal surplus could increase to around 15 % of GDP. However, this outlook is subject to downside risks should global recovery turn out to be not as strong as expected and oil prices decline to around USD 60 per barrel. The overdependence of the Libyan economy on oil and its vulnerability to price shocks remains the biggest challenge. Investments and imports related to oil and gas are expected to grow provided that foreign investors are not deterred by threats of nationalisation or regulations designed to give the Libyan government greater control over oil assets. To this end, efforts to diversify the economy should continue, while the emphasis should be put on the quality and composition of public expenditure on the necessary infrastructure projects.

Inflation is expected to increase to 4.5 % in 2010 as subsidies are cut, consumer confidence returns and higher oil revenue boosts domestic liquidity. The effectiveness of monetary policy should therefore be enhanced with new monetary instruments and changes in the scope of Specialised Credit Institutions, which are crowding out commercial banks' credit, and with moves to make the economy less sensitive to the level of interest rates.

In 2010 the current account surplus is expected to grow to 23 % of GDP from around 16 % in 2009, driven by increases in oil production and the higher level of oil prices. Net foreign direct investments are expected to turn positive in 2010, reflecting the recovery in investment confidence, provided that uncertainty over policy-making vis-à-vis foreign companies does not continue.

Policy reforms and measures

Economic reform in Libya has been limited as regards the diversification of the economy and the development of the private sector, with the exception of the privatisation of two banks. Nevertheless, Libya has recorded several improvements in different aspects of its macroeconomic policy. Progress has been made in customs and tax administration with the establishment of large taxpayer units and the automation of customs inspection. However, import duties have been increased from 4 % to 10 %, and corporate tax is not universal and can be up to 45 % in some cases. Steps to improve monetary policy have been taken with the introduction of CDs by the Central Bank on a weekly basis for single maturity (91 days) at a fixed rate. Efforts are also being made to contain lending by Specialised Credit Institutions by reducing their funding from the state budget to leave more space for commercial banks. The Central Bank also receives technical support from the IMF to boost its research, forecasting and monetary policy implementation capabilities. Banking supervision is also being improved in terms of supervision procedures, reporting standards for banks, calculation of prudential ratios, and IT structures. A credit bureau was also established in 2009, and a financial stability report is expected to be produced in 2010.

Progress has been made in Public Finance Management, especially in budget classification and budget unification, and with the establishment of a macro-fiscal unit. Also, the recent merger of the ministries of planning and finance is likely to enhance public expenditure planning, execution and control. However, the establishment of a Single Treasury Account, still not in place, will bring about a major improvement in expenditure control and cash management.

Efforts to improve economic and financial statistics continued with the completion of a household survey and the first moves towards establishing a producer price index. There has also been progress on improving inter-governmental cooperation on external trade and monetary statistics.

The Libyan Investment Authority, which controls the major part of Libya's investments abroad, continued strengthening its regulatory framework and pursuing prudent investment strategies. Some of its investments were channelled to the Libyan oil sector and to the Libyan Development and Investment Fund (around USD 13 billion) for private sector development. Also, the Libyan parliament approved in early 2010 a law establishing tax-free a investment zone along the Mediterranean coast which will allow unrestricted mobility of capital and goods and will grant a ten-year tax exemption.

Foreign reserves, excluding gold, reached a record high of USD 103 billion in December 2009, while ten years ago, just before the easing of international sanctions, they stood at only USD 7 billion. This reflects not only the flow of oil revenues but also the difficulty the government has to absorb and distribute these large cash flows — a fact that also contributed to inflationary pressures.

Social development and poverty

According to unofficial estimates unemployment was around 21 % in 2009, the highest rate in the Maghreb region. Libya's workforce is dominated by the public sector, which employed around one million civil servants in 2009 — some 50 % of the total labour force. The scarcity of scientific and technically-skilled staff remains a core human resource issue, while the employment problem is compounded by the high rate of population growth, which is higher than the rate of job creation. New employment regulations are intended to provide work opportunities for Libyan nationals, reducing both state payrolls and the country's dependence on foreign workers — mainly from central Africa. For example, foreign companies are required by law to train Libyan nationals for more skilled jobs and to provide all local employees with the same benefits as foreign workers. However, other policy intentions, like the potential nationalisation of the hydrocarbons sector or proposed legislation requiring foreign companies to have Libyan nationals as chief executives, create uncertainty among investors and have negative consequences for employment. Despite the poor educational system and the high unemployment rates, many direct and indirect subsidies and free services have helped raise the economic status of low-income families, a policy which has prevented extreme poverty. Consequently, while certain social groups (e.g. top civil servants, military officers and politicians) enjoy much higher living standards than average citizens, Libya is not a highly polarised society divided between extremes of wealth and poverty. Efforts to raise the employment rates of Libyan nationals, along with a possible expansion of private sector activity and even the partial implementation of the Wealth Distribution Plan, which was put on hold, could further improve living conditions in Libya. In any case, Libya has the highest ranking in the UN Human Development Index among African countries and the second highest GNI per capita in PPP in the European Neighbourhood Policy area, according to the World Bank.

Table III.10.1:
Libya - Main economic indicators

	2006	2007	2008	2009 prel.	2010 proj.
Real sector					
Real GDP growth (% change)	5.9	6.0	3.8	2.1	5.4
GDP (EUR, billion)	42.5	48.9	65.5	43.9	53.7
GDP (USD, billion)	56.5	71.7	89.9	59.9	73.2
GDP per capita (EUR)	7208	8023	10567	6973	8353
GDP per capita (USD)	9576	11754	14500	9508	11384
GDP (Libyan Dinars, billion)	72.3	87.6	114.0	78.2	95.6
Inflation (average, %)	1.4	6.2	10.4	2.5	4.5
Social indicators					
Unemployment (off. registered, average, %)		17.0	20.7		
Life expectancy at birth (years)	73.6	73.8			
Adult literacy (% ages 15 and older)	86.2	86.8			
Population (annual growth rate %)	1.9	1.9	1.9	1.9	1.9
Human development index	0.840	0.847			
Population (in millions)	5.9	6.1	6.2	6.3	6.4
Fiscal sector					
General government revenues (% GDP)	62.4	60.8	64.0	66.5	64.9
of which: Oil - revenues (% GDP)	57.5	54.5	57.4	53.3	52.9
General government expenditures (% GDP)	31.0	35.3	39.3	55.9	49.1
Overall balance, (% GDP)	31.4	25.5	24.6	10.6	15.8
Non - oil balance (% GDP)	-26.2	-29.0	-32.7	-42.6	-37.2
Non - oil balance (in % of non-oil GDP)	-135.3	-136.0	-165.8	-131.8	-124.6
General government debt (% GDP)	5.4	4.9	4.3	7.3	7.3
Monetary sector					
Broad money (M2, % change)	16.0	40.1	47.8	14.0	18.0
Credit to the economy (% change)	11.6	14.5	12.5	13.7	15.6
Net credit to the government (% change)	-60.9	-22.2	-17.7	-16.5	-15.8
External sector					
Current account balance (% GDP)	44.6	40.7	40.7	16.8	23.5
Trade balance (% GDP)	42.9	38.5	42.0	19.7	26.8
Oil exports (in USD million)	38.2	45.8	60.7	36.2	44.0
Oil exports (in % GDP)	67.6	63.9	67.5	60.4	60.1
FDI (net, % GDP)	2.6	1.1	-2.0	2.1	2.0
External vulnerability					
Total external debt (% GDP)	8.7	9.1	8.9	17.0	17.0
Net international reserves (USD, billion)	52.7	48.5	49.4	53.4	57.6
In months of next year's imports)	31	22.9	22	22	22
Total foreign assets (in USD billion)	74.8	98.3	136.1	147.4	166.1
Financial sector					
Lending rate (average, %)	6.3	6.0	6.0	6.0	
Exchange rate (LD per USD, mid FY)	1.28	1.22	1.25	1.21	
Exchange rate (LD per EUR, mid FY)	1.70	1.79	1.74	1.78	
Real effective exchange rate (%, + is apprec.)	-0.6	-0.3	6.0	8.2	

Sources: IMF, EIU, EUROSTAT and Commission.

11. MOLDOVA

- ***The global crisis triggered a severe economic downturn.***

- ***The incoming government adopted a national recovery plan to weather the downturn; international assistance is needed to cover the financing gap.***

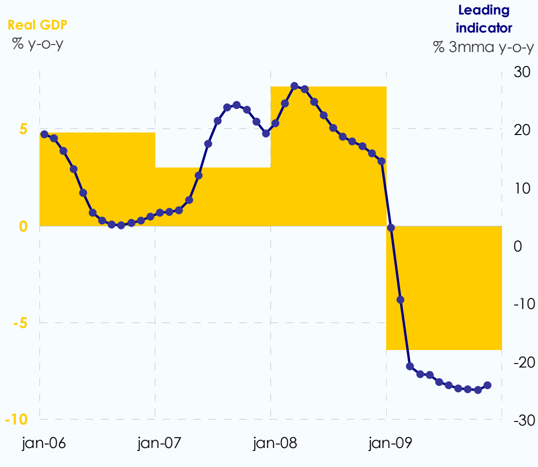
- ***Many challenges remain for the reform agenda.***

Macroeconomic and financial developments

The Republic of Moldova is one of the countries in the Eastern neighbourhood hardest hit by the global recession. Moreover, political uncertainty delayed the policy response to the crisis, as in July 2009 repeat parliamentary elections were held, following the contested ballot in April. In September, a new coalition government uniting the four non-communist parties took office. However, no sufficient majority could be achieved to elect a president, meaning that a fresh parliamentary election may have to follow (but the date is uncertain).

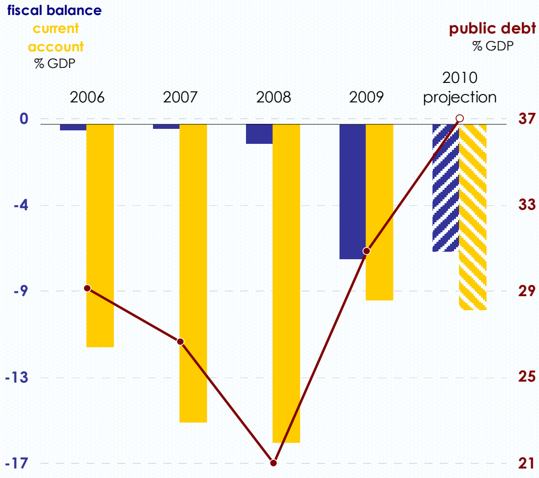
In 2009, real GDP shrank by 6.5%, which is in sharp contrast with the 7.2% GDP growth in 2008. External shocks due to the global crisis, such as falling remittances and FDI inflows and the slump among main trading partners (Russia, Ukraine, Belarus and the EU) were the main transmission channels. The crisis started affecting the economy already in the last months of 2008. In 2009, a broad-based downturn occurred. Private consumption declined by 7.9% and fixed capital formation even by 31.3%. Exports also fell substantially while imports decreased even more sharply, in line with the slump in domestic demand. With the trade balance improving due to imports contracting faster than exports, the current account deficit decreased markedly, from around 16% of GDP in 2008 to 9% of GDP in 2009. But external financing sources fell even sharper than the current account deficit, with remittance inflows lower by nearly 30% in 2009, while foreign direct investment nearly halved. In 2009, industrial production declined by around 22%. The ensuing fall in real incomes

Graph III.11.1: **Moldova - GDP and industrial production**



Sources: ECOWIN Reuters.

Graph III.11.2: **Moldova - Fiscal balance, fiscal debt, current account**



Sources: Moldovian authorities and IMF.

Graph III.11.3: **Moldova - Exchange rates**

Sources: ECOWIN Reuters.

was partly cushioned by the rapid deceleration in prices. CPI inflation decreased from around 16% in the second quarter of 2008 to -2.3% in August 2009, before picking up again to 3.0% in February 2010.

The fiscal situation has deteriorated quickly since the middle of 2008, despite expenditure cuts of around 20% across the board decided in spring 2009. Substantial revenue shortfalls largely reflected the strong reduction in imports as a key source of revenue, which were only partly offset by lower-than-budgeted expenditures and rectifications implemented by the new government. The government deficit reached 6.9% of GDP in 2009, against 1% of GDP in 2008. As a result of the double external shock on trade and remittances, pressures on the national currency built up. The National Bank of Moldova (NBM) was, however, able to partly counter these pressures by using some of the country's official reserves. These were reduced between September 2008 and April 2009 by nearly 40%. The bulk of this reduction took place in the first part 2009. Subsequently, the exchange rate of the Moldovan leu versus the US dollar (the traditional anchor currency) stabilised and reserve levels gradually started increasing again. After a soft spell in September 2009 the exchange rate against the dollar weakened again by around 15% from early December 2009 onwards. In order to counter the impact of the crisis, monetary policy was eased substantially, despite concerns about the exchange rate. Between September 2008 and September 2009, the NBM cut its main refinancing rate from 18.5% to 5.0% while reserve requirements were also reduced drastically. However, in late January 2010, the NBM raised the base rate to 6%, due to an increased risk of overshooting the inflation target.

On 29 January 2010 the IMF Executive Board approved three-year arrangements for Moldova under the Extended Credit and Extended Fund facilities. The IMF assistance is equivalent to SDR 369.6 million (around USD 574 million) and is intended to help restore fiscal and external sustainability. IMF assistance is linked to the implementation of adjustment measures and structural reforms. As part of the coordinated assistance efforts of international institutions, the World Bank is preparing a Development Assistance operation directed towards supporting post-crisis growth. The European Commission is preparing a proposal for a package of macro financial assistance to close the residual financing gap which is estimated after the contributions by the Bretton Woods institutions. In addition, the United States pledged substantial medium-term funding to finance overdue improvements in infrastructure. However, details of this pledge in terms of timing, projects and conditions still have to be filed in.

Risks and outlook

The outlook for the Republic of Moldova in overcoming the unsustainable budgetary and external starting position is challenging. The expected recovery among main economic partners will only be gradual. Moreover, external financing conditions remain difficult. Thus, after the sharp adjustment in 2009, the economy is expected to recover only slowly in the years ahead. The latest business cycle indicators point to a stabilisation in economic activity towards the end of 2009. From October onwards, industrial production data even show an incipient recovery from the very deep slump that began in the second half of 2008. For 2010, real GDP growth is expected to be 2%. Macroeconomic stabilisation would lead to an improvement in the government balance (6.5% of GDP deficit with the 2010 budget containing several measures to raise revenue and curtail expenditure). The government debt level is expected to rise to nearly 40% of GDP, whereas the current account deficit would remain at around 10% of GDP. Inflation is projected to rebound to around 6% on average in 2010, reflecting the pass-through of depreciation and the marked increase in indirect taxes and utility tariffs. As inflows in the financial account are not expected to increase markedly, this results in substantial external financing needs which in the near term need to be partly covered by international assistance.

Downside risks to the recovery remain. The budget in particular remains highly vulnerable. Successful macro-economic stabilisation as a stepping stone to sustainable positive growth is contingent on implementation of a comprehensive reform agenda, aimed at promoting economic diversification and market integration, and improvements to the business environment and public and private governance. During the next couple of years financial assistance from the international community will be crucial in achieving the turnaround.

Policy reforms and measures

In the first part of 2009, in the extended period surrounding the repeated parliamentary elections, fiscal policy was not adjusted, despite the rapid economic slowdown. Crucial structural reforms initiated in 2008 and early 2009 were also put on hold.

The incoming government announced an ambitious reform programme of deregulation to relaunch economic recovery and boost potential growth, the programme being designed with a view to supporting international assistance. The 2010 budget includes several adjustment measures aimed at reducing the deficit. On the revenue side, taxes were increased for gambling and diesel-powered and luxury cars, the road tax was increased and excise duties were raised substantially for petrol (+50%), beer (+25%), other alcoholic beverages (+3.1%), and cosmetics. Local taxes will also be higher, whereas the real estate tax will be levied on the market value of properties, not on the book value. In addition, utility tariffs were raised to bring them to cost recovery levels. This entailed sharp increases for the costs to households of gas (16.5%), heating (29%) and electricity (20%) as of January 2010. On the expenditure side, several measures were implemented too. Public employment will be reduced and early retirement options curtailed for civil servants, while public sector wages are set to increase less than had been originally planned by the previous government.

Announced reforms further include simplifying the procedures to register, start and wind up a business and to obtain construction permits. The intended overhaul of the pension and social security schemes includes extension of the obligation to pay social security contributions to all employees. The statutory pension age (currently 62 for men and 57 for women) will not be raised, however.

As regards monetary and exchange rate policy, the National Bank of Moldova announced a redefinition of its medium-term strategy for the period 2010-2012, which has the maintenance of price stability as its chief objective. For 2010, the central bank announced an inflation target of 5.0% with a deviation band of ±1 percentage point. The NBM's policies will be gauged in quarterly Monetary Policy Reports, the first of which was published in February 2010.

Social development and poverty

As Moldova is relatively poor the impact of the recession on living standards is acute. Unemployment has risen and the economic slowdown implied decreases in purchasing power which affected the most vulnerable strata of society. With a GDP per capita of around 1 000 euros, about 30% of Moldova's population live in absolute poverty and 4.5% live in extreme poverty. The average amount of pensions received by pensioners is only about half of the official subsistence level (although many pensioners are likely have some additional form of income). Social spending thus remains a major component of public expenditure. As the economic adjustment programme encompasses measures to substantially increase utility tariffs and streamline subsidies, targeted compensations for the most vulnerable groups in society have been put in place. The compensation schemes for heating costs chiefly targets families receiving social assistance and public sector workers and pensioners with salaries and pensions under a certain threshold. For the year 2010 heating costs compensations will be partly covered by one-off earmarked EU assistance of 2.4 million euro under the ENPI 2007 social sector budget support, to be disbursed under the condition that the bylaws putting in place the compensation distribution scheme are put in place In order for the authorities to be able to set up an integrated system of targeted social assistance, administrative procedures for targeting (such as means testing) have to be improved or developed.

Table III.11.1:

Moldova - Main economic indicators

	2006	2007	2008	2009 prel.	2010 proj.
Real sector					
Real GDP growth (domestic currency, % change)	4.8	3.0	7.2	-6.4	2.0
Industrial production volume (% change)	-4.8	-1.3	1.5	-22.2	n.a.
GDP nominal (EUR, billion)	2.7	3.2	4.1	3.9	3.5
GDP per-capita (EUR)	757	902	1160	1091	979
Inflation (average)	12.8	12.4	12.8	-0.2	6.2
Inflation (end-year)	14.0	13.3	7.2	0.5	6.5
Social indicators					
Unemployment (ILO definition, %)	7.4	5.1	4.0	5.5	n.a.
Population (millions)	3.6	3.6	3.6	3.6	n.a.
Poverty rate (% of population)	30.2	n.a.	n.a.	n.a.	n.a.
Fiscal sector					
Total revenues (% GDP)	39.9	41.7	40.6	39.3	38.8
Total expenditures (% GDP)	40.2	42.0	41.6	46.2	45.8
General government balance (% GDP)	-0.3	-0.2	-1.0	-6.9	-6.5
Gross public debt (% GDP)	29.2	26.8	21.3	30.9	36.9
Monetary sector					
Domestic credit to the private sector (% GDP)	30.7	39.1	39.9	39.8	n.a.
Domestic credit to the private sector (% change)	37.8	51.7	20.3	-4.9	n.a.
Broad money (M2, % change)	12.2	47.3	18.4	-6.0	n.a.
Degree of monetisation (M2/GDP, %)	27.9	34.5	34.6	34.1	n.a.
Dollarisation in bank deposits (%)	49.1	43.3	31.3	43.8	n.a.
External sector					
Current account balance (% GDP)	-11.4	-15.3	-16.3	-9.0	-9.5
Trade balance (% GDP)	-48.2	-53.3	-52.8	-36.6	n.a.
FDI (net, % GDP)	7.4	11.2	11.8	6.4	n.a.
Remittances (% GDP)	34.4	33.9	31.2	22.5	23.6
External vulnerability					
External public and private debt (% GDP)	74.1	64.2	56.0	65.9	n.a.
External public debt (% GDP)	25.2	20.9	15.5	14.4	n.a.
International reserves (USD, million)	775	1334	1672	1456	n.a.
Financial sector					
Real effective exchange rate (%, + is apprec.)	-5.7	16.0	23.3	-19.7	n.a.
Exchange rate (Moldovan leu per EUR, avg)	16.5	16.5	15.2	15.5	n.a.
Exchange rate (Moldovan leu per USD, avg)	13.1	12.1	10.3	11.1	n.a.

Sources: authoritiesof Republic of Moldova, IMF, EBRD, WB, NBM, Commission services.

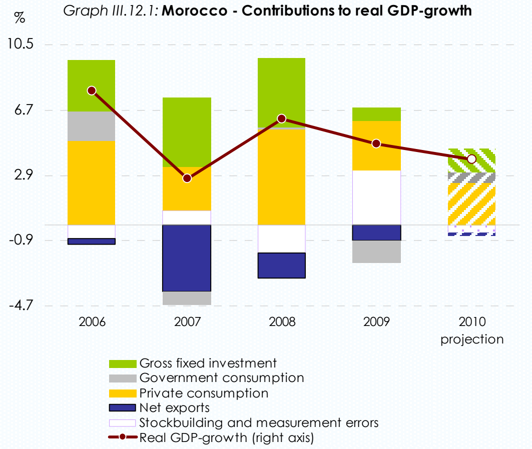
12. MOROCCO

- ***GDP Growth slowed to 4.5% in 2009 as the Moroccan economy felt the impact of the global economic crisis through a drop in exports and inward investment.***

- ***After registering a mild surplus in 2008, the general government balance turned slightly negative in 2009 mainly on account of lower tax revenues from slowing economic activity. The government has targeted a deficit of 2.9% of GDP for 2009 which appears achievable.***

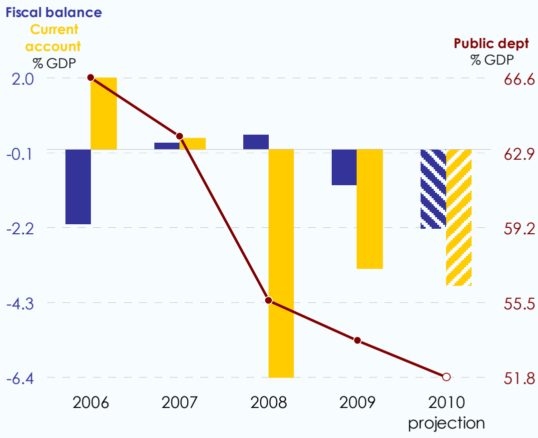
- ***The Moroccan economy is still held back by social factors such as high levels of rural poverty and illiteracy which need to be addressed to support economic diversification and long term growth.***

Graph III.12.1: **Morocco - Contributions to real GDP-growth**



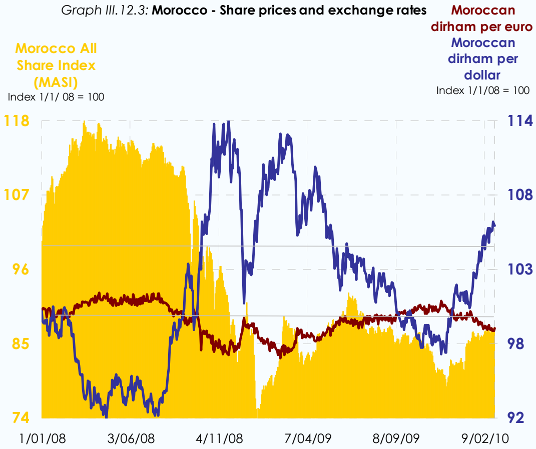
Sources: Haut Commissariat au Plan.

Graph III.12.2: **Morocco - Fiscal balance, public debt, current account**



Sources: Moroccan authorities.

Graph III.12.3: **Morocco - Share prices and exchange rates**



Sources: ECOWIN Reuters.

Macroeconomic and financial developments

The Moroccan economy grew strongly in 2008 mainly driven by a strong rise in output of the agricultural sector which boosted private consumption growth. Since the end of 2008, the global economic crisis has had a negative impact on exports, particularly phosphate based products, tourism, remittances and inward investment. In the first half of 2009, exported goods fell 32.2% and tourism revenues by 11.1%. Remittances, which account for nearly 10% of GDP, declined by 12.1% as the employment market in Europe worsened. Offsetting some of the negative impact of the global economic crisis, the agricultural sector continued to grow strongly. The government also proceeded with an extensive social housing programme providing a boost to investment.

Private consumption growth moderated to 5% in 2009 primarily on account of low wage pressure and lower remittances from abroad. On the other hand, firm growth in the agricultural sector averted a stronger slow down. A bumper harvest helped the Moroccan economy weather the crisis. Unemployment continued to fall to a record low level of 9.2%, but could rise again as many of the new jobs are the result of seasonal hiring in the large agricultural sector, which accounts for about 15% of GDP and employs around 40% of the workforce.

Since the end of 2008, the CPI gradually declined due to a reversal in commodity prices and slowing economy activity. After briefly turning negative in the middle of the year, the CPI was on average 2% for the year([1]) from 3.9% in 2008. After raising its key policy rate in September 2008, on account of inflationary pressures, the central bank, Bank Al Maghrib (BAM), reversed the rate hike in March 2009 from 3.5% to 3.25% in order to boost liquidity. To support investment, the BAM gradually lowered the reserve requirement 15% to 8% in 2009.

Pressure on government expenditure for 2009 eased due to falling inflation, in particular oil and food prices, while the government remained committed to a large investment programme in social housing, targeting the construction of 150,000 new housing units per year up to 2013. The government's target of a public finance deficit of -2.9% of GDP in 2009 (excluding privatization receipts) appears comfortably achievable given the economic outlook and the budgetary outturn in the first part of the year. The budget ran a slight surplus in the first half of 2009 pointing to the possibility of a better-than-targeted outturn for the whole year. This reflects a broad based reduction in tax revenue, notably indirect taxation and customs duties, while still in line with the budget. Public debt is set to increase in 2009 to 55% of GDP.

The current exchange rate regime which pegs the MDH to a euro-dominated basket of currencies resulted in the appreciation of the Moroccan dirham in 2008 in line with the EUR-USD exchange rate. Since the start of 2009, the MDH has depreciated 12% against the dollar and remained broadly neutral against the Euro. In spite of pressure for a devaluation of the MDH to improve export competitiveness, the central bank (BAM) continues to see the benefits of using the currency as a macroeconomic anchor and tool against inflation, while gradual steps have been taken to lessen currency controls with the aim of introducing a fully floating currency in the future. The fall in international commodity prices and decline in export goods may encourage further moves in this direction.

([1]) This rate undershoots the government's inflation target of 2.5% for 2009.

The current account deficit narrowed to 4% of GDP in 2009, mainly on account of a marked improvement in the trade balance, given a strong fall in imported goods. This offset a reduction in the services balance, driven by the decline in tourism and lower remittances from Moroccans working abroad. Exported goods fell 27% in Q1 2009, compared to the same period last year, with exports of phosphate based goods falling 65% as a result of a collapse in external demand, while inward investment was down 36%. Over the longer term, action needs to be taken to boost the export base, as the value of exports is still only half the value of imports with a strong concentration of phosphate based goods (16% of all exported goods), leaving the economy vulnerable to an external shock.

Risks and outlook

The weak outlook for European growth will have a negative impact on the Moroccan economy into 2010, as the EU is Morocco’s main export market and where an equivalent of 20% of Morocco's domestic workforce is employed. While export demand may improve in the short term, inward investment and remittances are likely to take longer to recover. The exceptional harvest provided a significant boost to the economy in 2009, but in 2010-11 agricultural performance is likely to be weaker with only modest growth in other sectors. The general government balance is expected to remain in deficit in 2010-11 as revenue growth recovers only modestly and government expenditure looks set to rise with an emphasis on capital investment.

Morocco's financial sector has been relatively unaffected by the fallout from the global financial crisis. Domestic banks are well capitalized with limited exposure to international financial markets partly due to restrictions on capital outflows. The banking sector has a low level of external indebtedness and the rate of non-performing loans is relatively low at 5%. While banking sector indicators remained sound, the proportion of property lending grew by 20% up to October, compared to the same period in 2008 reflecting in part a limited supply of new housing. The government launched several initiatives to more closely monitor the property market. The index of the Casablanca Stock Exchange (CSE) dipped sharply at the end of 2008 but has remained relatively stable through 2009.

The crisis has, however, triggered a series of reforms aimed at boosting the capital market and improving accountability. In January 2009, the Minister of Finance launched a set of proposals aimed at increasing the financial market regulator's independence and improving the management structure of the CSE.([1])

Policy reforms and measures

In the context of a medium-term fiscal framework, the Moroccan government aims to keep the government deficit below 3% of GDP. To support the consolidation, the government plans to reduce the substantial public sector wage which stands at 10% of GDP. All vacant positions will be eliminated by the end of each budget year in future, which is set to have a significant impact given that the increase in the number of civil servants retiring over the medium-term. While the burden of food and fuel subsidies on the budget fell considerably in 2009, in comparison to 2008, this is likely to remain at about 2% of GDP over the medium-term. Therefore, a gradual move to direct subsidies, targeted at the most vulnerable, would increase the efficiency and stability of public expenditure.

In September 2009, a major new reform programme to modernise the fisheries sector was presented. The programme aims to improve the management and international competitiveness of the fisheries sector to exploit growing external demand, including three new fisheries centres in Tangier, Agadir, and Laâyoune-Dakhla. The programme aims to create 20,000 jobs in the fishing industry by 2020.

Social development and poverty

Social problems in Morocco remain acute, although social indicators have improved since the authorities decided to prioritise the fight against poverty. Official poverty dropped from 14% in 2005 to 9% by the end of 2008, although its distribution is highly unequal with strong variations between urban and rural poverty (two-thirds of poor people live in rural areas). An additional 25% of the population living above the poverty line are considered economically vulnerable. Morocco ranks 126th (out of 177 countries) in the UN 2007/08 Human Development Index, between Namibia and Equatorial Guinea, and the lowest of the ENP countries, which highlights its relative human underdevelopment compared to countries with similar GDP per capita.

Although the government allocates over a quarter of government expenditure to education, and enrolment and literacy rates are rising, adult illiteracy still affects almost 40% of the population aged over 15 years old. However, after making steady progress for many years, health indicators have deteriorated: only half of the rural population have access to proper healthcare and less than a fifth have access to sanitation and safe water. Morocco has one doctor per 1800 people (compared to one per 1200 in Tunisia and one per 450 in Jordan and Egypt). These statistics underline the need to develop a comprehensive social protection strategy targeted at the poor, and to continue to improve the quality and participation rates in education.

([1]) These measures include, for instance, allowing companies to buy back their own shares without a minimum set price in the event their share price falls below a certain level, and the possibility for insurance companies to hold up to 60% (instead of 50%) of their listed shares to cover their liabilities. The Oxford Business Group. *Correcting Itself*, 21 January 2009.

Table III.12.1:
Morocco - Main economic indicators

	2006	2007	2008	2009	2010
Real sector				prel.	proj.
Real GDP growth (domestic currency, % change)	7.8	2.7	5.6	2.5	5.0
Non-agriculture real GDP growth (% change)	5.4	7.1	4.0	2.3	4.0
GDP nominal, (EUR billion)	52.3	54.9	60.7	64.6	
GDP nominal, (USD billion)	65.6	75.1	88.9	89.9	96.8
GDP per capita (EUR)	1692	1759	1921	2079	
GDP per capita (USD)	2124	2407	2812	2892	3164
Inflation CPI (period average, % change)	3.3	2.0	3.9	1.8	2.3
Social indicators					
Unemployment (off. registered, average, %)	9.7	9.8	9.5	9.2	9.8
Domestic population (million)	30.9	31.2	31.6	32.0	32.3
Population growth (%)	1.3	1.0	1.3	1.3	0.9
Human Development Index (most recent)		0.654			
Fiscal sector					
Total government revenue (% GDP)	26.8	27.4	29.5	25.3	24.7
Total government expenditure (% GDP)	28.9	27.2	29.1	26.3	26.9
Government balance (% GDP)	-2.1	0.2	0.4	-1.0	-2.2
Total government debt (% GDP)	66.6	63.7	55.6	53.6	51.8
Monetary sector					
Credit to the economy (% change)	17.0	29.2	23.4	12.0	10.0
Credit to the economy/GDP (in %)	57.6	69.7	76.9	80.6	84
Broad money (Money + quasi money, % change)	17.2	16.1	10.9	8.0	8.0
Degree of monetisation (M3/GDP, % change)	6.4	7.8	4.7	-4.9	1.0
External sector					
Exports of goods (% GDP)	18.2	20.2	22.9	16.5	16.3
Imports of goods (% GDP)	33.0	39.0	44.8	33.8	33.5
Trade balance (% GDP)	-14.9	-18.9	-21.9	-17.3	-17.2
Current account balance, incl. official transfers (% GDP)	2.0	0.3	-6.4	-3.3	-3.8
FDI flows (% GDP)	3.1	2.9	2.3	3.3	
External vulnerability					
Total external debt (% GDP)	26.3	24.7	22.7	21.9	20.4
Debt service ratio (%)	8.6	8.0	6.5	6.6	6.4
Gross reserves (USD billion)	20.2	24.0	28.2	29.8	29.8
Gross reserves (months of imports)	7.0	6.2	7.5	6.9	6.7
Financial sector					
Short-term interest rate (money market rate, average)	3.3	3.3	3.5	3.2	
Exchange rate (MAD/EUR, average)	11.0	11.2	11.4	11.3	11.1
Exchange rate (MAD/USD, average)	8.8	8.2	7.8	8.1	7.8
Real effective exchange rate (average, percentage ch	1.2	-0.4	1.1		

[1] The HDI (maximum value 1) is a composite index measuring health, access to knowledge and standard of living.

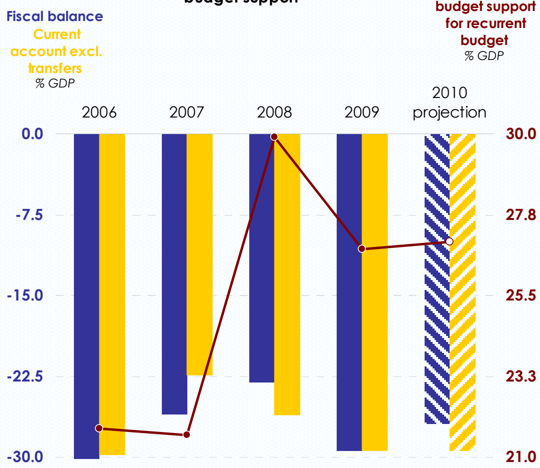
13. OCCUPIED PALESTINIAN TERRITORY

- ***Growth in the economy of the occupied Palestinian territory accelerated to an estimated 5.5% of GDP in 2009, due to sustained overseas development assistance, improved Palestinian security, and the partial relaxation of restrictions on internal trade and border controls with Israel.***

- ***The recurrent fiscal deficit, excluding emergency spending in Gaza, is set to narrow slightly in 2009 to around -18.5% of GDP from 20% of GDP in 2008 due to strict controls on government employment and wages, and a reduction in utility subsidies.***

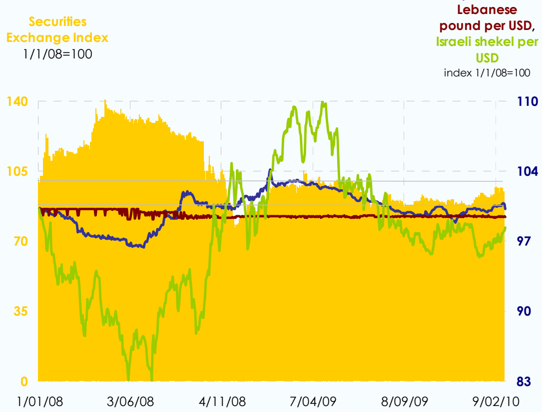
- ***The divergence between the West Bank and Gaza is growing. The West Bank has benefited from the partial removal of Israeli restrictions on movement and access while economic activity in Gaza is stagnating under the conditions of the blockade.***

Graph III.13.1: **oPt - Fiscal balance, current account, budget support**



Sources: National authorities, IMF.

Graph III.13.2: **oPt - Share prices and exchange rates**



Source: ECOWIN Reuters.

Macroeconomic and financial developments

The rise in GDP growth in 2009 to an estimated 5.5% of GDP compared with 2.3% of GDP in 2008 was driven by the partial relaxation of restrictions on movement and access as well as a strong rise in public investment and expenditure, helped by the support of international donors and improved Palestinian security. Public sector gross fixed capital formation rose from 3.3% to 6.7%, as a proportion of GDP, while the proportion of private investment remained stable. This includes greater capital expenditure on development projects in the West Bank and investment funds linked to the reconstruction effort in Gaza. Growth in the economy has been broad based while the construction sector rose by an average of 25% during the first three quarters of the year, compared with the same period in 2008. Growth in the economy also stabilised through the year with the sectors making the largest contribution to GDP all growing by the third quarter, compared with the same period in 2008. Although the economy in the West Bank benefited from the partial relaxation of restrictions on goods and access, it is notable that the wholesale and retail trade sector, one of the largest sectors of the economy making up around 10% of GDP, only grew by around 1% compared with the same period in 2008, highlighting the continued weakness of the private sector.

The Palestinian territory has been largely unaffected by the global economic crisis due to restricted external trade links, heavy dependence on international aid which has held up reasonably well during the crisis, and the low base of economic development following years of political strife.

The increase in GDP growth in 2009, compared with 2008, is due almost entirely to the economic performance of the West Bank, where the Palestinian Authority has made significant progress in improving the rule of law, the number of obstacles to movement has been reduced and Israel has issued several hundred new business permits to Palestinians. Due to the military conflict([1]) and continuing blockade of Gaza, the economy there remains almost totally reliant on government expenditure and international aid. The blockade has led to an expansion of the informal sector in Gaza, partly operating through a tunnelling system at the Egyptian border.

Palestinian export volumes remain small and out of proportion with imports. In 2009, exports remained at approximately the same level as in 2008, hampered by trade restrictions, while in real terms imports rose by about 9%, which could indicate rising donor-funded consumption rather than sustainable economic growth. Similar to recent years, the trade gap was approximately -60% of GDP in 2009, highlighting the extent of the external imbalance in the Palestinian economy and the need to urgently expand the export-oriented private sector. The current account balance excluding official transfers is estimated to have widened from -26.1% of GDP in 2008 to -29.4% of GDP in 2009. Remittances from the large Palestinian expatriate community fell but not significantly.

The inflationary pressure which peaked in mid-2008 has gradually subsided, mainly due to the decline in international food and fuel prices, falling to 2% by mid-2009. Inflation still remains higher in Gaza, due to the supply effect of the blockade. Real incomes have also risen due to the depreciation of the shekel against the dollar, the denomination of a large part of remittances and donor aid, which fell sharply in the first half of the year.

The rate of recorded unemployment improved to 23.5% from 28% at the end of 2008 on account of renewed economic activity in the West Bank while the rate in Gaza is estimated to be as high as 43%. Further improvements in employment will, however, be constrained in the absence of sustained private sector growth by the Palestinian Authority' aim of gradually reducing the size of the public sector wage bill from currently 22% of GDP to less than 10% of GDP, reinforcing the need to open up the Palestinian economy. The public sector remains the main employment provider accounting for 14% of total employment in the West Bank and 50% in Gaza. Average wages in the private sector are around 50% higher in the West Bank than in Gaza.

The Palestinian Authority plans to progressively consolidate public finances in order to improve sustainability. While the overall fiscal deficit will expand in 2009 to -29% of GDP from -23% of GDP in 2008, the recurrent fiscal deficit, excluding emergency spending in Gaza, will narrow to -18.5% of GDP in 2009 from -20% of GDP in 2008. Revenue was broadly in line with what was budgeted, as lower clearance revenues, owing to the Gaza blockade, were largely offset by lower tax refunds and improved collection of fees. On the expenditure side, an amendment to the budget was approved in August 2009 to allocate $300 million to emergency spending in Gaza. Other expenditure, including wage expenditure, was broadly in line with the budget. Total external support including capital expenditures was approximately $300 million lower in 2009 compared with 2008, representing a reduction of around 15%, but still covered over 90% of the estimated overall fiscal deficit for 2009, showing that international donor support has not been seriously affected by the global economic crisis.

The banking sector has been insulated from the global economic crisis due to limited exposure to global financial markets and conservative lending practices. However, the Palestinian Authority took legislative measures in 2009 to address the long-running issue of a shortage of credit for businesses due to the high risks of investing in the local economy. The Palestine Monetary Authority (PMA) introduced a new regulation requiring banks to reduce their foreign investment/total deposits ratio to 55% (from 65% currently). Partly as a result of the regulation and the improved security environment, private sector credit in the West Bank rose by a third in the first half of 2009, while in Gaza private sector credit fell due to weak investment demand. For the West Bank and Gaza combined, private sector credit is estimated to have

([1]) Direct losses resulting from the military conflict in Gaza have been estimated at $1.9 billion by the Palestinian Central Bureau of Statistics.

risen 13.5% in 2009 compared with a decline of -3.4% in 2008, and private sector deposits expanded by 8.5%.

Risks and outlook

The growth outlook for 2010 depends crucially on the further removal by Israel of restrictions on movement and access in the West Bank and Gaza. If restrictions are gradually removed, allowing the reconstruction effort in Gaza to go ahead and trade to resume between the West Bank and Israel, real GDP growth in 2010 may accelerate.

Israel is overwhelmingly the Palestinian Territory's main trading partner, with which it conducts over three quarters of external trade and as the only transit route for wider trade, as the Palestinian Territory has no functioning port or airport. Therefore, the role of Israel remains vital to the expansion and diversification of the Palestinian export sector. Although private sector activity picked up in 2009 in the West Bank, a sustainable economy in the Palestinian Territory still hinges on the complete removal of movement and access restrictions. In real terms, GDP in the Palestinian Territory is still well below the level of ten years ago.

Policy reforms and measures

The Palestinian Authority is committed to fiscal retrenchment and promotion of the private sector economy while also aiming to make public expenditure more effective by shifting resources away from public sector wages and subsidies to more efficient spending on investment. To this end the Palestinian Authority has maintained strict controls on government employment and wages, and substantially reduced utility subsidies. The management of public finances had also been strengthened: a General Accounting Department was established at the Ministry of Finance, and a new computerized accounting system links the Ministry of Finance to line ministries.

With respect to improving the efficiency of public expenditure, the Palestinian Authority embarked on a review of social transfers with the aim of better targeting transfers toward poor households. The Authority also started a review of the efficiency of the pension system which will examine provisions governing the age of retirement and the statutory replacement rates.

The Palestinian Monetary Authority (PMA) instigated a number of reforms in 2009 toward operating as an independent central bank. The supervision and regulatory framework was strengthened with a view to implementing Basel II standards; the credit registry service offered to commercial banks was improved, including more efficient risk assessment, and the development of an electronic payment system was instigated.

Social development and poverty

In real terms, GDP in the Palestinian Territory is still well below the level of ten years ago before the imposition of restrictions on movement and access by Israel, and the region remains mired in poverty. Real GDP is estimated to have declined by a cumulative 13 percent since 2000 up to 2008 (or 30 percent in per capita terms given the high population growth). The overall poverty rate in the Palestinian Territory is estimated to be 57% with around 80% of people in Gaza living beneath the poverty line. Following the military conflict and continuing blockade, living standards in Gaza have fallen markedly. A report by the United Nations in November 2009 estimated that over 60% of Gaza’s population are currently food insecure and an additional 16% are vulnerable to food insecurity.

Table III.13.1:

oPt - Main economic indicators	2006	2007	2008	2009	2010
Real sector				prel.	proj.
Real GDP growth (domestic currency, % change)	-4.8	-1.2	2.3	5.5	6.5
Nominal GDP (EUR billion)	3.7	3.8	4.4	4.6	4.9
Nominal GDP (USD billion)	4.6	5.2	6.5	6.4	7.0
Nominal GDP per capita (EUR)	946	947	881	1177	1227
Nominal GDP per capita (USD)	1187	1296	1289	1637	1729
Inflation CPI (% average)	3.8	2.7	9.9	2.5	3.0
Social indicators					
Unemployment rate (ILO definition)	23.6	22.0	23.9	23.6	20.1
Life expectancy at birth (years)		73.3			
Adult literacy (% ages 15 and older)		93.8			
Domestic population	3.6	3.7	3.8	3.9	4.0
HDI index (2005) [1] most recent		0.737			
Fiscal sector[2]					
Revenue (% GDP)	24.9	24.4	24.2	24.7	25.3
Total expenditure (% GDP)	49.3	48.2	43.6	47.8	42.7
Public sector wage bill (% GDP)	25.9	24.6	22.4	21.9	20.9
Non-wage expenditure (%GDP)	16.2	13.3	14.3	15.4	17.5
Net lending (%GDP)	7.3	10.3	6.9	5.8	4.3
Gaza emergency spending (% of GDP)	0.0	0.0	0.0	4.7	0.0
Government balance before ext. support (% GDP)	-30.2	-26.0	-23.1	-29.4	-26.9
Total external support (% GDP)	21.8	21.6	29.9	26.8	27.0
External sector[3]					
Exports of goods and nonfactor services (% GDP)	11.6	10.3	13.0	13.1	13.7
Imports of goods and nonfactor services (% GDP)	75.3	68.0	70.2	71.7	75.2
Net factor income (% GDP)	11.6	14.6	12.3	11.7	11.7
Trade balance (% GDP)	63.7	57.7	57.2	58.6	61.5
Current account balance (% GDP, excl. off. transfers)	-29.8	-22.4	-26.1	-29.4	-29.4
Official transfers (% GDP)	21.8	21.6	29.9	26.8	27.0
Current account balance (% GDP, incl. off. transfers)	-8.0	-0.8	3.8	-2.6	-2.4
Financial sector					
Credit to the private sector (annual % change)	4.1	-5.0	-3.4	13.5	16.4
Private sector deposits (annual % change)	8.8	19.8	14.0	8.5	10.7
Israeli Shekel (per EUR, eop)	5.6	5.6	5.3	5.5	
Israeli Shekel (per USD, eop)	4.5	4.1	3.6	3.8	
Jordanian Dinar (per EUR, eop)	0.94	1.04	0.99	1.05	
Jordanian Dinar (per USD, eop)	0.71	0.71	0.71	0.71	

1 The HDI (maximum value 1) is a composite index measuring health, access to knowledge and standard of living.
2 On a commitment basis 3 Trade data needs to be treated with caution and has been taken from several sources.

Source: IMF.

14. RUSSIA

- ***Russia experienced a far deeper contraction than expected.***
- ***Russia introduced abrupt changes in its WTO accession policy, via a joint accession bid.***
- ***Exit strategies, which for Russia are linked to the G20 process, are a major policy question for 2010-2011.***

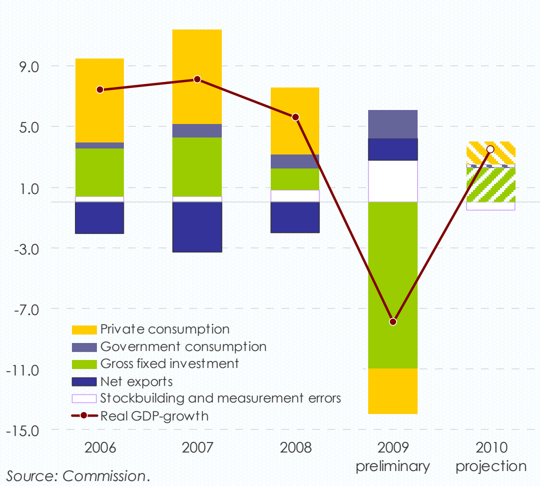
Macroeconomic and financial developments

Russia is one of the 8 largest economies on the planet, and 2008 was its 10th year of strong growth (the 1999-2008 average is 6.9%). However, amidst the global crisis, the country was hit in 2009 by an unexpectedly deep recession. After a fall in GDP close to double digits during the first three quarters of 2009 (the economy contracted by 9.9%), 2009 growth is estimated at -7.9%, while a relatively mild recovery is foreseen for 2010 (3.5%).

This contraction was the result of the twin shocks (and their interaction) that hit the Russian economy: the financial shock caused by the sudden halt in access to international capital flows for a domestic banking system that was financing double-digit credit growth with external resources; and the real shock linked to the sudden and sharp fall in prices of commodities that form the bulk of Russia's exports. On the demand side, the 2009 performance was driven by steep falls in the main domestic demand components: investment fell by 8.9% up to December, and retail sales (a proxy for consumption) by 3.6% in the same period, while the contribution of net exports to GDP was positive for the first time since 2006.

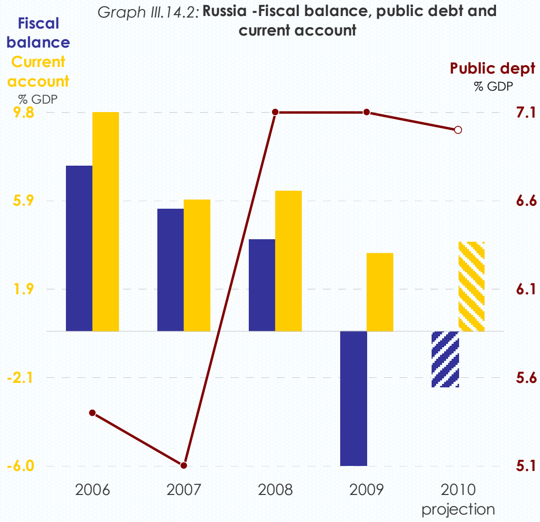
This fall in GDP was accompanied by a reduction of the current account and trade surpluses, and by a swing from large fiscal surpluses to significant fiscal deficits. The budget swung to a deficit of around 6% of GDP in 2009 (predicted to fall to 2.5% in 2010) as a result of the reduction in commodity prices and economic activity, plus the large fiscal stimulus package. Nevertheless, the deficit will be fully financed from one of the Russian Oil Stabilisation Funds.

Graph III.14.1: Russia - Contributions to real GDP-growth



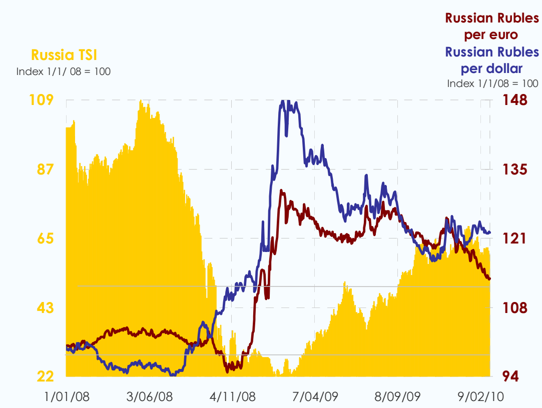
Source: Commission.

Graph III.14.2: Russia -Fiscal balance, public debt and current account



Source: Rosstat and Ministry of Finance of Russia.

Graph III.14.3: Russia - Share prices and exchange rates



Sources: ECOWIN Reuters.

Russia also saw a significant fall in both its current account and trade surpluses in 2009, with a limited recovery foreseen in 2010. Respectively, the current account surplus will grow from 3.5% to 4%, while the trade surplus will grow from 8.4% in 2009 to 9.5% in 2010, due to further increases in commodity prices. Unemployment hit 8.2% by end-2009, but is to fall to 7.5%, while inflation is expected to slow from 9% to 7.5% in 2010.

Signs of recovery in financial variables appeared as early as March 2009 (when oil prices started to increase again), while indications of growth were not perceptible in real variables until the summer of 2009, or even later during the autumn.

Russia's main stock market indexes (the MICEX and the RTS) experienced real rallies during 2009: from their low point in mid January 2009 to late January 2010, they increased by over 150% and 190% respectively,

A similar pattern is to be found in exchange rates. The Central Bank of Russia (CBR) has significantly reduced its market interventions after the introduction of a rouble 'band' in January 2009 (26-41 to the USD-EUR basket) in which the currency has been allowed to float freely for the most part. Compared to its lowest point in early 2009, by late January 2010 the basket had appreciated by almost 13%.

Likewise, Russian hard currency reserves reached a low USD 376 billion by March 2009 (their mid-2008 peak was around USD 600 billion), but recovered from that point on, reaching USD 437 billion by late January 2010. Moreover, throughout the crisis they kept their rank as the third largest on the planet. Also, part of the reserves loss was effectively a tool to enable a staged and orderly deleveraging of foreign currency debt by Russian companies and banks, faced with the 'sudden halt' in capital flows in late 2008/early 2009. The Russian banking system was financing double-digit growth rates of credit via external financing. Since the decline in international capital markets in 2008, the net external liabilities of the Russian banking system fell from USD 130 billion in mid-2008 to USD 1.3 billion by September 2009. Given this enormous adjustment it was only possible to avoid widespread bank failures by a massive transfer of hard currency reserves from the CBR to the Russian banking system.

Finally, interest rates give another clear sign of stabilisation. After massive liquidity provisions by the CBR, the overnight 'Mosprime' rate declined from highs of 25% to 4.7% by late January 2010. In parallel, and in line with the fall in inflation, the CBR reduced its own overnight rates (which had been hiked in late 2008 as part of its initial strategy to defend the peg) ten times between April 2009 and January 2010 (a cumulative fall of 425 basis points) ([1]). Nevertheless, neither the deleveraging of its banking system nor the reduction of interest rates has yet spurred a resumption of lending.

Indications of stabilisation in real variables are more recent and also more tentative. The 'Basic Sectors' monthly index, a composite indicator that proxies for GDP, hit its nadir in May 2009 (-15.7%), recovering to -7.9% by October, but without a steady upward trend. Similarly, industrial production hit its lowest rate at -17.1% in May 2009, but with inconsistent trend until the end of 2009, finishing the year with -10.8%, although both November and December 2009 showed positive single digit YoY values.

Russia is the EU's third most important trading partner. Its total USD exports fell by an estimated 33% in 2009, while imports fell by 28%. As a result, the trade surplus fell by 44%. The speed of the fall slowed down during the year, stabilising by the last quarter. In fact, the trade surplus for the last quarter of 2009 was up almost 20% YoY, due to a base effect.

Policy reforms and measures

Like other countries, Russia enacted an extensive set of policy measures, from the provision of liquidity to direct support to the banking sector, a discretionary fiscal stimulus for the economy (with a very significant component of social expenditure, including pension and unemployment benefit hikes), as well as a more flexible exchange rate. In a similar way to what is currently happening in mature economies, some of those were

([1]) The defence of the peg via interest rates, in parallel with persistent devaluation expectations in early 2009, led to a significant contraction of money supply during the first part of the year (with the low point in April, when it was a remarkable 23% below the January value), which some analysts blame for the strength and duration of the downturn. It was not until December 2009 that the monetary base reached its January 2009 value.

discontinued as the economic situation stabilised, including the auctioning of fiscal funds to banks by the Ministry of Finance and the provision of uncollateralised short-term funds by the CBR([1]). The headline fiscal impulse for 2009-2010 is estimated at around 6 % of the 2008 GDP.

On 28 December 2009 Russia opened its long-promised oil export route to Asian markets, with the completion of a section of the ESPO (Eastern Siberian Pacific Ocean) oil pipeline and the construction of a new oil terminal near Vladivostok. This followed the introduction of shipping of LNG from Sakhalin to Northeast Asia (Japan and Korea) in February 2009. This marks a **major development in the geographical diversification of Russian energy exports to high-growth Asia.** Previously this was limited in effect to the mature European markets with their dedicated infrastructure.

As indicated previously (see Regional chapter), a decision was taken to establish a customs union within **EURASEC**, with Belarus, Kazakhstan and Russia as initial members. This decision was linked to an announcement that those three countries would aim for a **joint WTO accession** after the constitution of a customs union among those countries. This strategy was seen to be reflecting the growing irritation of the Russian Government with its very lengthy WTO accession process, initiated in mid-1993 and on course to become the longest in the history of the WTO.

Risks and outlook

Russia was significantly affected by the global downturn, although some clear signs of growth resumption have appeared. The policies implemented by Russia to counteract the downturn are very similar to those pursued in more mature economies, with the significant use of interest rate hikes initially. One of the specific characteristics of the downturn was the limited amount of social unrest with which it was associated.

Certain policy matters imply risks for short-term developments in Russia. One of these is the implementation of the so-called 'exit strategies', which are also part of G-20 discussions and commitments undertaken by Russia. Essentially they are about a coordinated and staggered withdrawal of the monetary and fiscal stimulus. As regards the monetary stimulus (over and above the interest rate reductions, which seem set to proceed although within a timeframe which does not correspond to what has been observed globally), the CBR tried to roll back part of the additional liquidity measures. However, it backtracked on the removal of its unsecured loans to Russian banks. It has also extended until June 2010 the relaxation of provision requirements for credits which were introduced in December 2008. This is expected to lead to significant savings for the banking system for NPL provisions. Concerning the fiscal part, the Russian Government has approved a relatively conservative budget for 2010-12 (Russia has a rolling 3-year budget framework). For 2010 it assumes that real spending will be 5-10 % lower than in 2009 (depending on inflation). If these planned spending cuts take place within a scenario of higher than expected revenue (which is likely, given the conservative oil price assumptions in the budget), the actual budget deficit next year may be even lower than forecast, implying an even faster removal of the budgetary impulse.

Crisis-fighting policies implied greater involvement of the state in the economy. The Russian Government approved a 2010 **privatisation plan** which aims to reduce the share of state ownership in 450 companies, including a number of so-called 'strategic' ones where ownership can be reduced only with presidential approval. Quite apart from efficiency and long-term development aims, another reason for this would be to fund the budget deficit. The Russian Minister of Finance has stated that the objective is to reduce in the near future the state's share in the economy to around 30 % (currently at 50 %).

([1]) As with other regions, there is a significant difference between the announced amounts of the stimulus and the totals actually committed. For instance, in terms of capital injections in the banking sector, the values committed are only around 40 % of those announced, while for the purchase of assets and lending by the Ministry of Finance, they are even lower at around 31 %.

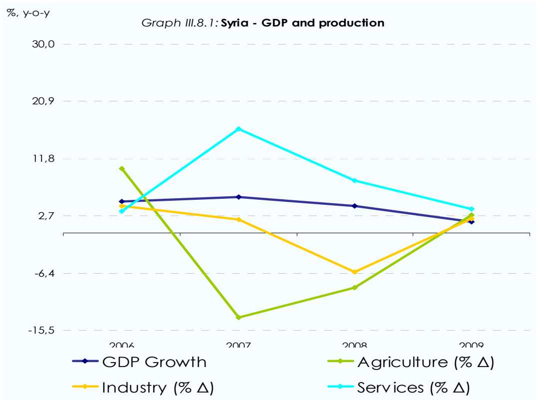
Table III.14.1:
Russia - Main economic indicators

	2006	2007	2008	2009 prel.	2010 proj.
Real sector					
Real GDP growth (domestic currency, % change)	7.4	8.1	5.6	-7.9	3.5
GDP nominal (EUR, billion)	788	942	1150	897	1032
GDP nominal (USD, billion)	979	1300	1677	1308	1504
GDP per-capita (EUR)	5521	6628	8099	6326	7264
GDP per-capita (USD)	6856	9142	11807	9222	10591
GNI per-capita (PPP, current prices, USD)	11630	14400			
Inflation CPI (average, %)	9.7	9.1	13.3	9.0	7.5
Social indicators					
Unemployment (%)	6.9	6.1	7.7	8.1	7.5
Life expectancy (years)	67				
Under 5 mortality rate (per 1000)	16	14			
Literacy (total, %)	95				
Population (million)	142.8	142.2	142.0	141.8	142.0
Fiscal sector					
Total revenue (% GDP)	23.2	24.3	26.2	18.1	19.0
Total expenditure (% GDP)	15.8	18.7	22.0	24.1	22.5
Central government balance (% GDP)	7.4	5.5	4.1	-6.0	-2.5
Gross public debt (% GDP)	5.4	5.1	7.1	7.1	7.0
General govt non-oil balance (% GDP)	-6.9	-7.1	-7.5	-6.5	-4.0
Monetary sector					
Private sector credit (% change)	48.3	50.9	43.0	2.0	15.0
Private sector credit (% total credit)	144.0	151.5	170.0	94.0	95.0
Broad money (% M2)	48.8	47.5	1.7	2.0	15.0
Degree of monetisation (M2/GDP, %)	33.4	40.1	32.4	30.0	35.0
Dollarisation in bank deposits (%)	27.1	24.1	36.1	30.0	28.0
External sector					
Current account balance (% GDP)	9.8	5.9	6.3	3.5	4.0
Trade balance (% GDP)	14.3	9.9	9.4	8.4	9.5
FDI (% GDP)	3.2	3.6	3.5	0.5	1.5
Import cover (months)	17.4	19.7	14.0	18.0	16.0
External vulnerability					
External debt (public plus private, % GDP)	31.7	35.8	28.9	25.0	23.0
Debt service/exports (%)	7.9	-5.9	-6.7	-8.0	-7.0
Gross reserves (excl. gold, USD, billion)	296	466	426	441	480
Reserves/M2 (%)	0.8	0.9	0.8	0.9	0.8
Financial sector					
Short-term interest rate (average, %)	3.4	6.3	12.0	9.2	8.0
Exchange rate (rouble per EUR, end of period)	34.7	35.8	41.4	43.4	42.0
Exchange rate (rouble per USD, end of period)	26.3	24.6	29.4	30.2	28.5
Real effective exchange rate (2000=100)	163	173	184	175	179

Sources: Rosstat, Ministry of Finance of Russia, MED, CBR, WDI, IMF and Commission.

15. SYRIA

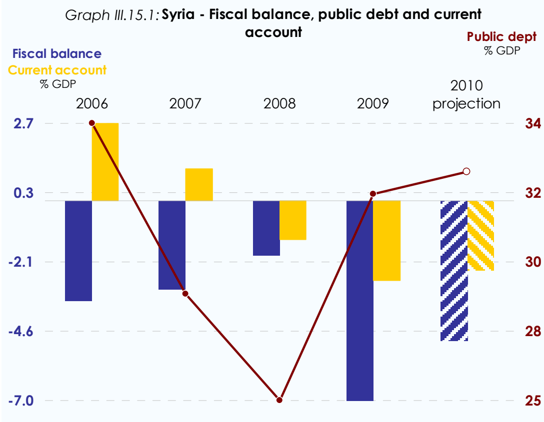
- ***Real GDP growth slowed to 2% in 2009, mainly due to the impact of the global economic crisis and a third year of drought in the North East of the country.***
- ***The government deficit expanded to an estimated 8% of GDP, cushioning some of the impact of the slowdown in the private sector.***
- ***The momentum of structural reforms needs to be maintained to ensure the continued development of the private sector in order to bring about a further rise in living standards.***



Source: EIU.

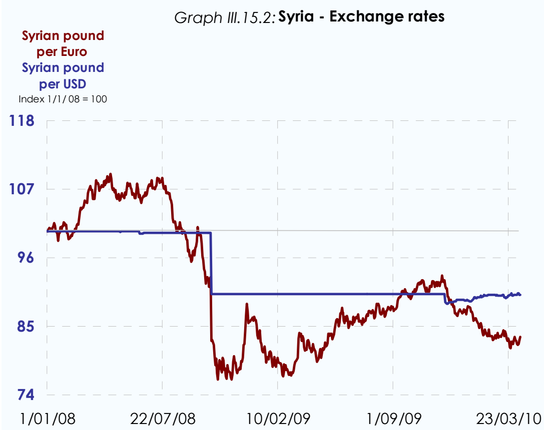
Macroeconomic and financial developments

After achieving average real GDP growth of 5% over the last three years, despite a drought in the north-east of the country, growth dipped to 2.2% of GDP in 2009. This was mainly due to the impact of the global economic crisis which hit export demand and inward investment. Export earnings declined by an estimated 25% in 2009 mainly driven by the fall in fuel and food prices as well a decline in oil production. Gross fixed investment is expected to fall marginally, driven by a decline in FDI from the Gulf region. Remittances have also fallen as the employment of Syrians working overseas has been affected by the crisis, although remittances as a proportion of output are less important in Syria than in many other countries in the region.



Sources: Syrian authorities, IMF and EIU.

Although the economy was hit by falling external demand, a wider slowdown was averted by stronger domestic demand. Private consumption growth accelerated compared to 2008 in part supported by expansionary public finances and a sharp fall in inflation. Consumer spending was also boosted by further increases in public sector salaries, which have risen by an estimated 65% since 2006 as part of a government pledge.



Sources: ECOWIN Reuters.

From the supply side, the industrial sector contracted by an estimated 3.5% in 2009, compared to 2008, while services and agricultural continued to expand. Although for agricultural this was primarily due to the base effect of two prior years of sharp contraction due a continuing drought in the North East of the country.

Partly as a consequence of acceleration in private consumption growth and increased government expenditure, the decline in export earnings was only partially offset by a moderation in imports. Both trade and current account balances deteriorated to 6% and 3% respectively, as oil production fell (The price impact of oil on the trade balance is broadly balanced given that Syria imports a similar amount of refined oil products as it exports crude oil). Export earnings were, nevertheless, slightly bolstered by improvement in the services balance driven continued growth of the tourism revenue.

The tourism industry has been prioritised by the government as part of a broader initiative to expand the export base, and to substitute for depleting oil supplies.

After soaring inflation in 2008, around 16% on average, partly due to a substantial reduction in energy subsidies which increased gasoline and diesel prices by 33 % and 240 %, respectively, the CPI started to decline steeply in the fourth quarter, on account of the combined effect of the reversal in commodity prices and the base effect. For 2009, the CPI averaged around 4%.

The Syrian banking system was not been directly affected by the global financial crisis, due to limited exposure to international financial markets, partly on account of restrictions on domestic banks imposed by the central bank, and US sanctions on many Syrian banks. State banks hold around 80 % of total assets and financial intermediation remains low, with the ratio of total assets to GDP around 64 %. The private banks that operate in Syria are well capitalised (13 % capital adequacy ratio) and the ratio of non-performing loans is estimated to be modest at around 5 %.

Public finances expanded sharply from a deficit of 1.9% of GDP in 2008, to 8% of GDP in 2009. This was mainly due to a sharp fall in tax revenue compared to 2008, highlighting the sensitivity of government revenues to oil production and, consequently, the need to diversify the tax base. Government expenditure grew by 14% compared with 2008, broadly balanced between investment and consumption which cushioned the impact of the decline in export earnings and supported private consumption. Net public debt rose sharply to 34% of GDP, compared to 26% in 2008.

In response to concerns of tightening liquidity, the central bank lowered reserve requirements by up to 5% percent for banks providing new lending for investment projects and reduced deposit interest rates from 7-9% to 6-8%. In a wider initiative to support investment and social development, the Ministry of Finance introduced tax incentives for companies locating to remote areas, increasing hiring, and making initial public offerings on the stock exchange. The Syrian pound has been pegged to a basket of currencies, based on the IMF's special drawing rights, since October 2007. This is a more flexible arrangement under which the Syrian pound has been allowed to gradually depreciate. The central bank's foreign exchange holdings remained stable at approximately four months of imports.

Risks and outlook

The relative insularity of the Syrian economy, particularly the financial sector, buffered it against the impact of the global economic and financial crisis. After a dip in 2009, growth is expected to gradually pick-up in 2010 as global demand recovers, and increased remittances, as the global outlook improves, as well as a further planned substantial increase to public sector wages.

According to the 2010 budget, the fiscal deficit will narrow slightly to just less than 7% of GDP but still continue to provide a strong impetus to the economy, particularly investment. On the revenue side the tax base is relatively narrow and unable to capture the large informal sector of the Syrian economy. On the expenditure side, government spending is likely to come under increasing pressure given the rapidly growing Syrian population and the need to invest in infrastructure and education. On the revenue side, a collapse in external demand in 2009 highlighted the sensitivity of taxation to the hydrocarbon sector and therefore the need to diversity the tax base.

The main concern for the medium and longer-term is the depletion of Syria's oil reserves coupled with a lack of export diversification. Oil production is increasing at a number of small fields but this is being offset by declining production at larger fields. The Syrian government has identified the tourism industry as a potential counterweight against deteriorating oil revenue. The government aims to increase the share of the tourism sector from approximately 5% in 2007 to 20% of GDP in 2020 based on significant investment.

Policy reforms and measures

Syria has made some progress on structural reforms. Major steps have been taken with the entry into force of new legislation on consumer protection, competition, trade, and enterprises. Advances have been made in trade liberalisation, in the context of bilateral and regional free-trade agreements, including a significant reduction in import tariffs. However, the export of key agricultural products still requires government approval. The government's future reform agenda includes streamlining agricultural subsidies, introducing a one-stop-shop for company registration and creating an independent regulatory body.

The government is preparing for the introduction of value added tax in 2010. Although implementing VAT will boost state revenues, and reduce dependency on revenues from oil production, further efforts are needed to combat the informal economy as overall tax revenue is relatively low as a percentage of GDP. It is estimated that that a large part of the economy (up to 60% of GDP) is in the informal sector, predominantly in services and transport.

The government plans to restructure the extensive public sector which is acknowledged to be inefficient. It is estimated that less than 10% of public enterprises are profitable. Therefore, the government's plan to progressively transform public sector companies into autonomous private sector enterprises would in principle significantly ease the pressure on public expenditure and boost private sector activity.

Banking supervision has improved as well as off-site surveillance techniques and methodologies to calculate capital adequacy requirements. The emergence of a small private banking sector, mainly through co-ventures with regional Arab investors, has had a positive impact on the sector as a whole. The stake of foreign ownership of banks has been increased from 49% to 60% in an effort to encourage more foreign investment. The Damascus Stock Exchange was launched on March 10, 2009 which will gradually improve the climate for corporate investment, as well as diversify the Syrian financial sector.

Social development and poverty

Some progress has been made on reducing the rate of poverty, which is estimated to be around 13 %, down from 14.4 % in 2004, due partly to the positive effect of liberalising reforms. The presence of Iraqi refugees, mainly in urban areas, has significantly increased prices, putting pressure on low-income households. Syria ranks 57th out of 135 developing countries according to the Human Poverty Index of the UN. Poverty is strongly correlated with the low literacy rate of 82.5 % underlining the need for development of the education system.

Several anti-poverty programs are currently being implemented in Syria. The authorities have focused on developing a Social Welfare Fund to provide a safety net mechanism after fuel subsidies were scrapped. Economic development programs in rural areas are being implemented to diversify employment prospects in addition to agriculture. The government also aims to launch projects to help Iraqi refugees, and similarly vulnerable Syrian people, in urban areas.

Nevertheless, Syria faces significant challenges to reduce poverty in future, given very high population growth of around 2.5% annually. This implies increasing financial pressure on the education and health services and rising demand for further investment in housing and utilities. In addition, unemployment is already at high levels, hence more profound economic reform will be required to advance the opportunities of a growing and increasingly young population.

Table III.15.1:

Syria - Main economic indicators	2006	2007	2008	2009	2010
Real sector				prel.	proj.
Real GDP growth (% change)	5.1	4.2	5.2	2.9	2.9
GDP nominal (SYR £, billion)	1.698	2.019	2.355	2.396	2.708
GDP nominal (EUR, billion)	23.2	28.7	35.9	36.4	42.4
GDP nominal (USD billion)	32.7	40.4	50.6	51.3	59.8
GDP per capita (EUR)	1171	1400	1694	1663	1886
GDP per capita (USD)	1650	1972	2386	2343	2656
Inflation (period average)	10.0	3.9	15.7	3.8	7.9
Social indicators					
Unemployment (officially registered)	8.3	8.4	8.6	9.2	9.7
Population (annual growth rate %)	3.5	3.4	3.3	3.2	2.7
Human development index	0.736	0.742			
Population (million)	20.4	20.8	21.3	21.8	21.8
Fiscal sector					
Total revenues (% GDP)	25.6	22.7	21.4	17.2	19.3
Total expenditure (% GDP)	29.1	25.8	23.3	24.2	24.1
Central govt, Balance (% GDP)	-3.5	-3.1	-1.9	-7.0	-4.9
Gross public debt (% GDP)	34.0	28.7	25.4	31.8	32.5
Monetary sector					
Credit to private sector (% change)	17.9	20.2	25.8	18.0	20.0
Credit to private sector (% of GDP)	14.9	15.1	15.0	18.3	21.2
Broad money (M2) (% change)	9.4	9.8	19.0	13.0	15.0
Degree of monetisation (M2/GDP, %)	71.0	65.5	66.9	74.3	75.6
External sector					
Current account balance (% GDP)	2.7	1.1	-1.4	-2.8	-2.4
Trade balance (% GDP)	2.7	-1.3	-3.9	-5.8	-5.3
Remittances (% of GDP)	1.9	2.1	1.7	1.5	1.3
Foreign direct investment (% GDP)	2.7	2.8	4.2	3.7	3.2
Import cover of reserves (months)	13.7	11.6	9.4	10.5	9.2
External vulnerability					
External public debt (% GDP)	19.9	17.0	14.1	14.6	13.4
Gross reserves (USD billion)	6.7	6.4	6.7	6.0	6.0
Financial sector					
Exchange rate S£:US$ (end-period)	51.1	48.1	46.5	45.7	45.4
Lending rate	9.0	10.0	10.2	9.3	8.7
Real effective exchange rate (in %)	10.7	4.9	9.0		

Sources: Syrian authorities, IMF and EIU,

16. TUNISIA

- ***A fall in external demand has been the main driver of Tunisia's economic slowdown but the country's well diversified economic structure has allowed to limit the adverse impact of the global economic crisis.***

- ***High unemployment, especially among young university graduates, and low employment levels remain a double challenge for the Tunisian labour market.***

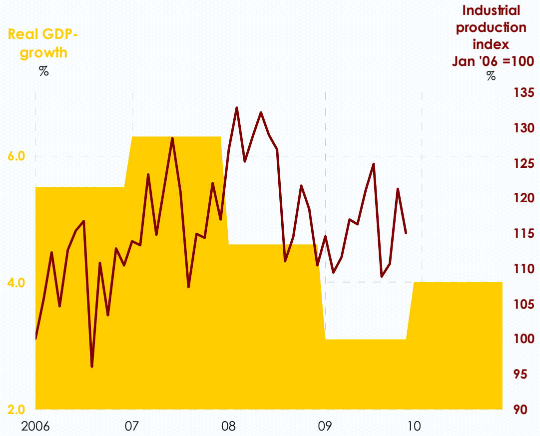
- ***While trade barriers for industrial products have now been dismantled, progress in liberalising trade in services and agricultural products between Tunisia and the EU is slow.***

Macroeconomic and financial developments

Despite the global financial and economic crisis, the performance of the Tunisian economy remained overall robust in 2009. Real GDP growth was lower in 2009 than in 2007 and 2008 when it stood at 6.3% and 4.6%, respectively. The growth rate in the first, second and third quarters of 2009 was at 1.6%, 2.5% and 3.1% respectively. The slowdown in growth in comparison to the previous years, especially in the mechanical, electrical and textile industries, was mainly due to the low or negative growth in the EU countries and the subsequent fall in external demand that contributed to a substantial contraction in Tunisia's exports. During the first three quarters of 2009, the mechanical and electrical industries, the chemical industry and the textiles contracted by around 12%, 6% and 13%, respectively. Industrial production recovered slightly in the second half of the year but it is still below its 2008 high. The government forecasts a growth rate of around 3.1% for 2009 as a whole.

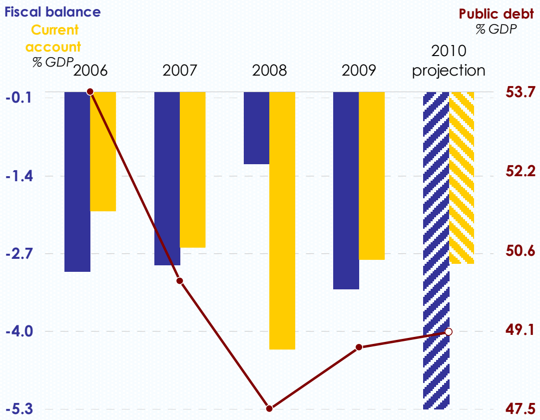
Macro-economic measures, both fiscal and monetary, were used to support the economy when external demand and investment contracted in 2009. To offset the fall in private investment linked to the global crisis, national authorities put in place a stimulus package of 1.3% of GDP (EUR 372 million) destined mainly for public investment in infrastructure, education, energy and health

Graph III.16.1: **Tunisia - real GDP growth and industrial production**



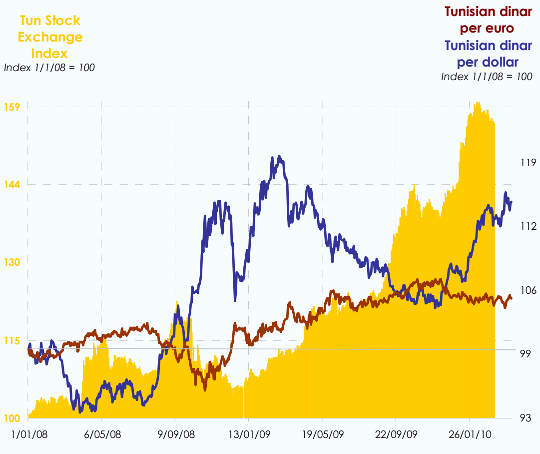
Sources: EIU and Tunisian authorities.

Graph III.16.2: **Tunisia - Fiscal balance, public debt and current account**



Sources: IMF, WB and Tunisian authorities.

Graph III.16.3: **Tunisia - Exchange rate and stock market developments**



Sources: ECOWIN.

but also for support of critical economic sectors such as tourism. Furthermore, to support the exporting companies the state took over a part of their social contribution and export insurance payments. Yet, while public investment projects coupled with salary increases helped sustain domestic demand, the expansionary fiscal policy and a fall in tax revenues meant that the fiscal deficit is projected to increase from 1.2% of GDP in 2008 to 3.3% in 2009. Public debt slightly increased, from 47.5% of GDP in 2008 to 48.7% in 2009, but the debt repayment profile remains manageable. Overall, despite the fiscal anti-crisis measures, Tunisia's public finance position remains sustainable as the share of short-term external debt is low and the government is planning to revert to medium-term fiscal consolidation once GDP growth stabilises at an appropriate level.

On the monetary side, to support the economy the Central Bank of Tunisia eased its monetary policy stance by reducing the key policy rate from 5.5% to 4.5% in February 2009 and by lowering reserve requirements. Due both to the slowdown in economic activity and to the fall in global fuel and food prices, inflation declined from 5% in 2008 to 3.7% in 2009. In their overall monetary policy framework the authorities remain committed to inflation targeting over the medium term. The Tunisian dinar has been pegged to a basket of currencies with the euro having the largest share. This allowed the dinar to withstand depreciation pressures during the global financial crisis: its value against the euro remained relatively stable losing only around 5% since the crisis erupted in late 2008. The monetary authorities are committed to leaving more scope for market forces in defining the exchange rate. Over the medium term, the currency should become fully convertible and capital account liberalised. In 2009, the monetary authorities started to reduce their interventions on the foreign exchange market. As far as foreign reserves are concerned, despite a considerable reduction in FDI inflows the authorities managed to somewhat increase the level of foreign exchange reserves. Gross reserves are expected to reach USD 9.7 billion by the end of 2010, which corresponds to five months of next year's imports of goods and services. However, a further build up of currency reserves is necessary in order to prepare for the liberalisation of the capital account.

For this purpose, a number of large-scale privatisations are planned for 2010.

As far as the country's external position is concerned, in 2009, imports contracted more strongly than exports, reducing the trade deficit somewhat. The current account deficit, which widened in 2008 to 4.3%, fell to 2.8% in 2009, reflecting adjustment in the trade balance, while receipts from the tourist industry and inflows of remittances remained relatively stable. The adjustment of the financial account was more pronounced as net foreign direct investment inflows fell to USD 1.3 billion in 2009, down from USD 2.3 billion in 2008.

Risks and outlook

The global economic and financial crisis mainly affected Tunisia through the contraction of external demand; in 2010, stronger growth performance very much depends on strengthened external demand. Some manufacturing sectors, such as the mechanical and electrical industries, are already experiencing a slight rebound, partly due to public support measures put in place in the EU countries' automotive industry. However, textiles, which account for around 20% of Tunisian exports, are still down. Overall, real growth of around 4% is projected for 2010. The positive real growth rates that Tunisia and other Mediterranean EU partner countries have achieved during the global economic crisis are certainly impressive considering the contraction in the global economy in 2009. However, while population growth is stagnating in most industrialised countries, Tunisia's population is growing by 1% per year.

Policy reforms and measures

In product markets, Tunisia has advanced furthest in the region in establishing the euro-Mediterranean free trade zone. After the final dismantling of trade barriers for industrial products in January 2008, the dialogue on liberalising trade in services, agricultural and maritime products between Tunisia and the EU has continued, albeit slowly. Some progress was made on facilitating access to goods markets for foreign investors and on strengthening instruments of trade facilitation. Thus, agreement on the new simplified mechanism regulating trade conflicts was reached in December 2009. Some progress was also achieved in the telecommunications sector. EU countries account for 70% of Tunisia's external trade.

The direct impact of the global crisis on the Tunisian financial system was limited. Restrictions on capital transactions meant that Tunisian banks' exposure to the international financial system remained very limited; external assets of Tunisian banks represent 4% of their total assets. At the same time, Tunisian banks have to remain prudent as the stock of old non-performing loans (NPL) accumulated during the tourism crisis in 2002 has not declined significantly. In 2008, 15.5% of loans were qualified as non-performing. The authorities took a number of measures to strengthen the stability of the banking sector: objectives for NPLs and provisioning ratios for the medium and long term were set and action plans for banks in difficulties were agreed.

As far as the business environment is concerned Tunisia fares well especially in comparison with its neighbouring countries: it is leading in Africa and the Maghreb region. In 2009 Tunisia could further improve its position in international rankings by modernising its tax payment and customs clearance systems and providing additional protection for investors. In 2009, due to the economic slowdown, the level of gross capital formation remained at its 2007 level, with private investment falling. Yet, the revival of private investment in the medium term is a precondition for sustained economic recovery and economic catching-up. With average net FDI inflows of 4% of GDP over the last five years Tunisia is in the middle field among the EU's Mediterranean partner countries with regard to attracting foreign investment.

Given that the role of foreign investors in the Tunisian economy is important but less pronounced than in some other EU's Mediterranean partner countries such as Lebanon or Jordan, one can only welcome the government's efforts to explore domestic sources of growth and wealth creation. Existing medium-term policies aimed at reducing regional inequalities and improving local developmental capacities were maintained in 2009: Tunisia has projects linked to improving road infrastructure, maintaining industrial zones in disadvantaged regions and supporting technological poles in agriculture and in agro-industry. Among the new developmental policy initiatives has been the National Dialogue on Productivity launched in February 2009. It brought together enterprises, professional associations, political parties and national authorities and suggested in its final report a number of policy measures that would strengthen human capital and vocational training, improve the use of ICT, promote R&D, modernise agriculture, promote strategic sectors such as health and biotechnology and further simplify administrative procedures. However, it is difficult to pinpoint the central economic priorities as, like the new presidential programme for 2009-2014, these programmes lack specific objectives and implementation modalities.

Social development and poverty

The global crisis had only a limited effect on the Tunisian labour market: the number of new redundancies remained small as employers used different work organisation measures such as working time reductions to keep the labour force. However, it would be over-optimistic to expect the high unemployment rate to fall quickly in the near future: in 2009, unemployment rate further increased from 14.2% in 2008 to 14.7%. High unemployment rate, especially among young university graduates, remains a major challenge for Tunisia's economy. Another challenge for the coming years is the low employment rate of around 46%. This low level of activity is determined by low female participation in the formal labour market as only one out of four women in Tunisia work.

When medium-term developmental trends are considered, Tunisia offers a mixed picture. Its GDP per capita has steadily increased over the last two decades at a rate of 3.4% per year. Furthermore, according to the UN Human Development Index, a central international measure of wellbeing, Tunisia's position improved from 0.753 in 2003 to 0.780 in 2009. The UN measure of extreme poverty, the Human Poverty Index, has also shown some improvement since the mid-2000s: the percentage of people who are vulnerable to death at an early age and lack access to basic economic provisions such as nutrition and clean water decreased from 17.9% to 15.6%. However, while some indicators of socio-economic development have shown progress, others remained worrying.

Table III.16.1:

Tunisia - Main economic indicators	2006	2007	2008	2009 prel.	2010 proj.
Real sector					
Real GDP growth (domestic currency, % change)	5.5	6.3	4.6	3.1	4.0
GDP nominal (EUR, billion)	24.8	26.1	28.0	28.4	30.6
GDP nominal (USD, billion)	31.1	35.6	40.9	39.7	42.1
GDP per capita (EUR)	2448	2550	2707	2735	2880
GDP per capita (USD)	3074	3486	3962	3808	4,001
GDP per capita (PPP current prices, US$)	6978	7561	8002	8285	8662
Inflation (period average)	4.5	3.2	5.0	3.7	3.4
Social indicators					
Unemployment (ILO definition)	14.3	14.1	14.2	14.7	15.1
Population (million)	10.1	10.2	10.3	10.4	10.5
Human Poverty Index (HPI-1, %)		15.6			
Inequality (Gini index consumption/ income)		40.8			
Life expectancy at birth (years)		74.2	74.3	74.5	
Human development index		0.769	0.774	0.78	
Fiscal sector					
Total revenue (% GDP)	23.4	23.8	26.2	23.7	23.3
Total expenditure (% GDP)	26.5	26.7	27.3	27.5	27.0
General government balance (% GDP)	-3.0	-2.9	-1.2	-3.3	-5.3
Public debt (% GDP)	53.7	50.0	47.5	48.7	49.0
Monetary sector					
Credit to the economy, % change	6.8	9.8	14.3	7.5	
Broad money (M3) (y-o-y % change)	11.4	12.5	14.4	10.9	
Degree of monetisation (M2/GDP, %)	60.0	61.8	64.2	66.5	
Foreign currency deposits to total deposits					
Three-month treasury bill rate	5.1	5.1	5.1	4	
External sector					
Current account balance (% GDP)	-2.0	-2.6	-4.3	-2.8	-2.9
Trade balance (% GDP)		-11.0	-13.1	-11.6	
Foreign direct investment (net, % GDP)	3.2	6	5.3	3.1	3.2
Import cover of reserves (months)	4.0	3.6	4.9	5.1	5.5
Terms of trade (- deterioration)	-3.6	-1.9	1.0	3.9	-2.1
External vulnerability					
Total external debt in % GDP	58.1	53.9	53.7	52.5	52.3
Debt service ratio[1]					
Gross reserves (USD billion)	6.8	7.9	9.0	9.7	11.0
Financial sector					
Overnight interbank lending rate (dec average or latest observ)					
Lending rate					
Exchange rate (hryvnia per EUR, average)	1.67	1.75	1.80	1.88	
Exchange rate (hryvnia per USD, average)	1.33	1.28	1.23	1.35	
Real effective exchange rate (percentage change)	-0.8	-2.8	-0.9		

[1] Public external debt service as % of exports of goods and services.

Sources: IMF,WB, Tunisian authorities and Commission.

Adult illiteracy had been decreasing but remained high, at 19.4% of total population in 2009. Income inequalities also remained high with the top quintile of the population accounting for 34.6% of total consumption, and the poorest quintile accounting for 2.4%. This brought Tunisia's Gini coefficient to quite a high level of 40.8, close to that of the USA.

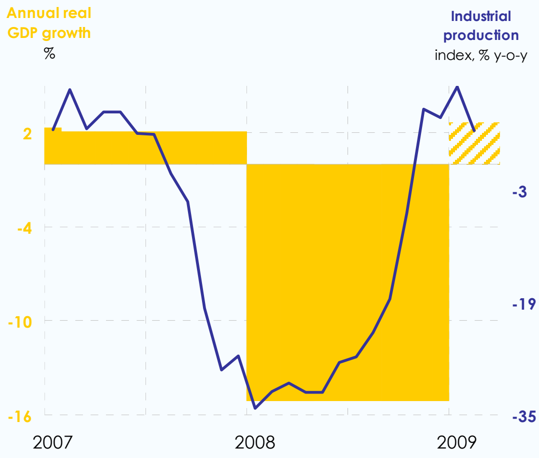
17. UKRAINE

- ***In the EU Neighbourhood, Ukraine has been among the countries worst hit by the global financial and economic crisis with a GDP drop of 15% and currency depreciation by around 70% against the USD.***

- ***Early and timely bank recapitalisation measures amounting to almost 3% of GDP have been crucial for preserving financial stability in the country.***

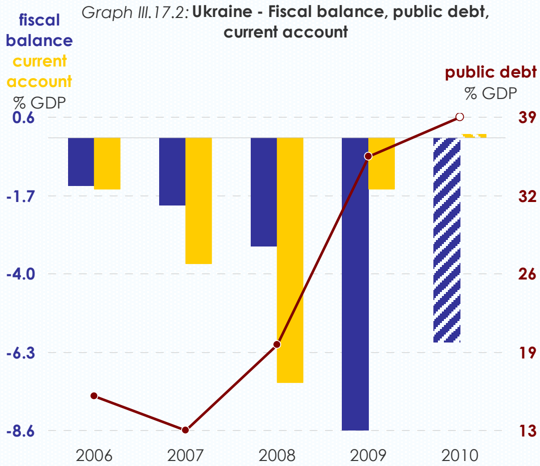
- ***The deficit of the state-owned utility company Naftogaz has been a significant burden for public finances and needs to be reduced so not to jeopardise wage and pension spending.***

Graph III.17.1: **Ukraine - GDP and production**



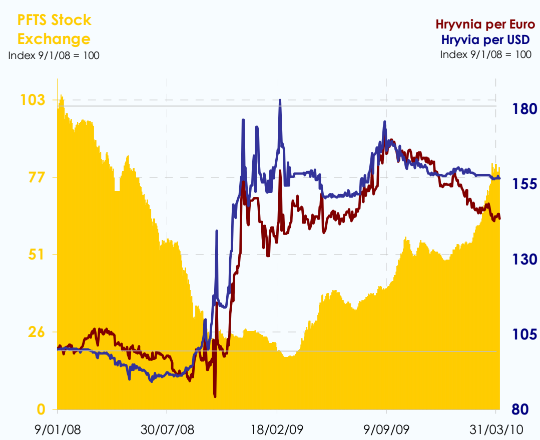
Sources: ECOWIN, IMF and Commission.

Graph III.17.2: **Ukraine - Fiscal balance, public debt, current account**



Sources: Ministry of Finance and Central Bank Ukraine.

Graph III.17.3: **Ukraine - Share prices and exchange rates**



Sources: ECOWIN Reuters.

Macroeconomic and financial developments

Since the onset of the global economic and financial crisis the Ukrainian economic situation has deteriorated dramatically as Ukraine is among the worst hit countries in the EU neighbourhood. After a strong deceleration of real GDP growth in 2008, GDP contracted by 15.1% year-on-year in 2009. Industrial output decreased by 21.9% in the same period. The latest projections point to a quite slow recovery for 2010. The sharpest decline was in machine building where output fell by 45% in comparison to 2008. Output in the metals and metal processing industries fell by 27% and in light industries by 26%.

The fall in real GDP has been driven by a reduction in external and domestic demand. This happened on the back of lower domestic credit growth, as the domestic financial system was less able to access external financing. Ukraine's external position has also been hit very hard by the crisis: its trade deficit of 8% of GDP in 2008 reduced to 1.7% in 2009 as following the strong devaluation of the domestic currency against both the US dollar and the euro imports have been falling faster then exports. Ukraine's main export – metals, which accounts for one third of country's total exports – more than halved. Fall in demand and in prices for steel have been behind this dramatic collapse. At the same time, imports of fuel and gas became more expensive with Russia phasing out its gas subsidies and hryvnia strongly depreciating. As a consequence to the crisis-related adjustments, Ukraine's current account has substantially improved; for 2009, a current account deficit of 1.5% of GDP was reported. The improvement of the current account deficit reflects only partially an improvement of Ukraine's competitiveness; it is mostly a consequence of the recession.

Ukraine has been experiencing a capital account deficit: loss of investor confidence led to capital flight, reversal of capital inflows and a fall in foreign direct investment and remittances. These pressures on the capital account produced strong pressures on international reserves that could be kept at an appropriate level only thanks to financial support by the IMF provided in the framework of the Stand-By-Arrangement (SBA). The international reserves of the National Bank of Ukraine (NBU) has remained stable at around USD 25 billion in 2009 and stood at USD 25.3 billion at the end of January 2010. Yet, Ukraine's reserve position might still be too low considering that external debt service obligations for 2010 are estimated at USD 30 billion.

Where the Ukrainian fiscal position is concerned, the consolidated government budget deficit increased to 6% of GDP in 2009. The increase was due not so much to active counter-cyclical policies as to the sharp fall in government revenues. Thus, in cyclically adjusted terms, the budgetary balance in 2009 remained practically unchanged in comparison to the previous year. Considering that two thirds of government expenditure go on public wages and social transfers this implies that Ukraine managed to preserve most of its social spending. Ukraine's counter-cyclical fiscal policies in 2009 were limited to the most urgent issues such as bank recapitalisation and support for the energy sector. The latter has affected the government budget: the budgetary deficit that includes payment obligations of Naftogaz amounts to 8.6% of GDP. By early April 2010 no budget law has been in place, with budget expenditures restricted to the amounts of 2009 until the budget law is approved.

The fiscal spending in 2009 comprises the cost of recapitalisation of Ukrainian banks, estimated at 2.8% of GDP. However, the bulk of these costs (2.6% of GDP) are covered by issuing domestic bonds. Already in late 2008 the Ukrainian authorities had prepared a stabilisation and restructuring programme for the banking system. The 'anti-crisis law' of October 2008 created a stabilisation fund which has the mandate to inject fresh capital into the banks and to provide support the real sector. Bank recapitalisation impacts heavily on public debt, which rose sharply from 13% in 2007, to 20% in 2008 and to 35% of GDP in 2009. Still, its overall level remains moderate by international standards.

Since late 2008, the de-facto exchange rate peg to the US dollar was abandoned and the National Bank of Ukraine (NBU) has followed a more flexible exchange rate policy. Between September 2008 and February 2010, the hryvnya has lost around 70% of its value against the US dollar and 66% against the euro. This has meant higher prices for imported gas and other goods. As a consequence, despite the deep recession that usually brings down inflationary pressures, Ukraine's consumer price inflation remained high at 15.9% in 2009 for the year average. To avoid the erosion of purchasing power depositors turned even more to foreign currencies: the share of foreign currencies in bank deposits increased from 32% in 2007 to 44% during the last two years.

Risks and outlook

The risk of economic slowdown due to the global economic crisis materialised in 2009. In order to stabilise the economy, the Ukrainian authorities negotiated an agreement with the IMF (approved in November 2008) on a 24-month SBA for USD 16.5 billion. To support the IMF efforts, in October 2009 the European Commission adopted a proposal for a EUR 610 million package of macro-financial assistance to Ukraine. However, since November 2009, when the third regular SBA programme review was to be published, the SBA has been at a standstill. This is because the public authorities failed to reach an agreement with the IMF on a number of policy benchmarks such as additional budgetary spending on wages and pensions for 2010 (the so-called 'Social Standards Law'). In spring 2010, after the presidential elections and the formation of the new government negotiations resumed but no agreement between the authorities and the IMF has been reached so far.

Policy reforms and measures

In 2009, the banking sector in Ukraine has been under strain: both state-owned and private commercial banks have had to be recapitalised, at the important cost to the tax payer. The sector has been significantly affected especially as foreign capital inflows dried up after a prolonged credit boom. The first quarter of 2009 was characterized by a strong outflow of household deposits. As a consequence of falling depositor confidence, the Ukrainian banks have been facing major loan losses. The share of non-performing loans (NPL), i.e. loans with payments that are more than 30 days overdue, doubled and could be as high as 15% of total loans. To avoid having the loans being classified as non-performing, some banks started to restructure the loan payments for businesses and households. Recently, signs of recovery have begun appearing: the commercial banks started to cut interest rates on hryvnia deposits and on some foreign currency deposits indicating an improvement in their liquidity. However, while the deposit situation seems to be stabilizing, bank credits remain low. Ukrainian banks have been reluctant to provide new loans to customers due to the rising loan losses and to the high level of uncertainty. New loans are mainly provided by foreign-owned banks and by Ukrainian state-owned banks.

The progress in public finance management, significant during the early 2000s, slowed down in 2009 due to inner political in-fighting of the pre-election period, as mentioned above. Although there was an obvious need to introduce a clear legislative framework for public procurement, a new law fell short of international standards and thus was vetoed by the President in March 2010. The new budget code that includes provisions on medium-term budget planning and internal auditing was approved by Parliament in June 2009 but has not yet been enacted.

According to the World Bank's enterprise surveys, regulatory and business environment indicators have somewhat improved during the 2000s - indicating that bribery, corruption, organized crime and regulatory uncertainty have somewhat receded. Yet access to financing and to land worsened and the judiciary system has not substantially improved. Ukraine performs slightly below the CIS average.

Social development and poverty

According to the United Nations' Human development index (which measures monetary and non-monetary dimensions of human development), Ukraine is ranked 85th out of 182 countries worldwide and has a medium level of human development. The country is in the middle range in comparison to other CIS countries: GNI per capita in purchasing power parity is somewhat below USD 7 000, life expectancy at birth is 68.2 years and adult literacy is 99.7%. Ukraine's prospects look rather bleak if its GDP per capita growth is taken as the indicator of the pace at which its economy is catching up with the EU: for the period 1990-2007, Ukraine's GDP per capita shrank on average by 0.7% per year and thus the country still has not reached its 1989 pre-transition level.

Despite the deep recession, Ukraine's unemployment rate remained relatively low in 2009, at 8.8% of the working age population, but the extent of deprivation in the country has been much higher. In 2005, 27.1% of the population was living below the national poverty line fixed at 75% of median daily expenditure. Half of the working population earned less than the subsistence minimum and around 8% of Ukrainian population were living in extreme poverty, on less than USD 2.15 per day. According to the UN data for 2007, 8.4% of the population have been vulnerable to death at an early age, 3% did not have access to clean water and 1% of small children were under-nourished. Thus, progress in economic reforms has not been sufficiently translated into improved living conditions. A certain improvement has been felt since 2004, with minimum and public sector wages and pensions increasing, but the current economic crisis has partially eroded these improvements: real wages fell in 2009 by 9.2% due to recession and high inflation. The stagnating or even deteriorating living conditions might explain the fast pace at which the Ukrainian population is currently shrinking. In recent years the population has fallen by 0.6% per year, which is faster than during the 1990s, making Ukraine the country with the world's worst figures for natural population decrease.

In terms of income and consumption inequality, Ukraine fares significantly better than many other CIS countries, with the upper quintile of its

Table III.17.1:

Ukraine - Main economic indicators	2006	2007	2008	2009	2010
Real sector				prel.	proj.
Real GDP growth (domestic currency, % change)	7.3	7.9	2.1	-15.1	2.7
GDP nominal (EUR, billion)	85.9	104.2	123.0	84.2	
GDP nominal (USD, billion)	107.8	142.7	180.0	117.4	
GDP per capita (EUR)	1848	2255	2678	1846	
GDP per capita (USD)	2319	3090	3918	2575	
GNI per capita (PPP current prices, US$)	6271	7002	7342	6461	
Inflation (period average)	9.1	12.8	25.2	15.9	10.3
Social indicators					
Unemployment (ILO definition)	6.8	6.4	6.4	8.8	10.0
Population (million)	46.5	46.2	45.9	45.6	45.3
Poverty rate (% of population)	27.3	12	9	14	
Inequality (Gini index consumption/ income)		28.2			
Real monthly wages (average change)	18.4	12.5	6.3	-9.2	-1.2
Life expectancy at birth (years)		68.2			
Human development index		0.796			
Fiscal sector					
Total revenue (% GDP)	43.7	42.3	44.2	41.4	42.2
Total expenditure (% GDP)	45.1	43.8	47.3	47.6	45.6
General government balance (% GDP) Incl NAK	-1.4	-2.0	-3.2	-8.6	-6.0
Public debt (% GDP) General gvt plus NAK from 2009	15.7	12.9	19.9	35.4	38.6
Monetary sector					
Domestic credit to private sector (% GDP)	45.2	59.4	74.4	83.0	73.8
Broad money (M2) (y-o-y % change)	34.5	51.7	30.2	-5.5	14.4
Degree of monetisation (M2/GDP, %)	48.0	54.9	52.1	57.1	56.7
Foreign currency deposits to total deposits	38	32.1	44	43.6	46.2
External sector					
Current account balance (% GDP)	-1.5	-3.7	-7.2	-1.5	0.1
Trade balance (% GDP)	-2.8	-5.7	-8.1	-1.7	0.1
Foreign direct investment (net, % GDP)	5.3	6.4	5.5	3.9	
Import cover of reserves (months)	5.0	5.3	4.8	4.9	
External vulnerability					
Total external debt in % GDP	49.7	54.0	54.5	85.4	85.3
Public external debt in foreign currency (% GDP)	12.5	10.1	15.0	25.0	23.8
Debt service ratio[1]	5.1	4.0	2.7	7.1	4.0
Gross reserves (excl. gold, USD billion), period end	22.3	32.5	31.5	26.5	31.0
External debt expressed as a share of exports	106.8	120.8	114.3	167.3	158.1
Financial sector					
Overnight interbank lending rate (dec average)	3.8	3.5	10.2	12.3	
Lending rate	15.1	13.9	17.6	17.3	
Exchange rate (hryvnia per EUR, average)	6.3	6.9	7.7	10.9	11.3
Exchange rate (hryvnia per USD, average)	5.1	5.1	5.3	7.8	8
Real effective exchange rate (percentage change)	4.8	2.6	12.6	-14.3	

[1] Public external debt service as % of exports of goods and services.

Sources: IMF,WB, Ukrainian authorities and Commission.

population enjoying 22.5% and the bottom quintile 3.8% of overall consumption. This brings Ukrainian Gini coefficient (the central international measure of relative income inequality) to the level similar to that of Germany.

While international comparisons show relatively little income inequality in Ukraine, regional economic disparities have increased in the 2000s: rural areas are now the most disadvantaged, with lowest real wages and the highest poverty incidence.

18. CENTRAL ASIA

- ***Central Asian countries*[1] *- Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan - shielded from the global recession helped by the fiscal savings and avoided the impact of global financial crisis, except for Kazakhstan, due to isolation from global financial markets.***

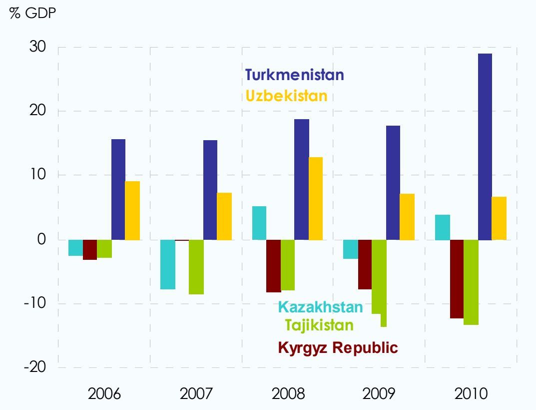
- ***Nevertheless, global downturn affected these countries through the fall in demand for key export commodities coupled with a sharp fall in remittances. Decrease in poverty halted or even reversed.***

- ***Economic prospects are improving with a recovering global economy and commodity markets. States, however, have to implement the overdue reforms to foster development of the private businesses outside the oil and gas sectors, including in the agriculture, to spread the gains of the economic growth and to alleviate the poverty.***

Macroeconomic and financial developments

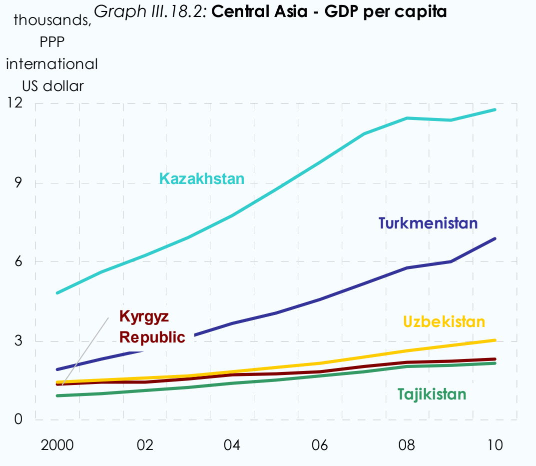
Central Asian countries in 2009 were able to mitigate the external shocks helped by cautious fiscal policies and external surpluses[2]**.** Countries had to cope with the impact of three negative external shocks - fall in trade and prices of export commodities; contraction of remittances from the depressed neighbouring economies; and withdrawal of external financing from the banking sectors. *Kazakhstan*, *Turkmenistan* and *Uzbekistan* – rich with fiscal reserves from the export revenues of hydrocarbon resources – were well prepared to withstand global and regional economic downturns. These countries have good prospects for recovery as global demand and prices for their commodity exports recover. *Kyrgyz Republic* and *Tajikistan*, the poorest countries in the region, were hit the hardest by the downturn. They also face a slower recovery.

Graph III.18.1: **Central Asia - Current account balance**



Source: IMF.

Graph III.18.2: **Central Asia - GDP per capita**



Source: WEO IMF, estimates starting from 2007.

Resource rich countries employed massive fiscal stimulus and used the prominent role of the state in the economies to promote economic activity. *Kazakhstan's* economic performance and recovery, however, was impaired by the problems in the banking sector. The authorities had to take over a significant part of the banking system to prevent a fully fledged banking crisis. GDP growth slipped from 8.9% in 2007 to 3.2% in 2008 and estimated to turn negative at -2% in 2009.

Uzbekistan's and *Turkmenistan's* economies have shown a high degree of resilience, as governments drew on fiscal reserves to administrate economic activities. These countries enjoy the most favourable outlooks for growth in the region.

(1) Please see Box 1.2.6. on Central Asia in the regional CIS and Russia chapter.
(2) The limited availability and accuracy of economic data constrained the analysis of economic developments, especially in Uzbekistan and Turkmenistan.

Buoyant economic growth was mostly supported by the growth of domestic consumption and investment. The key drivers of growth will continue to be hydrocarbons and public investment. *Uzbekistan*'s GDP increased at estimated 7.0% in 2009 with a strong support from growth in the industrial production, retail sales and services. The economy, however, was affected by weak markets for major export commodities and a significant decline in remittances. Moreover, Uzbek economy is underperforming relative to its potential, mostly because of the reform backlog in structural policies, despite the above-trend growth of the last two years. *Turkmenistan* benefited from favourable contractual prices for its gas exports and likely to record a strong growth in 2009 and 2010 following 10.5% GDP growth in 2008.

Kyrgyz Republic and *Tajikistan*, the smallest and poorest economies in the region with no hydrocarbon resources, had no substantial fiscal surpluses to mitigate economic downturn and were hit the hardest. They run rather prudent fiscal policies, while Kyrgyzstan made the best progress in structural reforms. Balance of payments difficulties, however, emerged already in 2008, because of the combined shocks, such as a hike in imported commodity prices and a major shortfall in domestic hydro-power capacity due to low water levels. Economic growth was to a great extent driven by remittances, but remittances fell sharply and the internal demand shrank drastically. Consequently, these countries faced steeper growth declines in 2009 and face slower recovery starting from 2010. GDP growth fell from 7.6% in 2008 to estimated 2.3% in 2009 in Kyrgyz Republic, and from 7.9% to 3.4% in Tajikistan.

External balances weakened from the strong positions in hydrocarbon exporting countries mostly due the fall in the value commodity exports. *Kazakhstan's* current account position deteriorated from surplus of 5.1% of GDP in 2008 to en estimated deficit of 3% of GDP in 2009, *Uzbekistan's* – from surplus of 12.8% to an estimated surplus of 7.2%. *Kazakhstan's* current account deficit in 2009 was financed through a sharp reduction in portfolio investments held abroad, reflecting the sale of foreign assets by the National Oil Fund, as well as by FDI flows to the hydrocarbon industries. These FDI flows are expected to remain substantial and current account is likely to return to a surplus in 2010. *Uzbekistan's* surplus is expected to remain high at around 6.7% of GDP in 2010. *Turkmenistan's* agreements on high hydrocarbon export prices allow maintaining high current account surpluses estimated at 17.8% of GDP in 2009 and forecasted at 29.1% of GDP in 2010. Official foreign exchange reserves stayed at comfortable level in oil and gas rich countries.

Remittances received in *Kyrgyz Republic* contracted by around one fifth in 2009 from estimated 30% of GDP in 2008. In *Tajikistan* they contracted by one third from estimated 40-50% of GDP in 2008 when almost a half of the labour force worked abroad. As a consequence, fall in exports were to some extent counterbalanced by the fall in imports due to depressed domestic demand.

National currencies were allowed to depreciate or were devaluated to guard competitiveness, while preserving foreign currency reserves. As an exception, *Turkmenistan* maintained a peg to the US dollar seeking to tame the inflation. In February 2009 the *Kazak* Tenge peg moved from 120 to 150 per US dollar. The *Uzbek* authorities maintained crawling peg targeting small nominal depreciation. *Kyrgyz* authorities opted for the managed floating with no predetermined path for the exchange rate. *Tajik* authorities abandoned conventional peg against the dollar in 2008 and moved to a flexible exchange regime leading to depreciation of real effective exchange rate in 2009 estimated at 30%.

States managed to maintain sound fiscal positions even thought fiscal policies were actively employed to sustain economic activity helped either by earlier accumulated fiscal reserves or concessional financing. *Kazakhstan's* general government recorded surplus estimated at 1.1% of GDP in 2008 despite tax cuts and a notable acceleration in spending. Even though initial budget proposals showed a surplus for 2009 loosened fiscal policy led to an estimated consolidated budget deficit close to 2% of GDP. A tightening of the fiscal policy is expected in 2010, which should reduce the deficit to 0.4% of GDP. The *Uzbekistan's* fiscal surplus for 2009 is expected to be around 2% of GDP and strengthen further in 2010. *Turkmenistan* maintained fiscal surplus close to double digits of GDP. *Kyrgyz* fiscal policy was prudent in 2008, with revenues rising sharply, resulting in balanced budget, but fiscal position deteriorated in 2009. Government provided 5.5 percent of GDP fiscal stimulus in 2009 helped by significant concessional lending. *Tajikistan's* fiscal deficit was modest at 0.5% of GDP in 2009 and expected to widen to 1% in 2010, but these estimates exclude externally financed investment.

Monetary policies had to balance two conflicting tasks – to sustain economic activity and to curb inflation. *Kazakhstan* further eased monetary policy as a result of the devaluation in February 2009. Weaker growth has resulted in a gradual dis-inflationary trend allowing the central bank to reduce its refinancing rate. Prevailing weak domestic demand led to decrease of annual inflation rate in 2009 but inflation was not expected to fall futher, because of planned increases in public sector wages, pensions, social payments and import tariffs.

In *Uzbekistan* inflation declined slightly from the peak level of 12.7% in 2008 to an estimated 12.5%, but is still expected to remain high in 2010 at around 9.5%. (based on the IMF calculations). Inflation peaked because of the increases in administered prices and salaries. The authorities responded by tightening the fiscal and monetary policies, reducing the pace of nominal depreciation of the national currency, administrating food prices. *Kyrgyz Republic* enjoyed low inflation until the second half of 2007 but (mostly imported) inflation hit a record high of 24.5% by the end of 2008. For 2009 and 2010 the inflation is estimated to ease to around 8.0%. *Tajikistan* was also affected by a hike in import prices 2008 and while annual inflation halved since then it might stay close to double digits in 2010.

Financial sectors were barely affected by the global financial crisis, except for Kazakhstan's, because of isolation and underdevelopment. *Kazakhstan's* banking sector remains constrained by the lack of trust from the population, heavy involvement of the state and accumulated bad assets as almost one third of loans were non-performing at the end of 2009. The *Uzbek* banking system remained default-free and adequately supervised. Banking system, however, was underdeveloped and government's directed lending through commercial banks constrained availability of credit to some economic sectors and constrained effective allocation of credit resources.

Policy reforms and measures

States should gradually disinvest from some sectors to put them back on the commercial footing, given an advance of the state ownership in the economy during the downturn. Central Asian countries used a strong fiscal stimulus and prominent role of the state in the economy to sustain economic activities during the global recession. These measures resulted in even bigger role of the public sector in the economy, especially in the oil and gas rich countries.

Business and investment climates have not been improved over the last years, except for Kyrgyz Republic. Actually, in some countries they even worsened, as governments advanced in taking over some economic activities and imposing administrative measures in reaction to the global recession. Corruption remained systemic. Some modest reforms were introduced, but much more needs to be done to make the region attractive to the investments outside the hydrocarbon sectors.

Banking sectors need to be strengthened by recapitalising, building funding base from domestic deposits, improving corporate governance and risk management and strengthening prudential supervision. Directed lending by the banks to the preferred sectors risks resulting in accumulation of non-performing assets and constraining effective allocation of credit.

Longer term goal is to diversify economies from hydrocarbon sector and to promote regional cooperation. In this context, structural reforms are crucial to empower private sector development outside the hydrocarbon sectors. For a time being geographical diversification of hydrocarbon exports is a welcome step. Regional economic cooperation, however, is very weak and progress needed in advancing it, especially in the areas of energy supply, water usage and transit of goods given regional interdependence on access to water, energy resources and export markets.

Risks and outlook

The economic recovery of these countries is dependent on the global and regional outlooks, which translates in to the higher demand for export commodities and jobs for migrant workers. The dependence on remittances and on the hydrocarbon

Table III.18.1:
Central Asia - Main economic indicators

	2006	2007	2008	2009	2010
Real GDP growth (domestic currency, % change)				prel.	proj.
Kazakhstan	10.7	8.9	3.2	-2.0	2.0
Kyrgyzstan	3.1	8.5	7.6	2.3	4.5
Tajikistan	7.0	7.8	7.9	3.4	4.0
Turkmenistan	11.4	11.6	10.5	4.0	15.3
Uzbekistan	7.3	9.5	9.0	7.0	7.0
Inflation (% change)					
Kazakhstan	8.6	10.8	17.2	7.5	6.6
Kyrgyzstan	5.6	10.2	24.5	8.0	8.0
Tajikistan	10.0	13.2	20.4	8.0	10.9
Turkmenistan	8.2	6.3	14.5	0.4	3.5
Uzbekistan	14.2	12.3	12.7	12.5	9.5
General government budget balance (% of GDP)					
Kazakhstan	7.2	4.7	1.1	-1.9	-0.4
Kyrgyzstan	-2.1	-0.3	0.0	-3.8	-6.3
Tajikistan	1.7	-6.2	-6.1	-6.7	-6.4
Turkmenistan	5.3	3.9	11.3	9.3	9.4
Uzbekistan	1.2	5.1	10.5	2.0	5.3
Current account balance (% GDP)					
Kazakhstan	-2.5	-7.8	5.1	-3.0	3.9
Kyrgyzstan	-3.1	-0.2	-8.2	-7.8	-12.4
Tajikistan	-2.8	-8.6	-7.9	-13.7	-13.3
Turkmenistan	15.7	15.5	18.7	17.8	29.1
Uzbekistan	9.1	7.3	12.8	7.2	6.7
Total gross public external debt (% GDP)					
Kazakhstan	6.7	5.8	6.6	8.8	8.9
Kyrgyzstan	72.5	56.8	48.6	54.3	53.6
Tajikistan	34.5	34.9	30.1	41.1	44.7
Turkmenistan	3.3	2.4	3.2	2.9	1.9
Uzbekistan	21.3	15.8	13.3	11.2	9.1

Sources: IMF, own judgement and calculations.

sectors, combined with the lack of market-oriented reforms and limited diversification, leaves the economies vulnerable to the external shocks. Dependence on the wholesale foreign financing foreign financing translates in to a major vulnerability for domestic financial markets. In Kazakhstan, in the short term, the main economic risks relate to the uncertainty surrounding the progress of the protracted debt restructuring negotiations of several banks.

Social development and poverty

Real per capita income likely contracted after a long period of augmentation. Over the last several years generally robust economic growth complemented with high migration and consequent inflow of remittances to the poor households led to the reduction of poverty in this relatively poor region. Remittances have been the main coping mechanism for the households, but generally have not resulted in the productive investments, such as small enterprises. Economic downturn drastically reduced remittances and must have had negative impact on welfare levels, especially where poverty reduction was not supported by restructuring agricultural economy, strengthening social services and business environment.

Employment situation is bound to worsen. Official employment figures do not always convey the actual situation in the labour markets, as in some countries sizable underemployment exists, witnessed by massive employment abroad. Return of unemployed migrant workers might negatively affect the employment situation until Russia's (and Kazakhstan's) economy does not recover creating jobs for migrant workers.

19. GCC COUNTRIES

- ***In the Gulf Cooperation Council (GCC) countries – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates economic growth fell sharply in 2009. Growth even contracted in the United Arab Emirates and Kuwait. A rebound is expected in 2010 thanks to the resurgence of global demand and, first and foremost, rising global oil prices.***

- ***The debt crisis in Dubai worsened the economic situation in the United Arab Emirates, mainly due to a loss of confidence of (foreign) investors in the sovereign government.***

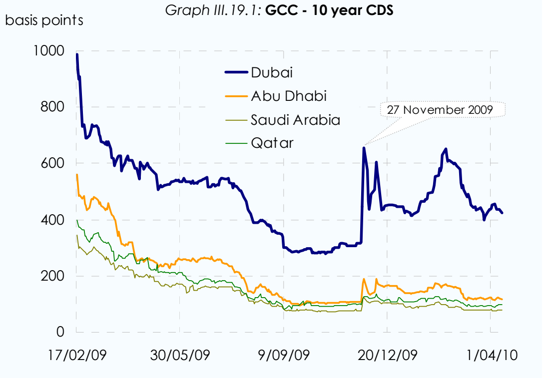
- ***In comparison with many other countries worldwide, the GCC countries are in a relatively good position to weather the storm in view of their ample resources and the improvement in their macroeconomic fundamentals. However, the risk looms of investment being addressed more towards the GCC markets instead of abroad.***

Macroeconomic and financial developments

The year 2009 was difficult in several respects. The economies of the United Arab Emirates and Kuwait entered a recession, with a drop in economic growth of 3.5% and 1.7%, respectively. Current account balances remained positive, mainly thanks to lower imports, and government balances were low and even negative in the United Arab Emirates and Bahrain. On top of this crisis in the real economy, the United Arab Emirates faced a sharp correction in its real estate sector, which triggered much commotion in global financial markets as the government hesitated in the first instance to provide state aid.

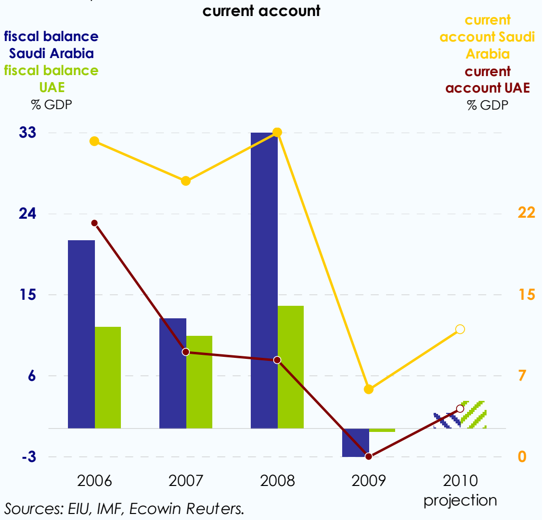
Dubai, one of the seven emirates of the UAE, enjoyed a boom until 2009. Investments in real estate had grown by 73% in 2008 (according to the Collier International House Price Index), but dropped 40% in the first quarter of 2009 due to the falling demand from domestic and foreign buyers of

Graph III.19.1: **GCC - 10 year CDS**



Bron: Bloomberg.

Graph III.19.2: **Saudi Arabia, UAE - Fiscal balance and current account**



Sources: EIU, IMF, Ecowin Reuters.

Graph III.19.3: **GCC - Stock market prices developments**

Source: Reuters ECOWIN.

the finished construction projects (apartments, hotels, houses). End November 2009 the situation worsened when Dubai World, one of the biggest conglomerates announced that it would not be able to pay on its debt during the next six months. The CDS of Dubai jumped 300 basis points in one week. Financial markets were shocked, not only by this news, but more so because of the announcement by the government of Dubai and the federal government of the United Arab Emirates that they would not provide state aid.

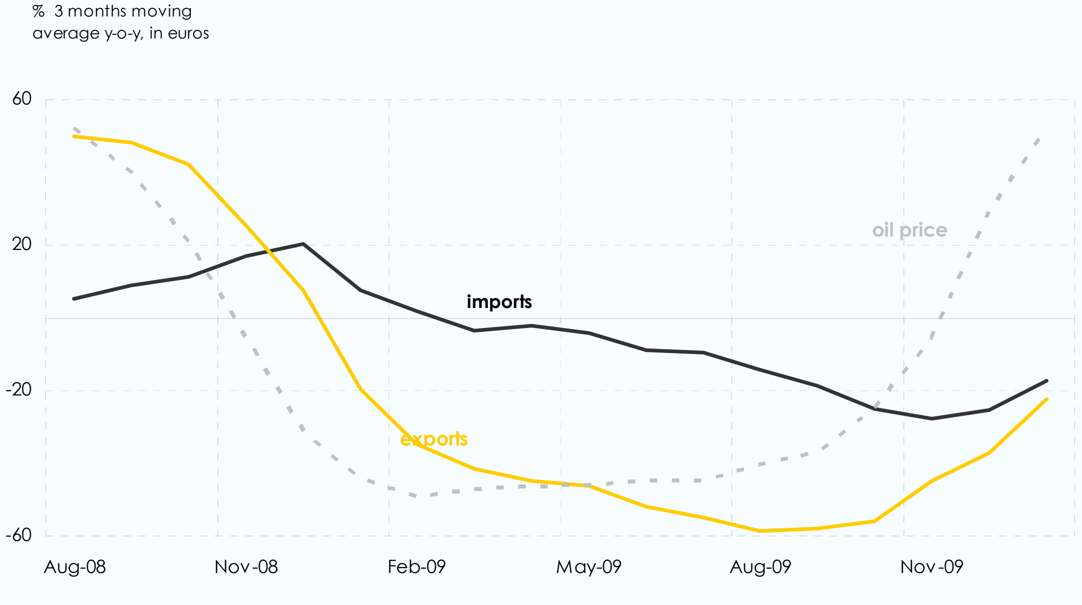
Although oil-rich neighbour Abu Dhabi gave aid by buying USD 10 billion worth of bonds from the central bank that were issued by Dubai, the debt problems are not solved. Dubai World remains with a non-government debt stock of USD 34 billion. Moreover, the whole emirate of Dubai is highly indebted (allegedly with USD 170 billion) in relation to its GDP (USD 82 billion). The *moral hazard* of companies seeking risky projects while relying on state aid is at play in the UAE that as a country has just become more vulnerable because of its indebtedness to foreign economies.

Putting the uncertainties surrounding the United Arab Emirates aside, the expectations are that economic growth in the GCC will rebound strongly in 2009. In particular Qatar in particular stands out as its growth expectations surpass the 20% mainly thanks to its exports of liquefied natural gas. But also Saudi Arabia is expected to achieve solid growth, of around 3%. These strong rebounds are the result of the fiscal packages that are being implemented (among others, 7.5% of GDP by Saudi Arabia) and monetary policy easing.

In Saudi Arabia hefty spending on military and security programmes and activities and financial support for civil servants and needy nationals drove up fiscal expenditures. Oil revenues constituted 86% of the revenues. Net public debt as a percentage of GDP increased in the fiscal year 2009/10 as a result of the drop in GDP.

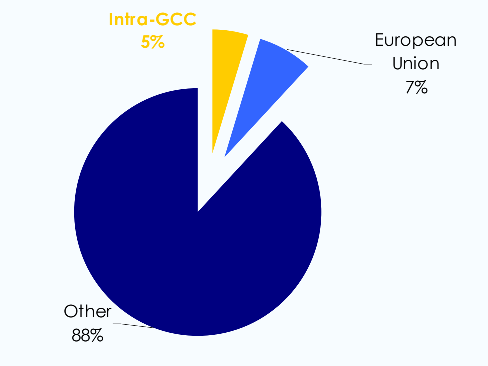
Lower exports and lower consumer and business confidence leading to lower private consumption and business investment have been depressing domestic economic activity. After several years of solid economic growth of almost 6%, growth did not exceed 1% in 2009. On a more positive note, the lower global commodity prices and the fall in global demand diminished pressure on consumer prices and brought inflation down from its high levels in 2008 (16% in the United Arab Emirates) to around 5% in 2009 (though even deflation in Qatar).

Graph III.19.4: **Saudi Arabia and UAE - Exports and imports**

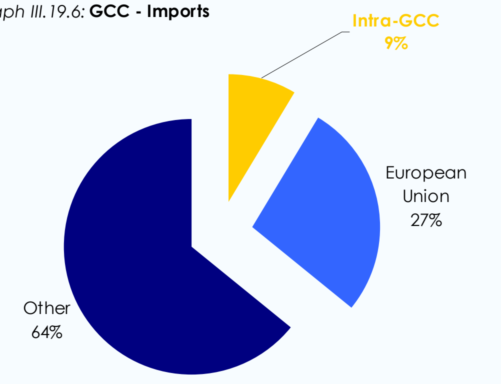


Source: IMF DoTs, ECOWIN Reuters.
Data on exports (imports) are measured by the imports (exports) of the eurozone and the US.

Graph III.19.5: **GCC - Exports**



Graph III.19.6: **GCC - Imports**



Source: IMF Directorate of Trade Statistics.

Foreign exchange reserves in the GCC are still low in relation to GDP. But, despite the losses during the global crisis there are allegedly still sufficient buffers in the form of sovereign wealth funds.

In order to strengthen monetary policy and boost intra-regional trade, agreement was reached on the creation of a central bank for the monetary union in Riyadh and the introduction of a single currency. Saudi Arabia, Bahrain, Kuwait and Oman will participate in this union. As trade within the GCC is still low at only 5% of total exports and 9% of total imports (see graphs III.19.5 and III.19.6), there is ample scope for regional trade integration.

Risks and outlook

The economies of the GCC are expected to rebound in 2010, thanks to the resurgence of global demand. This holds in particular for Asia, which has become an important trading partner of the GCC countries. As commodity prices rise in the wake of global demand, the oil and gas exports of the GCC are also strongly on the rise (see III.19.4).

Only the United Arab Emirates may lag behind. The chief risk for the UAE is that the full extent of the real estate prices bubble will burst. Although ample funds are available in the United Arab Emirates, in view of the SWFs and foreign exchange reserves, the main question is whether the government will step in if Dubai World or any other private/public company will defaults on its debt. On the one hand government aid will settle the debt problems within the country borders and not affect foreign creditors. But on the other hand, providing government aid opens opportunities for private/public companies to invest more and more in risky projects, which may trigger an upward spiralling debt burden for the government.

Another looming risk, directly associated with the Dubai debt crisis, is that foreign investors will lose confidence in the region. This may have long-lasting effects.

Further to this, diversification of the economy is needed.

Policy reforms and measures

Since the start of the financial turmoil various measures have been taken. Saudi Arabia eased its monetary and fiscal policy. Banks with loan-to-deposit ratios exceeding 100 have been deleveraging to protect their capital base and meet central banks' guidelines.

Saudi Arabia will maintain a loose fiscal policy to support economic growth. In the 2010 budget a budget deficit is foreseen. The bulk of budgetary appropriations have been earmarked for education, health and social services and infrastructure development. The new budget provides for development schemes intended to create new jobs particularly in the sectors of education, health, security and social services, municipalities, water, drainage, roads, electronic trade and scientific research.

Table III.19.1:
GCC - Main economic indicators

	2006	2007	2008	2009	2010
Real GDP growth (domestic currency, % change)				prel.	proj.
Saudi Arabia	3.2	3.4	4.2	0.2	3.2
United Arab Emirates	14.9	6.0	7.4	-3.5	1.0
Bahrain	6.7	8.4	6.3	2.9	4.0
Kuwait	5.2	4.4	8.5	-1.7	3.7
Oman	7.5	5.8	6.4	2.7	3.9
Qatar	12.2	17.3	13.4	9.5	23.5
Inflation (average, %)					
Saudi Arabia	2.3	4.1	9.9	5.2	3.5
United Arab Emirates	13.5	13.3	15.8	1.5	4.8
Bahrain	2.0	3.8	7.0	3.0	3.5
Kuwait	3.0	5.5	10.6	5.0	4.5
Oman	3.0	5.9	12.5	5.3	3.0
Qatar	11.8	13.6	15.2	-4.3	2.6
Fiscal balance (% GDP)					
Saudi Arabia	21.0	12.3	33.0	-3.2	1.7
United Arab Emirates	11.3	10.3	13.6	-0.4	3.0
Bahrain	4.3	3.1	6.6	-0.6	-0.8
Kuwait	29.1	41.4	27.4	9.0	13.2
Oman	0.3	0.3	1.3	0.7	2.1
Qatar	8.9	11.4	14.0	8.3	11.7
Current account balance (% GDP)					
Saudi Arabia	28.0	24.5	28.8	6.2	11.5
United Arab Emirates	20.8	9.5	8.8	0.3	4.5
Bahrain	13.8	15.7	10.3	5.9	6.3
Kuwait	44.7	40.8	43.7	20.9	26.2
Oman	15.4	6.2	10.1	1.2	4.4
Qatar	16.7	14.0	14.2	0.9	17.8
Public external debt (% GDP)					
Saudi Arabia	13.9	18.3	16.8	18.8	17.7
United Arab Emirates	44.8	53.3	52.9	57.5	52.2
Bahrain	49.0	45.9	47.2	50.2	49.3
Kuwait	25.2	29.6	24.9	25.6	21.2
Oman	13.1	14.3	14.2	14.1	13.5
Qatar	52.5	66.4	57.7	86.2	62.2
Cross-border banking GCC countries (% GDP)					
External liabilities	24.4	37.9	31.6	37.0*	
External assets	35.6	47.7	37.3	40.3*	
External loans	23.0	35.8	30.0	35.2*	
External deposits	39.2	49.0	34.3	37.1*	

Note: The oil Brent price assumption is USD 97.7 per barrel in 2008, 61.9 in 2009 and 75.0 in 2010. *September 2009.
Sources: EIU, BIS, own judgement and own calculations.