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The EU's neighbouring economies: managing policies in a challenging global environment

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The EU's neighbouring economies:

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ABBREVIATIONS

AA	Association Agreement
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AP	Action Plan
BIS	Bank for International Settlements
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
DCFTA	Deep and Comprehensive Free Trade Area
DoTS	Directorate of Trade Statistics (IMF)
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
ECF	Extended Credit Facility
EFF	Extended Fund Facility
EFI	European Financial Institution
EFTA	European Free Trade Area
EIB	European Investment Bank
EIU	Economist Intelligence Unit
ENP	European Neighbourhood Policy
ENPI	European Neighbourhood and Partnership Instrument
EU	European Union
EUR	Euro
EURASEC	Eurasian Economic Community
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
FY	Fiscal Year
G8	Group of Eight
GCC	Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE)
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
IDB	Islamic Development Bank
IDP	Internally Displaced Person
IFC	International Finance Corporation
IFI	International Financial Institution
ILO	International Labour Organisation
IMF	International Monetary Fund
IT	Inflation Targeting
MENA	Middle East and North Africa region
MFA	Macro-financial Assistance
MSME	Micro, Small and Medium Enterprises
NIF	Neighbourhood Investment Facility
NIP	National Indicative Programme
NPLs	Non-Performing Loans
OECD	Organisation for Economic Co-operation and Development
OIC	Organisation of Islamic Cooperation
OPEC	Organization of the Petroleum Exporting Countries
PA	Palestinian Authority
PLL	Precautionary Liquidity Line
PPP	Public-Private Partnership
SBA	Stand-By Arrangement
SCF	Standby Credit Facility
SDR	Special Drawing Right (IMF)
SMEs	Small- and Medium-sized Enterprises

SPRING	Support to Partnership, Reform and Inclusive Growth
UAE	United Arab Emirates
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNHCR	United Nations High Commission for Human Rights
UNICEF	United Nations Children's Fund
UNRWA	Relief and Works Agency for Palestine Refugees in the Near East
UNWTO	United Nations World Tourism Organisation
USD	US dollar
VAT	Value Added Tax
WTO	World Trade Organization

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FOREWORD

The euro area went back into recession in 2012, negatively affected by the continuing deleveraging by both banks and the private sector, fiscal consolidation efforts and a weak global environment. The prolongation of the euro area crisis contributed, in turn, to the weakness of global economic activity throughout the year.

The EU's neighbours did not remain immune to this weaker global environment and witnessed decelerating growth, which was coupled with growing internal (namely fiscal) and external imbalances. As with the global crisis of 2009, the impact of the euro area crisis was more pronounced in the Eastern neighbours, where activity decelerated markedly after two years of robust recovery from the deep recession in 2009. They were also hit by the deceleration of the Russian economy (an important market for many of them) and, in some countries, by domestic political volatility, as numerous elections impacted on the structural reform drive and negatively affected consumer and business confidence. In a more positive development, many of the Eastern neighbours are on their way to a successful graduation from the IMF-supported programmes put in place at the time of the 2009 crisis. These financial arrangements helped them strengthen macroeconomic policies and pursue ambitious reforms, all of which contributed to a rebound of capital flows after the sharp contraction observed in 2009. However, the Eastern neighbours continue to face significant macroeconomic and reform challenges, particularly in a context of persistent weak growth in the EU and Russia.

This challenging global environment also impacted on the Southern neighbours, although at a smaller scale due to the lower degree of openness of these economies and the positive buffering role of the Gulf Cooperation Council countries. Nevertheless, these countries continued to be negatively affected by the disruptions and uncertainties created by the political transitions that started in 2011 as a result of the Arab Spring uprisings, some of which are proving harder than initially hoped for (as the events in Egypt in July 2013 underline), and by the intensification of the conflict in Syria, which is having negative spill-overs on its neighbours. In order to address public discontent, governments in many cases put structural reforms on hold and resorted to expansionary policies that exacerbated weak fiscal and external positions and eroded policy buffers. The situation was made worse by the still high energy and food prices, which have been little affected by the global economic slowdown. As a result, several of the Southern neighbours were forced to seek the IMF's assistance, while some also looked for support from their oil-rich neighbours. In almost all oil-importers in the region, there is a strong necessity for fiscal reforms to put public finances back on a sustainable track. The reform of the poorly-targeted oil and food subsidy systems remains a priority to this end. There is also a need for reforming the large and inefficient state sector that prevents the emergence of a vibrant private sector that should become the major driver for growth and job creation. Further trade integration can also make a key contribution to that effect. In a region characterised by very high rates of unemployment and very low rates of labour market participation, notably among women, unleashing new engines for job creation remains of paramount importance.

This paper is part of a series of reports produced by the European Commission's Directorate-General for Economic and Financial Affairs (DG ECFIN) on the economic developments and policy challenges of countries covered by the EU's European Neighbourhood Policy (ENP), published under DG ECFIN's Occasional Papers. The ENP region includes ten countries on or very close to the Southern and Eastern shores of the Mediterranean – Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria and Tunisia – and six countries to the East of the EU that were previously part of the Soviet Union – Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. The main motivation of the paper is to assess the economic situation in, and provide broad policy recommendations for, the neighbouring economies in the new global, regional and domestic environment.

The publication is structured into four parts. Part I starts with a comparison of the economic situation and outlook in the Southern and Eastern neighbours of the EU, before providing a brief overview of the main topics examined in the subsequent parts of the report. Part II describes recent economic developments separately for the Southern and Eastern neighbours and analyses the macroeconomic and structural policy challenges these two regions face. The last part of the chapter on the Southern neighbours also discusses the policy response of the EU and the international community to the Arab Spring process. Part III consists of two thematic chapters. The first one assesses the exposure of the EU's neighbours to the euro area sovereign debt and banking sector crisis, while the second provides an overview of the main principles of Islamic finance and its increasing role in the Mediterranean region. Finally, Part IV delivers a country-by-country analysis of the EU's neighbouring economies, including economic activity, price developments, fiscal and monetary policies, external developments and structural reform agenda.

This Occasional Paper was written under the guidance of Heliodoro Temprano Arroyo, Andreas Papadopoulos and Christoph Wagner; the editorial coordination was ensured by Radostin Neykov. The main authors were staff members of DG ECFIN: Hillen Francke (Overview; The potential of Islamic finance; Moldova; Palestine), Krista Kalnberzina (Exposure of EU neighbours to the euro area crisis; Economic developments in the EU's Southern neighbours; Armenia; Israel; Libya), Agnes Le Thiec (Exposure of EU neighbours to the euro area crisis), Jose María Medina Navarro (Exposure of EU neighbours to the euro area crisis; Egypt; Morocco), Diana Montero Melis (Overview; EU and international response to the Arab Spring; The potential of Islamic finance; Algeria; Lebanon; Syria), Radostin Neykov (Overview; Economic developments in the EU's Eastern neighbours; Exposure of EU neighbours to the euro area crisis; Azerbaijan; Belarus; Georgia), Christoph Saurenbach (Ukraine), Heliodoro Temprano Arroyo (Exposure of EU neighbours to the euro area crisis) and Irene Vlachaki (Overview; EU and international response to the Arab Spring; Jordan; Tunisia). The chapter on Lebanon was co-authored by Charles Abdallah (EU Delegation Lebanon). The paper also benefitted from contributions by Temenushka Milenkova (Exposure of EU neighbours to the euro area crisis) and Alessandro Ulliana (Analysis of 'Doing Business' indicators) during their internship at DG ECFIN.

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Part I

1. OVERVIEW

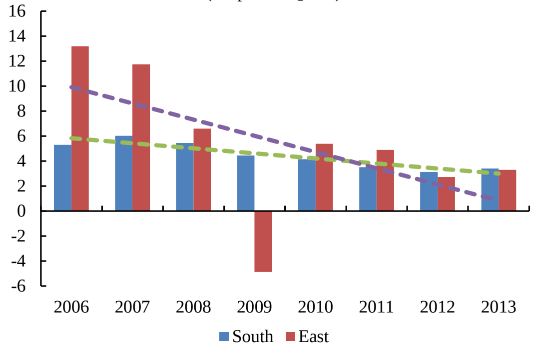
1.1. COMPARISON BETWEEN SOUTHERN AND EASTERN NEIGHBOURS

1.1.1. Growth slows in a challenging environment

When the EU's neighbours were still recovering from the impact of the deep global recession of 2009, the combination of a weak external environment and regional and domestic problems is again posing serious economic challenges to these countries. In particular, the prolongation of the sovereign debt and banking crisis in the EU, with which many EU neighbours maintain close economic and financial links, continues to have negative spill-overs on them. At the same time, regional and local factors, including political uncertainty, continue to negatively affect economic performance. This is particularly the case for the Southern neighbours, where political transition in the Arab states proceeds at a very slow pace and with significant setbacks, posing macroeconomic challenges and acting as a hinder to structural reforms and an impediment for investments. ([1]) The situation in the Southern neighbours is further complicated by the prolongation and intensification of the civil war in Syria, which is also affecting significantly its neighbours. Domestic factors, be it the build-up of macroeconomic imbalances or political uncertainty, are also weighing down on economic growth in several Eastern neighbours. They are also being affected by the rapid slowdown of the Russian economy since the second half of 2012.

This weak global environment, coupled with the above-mentioned regional and domestic problems, expectedly acted as a drag on the economies of the EU's neighbours in 2012. In the South, average GDP growth further slowed down (to 3.1% excluding Libya and Syria) (see Graph I.1.1). This was due to a moderate acceleration of economic activity in Algeria, Egypt, Jordan, Lebanon and a more significant rebound in Tunisia after the 2011 recession, which offset the weakening performance in Morocco and Israel. Libya was an outlier, as its GDP more than doubled in 2012 due to resumption of hydrocarbon production that had almost come to a halt during the war in the previous year. At the same time, activity in Syria has been dramatically affected by the conflict in the country, although reliable figures for the impact of the war on its economy are not available.

Graph I.1.1: **European neighbourhood - Real GDP**
(simple average, %)



Sources: National authorities; IMF; * Excl. Libya and Syria excluded as of 2011
Commission Staff forecast for 2013

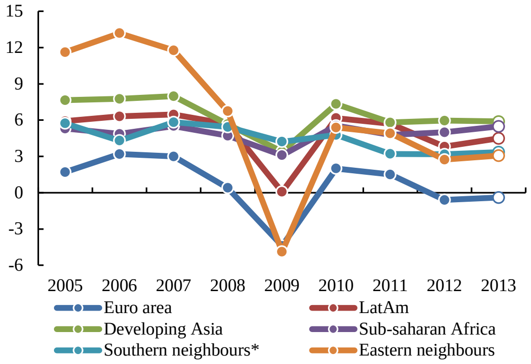
Following two years of strong post-crisis recovery, the Eastern neighbours witnessed a steep deceleration in economic growth in 2012, mostly due to their high exposure to the deepening crisis in the euro area (see Part III). The return of the euro area economy into recession contributed to the very hard landing of some countries such as Moldova (which suffered an economic contraction), Ukraine and Belarus. Tighter policies needed to tame high inflation (especially in Belarus) and address external imbalances (Ukraine) were also among the factors coming into play. In Georgia, political uncertainty also had a negative effect on growth, as investors and other economic agents wondered about the economic policy strategy of the new government formed after the elections of October 2012. The simple average of GDP growth in the region eased to only 2.7% in 2012 from about 5% in the previous two years. And the growth rate in 2012 is much lower if we calculate the weighted average of national growth rates in order to take into account the size of the economies (Ukraine accounting for more than half of the total). GDP growth in this case was only 1.3%, down three percentage points on the year.

([1]) In this paper, the EU's Southern neighbours include Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria and Tunisia. The EU's Eastern neighbours are Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.

Thus, while the Eastern neighbours, which had been much more harshly affected by the global recession of 2009, were recovering faster than the Southern neighbours, their deceleration in 2012 has brought their average growth rate again below that of the Southern neighbours, and this despite the fact that the latter continue, as noted, to be negatively affected by their political transitions and civil conflicts. While the growth rates that the Eastern neighbours were experiencing prior to the 2009 global crisis were admittedly not sustainable, the deceleration seen in 2012 has clearly pushed growth in the Eastern region below most estimates of the rate of potential growth. (2)

Graph I.1.2: **World - Real GDP**

(simple average %)

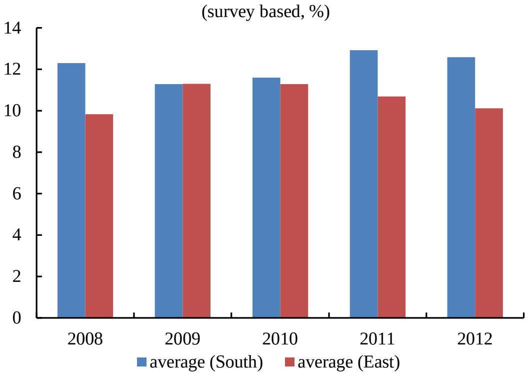


Sources: Commission calculations based on Eurostat and IMF * - excl Syria and Libya as of 2011

On a global comparison, the EU's Southern and Eastern neighbours fared worse than other emerging economies (see Graph I.1.2), which seems mostly due to their relatively high exposure to the problems of the euro area and the uncertainty stemming from the political transition in the Southern neighbours. The latter have in many cases brought fiscal adjustment and structural reforms to a halt, as the authorities have taken measures to assuage tensions (namely through wage and pension increases and delays in the reform of unsustainable energy and food subsidies). Although higher public spending, especially in the Southern neighbours, is likely to have contributed to limit the deceleration of growth in the region, it seriously clouds medium-term prospects due to the strong fiscal adjustment required to put public finances on a sustainable path. High dependence on both the EU and Russia, along with still weak institutions, is a major drawback for the Eastern neighbours, particularly since the Russian economy shows a relatively high correlation with the EU economy. By contrast, the significant economic and financial links of the Southern neighbours (notably those in the Mashrek) with the Gulf Cooperation Council (GCC) countries, has partly buffered some of them from economic developments in the EU. According to our forecasts, GDP growth in the neighbourhood area will rebound only slightly in 2013 (to 3.4% in the South and 3.3% in the East), although risks remain tilted to the downside due to high external vulnerability and civil unrest in some of the Mediterranean countries.

Graph I.1.3: **European neighbourhood - Unemployment rate**

(survey based, %)



Sources: National authorities; IMF

This lacklustre performance of the neighbourhood economies should be expected to negatively affect the labour markets. This is evident in the Southern neighbours, where unemployment rates crept up in 2010-11 from already very high levels, before stabilising in 2012 at about 12½% on average (see Graph I.1.3). (3) In the Eastern neighbourhood, where developments seemed affected by the lagged impact from the strong 2011 growth performance and where Armenia (the country with the highest jobless rate in the region) managed to cut unemployment substantially thanks to its

(2) The economies of the Southern neighbours had been much more resilient to the 2009 global recession, which partly explains their softer recovery in 2010. The Eastern neighbours, by contrast, were one of the regions most affected by the global crisis, partly reflecting the overheating that had occurred in the years preceding the crisis. For a description of the factors behind the different behaviour of the Eastern and Southern neighbours during the global crisis of 2009 and the recovery of 2010, see European Commission (2011).

(3) This was mainly due to improvements in Tunisia, which came from a very high unemployment rate.

strong economic growth, the average unemployment rate continued on a slight downward path 2012. However, this inertial downward trend is likely to be short-lived, as weaker economic activity is expected take its toll on the labour market in 2013. In both regions unemployment levels are above the ones before the global crisis despite a relatively high share of agricultural sector that often acts as a cushion for the labour market. Youth unemployment remains at elevated levels, presenting a pressing problem especially for the Southern neighbours, where growth is falling short of the one needed to ensure sufficient job creation for the fast-growing population. Moreover, in the Southern partners, participation rates remain very low, largely reflecting the limited participation of women in the labour force. Another problem stems from the traditionally high importance of the public sector, which in some cases crowds out private sector development, preventing it from playing its potential role as the driving force in job creation.

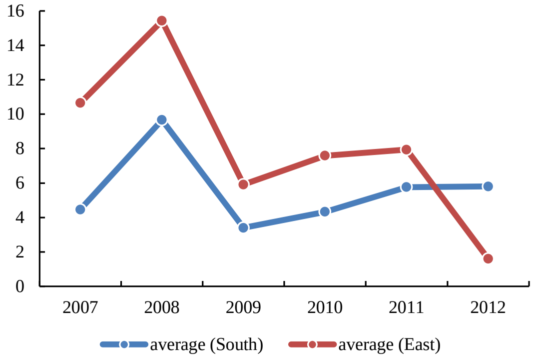
1.1.2. Inflation and monetary policy

In 2012, there was a markedly divergent pattern in inflation dynamics in the two groups of neighbours (see Graph I.1.4). In the East, price growth slowed down sharply throughout the year mainly on the back of lower global food prices. By contrast, the favourable food price developments worldwide failed to translate into lower inflation in most of the Southern neighbours, as they were offset by disruptions in the supply chains due to the political turmoil, expansionary fiscal policies (including wage hikes) aimed at easing social tensions and, in some cases, the impact of the depreciation of the domestic currency.

These factors kept average inflation in the Southern neighbours near 6% in 2012, as in 2011. In some cases (e.g. Jordan), progress with eliminating or reducing food and energy subsidies also explains the downward stickiness of inflation despite lower international food prices. Algeria witnessed the steepest inflation acceleration in 2012 (to 8.9% from 4.5% in 2011) due to expansionary fiscal policies and supply-chain problems. Egypt, where inflation halved to only 4.7%, was at the other end of the spectrum because of the pass-through of the global food price decline. However, this trend was already reversed in early 2013 due to the steep depreciation that the Egyptian pound suffered at the end of 2012.

Graph I.1.4: **European neighbourhood - CPI inflation**

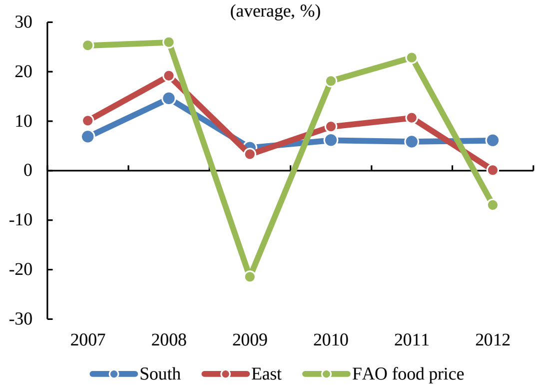
(average, %)



Sources: National authorities; IMF

Graph I.1.5: **European neighbourhood - Food inflation**

(average, %)



Sources: National authorities; IMF; UN FAO

According to the figures of the UN's Food and Agriculture Organization (FAO), global food prices dropped by 7% on average in 2012, following two years of nearly 20% growth. This decline, together with the high share of food prices in the consumer basket, was the key driver of the steep disinflation observed in the Eastern neighbours in 2012 (see Graph I.1.5). Weak economic activity and worsening consumer confidence also contributed to hold prices down in this region, with some countries (Georgia, Ukraine) recording deflation at the end of 2012. The strongest disinflation was recorded in Belarus, where price growth eased to 22% from more than 100% at the end of 2011 due to the tight monetary and fiscal policies introduced in response a the balance of payments crisis.

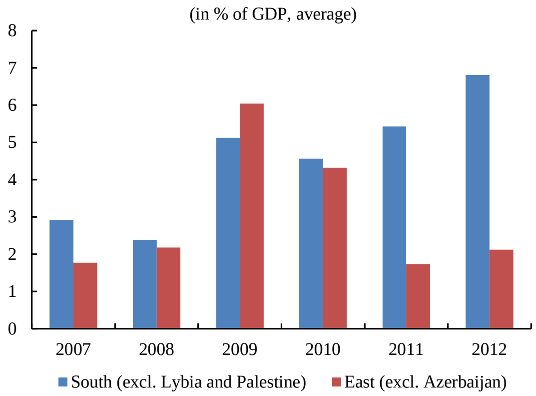
Looking ahead, stronger inflationary pressures could be expected for both regions. They mainly stem from the possible increase in energy and food prices as the world economy continues its gradual recovery, as well as from the envisaged reforms in energy and food price subsidies (discussed in Annex 2 of Part II).

Diverging inflation trends could largely explain the different monetary policy stances broadly observed in the two regions in 2012. In the East, the steep disinflation enabled central banks to embark on an easing cycle that also aimed at buttressing real activity. The key policy rate was reduced in all countries save Armenia, with the biggest cuts implemented in Belarus and Moldova. Further easing followed in early 2013, as inflation pressures remained subdued, while economic activity stayed weak. In the South, by contrast, there were not such dramatic changes in the monetary policy stances. The central bank of Israel reversed its tightening approach in view of lower inflationary pressures and weakening economic activity. Interest rates were hiked in Tunisia (in 2012 and 2013), Jordan (in 2012) and in Egypt (in 2013) to anchor growing price pressures and to halt the erosion of international reserves.

1.1.3. Ensuring fiscal sustainability

Fiscal policies remained on divergent paths in the Southern and Eastern neighbours in 2012 (see Graph I.1.6). The failure to address the fiscal burden arising from generalised energy and food subsidies in the South, which was compounded by the negative effect of weak economic growth on tax revenues and by expansionary expenditure policies to ease social discontent during the transition process, expectedly led to a further widening of the region's already high budget deficit. The average fiscal deficit reached 6.8% of GDP in 2012, up from 5.4% of GDP a year earlier. In the East, by contrast, fiscal consolidation continued with the exception of Ukraine and Azerbaijan. The former was negatively impacted by weakening activity and high energy prices that affected the budget through an inefficient subsidy system, notably for gas prices, which result in a large budgetary transfer to the loss-making, state-owned gas conglomerate Naftogaz. As for Azerbaijan, the country maintained its expansionary fiscal stance as it continued to benefit from relatively high oil prices. Despite the broadly prudent fiscal policies in the East, the general government deficit expanded slightly on average, reflecting the lower-than-expected growth. Still, both the trend (essentially downwards since 2010) and the level of fiscal deficits (about 2% of GDP in 2012) remain in stark contrast with those of the Southern neighbours.

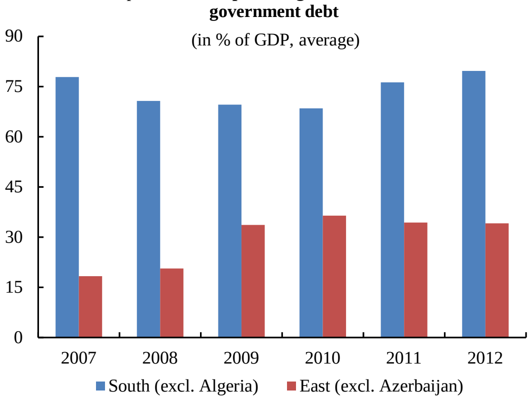
Graph I.1.6: **European neighbourhood - General government deficit**



Sources: National authorities; IMF

Following a strong increase during the 2009 recession, the public debt-to-GDP ratio has stabilised around 30% in the East and is expected to gradually ease in the medium term in the absence of policy reversals and significant external shocks (see Graph I.1.7).

Graph I.1.7: **European neighbourhood - Gross government debt**



Source: IMF WEO 2013

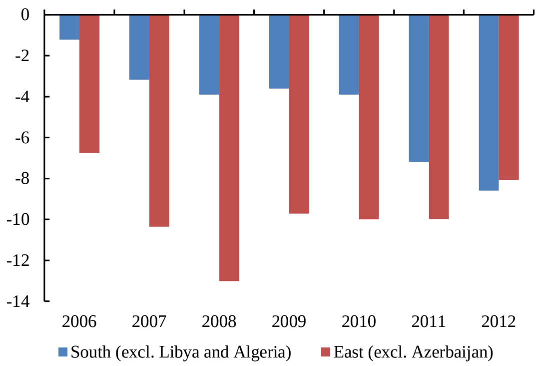
The situation in the Southern neighbours is much more alarming, as public debt, fuelled by expansionary fiscal policies, kept on climbing in 2012 from already high levels to nearly 80% of GDP at the end of the year. The risks are somewhat mitigated by the fact that this debt is owed largely to domestic agents (often banks, as in

Lebanon, which has the highest debt ratio in the region, and Egypt). Still, in order to keep public indebtedness under control a strong fiscal retrenchment will be needed.

1.1.4. The external constraint

The external positions of the EU neighbours are also a cause for concern. In the South, since the start of the global economic crisis, there has been a considerable widening of the current account deficits, reflecting unfavourable trends in the terms of trade (especially higher international commodity prices), expansionary public sector income policies that stimulate domestic demand, and the negative impact of the euro area crisis on exports. Regional conflicts also had a negative impact, in particular on the tourist sector, which is an important revenue source for a number of Mediterranean states. ([4])

Graph I.1.8: **European neighbourhood - Current account**
(in % of GDP, average)

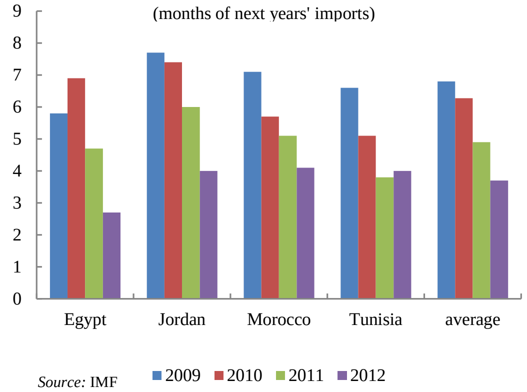


Sources: National authorities; IMF

By contrast, in the East, there has been a downward adjustment in current account deficits after the 2009 recession. Nonetheless, deficits remain at elevated levels, leaving these countries very vulnerable to external shocks and shifts in capital flows. The combination of a moderate decline and stabilisation at high levels of current account deficits in the East and of a marked deterioration from lower levels in the South has resulted in a convergence of deficits in both regions (excluding oil exporters) to levels just above 8% of GDP on average (see Graph I.1.8). While running current account deficits may be justified in a catching-up process in which countries borrow resources from abroad to finance domestic investment that supports productivity growth, current account deficits in both the Eastern and Southern neighbours are too large, increasing their balance of payments vulnerability.

The financing of the high current account gaps also poses risks. In the case of the Southern neighbours foreign direct investment (FDI) and other capital inflows declined substantially, reflecting both increased political and macroeconomic instability and the impact of the euro area crisis. As a result, and despite substantial flows of official assistance, total external financing was insufficient to meet growing needs, leading to a sharp decline in international reserves in several cases, both in nominal terms and in coverage of next years' imports of goods and services (see Graph I.1.9). By contrast, financing resources for the Eastern neighbours – with the exception of Ukraine and Armenia – were not only sufficient to cover the gap but actually enabled a further build-up of international reserves, although they remained at lower levels in terms of import coverage (3.5 months) than in the Southern countries. ([5]) At the same time, FDI did decline (although more moderately than in the Southern neighbours) and thus the share of debt financing increased, which was reflected in a growing external debt (reaching 80% of GDP at the end of 2012).

Graph I.1.9: **Selected Southern neighbours - International reserves, 2009-12**
(months of next years' imports)



Source: IMF

The risks arising from the weak external positions of the EU's neighbours have been somewhat mitigated by IMF and other official assistance. The

([4]) Tourist sectors in Egypt, Jordan, Lebanon and Tunisia were badly hurt by the high regional instability.

([5]) This also reflects the relatively high degree of openness of the Eastern neighbours, which implies a higher import base.

2009 crisis forced all Eastern neighbours (save oil-rich Azerbaijan) to seek assistance programmes from the Fund (for more information on IMF assistance, as well as related Macro-Financial Assistance (MFA) from the EU, see Annex 1 of Part II). In Armenia, Moldova and Georgia these programmes (of either a disbursing or a precautionary nature) continued, while Ukraine and Belarus seek to secure new arrangement to fend off risks arising from vulnerable balance of payments positions, growing external debt repayments and an inauspicious global environment. The growing, twin deficits in the Southern neighbours have also prompted them to seek IMF support. Jordan and Morocco were the first to enter agreements in 2012 (the latter of a precautionary nature only), while Tunisia followed suit in 2013. Egypt has been trying to negotiate a USD 4.8 billion package since early 2011, so far unsuccessfully. It is still too early to tell what the political developments of early July, which resulted in the replacement of the Muslim Brotherhood administration by a technocratic government, will imply for the prospects of Egypt reaching an agreement with the IMF.

1.1.5. Managing economic policies in a challenging global environment

Both the Southern and the Eastern EU neighbours have to manage economic policies in a weaker and more volatile global environment. According to the European Commission's Spring 2013 forecasts, the euro area economy, the major economic partner for many of the neighbouring countries, is projected to further contract in 2013 before posting a very gradual and moderate expansion in 2014. ([6]) The downside risks to these projections remain sizeable due to the impact of on-going fiscal consolidation on economic activity, continued deleveraging by households and the financial sector, and the risk of a re-intensification of the turmoil in the euro area's public debt and financial markets. Adjustment fatigue might also put a hold on the reform drive needed to address the imbalances. Moreover, the Eastern neighbours could be further negatively affected by the spill-over effects of the euro area crisis on Russia, which seems to be already taking place. ([7]) In this respect, the Southern neighbours seem in a better position given their considerable reliance on the GCC area, which, as noted, can act as a buffer. However, this should also not be overestimated as activity in the GCC countries will be affected by production constraints and is exposed to the volatility of energy prices. At the same time, regional conflicts and high political uncertainty remain a serious impediment for economic policymaking in many of the Southern neighbours. In this context, the EU's neighbours should persevere in their macroeconomic adjustment and structural reform efforts and, in some cases, consider adopting a more ambitious economic policy response.

Regarding macroeconomic policies, although there is no 'one-size-fits-all' strategy, measures should be tailored towards ensuring fiscal and external sustainability and price stability, while supporting economic activity. In the Southern neighbours, there is an urgent need for fiscal reforms to bring back public finances under control and reduce current account deficits, especially in a situation where external financing sources have weakened. This should be ensured through a gradual abolishment of the broad-based energy and food subsidies, accompanied by their replacement with better targeted social assistance. Government expenditure reforms should also include a reallocation from wages (which generally encourage consumption and erode competitiveness) to more productive sectors such as education and infrastructure. In the Eastern neighbours, considerable fiscal reforms were implemented after the 2009 recession, placing them in a good position to address the new economic challenges. But fiscal consolidation efforts must continue in many countries, also as a way of addressing large structural current account deficits.

Monetary policies in both sub-regions should continue to have ensuring price stability as their primary aim. The task of monetary policy continues to be complicated in some countries by high dollarization (notably in the East but also in Lebanon) and in all of them by still insufficiently

([6]) The recovery of the euro area economy is expected to start, although mildly, in the first half of 2013. See European Commission (2013).

([7]) Russia's economic growth slowed down to 3.4% in 2012 from 4.3% a year earlier and is expected to further moderate to 2.4% in 2013.

developed monetary policy instruments. Measures to encourage de-dollarization and to develop new monetary control instruments (which in some cases have as a prerequisite the development of the domestic public debt and other security markets) are important in this respect. Some countries should also consider moving towards increased exchange rate flexibility, in some cases hand in hand with the adoption of inflation targeting regimes.

The strengthening of macroeconomic policies should be accompanied by more resolute structural reforms, which in some cases have been put on hold due to complicated social and political situations. Many of the key structural reform challenges are common to both sub-regions. They include: strengthening public finance management and economic institutions; implementing tax reforms aimed at increasing revenues, making tax systems less distortionary and increasing progressivity; conducting energy sector reforms (including not only energy price subsidy reform but also other measures to promote energy efficiency and energy diversification); improving the business climate and regulatory framework, which should also boost the country's appeal to foreign investors. The latter is particularly important for the Southern neighbours, most of which continue to score very poorly in business climate indicators, in contrast with the rapid catching-up vis-à-vis developed countries achieved by Eastern neighbours in recent years (see Box II.2.1 in Part II). Measures to support private sector development, which is sometimes (notably in the Southern neighbours) overshadowed by dominant public sectors, are also needed. In some countries (e.g. Algeria or Belarus) there is still a considerable scope for further privatisation of the state-owned enterprises and other state assets. In order to support the private sector, it is also important to promote financial sector development and adopt schemes that facilitate the access of small- and medium-sized enterprises (SMEs) to finance.

Further trade integration, even for the very open Eastern neighbours, could also support growth and be an important source of job creation, technological progress and competition. This may involve in some cases joining the WTO, in others the conclusion of bilateral trade agreements with key partners such as the Deep and Comprehensive Free Trade Areas (DCFTAs) with the EU or the participation in regional trade integration initiatives such as the Agadir Agreement in the North of Africa. Finally, a reform area of particular relevance to the Southern neighbours is labour market and educational system reform, to raise participation rates (notably among women), reduce unemployment rates and reorient skills towards those effectively demanded by the private sector.

1.2. THE ARAB SPRING MORE THAN TWO YEARS LATER

1.2.1. A still vulnerable macroeconomic situation

Two and a half years after the first protests that led to the process known as Arab Spring, the macroeconomic situation of the Arab countries in transition remains very fragile and their political and economic reform processes face important challenges and uncertainties. While growth in the four oil-importing Arab countries in transition that are part of the European Neighbourhood Policy (Egypt, Jordan, Morocco and Tunisia) recovered to some extent in 2012, the recovery was much weaker than initially expected and growth remains well below pre-revolution levels. Thus, average GDP growth in those four countries accelerated from 1.9% in 2011 to 3% in 2012, but still remains well below the 2009-10 average. At the same time, the fiscal positions deteriorated further in 2012 (with the average deficit increasing from 6.5% of GDP in 2011 to 8% of GDP in 2012) and the balance of payments situation has remained very weak. The current account deficits further increased in most of the countries last year, averaging 8.5% of GDP, while FDI inflows are still well below those seen before the upheavals started (with the exceptions of Tunisia and Morocco) and official reserves experienced in a number of cases further declines. This adverse environment has put a drag on job creation and has further increased unemployment, one of the factors behind the social unrest.

There have also been some positive developments, notably the economic situation in Libya, which improved markedly in 2012 as hydrocarbon production returned to almost pre-conflict levels more rapidly than initially expected. Also, the Moroccan and Algerian economies have continued to show significant resilience despite the unpropitious regional and global environment. Hydrocarbon-rich Algeria has so far managed to ease Arab Spring-related social tensions and to mitigate their economic impact, essentially through the mobilisation of its abundant fiscal resources, which has allowed it to increase current government expenditures (civil servant wages, price subsidies and social transfers), while maintaining an ambitious public investment programme.

At the same time, the intensification of the Syrian conflict since 2012 has been affecting (including through the refugee crisis) countries in the Mashrek, notably Lebanon and Jordan. This negative development is generating an additional source of regional economic and political instability. Also, the difficulties and uncertainties surrounding Egypt's political transition, highlighted by the situation created following the ousting of President Morsi in July 2013, and the delays in the adoption by the Egyptian authorities of a clear economic adjustment and reform strategy, including the complicated negotiations with the IMF, leave the largest economy in the region in a very vulnerable balance of payments and fiscal position.

Apart from the domestic and regional factors, economic recovery is further hampered by weak external demand, notably from Europe. The prolongation and deepening of the euro area crisis is having a particularly negative effect on the Maghreb countries, for which the euro area is the most important trading and investment partner (see Chapter 1 in Part III). More generally, the combination of a weak global economy and relatively high international food and energy prices has continued to hurt the Arab countries in transition since most of them are net energy importers and are very sensitive (both socially and from a budgetary point of view, given their extensive use of generalised energy and food subsidies) to increases in international food prices. ([8]) In that respect, it should be recalled that the increase in international food prices was one of the economic factors that contributed to trigger the Arab Spring upheavals.

([8]) While international food prices have seen a moderate downward correction from their historical peak of mid-2011, they are still close to the 2008 peak.

Assistance from the GCC and other countries in the region, as well as from other bilateral (including the EU and G8 partners) and multilateral donors, has provided some welcome breathing space while adjustment and reform measures are put in place. Programmes with the IMF have already been agreed by Jordan, Morocco and Tunisia and, as noted, are under negotiation with Egypt. Thus, for example, Egypt's balance of payments position has been temporarily supported through assistance from GCC countries, ([9]) Libya and Turkey, while Jordan has benefited from significant flows from the Gulf countries, notably Saudi Arabia. However, although this assistance has allowed beneficiary countries to buy some time, it cannot be a substitute to addressing the underlying sources of macroeconomic vulnerability.

1.2.2. The need for structural reform

Although political demands for democracy, strengthened civil liberties and better governance are evidently at the heart of the Arab Spring, economic adjustment and reforms will be critical to maintain macroeconomic stability and address the structural economic weakness that contributed to the Arab Spring uprisings. ([10]) This is, in turn, essential for ensuring the continuity and success of the on-going political reforms. The need for policy actions that appropriately address these challenges is therefore stronger than ever. At the same time, implementing such measures is not proving easy. Fragile transitional governments are under social pressure to delay difficult, yet much needed, reforms and adjustment measures and in some cases, the transitional governments have yet to develop a clear vision of their economic reform priorities.

Measures that need to be implemented include a growth-friendly fiscal adjustment, the reform of generalised price subsidies and their replacement by a system of cash transfers targeted to the needy, measures to strengthen economic governance, and measures to promote the development of the private sector and the improvement of the

([9]) In July 2013, Saudi Arabia, Kuwait and the United Arab Emirates announced a fresh package of financial assistance for Egypt in the amount of USD 12 billion.

([10]) The underlying economic factors behind the Arab Spring are discussed in Chapter 3 of European Commission (2011).

investment climate. Labour market reforms and efforts to redesign the education system to better align worker skills with the real needs of the economy are also paramount. Deeper international and intra-regional trade and financial integration can also help raise potential growth, including by encouraging investment and technological development, while increasing employment opportunities.

For the transition to be successful, economic reforms must go hand-in-hand with political reform. This is important to ensure that economic reform plans are prepared with society's input and ownership, thus increasing the likelihood that they will be fully implemented. Reforms should also be measurable and point to a final goal. In this context, communication can prove a key policy tool. At the same time, growth policies must be more inclusive, allowing the less privileged to improve their lives. Subsidy reform is one way to achieve this goal through the reallocation of funds to those most in need. Also, higher investment in health and education services can raise sustainable growth while improving human capital, thus giving poor households the means to improve their well-being in a more durable way (as opposed to cash transfer schemes).

Addressing simultaneously macroeconomic stability risks, structural/regulatory economic reform and political reform in a difficult global and regional environment is no doubt a challenging task. But it is nonetheless feasible, as the transition experience of Portugal and Spain in the 1970s and of Central and Eastern European countries in the 1990s illustrates. These countries managed successfully to undertake political reforms that helped them establish democratic systems and deep regulatory reforms in the economic area, while restoring macroeconomic stability in a difficult economic environment (the oil shocks of the 1970s, in the case of Portugal and Spain, and the macroeconomic instability that accompanied the abrupt abandonment of centrally planned regimes in Central and Eastern Europe). It is true that all these countries had the incentive to join the EU, as well as a regulatory model to import from it, and that, following their EU accession, they received substantial financial support from the EU. But the Arab countries in transition can also count on substantial financial assistance from the international community and have the incentive to fully participate in the EU's internal market through the conclusion of DCFTAs (see below). While the political transition may admittedly be more complex, they also stand, therefore, a good chance of succeeding.

1.2.3. The role of the international community

Although the responsibility to take the above-mentioned policy decisions and move forward with essential structural reforms rests primarily with national authorities, the international community can also play a catalytic role. Since the beginning of the Arab Spring, the international community has shown its political and financial support, notably through the Deauville Partnership initiative launched by the G8 in 2011. The EU has adopted a comprehensive response to support Arab countries in transition, including by participating actively in the Deauville Partnership (see Part II).

The international community is helping transitional governments implement home-grown reform programmes and achieve more sustainable and inclusive growth in the medium term through the provision of financial assistance, technical assistance and policy advice, a number of trade policy initiatives aimed at facilitating market access for the region's exports, and, in some cases, the provision of debt relief.

The international community has already provided substantial financial assistance. In addition to sizable contributions from bilateral donors, especially the GCC countries, international financial institutions have committed USD 18.5 billion since the beginning of the transition period. As the leading donor in the region, the EU has made available considerable financial resources (loans and grants) to facilitate economic and political reform. Over the period 2011-13, the EU intends to mobilise up to about EUR 2 billion in support of Deauville Partnership beneficiary countries (excluding Yemen) through its European Neighbourhood Policy Instrument (ENPI) alone. This amount includes EUR 540 million under the SPRING Programme, put in place specifically to support transition-related projects, governance and socio-economic development, in the Southern neighbourhood countries demonstrating good progress with reforms.

At the same time, the ceiling for the Mediterranean region under the EIB's external mandate has been increased to EUR 9.7 billion for the 2007-13 period on top of an additional EUR 2 billion mandate for climate change operations, of which the Mediterranean region could use up to EUR 700 million for the period through 2013.

In the area of economic stabilisation, the EU stands ready to complement IMF programmes with its MFA, an emergency balance-of-payments support instrument aimed at addressing short term external imbalances. The EU is already advancing with the provision of EUR 180 million to Jordan and is ready to consider supporting Tunisia and Egypt provided certain pre-conditions are met. The EU and its Member States also actively support the extension of the EBRD's mandate to the region, which can make another EUR 2.5 billion of funds available for the region.

As the region's main trade partner, the EU also supports long-term growth through economic integration, in particular through the establishment of DCFTAs and the development of a Pan-Euro-Mediterranean system of rules of origin and its support for intra-regional integration schemes.

All these initiatives are part of a wide-ranging response by the EU to the Arab Spring. In order to effectively coordinate resource mobilisation in support of the region, the EU has also organised a series of meetings bringing together the EU and international financial institutions (IFIs), including the EIB, the EBRD and the World Bank, and also potential private sector investors.

1.3. THE EXPOSURE OF EU NEIGHBOURS TO THE EURO AREA CRISIS

The first thematic chapter in this year's report attempts to assess the vulnerability of the EU neighbours to the developments in the euro area, especially in view of the crisis in the latter and the persistence of weak activity. Most of the neighbours have embarked on a rapid trade liberalisation course since the start of the century, which was accompanied by a gradual financial opening. Even though this process was much more pronounced in the Eastern partners, both groups of countries moved closer to the global business cycle and reaped sizeable benefits during the boom years that preceded the 2008 global financial crisis. At the same time, they became more exposed to global downturns, which was the case during the deep recession of 2009. At that time, the Eastern neighbours were especially strongly hit, while the Southern ones demonstrated resilience, benefiting from their less open economies, conservative banking practices, the buffering role of the GCC countries and, in some cases, the room for counter-cyclical policies. ([11])

Just a few years after the deep global recession, the EU's neighbours are again facing headwinds from an unfavourable external environment. This time external risks for the neighbourhood arise mainly from the sovereign and banking crisis in the euro area, the biggest trading partner for both the Southern and the Eastern neighbours as well as a major source of tourism inflows, worker remittances and financing (through both private capital flows and official assistance). The euro area economy contracted by 0.6% in 2012 and, according to the Spring 2013 Economic Forecast of the European Commission, GDP in the euro area will again contract this year (by 0.4%), before witnessing a gradual and moderate recovery as of 2014. The negative impact of the euro area crisis on the EU's neighbours comes at a time of elevated political uncertainty in many of them, particularly in the Southern ones, reflecting the gradual and complicated transition to more democratic regimes that started with the Arab Spring process in 2011 as well as the prolonged civil war in Syria, which has significant regional repercussions.

In trying to evaluate the potential spill-over effects for the EU neighbours from the euro area crisis, the chapter examines various transmission channels identified in the economic literature. They are grouped into two categories. The first one studies the factors at play through transactions in the current account of the balance of payments, namely the impact on merchandise trade (and in particular on exports from the neighbourhood to the EU), tourism, and remittances. The second category focuses on the impact through the capital account, with the analysis looking at FDI inflows, banking flows and financial contagion. Apart from

([11]) For a detailed discussion of the impact on the EU's neighbours from the global crisis see European Commission (2009).

trying to assess the vulnerability of the neighbours to each of these transmission channels, the chapter also discusses the most recent trends, thus looking at the extent to what the negative spill-over effects have materialised.

The final section of the chapter tries to empirically assess the degree of convergence of the neighbourhood countries with the economic cycle in the EU. It does so by examining evidence on correlations of growth between the EU neighbouring economies, or groups of them, and the EU and other key economic and financial partners. This is done by performing a correlation analysis to study the business cycle linkages as well as by a short overview of the existing empirical evidence on the topic. The objective of this section is to try to overcome some of the shortcomings of the first part of the analysis (based on a partial examination of the different transmission channels), which does not sufficiently take into account the interaction of the linkages among themselves and with other factors. The results of both analytical approaches yield consistent results.

The results of this chapter suggest that Eastern neighbours are somewhat more exposed to the euro area problems, with Ukraine standing out among the most vulnerable countries. But some Southern neighbours, notably those in the Maghreb region, also seem particularly exposed, reflecting some of the highest trade dependence in the whole neighbourhood on export, tourism and remittances receipts from the EU, as well as a relatively high exposure to FDI and banking flows from the euro area. One important reason why the Eastern neighbours are relatively more exposed to the euro area crisis is the fact that the Russian economy, a key export market and a key source of tourism, remittances and financial flows for many of them, is relatively correlated with the euro area economy and that, partly as a result, it has been decelerating markedly since the second half of 2012. By contrast, in the Southern neighbours, particularly those in the Mashrek, the GCC countries tend to play a more reliable buffering role. The Mashrek countries are, however, very vulnerable to the spill-over effects from the Syrian crisis and from the instability associated with the political transition in Egypt.

The impact of the euro area crisis on the neighbourhood economies will obviously depend on the way it will evolve, or namely whether it will lead to another full-blown global crisis that would hit international trade and depress commodity prices. In such a negative scenario, which seems unlikely at this stage, the effect for the neighbourhood from the developments in the euro area could be magnified through potentially weaker activity in Russia and the GCC countries. The impact from the persistently weak activity in the euro area will also depend on the relative fragility of the macroeconomic and political situation and the ability of the countries to respond to this external shock, including their room for implementing counter-cyclical policies.

Taking into account these caveats, Part III concludes with some policy recommendations for the EU neighbours on how to mitigate the potential negative impact for their economies from the euro area crisis or from other external shocks. The recommendations underline the need to build during good times room for counter-cyclical policies that can be used when the external shocks hit, the usefulness of exchange rate flexibility, the importance of prudential regulation and supervision of the financial system, the importance for net energy exporters of diversifying their export and fiscal revenues, and the role of some key structural reforms, notably those aimed at improving the investment climate and fostering trade integration.

1.4. THE POTENTIAL OF ISLAMIC FINANCE

The chapter on Islamic finance provides a brief introduction to the topic and assesses the growth prospects of the industry. Worldwide, the market is very small, with assets amounting to a mere 1% of conventional finance's total global assets. However, it is an emerging segment of international finance. The chapter discusses the basic principles and main products of Islamic finance, examines recent trends in the sector and assesses the opportunities and potential for further expansion.

The most prominent principles of the system, which are drawn from Sharia law, are the prohibition to pay or charge interest (*riba*), the avoidance of uncertainty (*gharar*) and speculation, the need to minimise risk and the requirement to link financial transactions to real economic activity. Islamic finance first developed in the 1960s and 1970s, while the 1980s and 1990s saw the expansion and development of Islamic financial products to a large number of Muslim-majority countries, and also to some Western financial hubs. Since then, Islamic banking and finance has spread throughout the Muslim world to more than 70 countries, in particular to members of the Organisation of Islamic Cooperation. The Arab Spring processes that started in 2011, and the associated coming into power of moderate Islamic governments in a number of countries, have reinvigorated the spread of Islamic finance. It is in this context that one needs to understand the global trends seen in recent years, as well as the debate about the role that Islamic finance could potentially play in the future.

By now, Islamic finance has developed into a segment of world finance that offers a broad range of Sharia-compliant products and services to meet the ethical and financial needs of individuals and institutions. The Islamic financial sector includes commercial and investment banks, leasing companies, private equity firms, capital markets companies (e.g. asset management), as well as microfinance institutions offering a wide variety of financial products. The most well-known of these are the *sukuk* (a type of bond), the *takaful* (insurance), financial partnerships such as *Musharakah* and *Mudarabah*, and credit sales (e.g. *Murabahah* or *Musawamah*).

Modern Islamic finance has seen a remarkable expansion in recent years, leading a number of world finance hubs to get involved into this niche of global finance. Over the past decade alone, the value of Sharia-compliant assets increased from USD 80 billion in 2001 to over USD 1.3 trillion in 2011, and they are expected to reach USD 1.8 trillion by the end of 2013 (Ernst & Young 2012-13). Asset growth is likely to continue hand in hand with its geographic expansion (Ernst & Young, 2012-13). Asset growth is likely to continue hand in hand with its geographic expansion. The GCC countries in particular, with their large surpluses as a result of hydrocarbon sales, are expected to look for opportunities in Arab countries in transition to diversify their huge portfolios with Islamic finance products, which they also promote for cultural and political reasons. In the current post-Arab Spring context, where specific legislative measures and issuance decisions are being taken by some of the new governments, an increased attention is being given to Islamic finance, also as a way to diversify sources of funding.

And yet, although a clear possibility for Islamic finance to grow further exists, its growth potential should not be exaggerated as its limits cannot be ignored. The impossibility to pay interest in the standard way or to undertake certain operations (e.g. forward sales) represents a drawback for its further development in the context of global financial markets. Furthermore, for a sustainable expansion to take place, a number of challenges will need to be dealt with. Over the past twenty years, we have seen the development of several international institutions exclusively dedicated to the regulation and standardisation of Islamic finance practices and products. However, as it grows and expands, one of the major challenges faced by the industry is the need for a strengthened regulatory framework in order to standardise and thus integrate the Islamic finance market globally. Today, the system complements, rather than supersedes, conventional finance. As such, it may provide a source of diversification and resilience to conventional finance but it is unlikely to replace it.

Part II

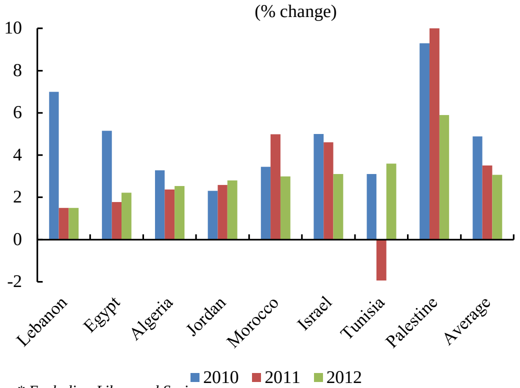
Regional macroeconomic trends and policies

1. SOUTHERN NEIGHBOURS

1.1. RECENT MACROECONOMIC DEVELOPMENTS

The economies of the EU's Southern neighbourhood had already rebounded from the 2008-09 global financial crisis when they were forced to face the social and economic impact of the Arab Spring and the conflicts in Libya and Syria. As noted in Part I, these regional political events, in combination with the implications of the weak performance of the European and global economies, resulted in a deceleration in average **GDP growth** rates (excluding Libya and Syria) from 4.9% in 2010 to 3.5% in 2011 and 3.1% in 2012 (see Graph II.1.1). ([12]) All countries, except Tunisia and Libya in 2011 and Syria most likely in both 2011 and 2012, managed to maintain positive growth rates. Political instability is harming investment and, in some cases, exports, clouding the growth prospects of most countries in the region. Consumption, by contrast, has been relatively resilient in a number of countries (including Egypt), supported by the expansion of current government expenditures, notably public sector wages and price subsidies.

Graph II.1.1: **Southern neighbours - Real GDP**
(% change)



** Excluding Libya and Syria*
Sources: National authorities; IMF

In 2011, economic disruptions were most significant in countries where political developments and changes were most radical – Egypt, Tunisia, Libya and Syria. In Egypt, growth plummeted but still remained in the positive territory (1.8%), while in Tunisia the economy contracted by 1.9%. Libya's GDP is estimated to have contracted by 62.1% due to the collapse of hydrocarbon production during the conflict and international sanctions. Palestine was somewhat of an outlier, as its economy continued to grow by 12.2% in 2011, supported by the easing of restrictions on access to the Israeli market. There is no information on economic indicators for Syria due to the on-going civil war in the country.

In 2012, Tunisia and Libya recovered from negative growth. The Tunisian economy grew by 3.6% and Libya recovered the lost growth by fully resuming its hydrocarbon production in 2012. It is estimated that the output of the Libyan economy more than doubled in 2012 (growth rate of 104.5%). However, it was still substantially (22.5%) below the level of 2010. The best performers, Morocco and Israel, which had grown by close to 5% in 2011, saw a slowdown in 2012 to around 3%, primarily reflecting the impact of limited global demand on their export performance. Unfavourable weather conditions in Morocco added to the slowdown. Egypt continued to record lacklustre growth, of just above 2%, reflecting its difficult political transition. The Palestinian economy, for its part, decelerated markedly reflecting a new tightening of Israel's policy on restrictions and the decline in donor aid.

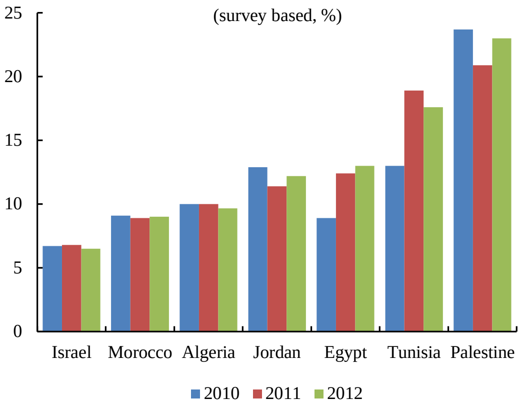
The spill-overs from the conflict in Syria, notably through its disruption of trade, the refugee crisis and its implications for the budgets of host countries, are weighing on growth rates in Lebanon and Jordan (see Box II.1.1). GDP growth in the two countries was limited to 1.5% and 2.6% in 2011 and 1.5% and 2.8% in 2012, respectively. For 2013, growth in the Southern neighbourhood is expected to accelerate only slightly (to about 3.4% excluding Libya and Syria), as difficulties in the political transition of some countries, the Syrian conflict and a persistently weak European economy continue to weigh on economic activity.

Unemployment remains one of the key concerns in the region as it increases social pressures and limits the overall economic growth potential. High levels of unemployment have persisted in most of the countries, reflecting limited job creation and demographic pressures. After increasing rather markedly in 2011 (see Graph II.1.2), unemployment rates declined moderately or stabilised in 2012 in a majority of countries, but

([12]) Including Libya, the region's GDP growth (measured by the simple average) accelerated from -4% to 14%.

increased further in Egypt, Morocco and Palestine. In 2012, the highest unemployment rates were recorded in Palestine and, despite the significant reduction achieved in that year, in Tunisia. In Palestine, the unemployment rate reached 23% of total active population (up from about 21% in 2011). In Tunisia, it decreased to 16.7% from 18.9%. All other countries in the region, except Israel, kept the unemployment rate in the 9-13% range or close to it. The sections of the population suffering most from inefficient labour markets are young people and women. Women's participation rates remain among the lowest in the world. On average, only one woman in four participates in the labour force (in Morocco, only 15% of women participate in the labour force and in Palestine and Jordan only about 20%). ([13]) Notwithstanding low participation rates, unemployment affects young people and women disproportionately. Thus, the youth unemployment rate in the region is often double the total unemployment rate, while about 20% of woman on average are unemployed. The combination of low participation rates and high unemployment rates implies that about 85% of women are *de facto* excluded from the labour market.

Graph II.1.2: **Southern neighbours - Unemployment**

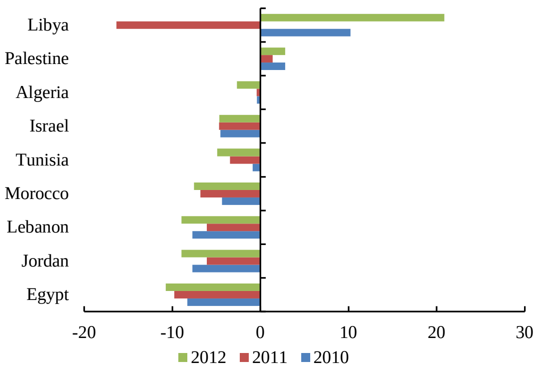


Source: IMF

Labour markets continue to rely disproportionately on government sector jobs, mostly due to significantly higher wages compared to the private sector. Wages in the public sector in Tunisia and Egypt are, respectively, 48% and 36% higher than those in the private sector. Moreover, due to social pressures following the 2011 Arab Spring uprisings, the wage bill in the public sector has grown further. Israel's labour market developments continued to be an exception in the region. In 2012, its already historically low unemployment rate continued to decrease and reached 6.5%, in spite of which wage growth remained modest, at 2% year-on-year. Moreover, participation rates in Israel continued to increase, reaching 63.6% of the working age population, much higher than the average seen in the rest of the region (about 46%) and slightly above the world average (about 61%). However, the Arab and ultra-orthodox communities of Israel continue to display much higher unemployment rates and much lower participation rates.

*Graph II.1.3:***Southern neighbours - General government balance**

(in % of GDP)



Source: IMF

Fiscal deficits were negatively affected by the slowing tax revenues (reflecting the weakening of economic activity) and increased expenditure meant to moderate social tensions, and remained very high in most countries. The increases in current expenditure consisted mostly of civil service wage rises, expanding food and energy subsidies and higher social transfers. Growing current expenditure left little fiscal space for public investment, even though some countries (notably Algeria and Tunisia) continued to carry out ambitious public investment programmes, in some cases partly financed by foreign grants. This combination of increased current expenditure and strong public investment, in a context of declining tax revenues, made it difficult for countries to avoid the widening of the budget deficits. Lebanon and Jordan were also affected negatively by the

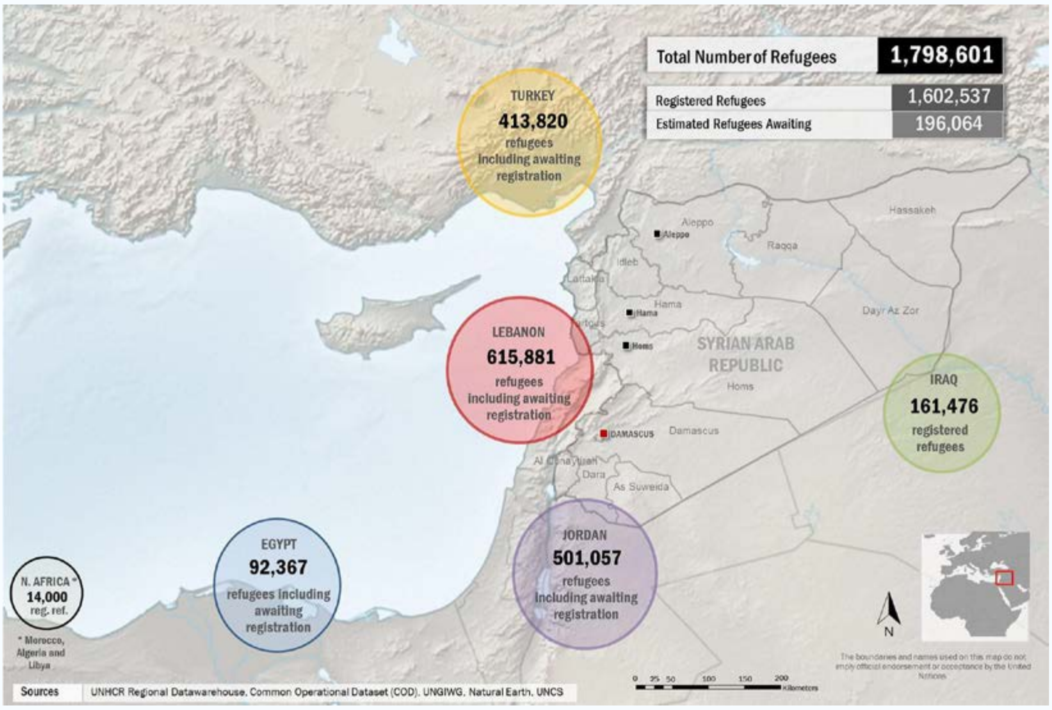
([13]) See European Commission (2010 and 2011) and World Bank (2011).

Box II.1.1: **The Syrian refugee crisis**

As Syria enters its third year of crisis, a drawn-out conflict is predicted. As of July 2013 and according to conservative estimates, more than 94,000 people have died, 1.6 million have become refugees, 6.8 million are in need of aid and 4.25 million have become internally displaced persons (IDPs). The protracted humanitarian catastrophe is spreading to neighbouring countries, endangering the stability of Lebanon and Jordan in particular. Refugees continue to leave Syria at an increasing rate (with the rate rising from 3,000 persons/day in December 2012 to 6,000 as of July 2013) and UNHCR foresees the possibility of 3.45 million refugees by end-2013.

Lebanon and Jordan are facing an unprecedented situation, which threatens their political and economic stability. As of mid-July 2013, the number of refugees is estimated to have reached 616,000 in Lebanon and 501,000 in Jordan. Given the relatively small population size of these countries, registered refugees currently represent approximately 15% of the population in Lebanon and 8% in Jordan. Informal estimates place the number of Syrians in Lebanon at over one million already, i.e. 25% of the population. Other countries with sizable Syrian refugees' inflows include: Turkey (414,000), Iraq (161,000), and Egypt (92,000) (see Map 1).

Map 1: **Syrian refugees in the region, July 2013**



Lebanon's border with Syria has remained open for all refugees, of which more than 70% are women and children. The country has not established specific camps and the uncontrolled settlement in around 1,000 locations across the country is placing serious strains on a number of basic services, from water to education and health care. The situation poses an increased risk to an already vulnerable political and macroeconomic situation, characterised by large fiscal and current account deficits and the highest debt-over-GDP ratio in the region. While the impact of the Syrian

(Continued on the next page)

Box (continued)

conflict on economic activity has been mixed (the conflict has disrupted Lebanese exports to and transit trade through Syria, but demand by refugees has also boosted domestic consumption and economic activity in some sectors) and the effects are difficult to estimate, it is clear that the Lebanese budget will suffer. Increased demand is also putting upward pressure on real estate and other prices. Furthermore, the inflow of refugees is contributing to the growing polarisation of the domestic situation and is increasing the risk of political contagion of the Syrian conflict.

Jordan has, like Lebanon, kept an open-door policy towards Syrian refugees, notwithstanding an intricate domestic political context and a difficult macroeconomic situation. Given the current rate of entry, UNHCR estimates that by end-2013 the number of refugees in the country could surpass the one million mark, which would amount to more than 16% of the population. According to the authorities, the refugee crisis had a budgetary cost of USD 250 million in 2012, mostly in the form of extra expenditure on health care, schooling and price subsidies. The cost could triple in 2013. Since the outbreak of the conflict, the budgetary cost of hosting Syrian refugees is estimated to have exceeded EUR 600 million (about 3% of GDP). Jordan has faced worsening economic conditions since 2011 due to the regional turmoil, persistent gas supply problems with Egypt and a weak global economic environment. The macroeconomic impact of the Syrian conflict, including through the refugee crisis, was one of the motivations behind the Stand-By Arrangement that Jordan agreed with the IMF in August 2012 and the complementary Macro-Financial Assistance (MFA) programme proposed by the European Commission in April 2013.

On 24 June 2013, the European Commission and the High Representative of the European Union for Foreign Affairs and Security Policy adopted a Joint Communication proposing a comprehensive **EU response** to the Syrian conflict and its consequences for both Syria and its neighbouring countries. The Communication proposes a fresh financial allocation of EUR 400 million to tackle the protracted humanitarian catastrophe, focusing on helping to alleviate the refugees' situation. The funds would be used for direct humanitarian aid (EUR 250 million) and development assistance (EUR 150 million). Close coordination with the Lebanese and Jordanian governments and UN agencies (UNDP, UNICEF, UNRWA, UNHCR) will be ensured. The amount would be in addition to the EUR 850 million already mobilised by the EU and its Member States and would bring the EU's overall contribution to address the implications of the Syrian crisis to EUR 1.25 billion.

The **international community's response** to the crisis includes pledges of more than USD 1.5 billion by the GCC countries in support of Syrian refugees in neighbouring countries and within Syria. The United States have pledged to give USD 58 million to Jordan as it handles the influx of Syrians, out of a total pledge of USD 385 million to help the countries in the region deal with the crisis. In addition, USAID has provided USD 100 million in direct budget support to Jordan's government to help it respond to its economic challenges, including those resulting from the humanitarian crisis caused by the conflict in Syria. The World Bank, for its part, is planning a USD 150 million loan to help Jordan address healthcare and basic household needs created by the influx of Syrian refugees.

fiscal cost of the strong inflow of refugees fleeing the Syrian conflict (see Box II.1.1). After increasing from 4.3% of GDP in 2010 to 5.6% of GDP in 2011, the region's average fiscal deficit (excluding Libya) further rose to 7.0% of GDP in 2012. Between 2011 and 2012, fiscal deficits increased in practically all the Southern neighbours (see Graph II.1.3). The only country enjoying a comfortable fiscal position in 2012 was Libya, as revenues from hydrocarbon production, which accounts for 95% of its fiscal income, started to flow again. As a result, a budget deficit of 15.4%

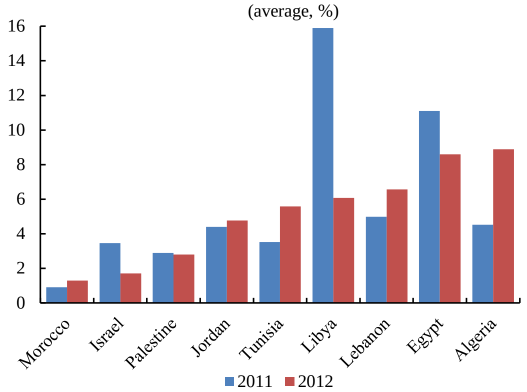
of GDP in 2011 was replaced in 2012 by an estimated surplus of 20.8% of GDP, providing ample fiscal space for post crisis reconstruction and measures to stimulate growth.

Inflation performance in the Southern neighbours was quite diverse (see Graph II.1.4). Most of them saw their inflation rates rise in 2012. The major factors contributing to acceleration of consumer price inflation were supply disruptions due to conflicts and social unrest, high global commodity prices and domestic demand pressures resulting from wage increases. In some cases (notably Egypt since the end of 2012), currency depreciation also contributed to put upward pressure on prices.

Supply disruptions influenced price developments particularly in Libya, Syria and Egypt. In Libya and Egypt, average inflation in 2012 reached 6.1% and 7.2% respectively, which implies a slowdown compared to 2011, when prices had increased by 15.9% and 10.1% respectively. High inflation in Syria (attested by anecdotal evidence since certified statistical data is not available, see chapter) is due to the conflict and ensuing supply disruptions. In Israel, slowing inflation in 2012 reflected the weakening of economic activity and remained moderate, at 1.7%.

Graph II.1.4: **Southern neighbours - CPI inflation**

(average, %)



Source: National authorities; IMF

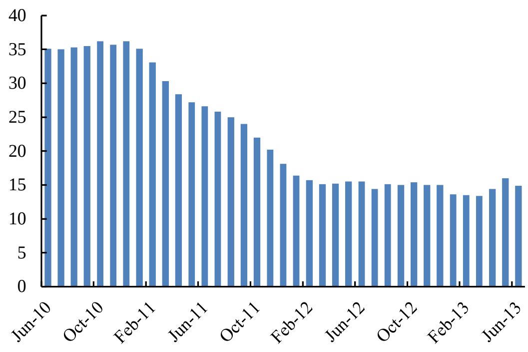
The stabilisation of global food and oil prices in 2012 has not yet translated into a slowdown of inflationary pressures in the region. The continuously high level of the global commodity prices, especially food, and, in some countries (e.g. Jordan and, to a lesser extent, Egypt and Morocco), cuts in food and fuel subsidies reflecting decreasing fiscal space, have maintained upward pressure on local consumer prices. Unfavourable weather conditions in Morocco have also added to food price inflation.

Most central banks in the region have been loosening their **monetary policy** in an effort to counter the slowing economic activity. Exceptions to this rule include, Egypt, Jordan, Libya and Tunisia, where a more cautious monetary policy strategy was implemented reflecting either concerns about inflation or the need to defend their currencies in the context of significant downward pressures.

With the exception of Israel, the countries in the Mediterranean neighbourhood are implementing some form of currency peg or closely managed **exchange rate regime**. Libya and Syria peg their currencies to the IMF's SDR (Special Drawing Right), Jordan and Lebanon to the US dollar, and Morocco and Tunisia to a currency basket with the euro as the dominant currency. The currencies of the region saw limited fluctuations in 2012 and the first half of 2013, with the exception of the Egyptian pound, which depreciated significantly (by about 15% against the US dollar) between November 2012 and July 2013, and the Tunisian dinar, which lost 5.2% of its value against the euro in the second quarter of 2013.

Graph II.1.5: **Egypt - Official reserves**

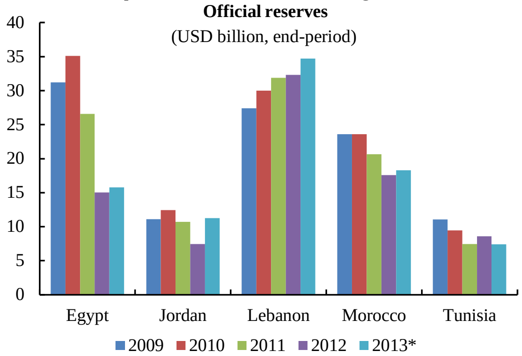
(USD billion)



Source: Central Bank of Egypt

In order to contain the pressures on exchange rates, several central banks reacted by intervening in the money market and draining their **foreign exchange reserves**. Egypt has lost more than half of its reserves since the January 2011 revolution (see Graph II.1.5) and without the substantial disbursement of foreign assistance, notably from some GCC countries and Turkey, the decline would have been much more marked. In Tunisia, reserves decreased by 20.3% in 2011. They recovered by 14.3% in 2012 but fell again by a similar percentage in the first four months of 2013. Jordan and Morocco also lost substantial reserves in 2011-12, although reserves have shown some recovery in the first half of 2013, in the case of Jordan mostly reflecting substantial disbursements of grants from the GCC countries, but also disbursements under an IMF programme (see Graph II.1.6). In Libya, reserves recovered strongly in 2012, after declining sharply during the war (a period during which a majority of the country's external assets were frozen under UN-led sanctions). In other countries, reserves were either relatively stable or rose during 2011-12.

Graph II.1.6: **Selected Southern neighbours - Official reserves**

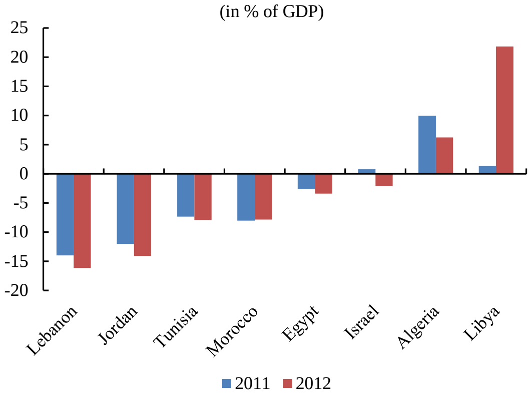


Note: 2013 shows the data for end-April for Tunisia and for end-May for the other countries
Source: IMF

The **current accounts** of virtually all Southern neighbours, with the exception of Libya, deteriorated rather markedly in 2011 and 2012 (see Graph II.1.7). This deterioration was mostly the direct translation of the worsening of the trade balances, reflecting higher costs of imports of oil and food, weakening import demand in the European markets and disruptions in exports caused by political and macroeconomic instability in the region. The impact of the contraction of import demand in Europe has led to a significant slowdown of exports of some Mediterranean partners (see Graph II.1.8), especially Israel where export growth came to a standstill in 2012. Exports also contracted in Egypt, Jordan and Algeria. The trade deficit of Jordan, whose dependence on imported energy is particularly high, widened to 33.7% of GDP in 2012 from 30.6% in 2011. This was exacerbated by political disruptions in the supply of gas imported from Egypt, which obliged Jordan to replace gas imports with much more expensive alternative fuels at a time of high oil prices. On the other hand, oil exporting Libya, with the resumption of crude oil exports, saw its current account surplus rise from just 7.6% of GDP in 2011 to 36.5% of GDP in 2012.

Graph II.1.7: **Southern neighbours - Current account**

(in % of GDP)



Source: IMF

In a context of worsening current account positions, the failure of **private capital flows** to recover, added to the vulnerability of the balance of payments positions. An important exception was FDI inflows to Tunisia, which rose strongly, even exceeding pre-2011 levels.

Graph II.1.8: **Southern neighbours - volume of exports**

(year-on-year % changes)

Note: Simple average, excluding Libya and Syria
Source: IMF DOTS database

Addressing macroeconomic vulnerabilities in the Southern neighbourhood countries would require, beyond political will, substantial financial resources. Yet, most countries are confronted with limited space for counter-cyclical policies as the fiscal and monetary buffers built over periods of economic growth and prudent macroeconomic policies, have by now been largely depleted. This has led some countries to request **financial support from the international community**. This support comprises, *inter alia*, financing provided by the IMF, the World Bank and other multilateral institutions. As noted, assistance has also been provided by bilateral donors, especially the GCC and other countries of the wider region (Turkey and Libya), the EU, its Member States and the US (see Section 1.3 below). In some countries, the rapid disbursement of bilateral assistance has provided essential breathing space until the packages of the multilateral institutions were put in place. Also, some countries enjoying international financial market access (such as Morocco, Jordan and Tunisia) have been able to issue bonds in the international capital markets, sometimes (as in the case of Tunisia) with sovereign guarantees from bilateral donors (the US or Japan).

1.2. MACROECONOMIC POLICY AND STRUCTURAL REFORM CHALLENGES

Two and a half years after the start of the Arab Spring many countries have undergone significant political reforms. Old non-democratic regimes have been overthrown and progress has been made in a number of countries in adopting or preparing constitutional reforms and new electoral laws, reforming the judiciary and providing freedom of expression and association. Yet, as the recent developments in Egypt underline, the political transition is by no means completed and some countries may still face a protracted period of political instability, with negative implications for the macroeconomic situation and the authorities' capacity to implement the necessary structural reforms.

Political uncertainty and insecurity, especially in Egypt, Libya and Tunisia, is weighing also on tourism and investment, both domestic and foreign. External developments, slowing growth and demand, along with high commodity prices, are increasing the negative effects of social instability, swelling the external imbalances and increasing the risk of macroeconomic instability.

In this context, the priority for policymakers should be to restore macroeconomic stability, while addressing the underlying structural economic problems that have resulted in the underperformance (in terms of both growth and job creation) of the economies of the Southern neighbours over the last three decades, and which were a key factor triggering the Arab Spring upheavals. It is essential, in this respect, to move to a more inclusive and equitable growth model that will help establish the necessary social consensus. Also, for some countries, like Libya, restoring/upgrading infrastructure is a priority.

Along with the reconstruction of infrastructure, social demands continue to put pressure on fiscal balances. Not surprisingly, in 2011 and 2012, most governments in the region increased public spending in the form of higher public sector wages and food and fuel subsidies, to alleviate some of the social pressures. In this context, a good balance must be reached between addressing these social expectations and returning to a serious fiscal consolidation path, after three years of deterioration in fiscal positions and increases in debt levels. The reform of food and energy subsidies and the parallel reinforcement and better targeting of the social safety net should be a key component of this fiscal strategy (see Annex 2 of Part II). Tax and public finance management reforms can also make an important contribution.

Monetary policy can support the macroeconomic stabilisation effort by ensuring price and exchange rate stability, while using any available room to support economic activity at a time when fiscal policy must focus on consolidation and debt reduction. In this context, it is also important to ensure that central banks have sufficient autonomy and focus on their main tasks, avoiding quasi-fiscal interventions and divesting themselves of non-core assets. Increased exchange rate flexibility, combined where appropriate with the adoption of IT regimes, may also be warranted in some cases.

The above mentioned fiscal, monetary and exchange rate policy strategies are also important to help reduce current account imbalances and gradually ease the balance of payments constraint.

A long-standing and increasingly urgent structural challenge in the Southern neighbourhood is to reduce the high level of unemployment, especially among the youth, while encouraging higher participation rates (notably among women). Unlike other regions, here the working age population (between 15 and 65 years of age) is growing more rapidly than its dependent population, creating a space for potential growth that is not being realised. High unemployment is the result of both rapidly rising populations and slow job creation. The latter is due not only to disappointing GDP growth performance but also to labour market rigidities and skill mismatches. Reforming labour market regulations that discourage hiring and adjusting the education skills to the private sector needs are therefore essential.

Finally, structural reforms aiming at decreasing the size of the public sector, improving the business climate, facilitating access to finance by SMEs and fostering international and intra-regional trade integration are necessary in order to allow the private sector to play its full potential in productivity growth and job creation. Regarding trade integration, the economies in the region remain relatively closed despite the trade liberalisation efforts undertaken since the 1990s. Further liberalisation, including through the participation in bilateral and intra-regional FTAs, should be considered. Concerning the business climate, indicators such as the World Bank's Doing Business rankings, suggest that the Southern neighbours continue to score on average weakly when compared with other regions of similar level of economic development and that they have made little progress over the last ten years (see Box II.2.1 in Chapter 2 of Part II). Addressing the factors that deter investment (e.g. procedures for starting a business, tax compliance burden for enterprises, enforcement of contracts, restrictions on foreign investment) should therefore be high in the reform agenda of their governments.

1.3. THE RESPONSE OF THE EU AND THE INTERNATIONAL COMMUNITY TO THE ARAB SPRING

As discussed above, two and a half years after the Arab Spring uprisings, the macroeconomic and political situation of Arab countries in transition remains vulnerable. The recovery of economic growth has been delayed, fiscal positions have suffered a further deterioration and balance of payments positions remain weak. Progress with political and structural economic reform, while significant, has proved more difficult than initially expected.

Both the EU and the G8 have worked on a comprehensive response to the Arab Spring, including in the context of the Deauville Partnership, which currently focuses on Egypt, Jordan, Libya, Morocco, Tunisia and Yemen and was launched in 2011. Actions involve closer political dialogue, increased financial and technical assistance and trade integration initiatives. This section reviews progress with these initiatives, both at EU level and within the G8.

1.3.1. The EU's response

Amid a changing political and economic environment, the EU recognised the need to adopt a new approach in its relations with its Southern Mediterranean neighbours, quickly identifying the transition challenges faced by the Southern neighbourhood region, notwithstanding the unexpected magnitude of the uprisings.

The EU's strategic response to the Arab Spring came as early as 8 March 2011, with a joint Communication from the European Commission and the European External Action Service proposing "A partnership for democracy and shared prosperity with the Southern Mediterranean". The approach was further elaborated in another joint Communication of 25 May 2011, covering the entire European neighbourhood, which launched "a new response to a changing neighbourhood".

These Communications provide the basis for a comprehensive EU response to the Arab Spring, including support for democracy, the political reform process and the role of civil society (notably through the creation of a Civil Society Facility), a reinforced political dialogue, increased financial assistance, trade policy initiatives, increased mobility of people and other sectoral policies (in areas such as transport, energy, education and culture). Both Communications stress the '**more for more**' **principle**, under which increased support in terms of financial assistance, enhanced mobility, and improved access to the EU's Single Market is to be made available to those partner countries most advanced in political and economic reforms.

Box II.1.2: The EU's SPRING Programme

The EU's Programme 'Support for Partnership Reform and Inclusive Growth' (SPRING) will have mobilised EUR 500 million over 2011-2013: EUR 390 million supported transition-related projects, governance and socio-economic development in 2011-2012; an additional allocation of EUR 110 million was adopted on 18 July 2013. Southern neighbourhood partner countries are in principle eligible beneficiaries, provided certain preconditions (in terms of good progress with democratic and economic reforms) are satisfied.

Of the 2011-12 allocation: EUR 100 million were for Tunisia, EUR 90 million for Egypt, EUR 80 million for Jordan, EUR 80 million for Morocco, EUR 30 million for Lebanon, and EUR 10 million for Algeria. The 2013 allocation was distributed as follows: EUR 40 million for Tunisia, EUR 35 million for Morocco, EUR 15 million for Jordan, EUR 15 million for Lebanon and EUR 5 million for Libya.

SPRING's objective is to respond to socioeconomic challenges in the Southern neighbourhood and support partner countries in their transition to democracy. Support through SPRING is tailored to the needs of each country, based on an assessment of the country's progress in building democracy and respect for human rights. The programme applies the 'more for more' principle, i.e. the more a country progresses in its democratic reforms and institutional building, the more support it will receive from SPRING.

The EU is one of the leading donors in the region, providing considerable financial resources (both loans and grants) to facilitate economic and political reform in Arab transition countries. Over the period 2011-13, the EU will have mobilised up to EUR 4.3 billion funds in support of Southern neighbours through the **European Neighbourhood and Partnership Instrument** (ENPI), its main financial cooperation instrument for the region. ([14]) Of this amount, about EUR 2 billion will be allocated to Deauville beneficiary countries, excluding Yemen (see Table II.1.1). It includes EUR 500 million provided for 2011-13 under the SPRING (Support to Partnership, Reform and Inclusive Growth) Programme (see Box II.1.2). Created in September 2011, the SPRING Programme complements on-going activities of the EU in partner countries, including those financed by the Deauville Partnership's Transition Fund (see Section 1.3.2 below).

Over 2011-12, the EU also combined EUR 200 million grant funds with EUR 2.2 billion in resources from European financial institutions (EFIs) through the EU's **Neighbourhood Investment Facility** (NIF). The NIF brings together grants from the EU budget and EU Member States, loans from European public finance institutions and contributions from partner countries, mostly to finance infrastructure projects and small- and medium-sized enterprises (SMEs).

Another important financial response was the increase by EUR 1 billion in the ceiling for the Mediterranean region under the **European Investment Bank**'s (EIB) external mandate. As a result, the EIB's lending ceiling for this region for the period 2007-13 reached EUR 9.7 billion (out of a total EIB external lending mandate of EUR 29.5 billion). This is in addition to the EUR 2 billion increase in the bank's lending ceiling (decided during the mid-term review of the EIB's external lending mandate), to finance projects in the area of climate change, of which the Mediterranean region could use up to EUR 700 million for the 2011-13 period. Despite a substantial decline in 2011, reflecting the challenging political and economic environment, EIB lending in the Mediterranean region increased in 2012 to EUR 1.7 billion, from EUR 975 million in 2011. Between 2002 and

([14]) Under the EU's Multiannual Financial Framework 2001-13, the total funds allocated to the ENPI, which also covers the Eastern neighbourhood, amount to EUR 12.8 billion, of which EUR 9.0 billion are for the Southern neighbourhood alone.

2012, the EIB financed 192 projects in the Mediterranean region with EUR 14.2 billion.

The EU also stands ready to complement IMF efforts in the region through its own **Macro-Financial Assistance** (MFA). The European Commission has adopted a proposal for an MFA operation of up to EUR 180 million for Jordan in the form of a medium-term loan (see Annex 1). The EU could also consider possible MFA operations in Tunisia and Egypt, the latter dependent on Egypt reaching a financial agreement with the IMF, as MFA requires the existence of an IMF programme entailing the actual use of IMF resources.

In the area of **trade policy**, the EU is also putting together a comprehensive response. The EU is the region's main trade partner, representing its main source of imports and its largest export market (see Part III, Chapter 1). In December 2011, the EU agreed to offer to Egypt, Jordan, Morocco and Tunisia the possibility to negotiate so-called Deep and Comprehensive Free Trade Agreements (DCFTAs), allowing those countries to effectively participate in the EU's internal market, thus focusing on economic integration instead of trade liberalisation, as in the FTAs put in place by the existing Association Agreements. DCFTA negotiations were launched with Morocco in March 2013. Preparations to launch negotiations are on-going with Jordan, Tunisia and Egypt, although at a slower pace. The EU also promotes regional trade integration through the Pan-Euro-Mediterranean system of 'cumulation' of rules of origin and by providing financial and technical assistance to the Agadir Agreement, a free trade agreement between Egypt, Jordan, Morocco and Tunisia. Finally, the EU supports the accession to the WTO of countries in the region that are not yet members (see also Section 1.3.2 below for more information on trade- and investment-related initiatives in the framework of the Deauville Partnership).

In order to effectively combine and coordinate resource mobilisation in support of the Arab countries in transition, the EU has also set up a number of **Task Forces** bringing together international players and the private sector to encourage business activities and investment between the EU and Arab transition countries and to better coordinate interventions by the EU institutions, including the EIB, EU Member States, the European Bank for Reconstruction and Development (EBRD), IFIs and potential private sector investors. Egypt, Tunisia and Jordan have already benefited from this initiative.

1.3.2. The G8's Deauville Partnership initiative

The EU's response must also be seen as part of the initiatives launched by the international community to support Arab Spring countries. The EU is one of the main contributors to the G8's Deauville Partnership with Arab Countries in Transition launched at the G8 Summit in Deauville on 27 May 2011 under the French Presidency. The objective is to coordinate the policy response (political, financial and trade) to the Arab Spring process, including by mobilising the IFIs and non-G8 bilateral donors (primarily GCC countries and Turkey). In the economic area, the Partnership aims to develop an agenda that enables transition countries to achieve sustainable and inclusive growth. All MENA countries undertaking political and economic reforms are potential beneficiaries. *De facto*, they were initially limited to Egypt, Jordan, Morocco and Tunisia, and then expanded to Libya and Yemen.

The Deauville Partnership has three pillars: i) governance; ii) finance; and iii) trade, investment and integration. Other topics have been variably associated, including in the areas of support to SMEs. So far, the finance pillar has been the most active. The remainder of this section describes in some more detail progress under the finance and trade and investment pillars.

The ultimate objective of the finance pillar is to help countries in transition meet their external and fiscal financing gaps (estimated by the IMF at USD 42 billion in 2013 alone). The finance pillar consists of: i) short-term stabilisation measures, including the possibility of IMF programmes, frontloaded support from multilateral development banks and assistance by bilateral donors; ii) supporting the extension of the EBRD's geographical mandate to the Southern and Eastern Mediterranean; iii) creating a 'Transition Fund' to provide technical assistance for reform efforts with strong demonstration effects; iv) facilitating access to international capital markets; and v) ensuring better coordination among IFIs under the Deauville Partnership IFIs Coordination Platform. The EU's

Table II.1.1:
EU Financial Assistance for Deauville Partnership beneficiary countries, 2011-13
Commitments in EUR million[(1)]

	Egypt[(2)]	Jordan	Libya	Morocco[(2)]	Tunisia	TOTAL
ENPI[(3)]	449	368	65	696	430	1,947
SPRING 2011-2012	90	80	0	80	100	350
SPRING 2013 [(4)]	0	15	5	35	40	95
EIB loans + private equity (commitments signed) [(5)]	295	90	0	1,205	477	2,067
Humanitarian aid	0	0	23	0	0	23
MFA	(6)	180	-	-	(6)	180
TOTAL	744	638	88	1,900	907	4,217

Notes:
(1) Excluding Yemen.
(2) Including country specific interregional NIF payments.
(3) Excluding participation in regional programmes
(4) First tranche of 2013 allocation. A possible second tranche would be allocated later in the year.
(5) As of mid-2013. Libya is not an EIB country of operations.
(6) All MFA operations must be approved by the Council of the EU and the European Parliament. Operations are being also considered for Egypt and Tunisia.

financial contributions to the Deauville Partnership beneficiaries are summarised in Table II.1.1.

A key achievement of the G8 Deauville Partnership initiative has been to promote the **extension of the geographical mandate of the EBRD**. To this end, Article 1 of the Agreement Establishing the Bank on the geographic scope of operations must be amended unanimously by shareholders. This change is expected to make available up to EUR 2.5 billion annually for the region. The Governors of the EBRD started the process of extending the EBRD's geographical mandate to the South in May 2011. As of July 2013, the procedure of ratification was almost completed, implying that full operations could start in autumn 2013. In the meantime, Tunisia and Jordan were accepted as EBRD members, joining Egypt and Morocco, which were already members.

Since the ratification of the amendment of Article 1 required unanimity and was potentially a lengthy process, two initiatives allowed the EBRD to quick-start its involvement in the region. First, Technical Cooperation Funds (in the amount of EUR 100 million) were created already in late 2011, allowing the EBRD to get involved in technical assistance and risk-sharing operations in the region. Second, following the ratification in August 2012 of an amendment to Article 18 of the Agreement Establishing the Bank, which required a lower threshold of shareholders, the EBRD was able to create a EUR 1 billion Special Fund allowing it to also undertake lending and equity investments in the region. The EU and its Member States have actively supported these efforts, including by contributing EUR 20 million from the NIF budget to the Technical Cooperation Funds. As of mid-2013, the EBRD had signed around EUR 260 million in investments in the region, complemented by EUR 10 million of technical assistance. EBRD country offices have been set up in Casablanca, Tunis, Amman and Cairo.

Another initiative under the Deauville Partnership's finance pillar was the creation of the so-called **Transition Fund,** launched in October 2012. Hosted by the World Bank, and supported by the participation of the Deauville Partnership's IFIs, the Transition Fund supports reforms to promote better economic governance, sustainable and inclusive growth, and greater employment opportunities for young people and women. The Fund was launched with an initial target capitalisation of USD 250 million, with the most sizeable pledges having been made by the United States (USD 50 million) and the United Kingdom and Saudi Arabia (USD 25 million each). Canada, Japan, France, Kuwait, Russia, Qatar and the UAE have also contributed. Funds are disbursed for technical assistance projects supporting country-owned institutional and economic reform. While the EU does not contribute directly to the Transition Fund, it closely coordinates with it so as to promote synergies and complement the Fund's activities with its financial instruments, including the SPRING Programme.

Another component of the finance pillar is the so-called **Capital Market Access Initiative**. This scheme aims at improving the access of Arab countries in transition to capital markets for both sovereign and private-sector (particularly small and medium sized) borrowers. Among the key proposals are policy-based partial credit guarantees for sovereign borrowers and project finance instruments, in addition to technical assistance. The EU is considering contributing to the Capital Market Access Initiative through the extension to the Deauville partner beneficiaries of the Project Bonds scheme already used within the EU. It has also launched, in cooperation with the OECD, the ISMED Support Programme (Investment Security in the Mediterranean Region). ([15]) The ISMED Programme, which amounts to EUR 1.5 million, promotes infrastructure investment in the Southern Mediterranean by providing host governments in the region with technical assistance and advisory services to reduce the legal risk of investment projects. The EU is also exploring further project-based risk-sharing instruments, including the possible creation of an investment-guarantee premium cost-sharing window funded by the NIF.

The **Deauville Partnership IFIs Coordination Platform** was created to coordinate, monitor and report on the implementation of the Partnership among IFIs operating in the region. ([16]) The EU participates through the EIB. In September 2012, the Islamic Development Bank (IsDB) took over from the African Development Bank as the rotating annual Secretariat. The Platform is organised around six thematic modules covering issues such as SMEs' access to finance, the development of local currency capital markets and the promotion of Public Private Partnerships (PPPs).

Key initiatives coordinated by the Platform include the MENA Micro-, Small- and Medium-sized Enterprise (MSME) Facility, which addresses access to finance by MSMEs in Jordan, Tunisia, Lebanon, Egypt and Morocco. Since the majority of enterprises in the MENA region are MSMEs, the sector's development is becoming a priority for policymakers seeking to foster employment creation and income generation. Under the Deauville Partnership, transition countries have also adopted Action Plans to foster SME growth. Another important project coordinated by the Platform concerns the Arab Financing Facility for Infrastructure. Set up in April 2011 by the World Bank in partnership with the Islamic Development Bank, this facility promotes infrastructure investment for economic growth and regional integration through PPP programmes. ([17])

Finally, the G8 is also undertaking **trade- and investment-related initiatives** towards Southern Mediterranean countries, recognising that insufficient trade integration is a key factor explaining the disappointing growth and employment performance of the region. On trade, actions include support to the abovementioned EU's offer to conclude DCFTAs and improve rules of origin. Under the Trade and Investment Partnership Initiative for the MENA region, the United States expressed interest to promote further FTAs with countries in the region (in addition to those already existing with Jordan and Morocco). However, the expectation that this initiative would result in the conclusion of new FTAs with Egypt and Tunisia has so far not been confirmed. Instead, the US has preferred to focus on promoting technical assistance and trade facilitation. In the area of investment, all Deauville Partnership countries agreed on April 2012 to a Statement on Openness in Investment. Finally, in 2012, the Partnership released a Trade and Investment Report, prepared in coordination with the Marseille Centre for Mediterranean Integration (CMI), the World Bank, and the IsDB. The report underlined the importance of greater economic integration, outlining the responsibilities of both G8 and beneficiary countries.

([15]) Project bonds are a common financing tool in North America and Asia. Due to different banking approaches, the market has not developed to the same degree in the Southern Mediterranean. However, capital markets' financing is expected to become more important following banks' more limited ability to provide long-term loans under Basel III rules.

([16]) Participating IFIs include: the African Development Bank (AfDB), the Arab Fund for Economic and Social Development (AFESD), the Arab Monetary Fund (AMF), the EBRD, the EIB, the International Finance Corporation (IFC), the IMF, the IsDB, the OECD, the OPEC Fund for International Development (OFID) and the World Bank.

([17]) The EU is considering supporting its Technical Assistance Facility (TAF) through the EIB.

Table II.1.2:
Southern neighbours - Main economic indicators

Real sector	2009	2010	2011	2012	2013 proj.
Real GDP (% change)					
Algeria	1,7	3,6	2,4	2,5	3,3
Egypt	4,7	5,1	1,8	2,2	2,4
Israel	1,1	5,0	4,6	3,2	3,6
Jordan	5,5	2,3	2,6	2,8	3,3
Lebanon	9,0	7,0	1,5	1,5	2,0
Libya	-0,8	5,0	-62,1	104,5	20,2
Morocco	4,9	3,6	5,0	3,2	4,5
Palestine	7,4	9,3	12,2	5,9	4,3
Syria	5,9	3,4	n.a.	n.a.	n.a.
Tunisia	3,1	3,1	-1,9	3,6	4,0
Simple average	*4,3*	*4,8*	*-3,8*	*14,4*	*5,3*
Nominal GDP (USD billion)					
Algeria	137,6	161,8	198,8	207,8	210,5
Egypt	188,6	218,5	235,7	255,0	257,3
Israel	194,9	217,7	243,7	246,8	260,4
Jordan	23,8	26,4	28,8	31,4	33,8
Lebanon	34,7	37,1	39,0	41,4	43,8
Libya	63,1	74,8	34,7	81,9	94,6
Morocco	90,9	90,8	99,2	97,5	104,8
Palestine	6,7	8,3	9,8	9,9	11,1
Syria	53,9	60,0	n.a.	n.a.	n.a.
Tunisia	43,5	44,3	46,0	46,1	48,0
GDP per capita (USD)					
Algeria	3.943	4.567	5.528	5.694	5.683
Egypt	2.366	2.694	2.857	3.032	3.005
Israel	26.333	28.643	31.643	30.970	32.674
Jordan	3.987	4.323	4.618	4.901	4.879
Lebanon	8.983	9.501	9.856	10.311	10.793
Libya	9.943	11.508	5.422	12.700	14.300
Morocco	4.546	4.683	4.844	4.725	5.018
Palestine	1.708	2.061	2.345	2.316	2.510
Syria	2.343	2.656	n.a.	n.a.	n.a.
Tunisia	4.171	4.199	4.320	4.284	4.409
Simple average	*6.832*	*7.483*	*7.937*	*8.770*	*9.252*
Inflation (% change)					
Algeria	5,7	3,9	4,5	8,9	5,0
Egypt	11,8	11,1	10,1	7,2	8,2
Israel	3,3	2,7	3,5	1,7	1,9
Jordan	-0,7	5,0	4,4	4,5	3,9
Lebanon	1,2	4,5	5,0	6,6	6,7
Libya	2,0	2,5	15,9	6,1	2,0
Morocco	1,0	1,0	0,9	1,3	2,4
Palestine	2,8	3,7	2,9	2,8	2,8
Syria	2,8	4,4	n.a.	n.a.	n.a.
Tunisia	3,5	4,4	3,5	5,6	6,0
Simple average	*3,3*	*4,3*	*5,6*	*5,0*	*4,3*
Unemployment rate (survey based, %)					
Algeria	10,2	10,0	10,0	9,7	9,3
Egypt	9,4	8,9	12,4	13,0	n.a.
Israel	7,7	6,7	6,8	6,5	6,4
Jordan	12,5	12,9	11,4	12,2	n.a.
Lebanon	6,4	6,0	5,8	n.a.	n.a.
Libya	20,7	20,0	n.a	n.a	n.a.
Morocco	9,1	9,1	8,9	9,0	n.a.
Palestine	24,5	23,7	20,9	23,0	22,0
Syria	8,1	8,6	n.a.	n.a.	n.a.
Tunisia	13,3	13,0	18,9	16,7	n.a.
Simple average	*12,2*	*11,9*	*11,9*	*12,9*	*12,6*

(Continued on the next page)

Table (continued)

Fiscal sector	2009	2010	2011	2012	2013 proj.
General government balance (% GDP)					
Algeria	-5,4	-0,4	-0,4	-2,7	-1,2
Egypt	-6,6	-8,1	-9,8	-10,9	-13,1
Israel	-5,3	-4,8	-4,7	-3,9	-4,7
Jordan	-8,9	-5,6	-6,8	-8,8	-9,1
Lebanon	-8,3	-7,7	-6,1	-9,0	-9,7
Libya	-3,0	8,9	-15,4	20,8	19,2
Morocco	-1,8	-4,4	-6,9	-7,5	-5,5
Palestine	-3,5	-2,5	-6,8	-7,7	-5,1
Syria	-2,9	-4,8	n.a.	n.a.	n.a.
Tunisia	-2,7	-0,6	-3,5	-5,4	-7,3
Simple average	*-4,8*	*-3,0*	*-6,7*	*-3,9*	*-4,1*
Gross general government debt (% GDP, end-period)					
Algeria	10,5	11,1	11,1	9,9	9,0
Egypt	80,9	79,4	82,3	85,0	88,8
Israel	79,4	76,1	74,3	73,4	75,6
Jordan	64,8	67,1	70,7	79,2	83,0
Lebanon	147,6	141,7	137,5	139,5	141,3
Morocco	48,0	51,3	54,4	59,6	61,2
Palestine	26,1	15,3	10,1	9,4	9,8
Tunisia	42,8	40,4	44,0	44,0	45,3
Simple average	*62,5*	*60,3*	*60,6*	*62,5*	*64,3*

External sector	2009	2010	2011	2012	2013 proj.
Current account balance (% GDP)					
Algeria	0,3	7,5	10,0	5,9	6,1
Egypt	-2,4	-2,0	-2,6	-3,1	-3,3
Israel	4,2	3,7	1,4	-0,1	1,7
Jordan	-4,9	-7,1	-12,0	18,1	11,0
Lebanon	-9,8	-9,6	-12,5	-16,1	-16,1
Libya	9,4	14,6	3,2	29,4	24,9
Morocco	-5,4	-3,7	-8,0	-8,6	-6,6
Syria	-3,6	-3,3	n.a.	n.a.	n.a.
Tunisia	-2,8	-4,8	-7,3	-8,1	-7,5
Simple average	*-1,7*	*-0,5*	*-3,5*	*2,2*	*1,3*
Foreign direct investment (net, % GDP)					
Algeria	1,8	1,3	1,0	0,8	0,9
Egypt	3,6	3,7	2,3	0,8	0,2
Israel	1,4	-1,6	3,2	2,9	n.a.
Jordan	2,3	1,7	1,5	1,6	1,9
Lebanon	10,5	9,9	8,3	9,3	n.a.
Libya	0,3	-1,3	-0,2	n.a	n.a.
Morocco	1,7	0,8	2,3	2,3	2,8
Palestine	27,5	28,0	20,5	21,9	n.a.
Syria	3,7	3,2	n.a.	n.a.	n.a.
Tunisia	3,3	3,0	0,9	2,5	2,8
Simple average	*5,6*	*4,9*	*4,4*	*5,3*	*1,7*
Gross external debt (% GDP, end-period)					
Algeria	149,4	162,9	182,2	193,9	208,6
Egypt	17,8	15,4	14,8	13,5	16,9
Israel	48,0	48,9	42,5	37,9	38,0
Jordan	22,9	24,6	21,9	20,8	19,5
Lebanon	168,6	167,2	174,0	175,2	173,8
Libya	8,8	7,6	15,6	6,5	5,7
Morocco	23,3	24,7	23,6	26,4	27,5
Tunisia	49,4	48,3	47,8	51,2	55,0
Simple average	*61,0*	*62,5*	*65,3*	*65,7*	*68,1*

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

2. EASTERN NEIGHBOURS

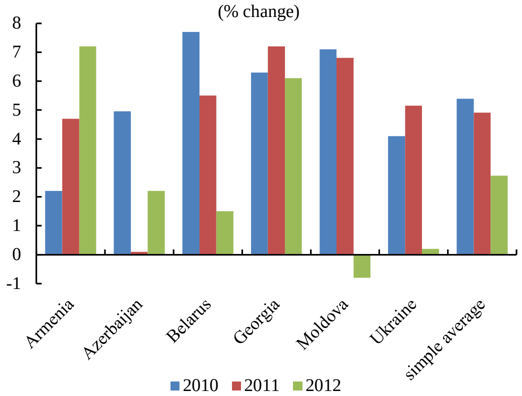
2.1. RECENT MACROECONOMIC DEVELOPMENTS

Following two years of relatively strong recovery from the deep recession of 2009, economic activity in the Eastern Neighbourhood eased significantly in 2012. The reasons were manifold, including a considerable worsening of the external environment, namely the return of the EU to recession and, particularly since the second half of 2012, lower growth in Russia, as well as domestic factors in a number of countries (such as Belarus and Ukraine) where macroeconomic policies had allowed imbalances to develop and the weaker external environment triggered a rapid adjustment. This obliged some countries to tighten their fiscal stance in order to either correct external imbalances or keep public finances on a sustainable path. This weaker external environment was reflected in a decline of capital flows, in particular FDI, as well as a slowdown in remittances, both important drivers of economic growth in the region. Still, the latter were relatively resilient to the global environment and served as a channel for maintaining domestic demand. Deteriorating terms of trade and, in some cases, weak agricultural harvests also took a toll on economic performance in 2012. Finally, parliamentary elections were held in a number of countries (Armenia, Belarus, Georgia, Ukraine), which probably affected investment and household spending, although the negative impact of these political factors on growth was to some extent compensated by government expenditure relaxation ahead of the elections.

Overall, **real GDP growth** in the Eastern neighbourhood moderated to 2.7% in 2012 from 4.9% in 2011 and 5.4% in 2010 (see Graph II.2.1). Moldova and Ukraine, the two countries in the region that are most exposed to the euro area (for more details on the region's exposure to the euro area crisis, see Chapter III.1), were the worst performers, witnessing a hard landing from their relatively strong rebound after the 2009 recession. Moldova was also negatively affected by unfavourable weather that contributed to a steep contraction of agricultural production. Growth slowed down markedly in Belarus as well, but this was mainly due to the very restrictive monetary and fiscal policies introduced in 2011 to resolve the balance of payments crisis and bring inflation down from triple-digit figures. At the other end of the spectrum were Armenia and Georgia, which recorded strong growth rates despite the negative impact of the weakening global economy. In Azerbaijan, economic growth remained constrained by the declining oil production. However, this was compensated by a continuing increase in state transfers to the non-oil economy, as global oil prices remained favourable.

Graph II.2.1: **Eastern neighbours - Real GDP**

(% change)



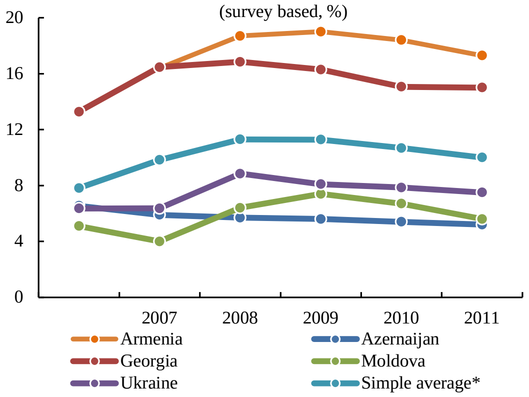
Sources: National authorities; Commission Staff calculations

Economic activity in the region remained weak in early 2013. The Eastern neighbours are experiencing the lagged impact from the recession the EU economy re-entered in 2012 and from its continuation in the first half of 2013. This effect is reinforced by the significant weakening of activity in Russia, an important export market for many of the countries as well as a key source of remittances and financial flows. Ukraine has been the worst performer so far this year, with a 1.3% economic contraction in the first quarter of 2013. At the same time, GDP growth further slowed down in Belarus and in Georgia, the latter reflecting political instability due to an uneasy co-habitation of the president and the new prime minister and doubts among investors about the economic policies of the new government. On a more positive note, GDP growth in Armenia remained high, while growth in Azerbaijan accelerated as the government intensified fiscal transfers from the hydrocarbon proceeds. Also, growth resumed in Moldova, despite the negative effect of political instability on business activity.

Weakening economic activity in 2012 has failed to negatively impact the **labour market** in the region for the time being, basically reflecting inertial factors. The jobless rate declined in all countries, with the strongest fall recorded in Armenia, although from a very high base. The region's average unemployment rate, based on labour force surveys, declined to 10.0% in 2012 from 10.7% in 2011 and 11.3% in the crisis 2009 (see Graph II.2.2). ([18]) Looking ahead, we expect a slight reversal in the downward trend due to the lagged impact from weaker economic activity in the second half of 2012 as well as the fact that in the fastest-growing countries in the region (Georgia and Armenia) unemployment has a high structural component and GDP growth comes to a large extent from productivity gains rather than new job openings.

Graph II.2.2: **Eastern neighbours - Unemployment rate**

(survey based, %)

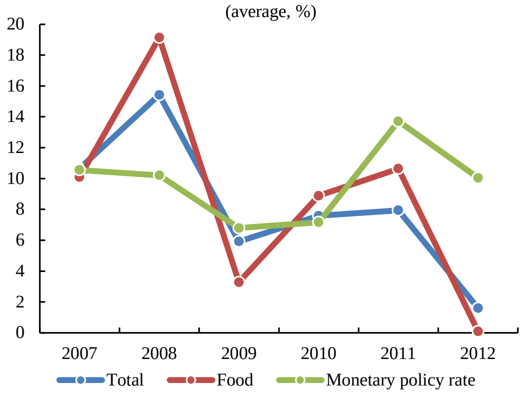


Sources: National authorities; Commission Staff estimates ; * - Excl. Belarus

Unlike in 2010 and 2011, **inflationary pressures** have not only subsided but even disappeared in many cases in 2012 (see Graph II.2.3). The year was marked by a steep disinflation that was mainly due to declining food prices on global markets (after a very steep increase in 2011), reinforced in some cases by good agricultural harvests. In some countries, local currency appreciation was also supportive of the slowdown in price growth. Finally, moderating activity also contributed to the disinflation, which saw several countries (such as Georgia and Ukraine) ending the year in the deflationary area. The average end-year inflation (excluding Belarus, which was still adjusting from the hyper-inflation caused in 2011 by a steep devaluation of its currency) was only 2% in 2012, after finishing close to 5% a year earlier. However, renewed upward price pressures can be expected throughout 2013, as food prices are likely to rebound and as some countries adjust energy and other administered prices. They are, however, likely to be kept in check by subdued economic activity.

Graph II.2.3: **Eastern neighbours - Inflation and monetary policy**

(average, %)



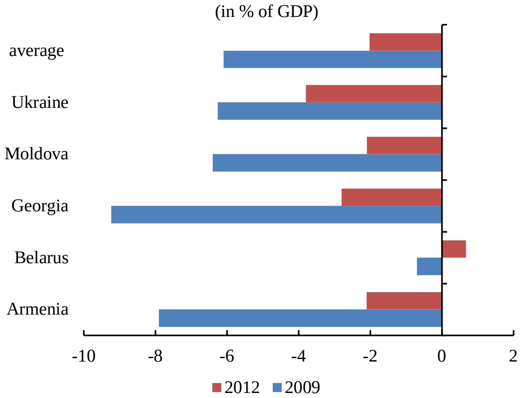
Source: National authorities

The improved inflationary outlook, in a context of weakening growth, gave room to most of the central banks to relax **their monetary policy** stance - the benchmark interest rate was cut in five out of the six Eastern neighbours. The most aggressive rate reductions were recorded in Belarus (although the rate remained at a very high level of 30% at the end of the year) and Moldova. The monetary easing continued in early 2013 (in Azerbaijan, Belarus, Georgia and Ukraine) with the objective of supporting waning economic activity. Despite these interest rate cuts, real interest rates remain on average high on a historical perspective (see Graph II.2.3). There is, therefore, considerable room for further monetary easing in the future to cushion negative external shocks without hurting exchange rate stability. Still, in some cases the space for accommodative monetary policy is limited by unfolding external vulnerabilities (Ukraine), which sometimes are coupled with persistent inflationary pressures (Belarus). It should also be noted that the monetary policy transmission mechanism in the region remains constrained by high dollarization ratios (exceeding 60% in Armenia and Georgia) and the lack of certain monetary control instruments

([18]) These figures exclude Belarus, which does not conduct labour force surveys.

In view of the constraints to monetary policy making, **fiscal stances** are of key importance in the EU's Eastern partners for navigating the economies through the current unfavourable global environment. Fiscal policy faces the challenging task of stimulating economic activity, while simultaneously repairing the significant fiscal and current account imbalances that were accumulated during the boom period and ensuring or preserving debt sustainability. Following a marked widening of the fiscal deficits in 2009 (with the exclusion of Azerbaijan that remains in a comfortable position due to huge, windfall hydrocarbon revenues), there has been an equally marked consolidation, supported by robust growth but also by a mixture of expenditure streamlining and revenue-boosting measures that were at the core of the IMF programmes the Eastern neighbours had to enter into.

Graph II.2.4: **Eastern neighbours - General government balance** (in % of GDP)



Sources: National authorities; IMF

As a result, the general government deficit declined to an average of 1.7% of GDP in 2011 from 6.0% of GDP in 2009 (see Graph II.2.4). ([19]) The downward trend came to an end in 2012, when public finances were hit by lower-than-expected growth. Another factor that affected negatively fiscal performance in the year was discretionary spending ahead of parliamentary elections, a move that is likely to weigh on the 2013 fiscal positions as well. Still, the average budget deficit of the region remained in 2012 at a relatively low level (2% of GDP on average). In some cases (notably Georgia and Azerbaijan), the share of capital expenditures has remained very high, continuing to provide some welcome support to economic activity. At the same time, it should be noted that Azerbaijan's budget remains heavily dependent on windfall oil revenues, making the country very exposed to a significant decline of energy prices. In fact, Azerbaijan currently seems to be among the countries in most urgent need for policy reforms to diversify fiscal revenues and ensure long-term fiscal sustainability, considering the relatively limited lifespan of its oil resources. Such reforms could include an enhanced management of public finances as well as a possible introduction of a fiscal rule that would decouple public spending from oil price developments.

Looking ahead, most countries plan a continuation of the prudent fiscal policy stances in place in order to support further deficit reduction. However, the worsening global environment can continue to affect negatively economic performance in the region, resulting in lower-than-projected revenues. At the same time, there is a growing pressure on the expenditure side from the significant loosening of the incomes policy (wage and pension hikes) in 2012, which is going to be reflected in the 2013 fiscal figures. Thus, the Eastern neighbours will have to either curtail capital expenditures to keep fiscal positions under control, which will most likely hurt their economic performance, or seek further improvements in revenue collection, which remains inefficient in many cases despite progress with public finance management and tax reforms in the last few years. Changes in the energy subsidy systems, which are especially generous and inefficient in Ukraine and, to a lesser extent, in Belarus, also seem required for improving fiscal sustainability (see Annex 2 at the end of this Part).

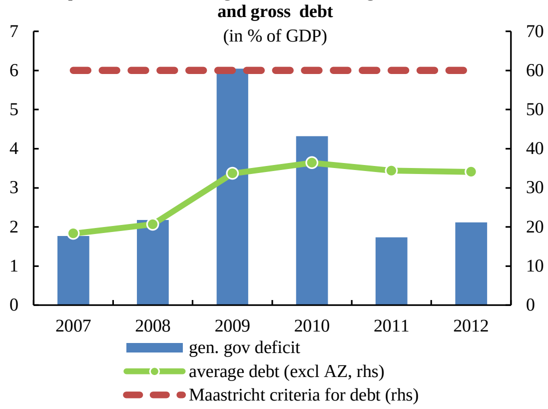
The 2009 contraction in the region contributed to a sharp increase in **public debt** levels, which have been traditionally rather low in most Eastern neighbours. This was due not only to growing fiscal gaps but also to the sharp fall in nominal GDP. As a result, public debt doubled to an average 36% of GDP in 2010 from 18% of GDP in 2007 (see Graph II.2.5). However, the debt-over-GDP ratio resumed a gradual downward path afterwards, reflecting the strong recovery of economic growth as well as progress with fiscal

([19]) These figures tend to underestimate the real fiscal gaps, as they do not take into consideration balances the quasi-fiscal organizations (such as Ukraine's oil and gas company Naftogaz) and the quasi-fiscal activities of the government (e.g, lending by banks under government programmes in Belarus).

consolidation. The highest debt level is recorded in Belarus, which was affected by the devaluation of its currency in 2011 and the high quasi-fiscal activities the government was engaged in. Still, the gradual downscaling of these operations made the country the best performer in terms of debt reduction in 2012. Overall, public debt levels in the region remain at manageable levels, but will require a continuation of the prudent fiscal policies implemented by most countries, as well as further development of domestic capital markets to reduce reliance on external financing.

Graph II.2.5: **Eastern neighbours - General government deficit and gross debt**

(in % of GDP)



Source: National authorities; IMF; Commission Staff calculations

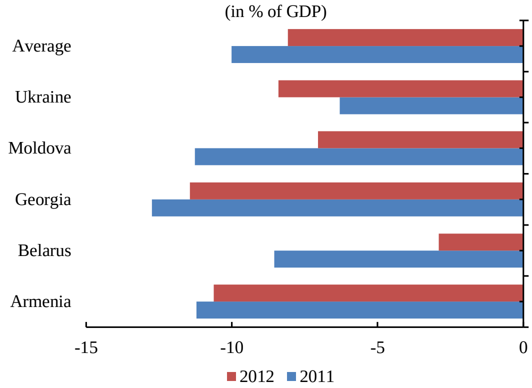
On the external side, Eastern neighbours retain sizeable **current account deficits** (again, with the exception of the oil producing Azerbaijan), although these deficits somewhat narrowed in 2012 due to weakening domestic activity in the second half of the year, which resulted in lower import demand. The current account deficit is estimated to have averaged 8.1% of GDP in 2012, down from 10% of GDP a year earlier (see Graph II.2.6). The most impressive corrections were recorded in Belarus and Moldova. The former managed to bring down its current account gap to just 2.9% of GDP in 2012 from 15% of GDP in 2010, following a steep currency devaluation in 2011 and a beneficial energy deal agreed with Russia. In the case of Moldova, the adjustment was mainly driven by the fall in demand for imported goods due to the marked worsening of economic activity in the country. Despite the economy's hard landing in 2012, Ukraine's current account deficit widened for the third year in a row, a development that is of a particular concern as it suggests a structural lack of international competitiveness.

Both **export and import growth** decelerated rapidly in 2012 after a very strong increase in the preceding two years. The average growth rate of exports and imports of goods was around 5% year-on-year, an impressive moderation from the 35-40% increases seen in 2011. As mentioned above, weaker demand from major export markets, in particular the EU but also Russia, was the main reason for this outcome. Worsening terms of trade (lower food and steel prices) also stand behind the weak performance. The only country that managed to record a double-digit export growth was Belarus, which, as noted, benefited from the 2011 devaluation as well as from favourable imported gas prices agreed with Russia. Imports in the region were affected by the weakening of economic activity as well. Here, the only country to report double-digit growth was Georgia, mainly because of strong investment activity in the first half of the year. For the region as a whole, the merchandise trade deficit widened in 2012, with the biggest increases reported in Ukraine and Georgia. At the same time, Belarus recorded a merchandise trade surplus for the first time since 2004, as the country's external adjustment that followed the 2011 balance of payments crisis continued. The high trade deficits recorded in the EU's Eastern partners, mostly due to very weak export base, remained offset to a considerable extent by sizeable remittance inflows (especially in Moldova where they account for around 25% of GDP, Armenia and Georgia, and to a smaller degree in Ukraine). Remittances retained their upward trend, although their growth also moderated significantly in 2012 in line with the weaker performance in key countries or regions where the remittances originate (in particular, Russia and the euro area).

Weak economic activity in early 2013, lower export demand from the EU and the relative resilience of remittances flows to cyclical shocks, all suggest that a further downward adjustment in the current account deficits of the Eastern neighbours is likely to take place this year. Belarus is well poised to represent an exception, however, as expansionary income policies and growing investments are likely to boost domestic demand, while its exports will be hurt by the suspension of exports of dissolvents following a trade dispute with Russia.

Graph II.2.6: **Eastern neighbours - Current account**

(in % of GDP)



Sources: National authorities; Commission Staff calculations

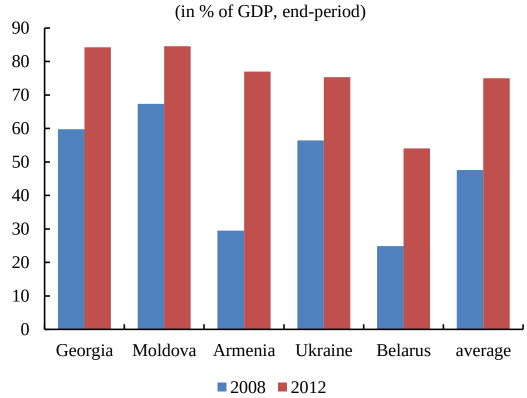
Turning to the financing side of the balance of payments, there was a pronounced tendency towards an increased reliance on debt financing as net **FDI**, already well below their pre-crisis levels, further contracted in 2012 to less than 4% of GDP on average in the oil-importing countries in the region (compared with more than 8% of GDP in 2007-08). Various factors could explain the drop in FDI in the region: the recession or economic slowdown in some of the key investment partner (the EU and Russia in particular), political uncertainty stemming from the parliamentary elections held in a number of countries, weakening investor demand due to increased global uncertainty, as well as a halt of privatisation. In the case of Belarus, a USD 5 billion sell-off programme agreed with the Eurasian Anti-Crisis Fund was put on hold. But while FDI inflows decelerated, in most cases other financing sources were readily available to cover current account gaps. This financing took the form of official grants and credits, debt market borrowing (Ukraine, Georgia), inter-company loans and trade credits.

The growing reliance on debt financing contributed to a fast rise of the **external debt** in all the Eastern neighbours (Graph II.2.7). When oil exporter Azerbaijan is excluded, the region's average external debt reached 75% at the end of 2012, up from less than 50% at end-2008. This implies a serious potential source of vulnerability, especially in view of the considerable currency risks in several countries stemming from high dollarization ratios. Growing debt repayments, to a large extent related to disbursement of IMF loans extended during the 2008-09 crisis, present a serious medium-term challenge for policy makers (in particular in Belarus and Ukraine).

On a more positive note, it should be noted that short-term external debt remains relatively limited in most cases. Furthermore, in some countries inter-company lending accounts for a significant part of the external debt and this is unlikely to present a debt burden for the state. Moreover, the central banks' policy of accumulating foreign exchange reserves provides several countries with a cushion for addressing external vulnerabilities. As a result of this policy, the average reserve coverage of next year's imports rose to 3.5 months on average in 2012 from 2.9 in 2007 (see Graph II.2.8). Moldova and Armenia are in the most advantageous situation in this case (reserve coverage of 4+ months), while Ukraine and Belarus are on the other end of the spectrum (coverage of less than 3 months). The situation in Ukraine seems most worrying, as the country's reserves were under significant pressure in 2012 as the central bank struggled to defend the exchange rate and will be further tested by sizable debt repayments in 2013.

Graph II.2.7: **Eastern neighbours - Gross external debt**

(in % of GDP, end-period)



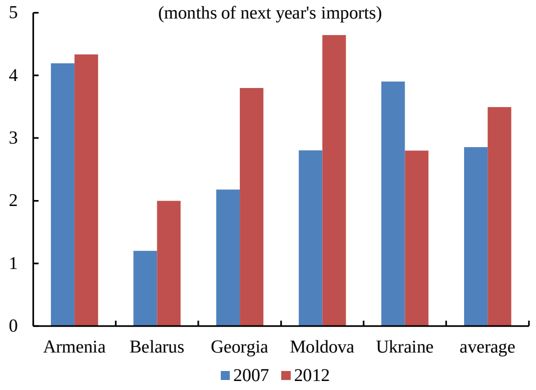
Source: National authorities; Commission Staff calculations

Financial sectors in the region fared relatively well during the global financial crisis, reflecting conservative banking practices and a very limited exposure to toxic instruments. The major impact thus came from the stress for the real economy and the ensuing devaluation pressures on the currencies, which contributed to a worsening of the credit portfolio. The retrenchment of lending from euro area banks as they struggled to deleverage also had a negative effect on some Eastern European banks (on this point, see also Chapter

III). However, the rebound in economic activity in 2010-11 contributed to an acceleration of credit growth in the Eastern neighbourhood. This was accompanied by the strengthening of prudential controls by central banks, which was also supportive of a gradual reduction of non-performing loans. Still, prudential instruments will have to be further reinforced to ensure that increased lending does not lead to renewed overheating pressures and that the financial system remains sound. ([20]) Special attention should be paid to operations of state-controlled banks, which in many cases (Azerbaijan, Belarus, Moldova) remain a potential source of weakness due to lax management oversight, weak capital positions and pervasive state intervention in their credit activities. In some cases, the best strategy may be to restructure the banks and, subsequently, to privatise them. This should improve efficiency, reduce the risks for the state stemming from contingent liabilities and encourage competition in the sector.

Graph II.2.8: **Eastern neighbours - International reserves, 2007-12**

(months of next year's imports)



Sources: National authorities; Commission Staff calculations

2.2. MACROECONOMIC POLICY AND STRUCTURAL REFORM CHALLENGES

The Eastern neighbours are small (with the exception of Ukraine) and very open economies, with an export base that is heavily skewed towards commodities and low-technology manufacturing. This exposes them to considerable cyclical risks through external channels such as exports, capital inflows and remittances. These risks materialised during the global financial crisis, when the region was among the worst performers in the world, and have also come into play since the second half of 2012, as demonstrated by the sharp moderation in economic activity.

In order to minimise the negative impact from the weakening global environment, the Eastern neighbours should adopt a policy mix that will enable them to keep under control relatively weak external positions and ensure debt sustainability while giving them some leeway to support economic activity. This argues for further **fiscal consolidation** supported by both revenue enhancing measures and prudent spending policies. Wherever fiscal space is available, expenditures could be temporarily increased for growth-boosting projects, but control over recurrent expenditures (wages and social spending) is also needed to ensure fiscal sustainability is on track and international competitiveness is not jeopardised. Fiscal consolidation should be underpinned by public finance management and tax reforms, as well as by the replacement of energy subsidies with targeted systems of social transfers.

In the **monetary area**, the focus should be on strengthening the role of central banks, notably by developing their policy tools and increasing the effectiveness of the monetary transmission mechanisms. This should be accompanied by a further reinforcement of their autonomy, which could help enhance their credibility. This is of particular importance for the countries that have decided to implement formal inflation targeting regimes. **Exchange rate flexibility** could be a useful tool for absorbing external shocks and reducing the negative impact from required adjustments due to external imbalances. While a number of countries have already moved to more flexible exchange rate regimes in recent years (see Chapter III of European Commission, 2011), further progress in this direction may be advisable (Azerbaijan, Georgia, Ukraine). However, this may need to be implemented carefully, considering the risks arising from high dollarization and potential exchange rate volatility and the need to prepare banks and economic agents for it (including through the development of forward foreign exchange markets).

([20]) This is particularly relevant to Azerbaijan, where very strong retail lending activity led the central bank to introduce various prudential measures to limit the pace of expansion.

Close **interaction with IFIs** could support the adoption of the policy mixes required to operate under a cloudy global economic outlook. The global financial crisis forced most of the Eastern neighbourhoods to seek IMF assistance. Apart from providing the financial support needed to compensate for the abrupt halt of capital inflows, the agreements with the Fund also strengthened policy responses to the crisis. IMF financing is being complemented by support from other IFIs as well as the EU, including MFA (on IMF support and MFA programmes see Annex 1 of this Part). Several of the countries in the region still have active programmes with the Fund that act as a buffer during the current crisis while promoting prudent policies. In view of the considerable external debt repayment obligations, both Ukraine and Belarus are also considering agreeing with the IMF adjustment and reform programmes to be supported by financial arrangements.

Prudent fiscal and monetary policies should go hand in hand with **structural reforms** needed to support long-term growth. The Eastern neighbours have demonstrated a very good track record in implementing measures to improve the business environment, which was also supported by closer integration and regulatory harmonisation with the EU. These reforms placed the region second only to the OECD high-income countries in terms of the ease for doing business in the annual ranking of the World Bank (for more details see Box 3). Georgia and Belarus stand out in their efforts to make the business climate more appealing as these two countries are among the top free performance globally since 2005. ([21])

Despite the considerable progress achieved in reducing barriers for business activity, institutional strengthening in all countries has a long way to go. Much more determined efforts are needed to fight corruption, which remains a major hurdle for business and investment activity. The reform plan should also include measures to reduce state intervention in the economy, which is prevalent in Belarus but also sizeable in Azerbaijan, so that the playing field is level.

Special attention has to be paid to the export-oriented sectors, which will not only support job creation are also key for making external positions more balanced. Due to low domestic savings, an important share of these countries' high investments needs must be financed by external capital flows and remittances. This requires more concerted efforts to encourage export-driven sectors and also a better use of comparative advantages (in agriculture, transport, energy generation).

The majority of the Eastern neighbours has made significant progress in further integrating their EU economies with the through concluding (Ukraine) or advancing fast (Moldova, Georgia and Armenia) in the negotiation of agreements on the establishment of DCFTAs. Once these agreements come into force, they are expected to positively affect the countries through trade creation, which should contribute to higher economic growth and new job openings. They can also have beneficial side effects, such as reduced inflation due to higher competition and an improvement in the investment climate as the agreements should contribute to a more predictable and business-friendly regulatory environment. For other countries (Azerbaijan and Belarus), a more near-term objective is the successful completion of the negotiations for entry in the WTO.

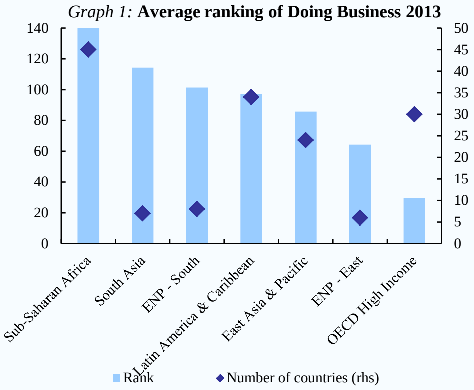
([21]) As measured by the narrowing of the distance to frontier from 2005 to 2012.

Box II.2.1: The World Bank's Doing Business Indicators: a comparison between the Southern and the Eastern neighbours

The regulatory framework and climate for investment is a key factor behind economic growth. This box analyses the main results on the World Bank's Doing Business indicators, which have become a standard reference and which have been discussed in our previous reports (see European Commission, 2010 and 2011). Based on the Doing Business 2013 report (World Bank, 2013), the main conclusion is that, on average, the Eastern neighbours offer a more investment-friendly economic environment and have been reducing the gap vis-à-vis the best performers, while, on the other hand, the Southern countries not only perform worse but have achieved little relative improvement in recent years.

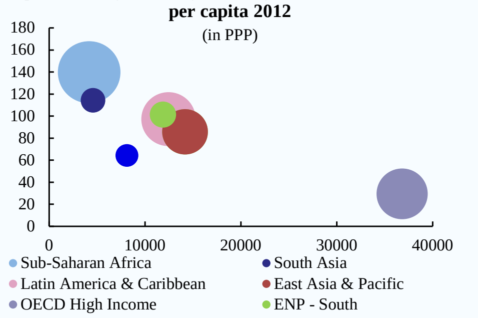
Current situation

Graph 1: **Average ranking of Doing Business 2013**



Note: Southern countries does not include Libya and Palestine; To a lower position in the ranking corresponds a better performance
Source: The World Bank

Graph 2: **Average ranking of Doing Business 2013 and GDP per capita 2012**
(in PPP)



Note:The dimension of the circles reflects the number of countries in the area; Southern countries does not include Libya and Palestine
Source: The World Bank, IMF

Graph 1 shows how the neighbouring countries performed related to the other regions of the world. It can be noticed immediately that the Eastern neighbours have attained a very favourable position, second only to the one of the OECD countries, while the Southern countries stand close to the tail of the graph, performing only better than Sub-Saharan Africa and South Asia, two regions with much lower average per-capita income (see Graph 2, which also shows that there is a strong correlation between GDP per capita and average position in the ranking). Moreover, the average of the Southern countries is affected by the very good position of Israel which, as it is clear from the observation of Graph 3a, is an outlier in the region (in fact, in the Doing Business, Israel appears in the high income, OECD group). If Israel is excluded, the average ranking for the Southern ENP region deteriorates to the 110th place, a level very similar to that of South Asia.

Table 1:
Ease of Doing Business 2013 ranking

	Southern	Eastern
Complexity and cost of regulatory processes		
Starting a business	87	31
Dealing with construction permits	128	101
Getting electricity	83	137
Registering property	117	30
Paying taxes	94	103
Trading across borders	70	125
Strength of legal institutions		
Getting credit	110	44
Protecting investors	83	58
Enforcing contracts	121	38
Resolving insolvency	91	91
Overall rank	101	64

Note: Southern countries do not include Libya and Palestine
Source: World Bank

Table 1 allows a comparison by indicator of the two regions, grouping the indicators in two broad categories, those trying to measure the complexity and cost of the regulatory framework and those reflecting the strength of legal institutions. Mediterranean neighbours do particularly poorly in many indicators, both with respect to the overall sample and to the Eastern countries. The particularly low standings for starting a business, registering property, getting credit and enforcing contracts highlight the ample room for improvement in the Southern economies, and how much they are lagging behind the other regions. ([1])

Within each of the neighbouring sub-regions, the dispersion of individual countries around the average is

([1]) The empirical literature has found evidence of the importance of some of these regulations for economic growth. On the effect of the cost of starting a business, in particular, see Eifert (2009) and Klapper, Laven and Rajan (2009).

(Continued on the next page)

Box (continued)

relatively small. However, some countries can be highlighted as standing out from the average. Among Southern countries, Algeria and Syria stand out as the worst performers, ranking 152nd and 144th, respectively. At the other extreme, performing much better than the average of the sub-region, are Israel (38th in the overall ranking) and Tunisia (50th), both with positions lower than the average for the Eastern neighbours. Regarding the Eastern neighbourhood, Georgia and Ukraine are at the opposite sides of the ranking (9th and 137th), while the other countries are concentrated around the average.

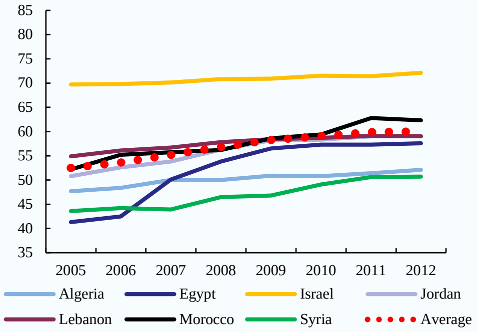
There are only three indicators where the Eastern neighbours perform worse than the Southern ones (getting electricity, paying taxes and trading across borders), all of them referring to the costs of the regulatory processes. The implications of scoring badly in these three indicators should not be underestimated, however. For example, there is evidence suggesting that the inability to get electricity in an economic way is an important constraint for business. (2) Also, costs related to the payment of taxes or uncertainty over the payment of tax refunds by the tax authorities can have an important negative effect on the investment climate, as the chronic accumulation of arrears on VAT refunds in Ukraine in recent years illustrates.

Trends

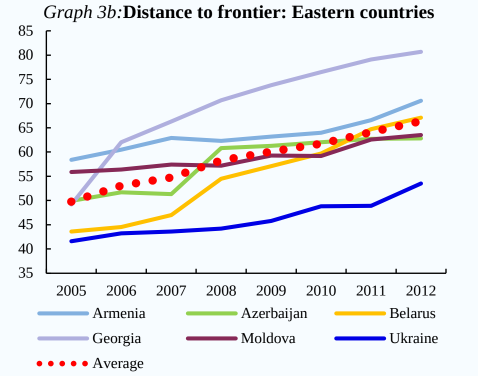
In order to analyse and disentangle the trends of the two areas, a measure of the "distance to frontier" was used. The measure is built by normalising the overall performance of countries to a range between 0 and 100, where 100 represent the best performer. (3) The graphs highlight the differences between the two areas. From 2005 to 2012, the Southern neighbours achieved only a marginal improvement, and with the exception of Egypt and Morocco they all present a weak trend. On the other hand, the Eastern countries show a strong positive trend, which, if sustained, would lead to an additional improvement in their relative position in the next years. It is also relevant to observe the remarkable trends of Georgia and Belarus which are, respectively, the first and third countries that narrowed the gap the most among the 174 economies that were observed in 2005.

Among the 50 economies that narrowed the distance to frontier the most since 2005, the only Southern neighbours appearing in the list are the already mentioned Egypt and Morocco, while, on the other hand, 13 of them belong to the Eastern Europe and Central Asia region, and 18 to the Sub-Saharan Africa region.

Graph 3a: **Distance to frontier: Southern countries**



Graph 3b: **Distance to frontier: Eastern countries**



Source: The World Bank

Conclusions

The graphs highlight that the two areas are improving their business environment at a different speed. Even though in 2005 the Eastern neighbours were performing worse than the Mediterranean (considering a simple average of countries' distance to frontier), this gap has been now strongly reversed, and, on recent trends, the positive gap is likely to become even wider in the next years. Therefore, it is crucial for the Southern neighbours to give a new impulse to their policies aimed at improving the regulatory framework and the business climate. This is important not only because empirical results seem to confirm the existence of a strong relationship between business climate indicators and economic growth, but also (and perhaps most crucially) because of the external spillovers related to that. In particular, a more welcoming business environment can prove essential in attracting FDI, which in turn can play an important role in fostering productivity growth in developing countries. Finally, regarding the Eastern neighbours, and despite their impressive progress in recent years, there is also a significant scope for further improvement.

(2) World Bank (2013). According to the World Bank Enterprise Surveys managers in 109 economies "consider electricity to be among the biggest constraints to their business".
(3) This allows controlling for shifts in rank caused by variations in the total number of observed countries.

Table II.2.1:
Eastern neighbours - Main economic indicators

Real sector	**2009**	**2010**	**2011**	**2012**	**2013 proj.**
Real GDP (% change)					
Armenia	-14,1	2,2	4,7	7,2	6,0
Azerbaijan	9,3	5,0	0,1	2,2	4,0
Belarus	0,2	7,7	5,5	1,5	1,8
Georgia	-3,8	6,3	7,2	6,1	3,8
Moldova	-6,0	7,1	6,8	-0,8	4,0
Ukraine	-14,8	4,1	5,2	0,2	0,0
Simple average	*-4,9*	*5,4*	*4,9*	*2,7*	*3,3*
Nominal GDP (USD billion)					
Armenia	8,6	9,3	10,1	9,9	10,9
Azerbaijan	44,3	52,9	64,8	68,7	74,3
Belarus	49,2	55,1	58,8	63,2	65,5
Georgia	10,8	11,6	14,4	15,9	16,6
Moldova	5,4	5,8	7,0	7,3	7,9
Ukraine	117,2	136,4	163,4	176,2	181,6
GDP per capita (USD)					
Armenia	2.703	2.894	3.168	3.050	3.355
Azerbaijan	5.018	5.922	7.156	7.491	7.930
Belarus	5.178	5.810	6.212	6.674	6.931
Georgia	2.455	2.623	3.231	3.520	3.689
Moldova	1.524	1.631	1.971	2.037	2.218
Ukraine	2.550	2.980	3.584	3.877	4.015
Simple average	*3.238*	*3.643*	*4.220*	*4.441*	*4.690*
Inflation (average %)					
Armenia	3,4	8,2	7,7	2,6	4,0
Azerbaijan	1,5	5,7	7,9	1,1	2,4
Belarus	13,0	7,8	53,2	59,2	18,3
Georgia	1,7	7,1	8,5	-0,9	-0,1
Moldova	0,0	7,4	7,7	4,7	4,6
Ukraine	15,9	9,4	8,0	0,6	0,8
Simple average	*5,9*	*7,6*	*15,5*	*11,2*	*5,0*
Unemployment rate (survey based, %)					
Armenia	18,7	19,0	18,4	17,3	16,5
Azerbaijan	5,7	5,6	5,4	5,2	5,1
Belarus	0,9	0,7	0,6	0,5	0,5
Georgia	16,9	16,3	15,1	15,0	14,8
Moldova	6,4	7,4	6,7	5,5	6,2
Ukraine	8,8	8,1	7,9	8,0	8,2
Simple average	*9,6*	*9,5*	*9,0*	*8,6*	*8,6*

(Continued on the next page)

Table (continued)

Fiscal sector	2009	2010	2011	2012	2013 proj.
General government balance (% GDP)					
Armenia	-7,9	-4,6	-2,8	-2,1	-2,5
Azerbaijan	-0,7	-0,9	0,6	0,3	-1,7
Belarus	-0,7	-1,8	2,8	0,7	0,2
Georgia	29,3	-6,6	-3,6	-3,0	-3,5
Moldova	-6,4	-2,5	-2,4	-2,1	-2,1
Ukraine	-6,3	-5,8	-2,8	-3,8	-4,5
Simple average	*1,2*	*-3,7*	*-1,4*	*-1,7*	*-2,3*
Gross government debt (% GDP, end-period)					
Armenia	38,9	41,0	40,7	44,1	42,2
Belarus	34,9	42,0	43,4	36,9	n.a.
Georgia	37,3	39,2	33,8	32,7	n.a.
Moldova	26,7	26,5	23,1	23,8	22,5
Ukraine	35,4	40,5	36,8	37,4	42,2
Simple average	*34,6*	*37,8*	*35,6*	*35,0*	*35,6*

External sector	2009	2010	2011	2012	2013 proj.
Current account balance (% GDP)					
Armenia	-15,8	-14,7	-10,9	-10,7	-10,5
Azerbaijan	23,0	28,4	26,5	21,7	16,0
Belarus	-12,5	-15,0	-8,5	-2,9	-8,5
Georgia	-10,5	-10,2	-12,7	-11,4	-9,6
Moldova	-8,2	-7,7	-11,3	-9,4	-10,0
Ukraine	-1,5	-2,2	-6,3	-8,2	-8,2
Simple average	*-4,3*	*-3,6*	*-3,9*	*-3,5*	*-5,1*
Foreign direct investment (net, % GDP)					
Armenia	8,4	6,1	4,4	4,8	4,9
Azerbaijan	0,3	-0,6	1,4	1,2	1,6
Belarus	3,6	2,4	6,6	2,1	4,6
Georgia	6,3	5,8	6,2	3,8	n.a.
Moldova	2,5	3,3	3,7	1,9	2,5
Ukraine	4,0	4,2	4,3	3,8	3,5
Simple average	*4,2*	*3,5*	*4,4*	*2,9*	*3,4*
Gross external debt (% GDP, end-period)					
Armenia	58,1	67,9	72,9	77,0	75,5
Azerbaijan	n.a.	7,4	7,3	10,6	n.a.
Belarus	44,8	51,5	55,6	54,1	53,0
Georgia	81,8	86,6	79,9	84,2	86,0
Moldova	80,2	82,3	77,6	84,5	n.a.
Ukraine	88,2	86,0	77,2	76,6	79,0

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

ANNEX 1

IMF support to neighbourhood countries and EU Macro-Financial Assistance

The IMF's lending commitments reached record levels in response to the 2008-09 crisis, mainly due to the Fund's substantial engagement in ailing euro area economies. The EU's Eastern neighbours were also a major beneficiary of IMF funding starting from 2008, as the countries of the area were hard hit by the global crisis, due to their large exposure to the EU and their reliance on external financing, but also because of domestic imbalances built up during years of rapid GDP growth. Later, as the Arab Spring uprisings, high commodity prices and the deepening of the euro area crisis negatively affected the macroeconomic situation of Southern neighbours, the IMF approved a number of programmes for the region. Macro-financial assistance (MFA) from the EU has normally complemented the assistance provided by the IMF to the EU neighbours. The text below summarises the recent IMF engagement and EU MFA to the Neighbourhood countries (see also Table II.A1.1).

IMF support to Eastern neighbours

From late 2008 onwards, the IMF agreed and implemented programmes in all Eastern neighbourhood countries with the exception of oil-rich Azerbaijan. The first financing arrangements were put in place already in late 2008 (**Georgia** and **Ukraine**) and early 2009 (**Belarus** and **Armenia**), in the context of considerable stress faced by beneficiary countries, in particular their financial systems. This was a result of adverse terms of trade movements, falling demand from trading partners and difficulties in securing external finance. Under this first generation of arrangements – always Stand-by Arrangements (SBA) – the IMF provided financing of unprecedented amounts to the countries.

The first SBA with Ukraine amounted to the equivalent of EUR 12.8 billion, i.e. eight times Ukraine's quota in IMF capital, under the programmes for Armenia and Belarus, the IMF provided nearly six times their quotas, for Georgia it was five times. The large size of these financial arrangements was justified by the magnitude of imbalances to correct but also by the ambition of the adjustment and reform programmes put in place. Starting from 2010, the poorer countries of the region also received access to the IMF's concessional facilities: first **Moldova**, later Armenia and Georgia. The SBA with Armenia was transformed, before its full implementation, into a longer duration arrangement under the combination of the Extended Fund Facility (EFF) and the concessional Extended Credit Facility (ECF).

IMF arrangements of the first generation have now been completed (arrangements with Armenia and Moldova – in the beginning of 2013). The IMF and beneficiary authorities are eager to continue their cooperation, but so far the only country that has succeeded to agree on a new programme is Georgia, who is implementing, since April 2012, a two-year SBA/SCF (concessional Standby Credit Facility) programme, although it is treating this as a precautionary programme. Ukraine requested a new SBA after this programme lapsed in December 2012, which was still not agreed as of mid-2013. Armenia and Moldova are in early stages of preparation of new programmes. The new programmes (whether agreed or under preparation) provide lower access to IMF financing and privilege structural reforms designed to consolidate the achievements of the first generation of stabilisation programmes. At the same time they help the beneficiaries to face growing external debt repayments (often resulting from earlier IFI financing) in worsening global environment.

IMF support to Southern neighbours

While the Southern Mediterranean countries coped with the global crisis of 2008-09 relatively well, due in part to their lower integration in the international financial circuits and their lower dependence on bank financing from developed countries, the situation changed in 2011 when the pressure on the economies of the region increased reflecting political upheavals, in combination with higher energy prices in the case of energy-importing countries. In reaction to significant economic challenges, the IMF recently stepped up its engagement in the South, agreeing on financing arrangements with Jordan and Morocco (August 2012), Tunisia (June 2013) and engaging several times into so far unsuccessful negotiations with Egypt. ([22])

([22]) Also, in April 2012, the IMF Board approved a programme of about EUR 70 million for Yemen, under the Rapid Credit Facility. This programme replaced the one approved earlier that had gone off track due to the political crisis. Yemen is one of the Arab countries in transition supported

Under the three-year SBA with **Jordan**, the IMF is granting the country an equivalent of EUR 1.7 billion, corresponding to 800% of the country's quota. Jordan's balance of payments and fiscal position are under strong pressure due to a combination of factors: an increasing energy import bill, partly related to supply disruptions of natural gas from Egypt, the decline in tourism and investment inflows, and the Syrian refugee crisis, which is having a significant – and over time increasing– budgetary impact. At the same time as the Jordan SBA, the IMF approved a two-year arrangement with **Morocco** under the Fund's Precautionary and Liquidity Line (PLL). Morocco was granted access of seven times its quota, i.e. more than EUR 5 billion. The PLL arrangement will allow the authorities to continue the implementation of their reform agenda aimed at achieving rapid and inclusive economic growth, while providing them with an insurance against external shocks. The authorities plan to treat the arrangement as precautionary and do not intend to draw on it, unless Morocco experiences actual balance of payments needs from a deterioration of external conditions. More recently, the IMF Board concluded an agreement with **Tunisia** on a SBA for an amount of four times the Tunisian quota (about EUR 1.3 billion) as, despite the macroeconomic improvement that the economy witnessed in 2012 (broadly attributed to increased FDIs and tourism), there are still pressing fiscal and external financing needs.

Egypt requested assistance from the IMF already in the spring of 2011. A staff-level agreement reached in June 2011 for a SBA of some EUR 2.2 billion was, however, rejected by the country's interim authorities. In January 2012, the negotiations resumed and were nearly concluded in May of that year, but were again interrupted as support from the different political forces, including from the Muslim Brotherhood, was not secured. The third attempts made in autumn of 2012 went the furthest: by November, an agreement on a 22-month SBA amounting to EUR 3.7 billion was ready. Yet, once again, the Egyptian authorities decided to withhold the request for IMF funds on clearly political grounds. Since then, while the IMF is maintaining its engagement with the country's authorities, prospects for an agreement seem more and more uncertain, in view of the unfolding political crisis in Egypt.

by the G8's Deauville Partnership but is outside the geographical scope of the ENP. The IMF hopes to agree on a new longer term arrangement with Yemen by the end of 2013.

EU macro-financial assistance

Among the EU's external financing instruments, MFA is designed to support the balance of payments in third countries which are geographically, economically and politically close to the EU. MFA is an arrangement which is complementary to IMF assistance (the existence of a disbursing IMF arrangement is a pre-requisite) and aims at closing the residual financing gap, while encouraging countries to address specific structural reforms. In contrast to IMF assistance, the EU's MFA can contain grant elements for countries with relatively low levels of developments and relatively high indebtedness.

Four neighbourhood countries, all in the East, were granted MFA since the start of the financial crisis in 2008: Armenia, Georgia, Moldova and Ukraine. In early 2012, the EU completed the implementation of MFA operations in Moldova and Armenia, while preparing the implementation of operations in Ukraine and Georgia. ([23]) In February 2013, Armenia formally requested to the EU further MFA. Also, as the IMF intensified its engagement in the Southern Neighbourhood, the EU started negotiations with Jordan, Egypt and Tunisia on possible future arrangements. In April 2013, the European Commission adopted a legislative proposal for a MFA programme for Jordan (a loan of EUR 180 million), expected to be adopted by the co-legislators (Council of the European Union and European Parliament) before the end of 2013. A possible MFA operation for Egypt will only be launched if there is an agreement with the IMF.

Other sources of financing

In addition to IMF and EU support, countries have access to a number of alternative financing sources. Belarus and Ukraine have for some time benefitted from significant implicit subsidies,

([23]) The second programme for Georgia. The implementation of the first programme was completed already in 2010.

Table II.A1.1:

Neighbourhood Countries - IMF Arrangements and EU Macro-Financial Assistance, 2008-13

	IMF Arrangements					EU Macro-Financial Assistance			
Country	**Quota**	**Arr. type**	**Period**	**Amount (mio EUR)**		**Approval***	**Amount (mio EUR)**		**Status**
				Total	% quota		Loans	Grants	
Eastern Neighbours									
Armenia	92	SBA	03.2009 - 06.2010	612	580%	-	-	-	-
	92	EFF/ECF	03.2010 - 07.2013	312	290%	11.2009	65	35	Completed
Belarus	386.4	SBA	01.2009 - 03.2010	2.515	587%	-	-	-	-
Georgia	150.3	SBA	09.2008 - 01.2011	817	497%	11.2009	-	46	Completed
	150.3	SBA/SCF	04.2012 - 04.2014	294	166%	08.2013	23	23	Under impl.
Moldova	123.2	EFF/ECF	01.2010 - 04.2013	411	300%	10.2010	-	90	Completed
Ukraine	1372	SBA	11.2008 - 07.2010	12.767	802%	07.2002	110	-	Under impl.
	1372	SBA	07.2010 - 12.2012	11.655	729%	07.2010	500	-	Under impl.
Southern Neighbours									
Jordan	170.5	SBA	08.2012 - 08.2015	1.680	800%	04.2013	180	-	Under prep.
Morocco	588.2	PLL	08.2012 - 08.2015	5.071	700%	-	-	-	-
Tunisia	286.5	SBA	06.2013 - 06.2015	1.314	400%	-	-	-	-

** Date of approval by the Parliament and the Council. For Jordan, date of adoption of the proposal by the Commission.*

Source: IMF, European Commission

notably through energy imports provided at below-market prices. This assistance was, however, phased out in the case of Ukraine, which, unlike Belarus, declined to join Russian-led integration projects in the post-Soviet space and retained control over its gas transportation network. Some Mediterranean countries have potential access to grants and loans from Gulf Cooperation Council countries (Qatar, Saudi Arabia, Kuwait and the United Arab Emirates) and from Turkey. Further potential financing sources include loans, sometimes concessional, from the World Bank and the regional development banks (e.g. the Asian Development Bank), bilateral loans (e.g. from the United States or China), and EU budget support provided under the European Neighbourhood and Partnership Instrument (ENPI). Moreover, some countries have retained access to international capital markets despite balance of payments difficulties, albeit at much higher interest rates compared to IMF and EU assistance.

ANNEX 2

The challenge of price subsidy reform in ENP countries

The need for reform

Energy subsidies are widespread in many European Neighbourhood Policy (ENP) countries, both in net energy importing and exporting countries. ([24]) Quite a few neighbours, notably in the Southern Mediterranean region, also provide substantial subsidies to basic food commodities. As discussed in European Commission (2011), the resulting budgetary cost has been a major factor behind the deterioration of fiscal positions experienced by these countries since the Arab Spring process began.

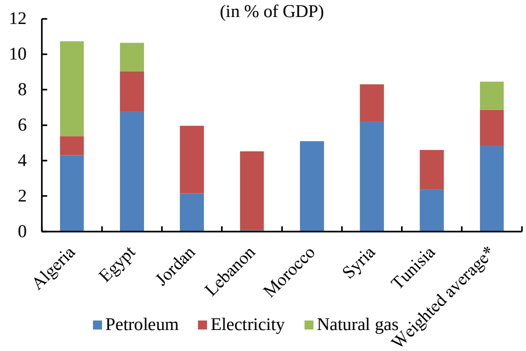
These two types of subsides not only entail a substantial fiscal cost but, being of a generalised nature (that is, they normally benefit households regardless of their income as well as enterprises), they are also inefficient from a social policy point of view since they are not targeted to the poorest households. In many ENP countries, particularly in the South, price subsidies are in fact the main component of the social safety net. Concerned governments often argue that subsidies are necessary in order to ensure a basic subsistence level for the poor and to protect the population from spikes in energy or food prices. However, as subsidies are general and consumption-based, they tend to disproportionally benefit wealthier households, which tend to account for a higher share of national energy consumption. In the MENA region, for instance, only 8% of subsidies reach the lowest 20% percentile of income distribution, while around 60% of subsidies are captured by the top 30-40% income brackets.

In addition, energy subsidies tend to distort the efficient allocation of resources in two fundamental ways. First, they encourage excessive energy consumption as prices are kept artificially low by limiting the pass-through of international prices to domestic markets. Second, they provide disincentives for investment in the modernisation of energy production and distribution. In the MENA region, energy consumption has been growing faster than GDP, as opposed to other parts of the world. This increase in energy intensity is partly attributable to high energy subsidies and has direct implications for the region's economic competitiveness. In Ukraine for instance, as a consequence of heavy energy subsidy implementation, the domestic production capacity has fallen from 20 to 15 billion cubic meters of gas over the past decade, and investment in energy-saving technologies or basic infrastructure, including gas meters, is low.

Worldwide energy subsidies in 2011 were estimated at about USD 480 billion (0.7% of world GDP) (IMF, 2013). MENA countries account for the largest share of world energy subsidies (nearly 42% of the world's total), although they represent only 6.1% of the world's population and 4.2% of the world's GDP. Energy subsidies are particularly high in oil-exporting MENA countries but are also significant in oil-importing ones. Half of the total subsidy spending in the region is allocated to petroleum consumption. The Southern neighbours, in particular, devoted about 7% of their combined GDP to energy subsidies. Egypt, Jordan, Morocco and Tunisia, four net energy-importers spent about USD 39 billion on energy subsidies in 2011 – approximately 90% of their fiscal financing needs in that given year (see Graph II.A2.1). In addition, the Southern neighbours provide, as noted, significant subsidies to basic food commodities (see Graph II.A2.2). In 2011, these subsidies amounted on average to 1.9% of their combined GDP, being particularly high for Egypt (5.6%) and Algeria (3.9%). It is clear, therefore, that the rationalisation of the subsidies system would drastically reduce the large external and fiscal financing gaps of these countries, a major source of macroeconomic vulnerability in the region.

Graph II.A2.1: **Southern neighbours - Subsidies to petroleum products, electricy and natural gas, 2011**

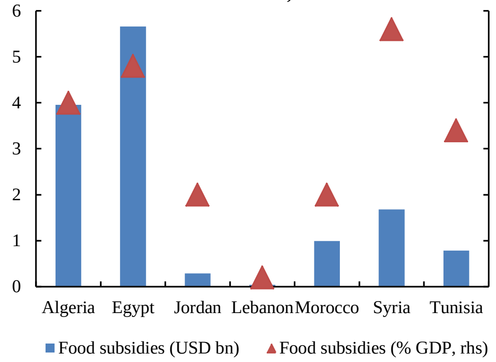
(in % of GDP)



Note: Data on Syria is projected; *Average on Egypt, Jordan, Morocco and Tunisia
Source: IMF

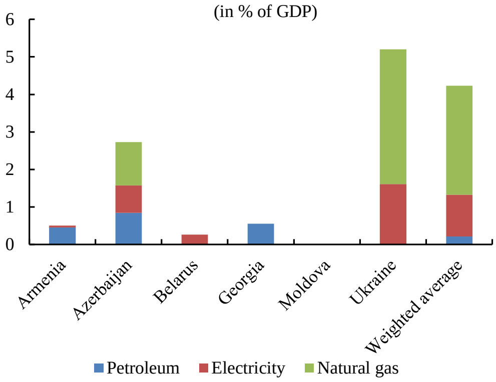
([24]) There are different ways to analyse subsidies. In this Annex, subsidies are calculated as the difference between the cost-of producing or importing energy or food, and the price at the point of consumption. These subsidies are often provided by state-owned enterprises, at an eventual cost to the state budget.

Graph II.A2.2: **Southern neighbours - Subsidies to Food Commodities, 2011**



Note: Data on Syria is projected
Sources: National statistical offices, IMF

Graph II.A2.3: **Eastern neighbours - Subsidies to Petroleum Products, Electricty and Natural Gas, 2011**
(in % of GDP)



Source: IMF

Energy subsidies in the Eastern neighbourhood countries are significantly lower than those in the Southern neighbours, although still significant at 2% of the world total whereas the region represents 0.5% of world GDP. Specifically in the Eastern neighbourhood, energy subsidies are still high at about 4.2% of GDP, although they tend to take a very different form to those in the South. Energy-rich Russia provides subsidised hydrocarbons, mainly in the form of natural gas, to Armenia, Belarus, and Moldova; whereas oil-reach Azerbaijan does so for Georgia. As a result, while the issues relating to inefficient spending and poor targeting do apply in these countries, the fiscal and external costs of these policies are partly outsourced, although they remain a source of vulnerability. In Ukraine, the increase in prices for imported gas, mainly from Russia, and the reluctance of authorities to adjust domestic prices for households and utilities resulted in the quasi-fiscal deficit of state-owned oil and gas monopolist Naftogas to surge to 5% of GDP in 2011 and 2012, while other natural gas-related transfers led to a further cost of 1% of GDP. The cost of energy subsidies is similarly high in Belarus, although Russia bears the much of the cost as it exports natural gas at a discounted price.

Some recent reform efforts

Despite the fact that generalised subsidies have long been recognised as inefficient and distorting, not sufficient effort has been made to reform them. The increase in international energy and food prices that took place in 2007-08, and again in 2011, put the public and external finances of net energy- and food-importing ENP countries under considerable pressure. At the same time, the social unrest that accompanied the Arab Spring movements in some Southern neighbours led governments to take a more cautious approach to price subsidy reforms, resulting in some cases in delays in the implementation of reform plans. With price subsidies representing, as noted, an important, often dominant, component of the social support programmes in ENP partners, it is obvious that their reform must go hand-in-hand with the reinforcement and better targeting of compensatory cash transfer programmes. In some cases, the reforms should be implemented gradually, so as to facilitate the adjustment of households and enterprises to the removal of the subsidies. At the same time, it is important to accompany these challenging reforms with a clear communication strategy that explains their rationale. The remainder of this section summarises some prominent recent efforts at price subsidy reform in selected ENP countries.

Jordan is a net oil importer and a highly energy-dependent country, with spending on energy subsidies estimated at 6% of GDP in 2011. Electricity subsidies constituted 14% of government revenues, while oil subsidies constituted 8% of those revenues in the same year. In addition, energy subsidies increased substantially since 2011 amid heightened social and political tensions in the region, growing international prices and the disruption of gas supplies from Egypt, which obliged Jordan to replace imported gas with expensive alternative fuels for electricity production. Fiscal sustainability concerns brought subsidy reform to the fore in 2012, in the context of the Stand-by Agreement approved by the IMF in August 2012.

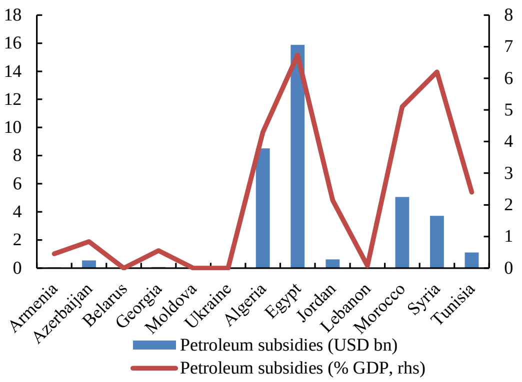
In September 2012, the government allowed a 6% price increase in diesel and removed subsidies to 90-octane gasoline. Although with some delay, the removal of subsidies to 90-octane gasoline, diesel, kerosene, and household gas prices was enacted in mid-November, in accordance with the structural benchmark set by the IMF programme. To compensate low-income households for the adjustment, the authorities introduced a system of targeted transfers to the poor that is meant to save over USD 500 million – nearly 50% of the subsidies cost foreseen for that year. While this cash transfer system is still not sufficiently targeted (covering about 70% of the consumers), the reform is clearly a step in the right direction. With a view to reducing the deficit of the main, state-owned power company (NEPCO), the Jordanian government also increased electricity tariffs twice in 2012 for industrial and commercial users and intends, in the context of the IMF programme, to proceed with new adjustments in electricity tariffs, with a view to bringing NEPCO tariffs back to cost recovery levels by 2017.

Morocco subsidises fuel and butane gas, as well as sugar and flour, although over 85% of this expenditure is allocated to energy consumption. Energy subsidies grew from about 2% of GDP in 2010 to 6.6% of GDP in 2012. In 2012 alone, spending on energy subsidies was 70% in excess of the budgeted amount, which was the main reason behind Morocco's overshooting of the 2012 fiscal deficit target agreed under the IMF precautionary arrangement. In response, and pending a full-fledged reform, Morocco undertook measures in June 2012 to reduce the fuel subsidy by 0.7% of GDP by increasing the prices of diesel, gasoline and fuel oil by 14%, 20% and 27%, respectively. ([25]) One year later, the authorities announced that they would soon launch a first phase price deregulation of energy products, except for cooking gas, and sugar, in order to allow a certain pass-through of international prices to domestic prices. The authorities noted in the past that subsidy spending should not exceed 2% of GDP, a policy consistent with their commitment to bring the fiscal deficit below the 3% of GDP target by 2017.

([25]) On the food subsidies side, Morocco reduced in September 2012 the subsidy to imported wheat by 15%, in parallel to providing DH 1 billion (EUR 90 million) as a form of compensation to the bakeries.

In **Egypt**, subsidy reform has been hesitant owing to the political instability, despite accounting for the largest energy and food subsidies among the oil-importing Southern Mediterranean countries. Petroleum subsidies rose from about 4.9% of GDP in FY 2010/11 to over 6% of GDP in FY 2011/12. In addition, Egypt's subsidies for wheat, sugar and rice amounted to 2% of GDP that same year. Subsidies to the electricity sector were also high. In this context, the authorities have taken a number of measures. Measures in this area are also likely to be part of the programme Egypt has been negotiating with the IMF for some time. Central to this reform will be the introduction of a rationing card system of subsidised petrol to vehicle owners. In the meantime, the authorities introduced a series of reforms since end-2012 such as the elimination of subsidies to 95-octane gasoline, the reduction of subsidies to fuel oil for electricity generation and to industrial companies, and the introduction of a new distributive system of cooking gas cylinders (LPGs) to households.

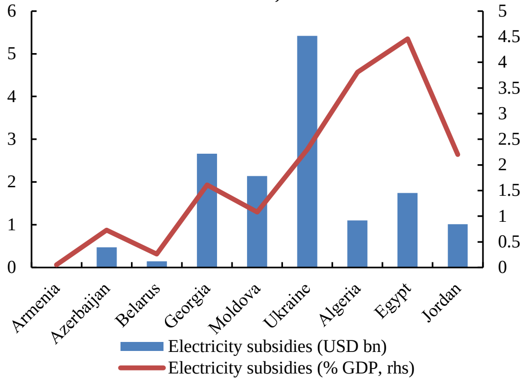
Graph II.A2.4: **European neighbourhood - Subsidies to Petroleum Products, 2011**



Source: IMF

The reform of the electricity sector in **Armenia** since 1996 provides an encouraging example. By the mid-90s, Armenia's electricity sector, characterised by a monopolistic power company was heavily subsidised (subsidies represented 11% of GDP in 1995), with chronically low collection rates. In addition, the collapse of the Soviet Union, from which Armenia imported petroleum for electricity generation, and the conflict with Azerbaijan, led electricity generation to fall by almost 50%, resulting in regular power outages. The authorities launched a reform process that significantly increased electricity prices, brought in private sector participation to achieve efficiency gains, improved the regulatory environment (including by establishing an independent regulatory commission charged with tariff-setting), and enforced strict collection policies. By 2004, collection rates had risen to nearly 100% (from 40% in 1996), whereas the deficit of the sector had been virtually eliminated. Three reasons stand as key for Armenia's success: the relentless political will for reform, supported by international donors; the overhaul of the social safety nets system to target only the poor, including the introduction of a means-tested cash transfer programme, as well as one-off cash transfers and dual-rate electricity meters for low-income households; and an effective public awareness campaign.

Graph II.A2.5: **European neighbourhood - Subsidies to Electricity Generation, 2011**



Source: IMF

Ukraine provides large subsidies on gas and heating for households which undermine both the budget and the balance of payments, in addition to promoting over-consumption, undermining incentives for domestic production and stifling investment in delivery systems (IMF, 2012). In this context, the Ukraine pursued reforms at a slow pace, including increasing tariffs for households and utilities by 50% in 2010, improving the collection rate and installing gas meters. The reform has been, however, insufficient as current gas tariffs cover less than one-fifth of the import cost. Disagreement on the need for energy sector reform, and in particular increases in the gas tariffs, was the main reason why the last IMF programme went off-track and why a new arrangement was not reached during the discussions held in the spring of 2013. The absence of corrective policies will affect economic growth and a high current account deficit will increase Ukraine's external vulnerability to shocks.

Part III

Thematic issues

1. EXPOSURE OF EU NEIGHBOURS TO THE EURO AREA CRISIS

1.1. INTRODUCTION

Only three years after experiencing a recession due to the global financial crisis, the euro area economy contracted again in 2012 and is projected to remain in recession in 2013, according to the Spring 2013 Economic Forecast published by the European Commission (see Table III.1.1). A gradual, but most likely subdued, recovery is expected from the second half of 2013, which is the baseline scenario of the Commission's forecast. Still, medium-term growth prospects for the region are currently clouded by the painful fiscal reforms required to put the public finances of some countries back on the sustainable track as well as by a weak banking sector that undergoes significant balance-sheet strengthening. High unemployment, which negatively affects consumer sentiment and acts as a drag to investment activity, is expected to start declining only in 2014. Despite the very accommodative monetary policy, lending remains restrained by weak demand and high economic uncertainty.

On a more positive note, the financial stress has been significantly reduced since the middle of 2012, supported by fiscal adjustment measures, reforms to strengthen the EU's economic governance and macro-financial stability architecture and interventions by the European Central Bank (ECB), including through non-standard measures. These moves, coupled with the various policy responses by all major economies, have reduced the likelihood that the EU crisis will deepen and possibly lead to another global recession, which would hit strongly emerging markets worldwide, including the ones in the EU neighbourhood.

In view of the persistence of the euro area crisis and the fact that the recovery of the euro area and EU economies is likely to be of a rather gradual nature, this chapter tries to shed light on the potential impact that weak economic activity might have on the EU's neighbours. There are several key transmission channels through which the euro area crisis can affect the global economy. They include both trade channels and financial channels. Their intensity and final impact depend on an array of factors such as the level of integration with the euro area economy, the existence of buffers allowing for counter-cyclical policies and the relative fragility of the domestic political and macroeconomic situation prevailing at the moment of the euro area crisis shock.

The geographical proximity of the EU's neighbours suggests that these countries would be potentially the most strongly affected by the euro area crisis or a weak recovery from it. This could also be expected in view of their significant trade and financial deepening since the start of the century, which has increased their synchronisation with the global economic cycle, including with the one of the EU. This chapter attempts to assess the exposure of the EU's Eastern and Mediterranean neighbours to the euro area crisis, identifying which sub-regions or countries seem particularly vulnerable. It also provides evidence on the actual impact the crisis has had so far.

Table III.1.1:

Selected macroeconomic indicators - Spring 2013 forecast

	2011	2012	2013	2014
			forecast	
Real GDP, % change				
Euro area	1.4	-0.6	-0.4	1.2
EU	1.6	-0.3	-0.1	1.4
USA	1.8	2.2	1.9	2.6
Japan	-0.6	2.0	1.9	2.6
China	9.3	7.8	8.0	8.1
World	4.2	3.0	3.1	3.8
Unemployment rate, %				
Euro area	10.2	11.4	12.2	12.1
EU	9.7	10.5	11.1	11.1
USA	8.9	8.1	7.7	7.2
Japan	4.6	4.3	4.3	4.2
Inflation, %				
Euro area	2.7	2.5	1.6	1.5
EU	3.1	2.6	1.8	1.7
USA	3.2	2.1	1.8	2.1
Japan	-0.3	0.0	0.2	1.8

Source: European Economic Forecast, Spring 2013

Obviously, the potential impact could be significantly larger if the euro area crisis intensifies and contributes to fuel another global economic crisis, which, as noted, is not the central or most likely scenario according to the European Commission's latest forecast. In such a case, the effect could also be magnified by the indirect impact on markets that are considered as having a 'buffering' role for the neighbourhood countries. These are Russia for the Eastern neighbours and the Gulf Cooperation Council (GCC) countries for the Southern ones, both of which are hydrocarbon exporters that would be negatively affected by the likely decline in oil and gas prices in a global recession scenario. While these markets often compensate in part for external shocks experienced by the neighbouring economies, during a global economic downturn they could exacerbate the crisis in the latter (as it was the case with Russia during the 2009 recession).

The chapter is organised as follows: Sections 2, 3, and 4 look at the impact of the euro area crisis for the neighbourhood countries arising from the items of the current account. They analyse the effect on merchandise trade, tourism, which is a major economic sector for a number of neighbouring countries, and remittances, in view of their growing importance in many of them for financing domestic consumption and offsetting sizeable merchandise trade deficits. Section 5 discusses channels of transmission via the capital account. In particular, it looks at the dynamics of FDI from the euro area to the neighbourhood countries as well as at banking flows and possible contagion through bank deleveraging. Section 6 takes a different, more empirical approach. Rather than looking at each of the transmission channels separately, it conducts a number of correlations to try to ascertain the relative dependence of the EU neighbours (both by country and by sub-region) on the economic cycle of the EU and of other key trading partners (Russia and the GCC countries), which helps summarise the overall impact of these different channels. The chapter finishes by drawing the main conclusions and providing a number of policy recommendations for minimising the negative impact from weak activity in the euro area.

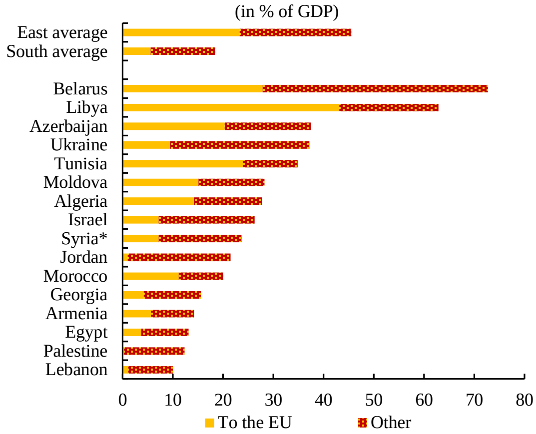
1.2. TRADE EFFECTS

The EU has long been the most significant export market for most of the neighbouring economies. The degree of exposure of each neighbour to the euro area crisis through the trade channel depends on several factors, such as its general dependence on trade, its level of export diversification, and the share of trade it conducts with the euro area or, more generally, the EU economies. ([26])

1.2.1. Vulnerability factors

The *economic openness* ratio, as measured by the share of total exports over GDP, determines a country's relative exposure to external trade shocks, over which it has no control. Graph III.1.1 displays the ratio of exports to GDP for both the Eastern and Southern regions as well as for each neighbouring country. We find that there is a large disparity of levels of overall openness among the countries in the European neighbourhood. The export-to-GDP ratio ranged from 13% to 71% in 2012. The countries that are the most exposed to external trade shocks are Belarus (70% of GDP), Azerbaijan (54%), and Libya. The lowest level of export to GDP is in Egypt and Armenia (13%). The Southern neighbours are, on average, less open and, therefore, tend to be relatively less exposed to external shocks through the export channel. Their average export-to-GDP ratio in 2012 was only 18%, compared to 46% of GDP for the Eastern neighbours.

Graph III.1.1: **EU neighbours - Exports of goods**
(in % of GDP)



Source: IMF DOTS, authors' calculations

In order to estimate the trade impact of the euro area crisis it is also important to measure the direct exposure to the external shocks through export flows to the EU. To that end, we combine the data on economic openness displayed in Graph III.1.1 with data on the share of exports directed to the

([26]) Since economic developments in the euro area tend to dominate developments in the EU economy as a whole, this chapter often uses, for simplicity or for reasons of data availability, data for the EU as a whole.

EU to calculate the share of exports to the EU over GDP (see Table III.1.2). The largest exposure to the shocks from the EU is found in Libya, where the exports to the EU amount to 68.6% of the country's total exports and to 41.3% of the GDP.

Table III.1.2:

EU neighbourhood - Export exposure to the EU in 2012

	Value of exports to EU, % total exports	Value of exports to EU, % of GDP
Southern neighbourhood		
Tunisia	68.7	23.9
Libya	68.6	43.1
Morocco	55.7	11.1
Algeria	51.0	14.1
Syria*	30.2	7.1
Egypt	28.1	3.7
Israel	27.2	7.1
Lebanon	10.7	1.1
Jordan	4.5	1.0
Palestine	1.7	0.2
Average	*34.6*	*11.2*
Eastern neighbourhood		
Azerbaijan	54.1	20.3
Moldova	53.5	15.1
Armenia	39.3	5.6
Belarus	38.3	27.8
Georgia	26.5	4.1
Ukraine	25.3	9.4
Average	*39.5*	*13.7*

* data for 2010
Source: IMF DOTS

Countries such as Tunisia, Azerbaijan and Belarus, are also among the ones with the highest exposure to export shocks from the EU. The lowest exposure in the region is found in Lebanon, Jordan, Georgia, Egypt and Palestine, where exports to the EU account for less that 5% of GDP. Graph III.1.1 and Table III.1.2 also show that, on average, the EU is a somewhat more important trading partner for the Eastern neighbours than for the Southern ones. This is due both to the fact that the Eastern neighbours direct on average a somewhat higher share of their exports to the EU (about 40% compared to about 35% for the Mediterranean countries) and to the fact that they have relatively more open economies, which means that a given share of exports to the EU represents a larger share of their GDP, implying a higher exposure to the EU economic cycle (their exports to the EU account for nearly 14% of GDP compared to about 11% for the Southern neighbours). However, the sub-region of the Maghreb (Algeria, Libya, Morocco and Tunisia) shows a very high dependency on the EU market, both as a share of total exports and in per cent of GDP.

Table III.1.3:

Exports to the EU, the GCC and Russia in 2012, % of total exports

	Exports to EU	Exports to GCC	Exports to Russia
Eastern neighbourhood			
Armenia	39.3	0.7	19.6
Azerbaijan	54.1	0.1	2.6
Belarus	38.3	0.1	35.4
Georgia	26.5	1.8	3.5
Moldova	53.5	0.0	21.1
Ukraine	25.3	2.1	24.1
Average	*39.5*	*0.8*	*17.7*
Southern neigbourhood			
Algeria	51.0	0.1	0.0
Egypt	28.1	11.1	0.9
Israel	27.2	0.0	1.7
Jordan	4.5	19.2	0.3
Lebanon	10.7	21.7	0.2
Libya	68.6	0.6	0.0
Morocco	55.7	0.9	0.9
Palestine	1.7	n.a.	n.a.
Syria*	30.2	13.0	0.3
Tunisia	68.7	1.0	0.6
Average	*34.6*	*7.5*	*0.5*

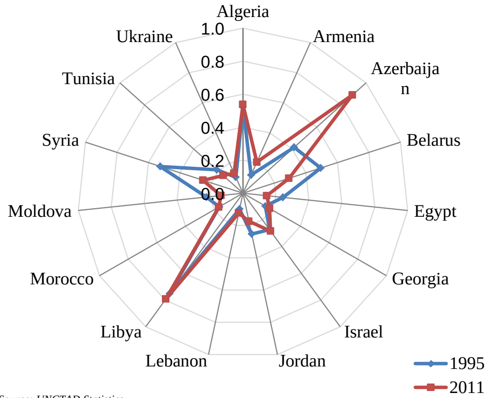
* data for 2010
Source: IMF DOTS

In order to gather additional insights into the geographical exposure of EU neighbours, Table III.1.3, shows the share of total exports of these countries that is directed to the EU, as well as to Russia and to the GCC countries, two other key trading partners for many of them. Table III.1.3 illustrates the relative important role that Russia plays as a trading partner for many Eastern neighbours (in particular Belarus, Ukraine, Moldova and Armenia) and the also important role the GCC countries play for geographically close Southern neighbours of the Mashrek (notably for Lebanon, Jordan, Syria and Egypt). ([27]) The relatively steadier economic situation in the GCC countries can have a buffering effect on total exports in the Southern neighbours, as demand from the EU decreases. Moreover, the Southern countries that export more to the GCC area also tend to export less to the EU, which further reduces their exposure to the EU crisis. The Russian economy, on the other hand, is much more influenced by the developments in Europe though trade and financial linkages. Depending on the circumstances, therefore, it can play either a buffering or an exacerbating role. While in cases where the slowdown in EU growth is combined with high energy prices (as in 2011) the Russian economy can delink from the EU cycle and thus help buffer the impact of the EU downturn on Eastern neighbours, in cases when the EU downturn is accompanied by lower international energy prices, the co-movement of the Russian

([27]) Israel is at the other extreme, with no exports to the GCC countries, reflecting political factors.

economy can add to the negative impact of the EU cycle on the Eastern neighbours (as it seems to have happened from second half of 2012).

Graph III.1.2: **Export concentration index**



Source: UNCTAD Statistics

While the degree of openness of a country determines its vulnerability to external shocks, the scale of the impact of a shock also depends on the degree of export concentration. It is commonly argued that the higher the rate of the export concentration, the higher the volatility of export earnings and also the higher the exposure to changes in economic activity in export markets (Briguglio et al., 2009). Graph III.1.2 displays the export concentration index calculated by the UNCTAD, which can vary from 0 to 1 (with 1 denoting the maximum concentration), for each neighbouring economy. ([28]) The economies of the European neighbourhood are characterised by a high degree of export concentration, thus suggesting a higher vulnerability to foreign demand shocks. The highest rates of export concentration in the region in 2011 are found in Libya, Azerbaijan and Algeria, economies where exports mainly contain hydrocarbon products. While the high level of concentration of exports in these countries is partially offset by the fact that real demand for hydrocarbon commodities is less sensitive to the business cycle than the demand for manufactured goods, hydrocarbon product prices and, therefore, hydrocarbon exports in nominal terms are very sensitive to the global economic cycle. These countries are therefore particularly vulnerable to a scenario in which the euro area crisis deepens and pushes the world economy into a serious downturn.

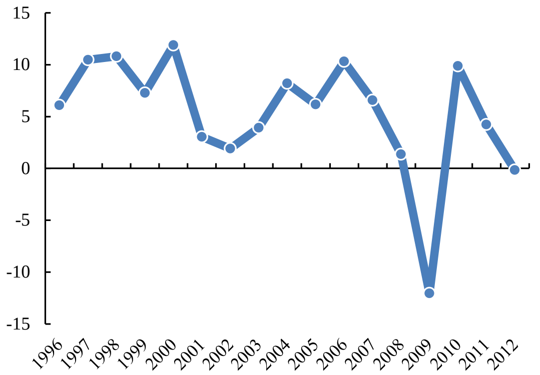
The countries with relatively more diversified export bases, with therefore less risk to high volatility of export revenues, are Lebanon, Moldova, Tunisia and Ukraine. Belarus and Syria increased very significantly the level of export diversification between 1995 and 2011. A similar trend, although of a more moderate nature, was also witnessed in Jordan, Egypt, Moldova and Tunisia. By contrast, Azerbaijan experienced during this period a further increase in export concentration from already high levels, reflecting further investments in the oil sector.

1.2.2. Recent trends

Following the collapse of trade that accompanied the 2009 global crisis, import levels in the EU recovered markedly in 2010, growing by 10% in real terms. But as the euro crisis unfolded, fiscal consolidation measures and soaring unemployment hit domestic demand in the euro area, thus slowing import growth in 2011 and 2012 (Graph III.1.3).

Graph III.1.3: **Import flows from the EU**

(constant prices, % change)



Source: European Comission (Ameco)

Mimicking the slowdown in euro area import growth, export growth rates of the EU neighbouring countries (which had also been generally recovering in 2010 after the decline caused by the global recession) slowed in 2011 and 2012 (see Table III.1.4, which shows export growth rates in nominal terms). In the Southern neighbours, the 2011 slowdown in export growth to the EU and overall (see also Graph III.1.4 for total export growth rates in real terms) was exacerbated by the Arab Spring revolutions,

([28]) The concentration index calculated by UNCTAD: http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx.

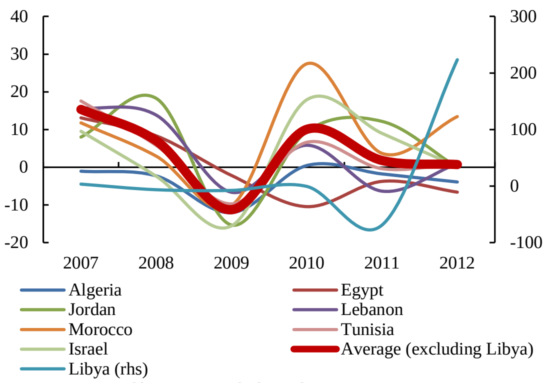
especially in Egypt, Libya and Tunisia, which disrupted economic activity. In 2012, total export growth rates recovered markedly in Libya but this was due to the resumption of oil production after the 2011 war. Export activity in Egypt has continued to slow as the political and macroeconomic situation remained highly instable. Export volumes contracted by 10% in Egypt and by 7% in Algeria in 2011-12. Jordan and Israel, for their part, saw their export growth coming to a standstill in 2012 after a sharp increase in 2010-11.

Table III.1.4:
EU neighbourhood - nominal exports to the EU (year-on-year, % change)

	2010	2011	2012
Southern neighbourhood			
Algeria	20.9	33.0	-21.2
Egypt	19.3	18.3	-1.2
Israel	24.9	21.1	-7.5
Jordan	45.4	43.6	-4.5
Lebanon	-3.7	16.3	-12.6
Libya	19.9	-62.2	193.4
Morocco	13.1	19.0	-6.7
Syria	*43.8*	*-3.7*	*-92.5*
Tunisia	6.2	8.8	-11.2
Palestine	483.3	-65.7	33.3
Average	*67.3*	*2.9*	*6.9*
Eastern neighbourhood			
Armenia	61.5	21.2	-7.8
Azerbaijan	57.5	56.1	-11.7
Belarus	-18.2	106.5	12.0
Georgia	9.8	8.3	-4.9
Moldova	9.1	44.4	3.3
Ukraine	37.3	39.5	-9.0
Average	*79.3*	*24.7*	*1.2*

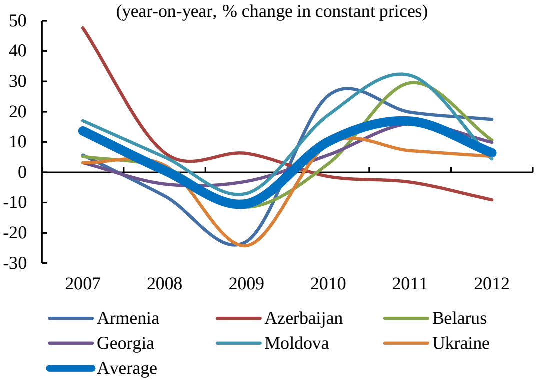
Source: IMF DoTS, DG TRADE

*Graph III.1.4:***Southern neighbourhood - exports**
(year-on-year, % change in constant prices)



Source: IMF World Economic Outlook, April 2013

Graph III.1.5: **Eastern neighbourhood - exports**
(year-on-year, % change in constant prices)



Source: IMF World Economic Outlook, April 2013

In the Eastern neighbourhood, the decline in exports witnessed during the 2008-09 global recession had been, on average, more marked than in the Southern region, partly reflecting their higher degree of dependence on manufactured exports, which were those that were more seriously hit by the global crisis. The decline in real terms was particularly sharp for Ukraine and Armenia (see Graph III.1.5). The 2010 recovery in exports was, however, also much stronger in the Eastern partners. As in the Southern neighbourhood, export growth slowed down in 2011-12, reflecting the moderating external demand from the EU but the slowdown was in 2011 somewhat less pronounced than in the Southern neighbours. This reflected (in addition to the absence of the Arab spring factor) the momentum from the strong 2010 recovery and the fact that Russia, which benefitted from relatively high oil and gas prices in 2011, continued to grow at a significant rate, providing a buffering role to most Eastern neighbours. During the second half of 2012, however, the Russian economy, affected by the downturn in the EU and lower energy prices, experienced a significant slowdown. As it finally started to co-move with the EU, the Eastern neighbours' exports were more seriously affected. In some of them (Armenia, Azerbaijan, Georgia, and Ukraine), nominal export growth turned negative. In Belarus and Ukraine, lax macroeconomic policies that fed domestic demand and imports may have also contributed to the slowdown in exports as export industries reoriented part of their sales towards the local market. In Azerbaijan, where slowing exports are mostly due to declining oil production, export volumes have contracted in real terms by 12% in two years since 2010. Georgia actually experienced an acceleration in export growth in 2011, but this was followed by a steep slowdown in 2012 as weakening exports to the EU were only partially offset by growing demand from the CIS countries (in particular Azerbaijan).

1.2.3. Conclusions

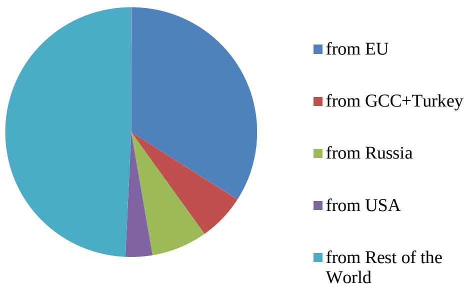
In sum, trade linkages between the EU and its neighbours are significant. Overall, the weakening demand in the EU due to the sovereign debt and banking crisis in the area has had an important slowing effect on the export growth of the neighbouring countries. Although vulnerability analysis suggests that the Eastern partners are relatively more exposed to the euro area crisis as their economies are more open and somewhat more dependent on the EU market, their export performance was initially (during 2011) more resilient reflecting the buffering role of Russia and other CIS countries. By contrast, several Southern countries saw their exports slow down markedly reflecting a special, domestic factor, namely the political instability and conflicts related to the Arab spring, which disrupted their production and exports. In the case of the Maghreb countries, this also reflects their high degree of dependence on the EU market. In the Eastern neighbourhood, as the Russian economy showed weaker results since the middle of 2012, along with the continuously weak demand from the EU countries, export performance further weakened. The Eastern neighbours as a whole, but also the Maghreb countries (which also benefit less from the buffering role of the GCC countries) seem more exposed to a prolongation or intensification of the euro area crisis, especially since under such scenario the Russian economy is likely to increase its co-movement with the EU cycle. The Mashrek countries, for their part, are relatively less exposed to the euro area crisis but are vulnerable to an intensification of the Syria crisis or to a serious decline in oil prices that impacts growth in the GCC countries.

1.3. TOURISM FLOWS

1.3.1. Vulnerability analysis

Tourism is a key industry in some ENP countries, which provides crucial foreign exchange revenue to finance the trade balance, which is in deficit in most of them, the main exceptions being the exporters of hydrocarbon products. The tourism industry is particularly significant for the Southern neighbourhood. In 2010, prior to the Arab Spring, tourism-related foreign exchange earnings to the Southern neighbourhood totalled USD 50 billion (5.8% of GDP), but by 2011 inflows into the region had fallen to USD 38 billion, with particularly devastating effects in Egypt and Tunisia – which saw a one third reduction in revenue, and Syria, which saw its USD 6 billion industry wiped out. Despite the Arab Spring effect, the tourism industry accounted on average for nearly 6% of GDP in 2011 (and 16% of export earnings) in the six Southern partners selected in Table III.1.5, about twice as much as in the Eastern partners. It was particularly important in Lebanon (18% of GDP in 2011, down from 22% of GDP in 2010) and Jordan (13% of GDP in 2011, down from 17% of GDP in 2010), followed at some distance by Morocco. In terms of the number of tourists received, the top recipient countries remained in 2012, despite the Arab Spring, Egypt with 11.5 million tourists and Morocco with 9.7 million, followed by Jordan with 6.3 million and Tunisia with 5.8 million.

Graph III.1.6: **Southern neighbours - Incoming tourists, 2011**



Note: Chart includes data for Egypt, Israel, Jordan, Lebanon, Morocco and Tunisia
Source: UNWTO

The important role of the industry in the Southern neighbourhood increases its exposure to economic developments in the EU, as nearly one third of total incoming tourists come from the EU (see Graph III.1.6), of which three fourths come from euro area countries. In comparison, tourist inflows from the GCC and Turkey, from Russia or from the USA stand, respectively, at 9%, 5% and 3% of total tourism inflows into the region, significantly behind those from the EU. The region's exposure

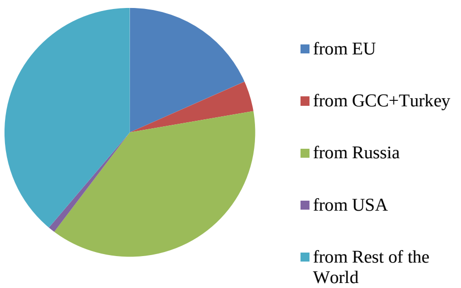
Table III.1.5:
Tourism inflows indicators, 2011

	Tourism revenues		Incoming tourists (% of total)			
	(% of GDP)	(% of export earnings)	from EU	from GCC/Turkey	from Russia	from USA
Egypt	4.0	19.8	44.9	3.8	18.6	1.9
Israel	2.3	6.1	34.3	0.4	14.6	18.9
Jordan	13.4	29.4	5.0	20.3	0.8	2.3
Lebanon	18.2	28.3	24.4	16.1	0.7	6.7
Morocco	9.2	28.6	42.6	1.3	0.2	1.4
Tunisia	5.5	11.2	39.3	0.4	3.2	0.3
Selected Southern Neighbours	**5.8**	**16.3**	**23.9**	**8.5**	**4.9**	**2.5**
Armenia	4.7	20.4	15.3	1.6	31.7	9.1
Azerbaijan	2.3	4.1	2.2	10.9	35.1	0.5
Belarus	1.6	1.9	16.2	3.1	72.5	0.5
Georgia	7.5	20.4	3.3	26.2	9.9	0.9
Moldova	3.7	9.6	n.a.	n.a.	n.a.	n.a.
Ukraine	3.3	6.5	21.9	0.4	42.1	0.6
Eastern Neighbours	**3.0**	**5.4**	**18.3**	**3.9**	**38.0**	**0.9**

Sources: IMF and United Nations World Tourism Organisation, Commission's calculations

to the EU is particularly marked in the Maghreb countries and in Egypt. In Morocco, Tunisia, and Egypt 40% or more of incoming tourists hail from the EU and the great majority of them – 9 out of 10 in Morocco and Tunisia – come from euro area countries. The sources of tourism among the Middle Eastern neighbours other than Egypt, however, are more diversified, with a stronger exposure to the countries in the region. Thus, incoming tourists from the GCC countries and Turkey represented 16% of the total in Jordan and Lebanon, whereas EU tourists represented a mere 7%.

Graph III.1.7: **Eastern neighbours - Incoming tourists, 2011**



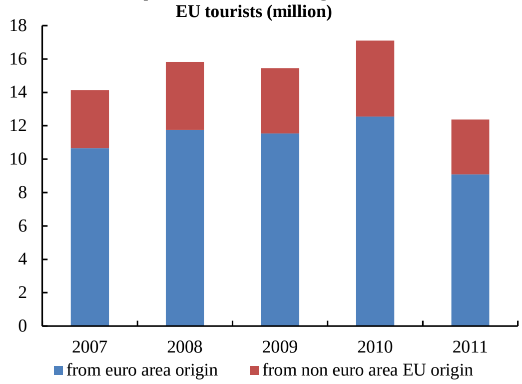
Source: UNWTO

The tourism industry plays a less important role in the Eastern neighbourhood. In 2011, tourism-related foreign exchange earnings to these countries represented 3% of the combined GDP (and about 5% of export earnings) of the region (or USD 9.6 billion). The region is also relatively less dependent on euro area countries, and is therefore less exposed to the crisis, as only a mere 5% of tourists into the region come from the euro area, whereas 13% come from the non-euro area EU Member States (see Graph III.1.7). By contrast, owing to the geographical and cultural proximity, the Russian Federation provides over a third of visitors to the region, the bulk of which go to Ukraine.

1.3.2. Recent trends

Since 2009, the tourism industry of the neighbouring economies has suffered from three shocks, namely the global financial crisis in the second half of 2008 and 2009, the euro area crisis since 2010, and, in the Southern Mediterranean, the Arab Spring since 2011. It is, therefore, difficult to disentangle the effects of the euro area crisis from the others, although the timing of the crisis as well as the origin, can serve to isolate the effects.

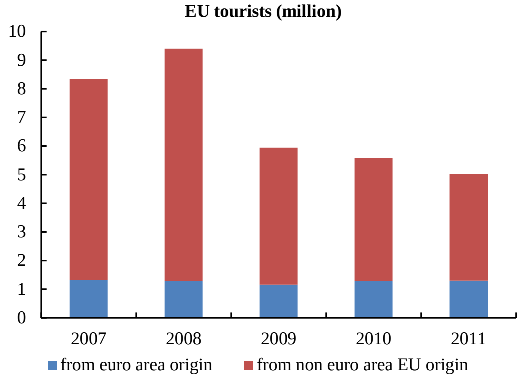
Graph III.1.8: **Southern neighbours - EU tourists (million)**



Note: Chart includes data for Algeria, Egypt, Israel, Jordan, Lebanon, Morocco and Tunisia
Source: UNWTO

The global crisis of 2009 was felt more strongly in the Eastern neighbourhood's industry, as EU-originating tourist arrivals into the region fell by 37% to 6 million. EU-originating tourist arrivals to Ukraine fell by 3.4 million visitors (a 40% fall), the single largest drop among all ENP countries, owing in particular to the drop in Polish visitors and, to a lesser degree, Romanian. From non-EU countries, the drop of Russian visitors was the most significant, reflecting the strong effect the global crisis had on Russia. By contrast, the fall was less pronounced in the Southern neighbourhood, as tourist arrivals from the EU shrunk by only 2.3% (to 15.4 million visitors) in 2009. EU tourist into Lebanon in 2009 actually recorded an increase. As a result, the Southern neighbourhood's industry remained relatively impervious to these developments.

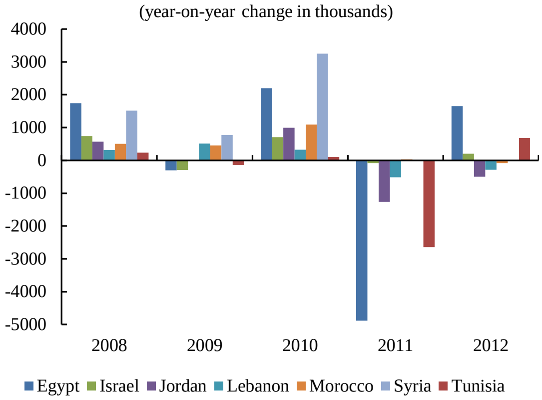
Graph III.1.9: **Eastern neighbours - EU tourists (million)**



Source: UNWTO

The year 2010 was one of mild recovery in the tourism sector for the ENP region, albeit facilitated by favourable base effects. EU tourists to the Southern neighbourhood increased by 11% and reached a series high of 17 million. Tunisia was the country least favoured by this recovery, actually seeing a moderate decline of tourists from the EU, in particular from Italy and Germany, whereas the traditional French market was unaffected. By contrast, EU originating visits to the Eastern neighbourhood fell for the second year running, although the fall was moderate (-6% as supposed to -37% the year before). This was again due to the fall in visits to the Ukraine, the largest recipient country, as visits to other Eastern neighbours recovered on average the ground lost in 2009. As a result of these developments, the Eastern neighbourhood's exposure to the EU was diminishing as the share of EU-originating tourists in the region fell from 25% in 2008 to 16% in 2010, whereas that in the Southern neighbourhood remained stable at about one third.

Graph III.1.10: **EU tourists to Southern neighbours**
(year-on-year change in thousands)



Source: UNWTO

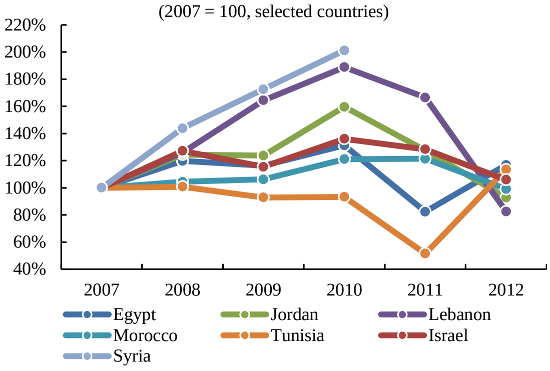
A clear exception to the relatively weak trend in tourism revenues observed since 2009 in the Eastern neighbourhood is Georgia, which saw an increase in tourism inflows in the middle of the 2009 global crisis (+7%) and has since experienced a very strong growth of inflows, with annual increases of about 45% in 2011 and 2012 and of 30% year-on-year in the first six months of 2013. Tourists originated mostly in neighbouring countries (Turkey, Armenia, and Azerbaijan in particular) wishing to visit the Black Sea resorts, the ski and mountain resorts in the Caucasus and the wine producing regions. Tourists from the EU, by contrast, remain marginal (3% of the total), suggesting a low exposure to the EU economic crisis but also presenting a significant potential for further expansion.

The third blow to the tourism industry in the Southern neighbourhood came, as noted, in early 2011 as the Arab Spring shook the political establishments across the region, leading to the toppling of the governments in Tunisia and Egypt, political reforms in Morocco and Jordan, and civil conflicts in Libya and Syria. As a result, the entire Southern neighbourhood excluding Libya is estimated to have received 41 million visitors in 2012 (4% of the world market), that is a loss of 10 million visitors from the pre-Arab Spring year of 2010.

These effects were mostly seen in those Arab countries in transition where instability was highest. Thus, tourist arrivals from EU countries, as well as from the rest of the world, fell in 2011 in both Tunisia and Egypt by nearly half. Egypt, in particular, went from a high of nearly 14.7 million tourists in 2010, to 9.9 million in 2011, and 11.5 million in 2012. Tunisia, for its part, lost nearly 3 million tourists to reach 5.1 million in 2011 and 5.7 million in 2012. Together, they lost about USD 5.3 billion in revenue, as a result. By contrast, in Morocco tourism revenue increased by 11% to USD 9.1 billion in 2011 even as tourist visits stagnated at almost 10 million, probably benefitting from some deviation of activity from other more politically unstable and insecure locations in the region.

Graph III.1.11: **Southern neighbours - EU tourists**

(2007 = 100, selected countries)



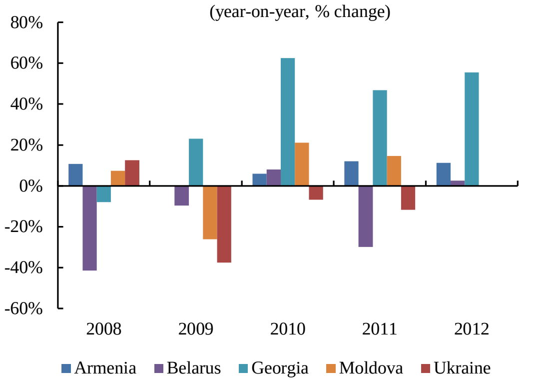
Source: UNWTO

By 2012, the industry had recovered some of the lost ground in Tunisia and Egypt, whereas Morocco was unaffected. On the other hand, the industry in Jordan, which was gravely affected by the Syrian refugee crisis, lagged significantly behind the pre-crisis peak. Syria has of course lost all of its USD 6.3 billion industry. The intensification of its conflict has eliminated any hope of a recovery of tourism inflows in the foreseeable future, and could also be having negative spill-over effects on tourism in neighbouring countries, notably Lebanon, the country that looks more politically vulnerable to contagion from Syria.

This weak performance of tourism in the Southern neighbours since 2011 is not solely due to the regional stability, but also to the continuation of the euro area crisis, as visitors from euro area countries that were more affected by the crisis fell at a faster speed than the rest. In Tunisia, for example, whereas visitors from France and Germany, the two largest origin countries, fell by about 40%, arrivals from Italy, the third largest origin country, fell by 67%. In Egypt, arrivals from the UK and Germany, the second and third largest origin countries after the Russian Federation, fell by nearly one third, whereas visits from Italy, the fourth largest origin country, fell by half. Tourist from Spain and Greece, two countries seriously affected by the euro area crisis, fell by about two thirds.

Graph III.1.12: **EU tourists to Eastern neighbourhoods**

(year-on-year, % change)

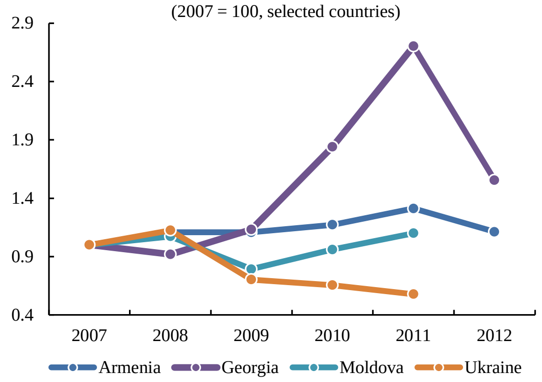


Source: UNWTO

There is, however, evidence suggesting that the Arab Spring factor has tended to be more important than the euro area crisis in explaining the decline in tourism inflows observed in the Arab countries undergoing political transitions (Lanqar, 2012). For example, in Israel, which was not directly affected by the Arab Spring, incoming tourists and tourism-related expenditure were broadly constant throughout 2011 and 2012, even though a small dip from EU tourists was noticed. This is also consistent with general empirical evidence suggesting that tourism inflows are relatively inelastic to cyclical fluctuation in the economies of the countries of origin when compared to exports to those countries. ([29])

([29]) There is some evidence that international tourism tends to be relatively inelastic to cyclical fluctuations in GDP in the originating country (see Dwyer, Gill and Seetaram, 2012). International tourism tends also to be relatively price inelastic (see Dwyer and Forsyth, 2006). In both cases, however, there can be significant variations per country.

Graph III.1.13: **Eastern neighbourhood EU tourists, 2007-12**
(2007 = 100, selected countries)



Source: UNWTO

1.3.3. Conclusions

Southern neighbours are relatively more dependent on tourism than Eastern neighbours and, therefore, are more vulnerable to the euro area crisis to the extent that the latter impacts euro area spending on tourism. Indeed, tourism arrivals from euro area did fall more markedly than those from other EU countries. However, the major shock to the industry in the region seems to have been the Arab Spring. By 2012, the region's tourism balance had dropped by nearly three percentage points to 4.6% of GDP compared to 7.3% in 2010. While this development was felt across the region, Tunisia and Egypt were the countries most affected by this contraction, aside from Syria of course. The deterioration of the tourism balance has therefore contributed to increase the vulnerability of the external position of these countries, a development that continued into 2013. The prolongation and possible propagation or spill-over effects of the Syria conflict could also have a lasting negative effect on the tourism inflows into its neighbouring countries.

The tourism industry plays a much less developed role in the Eastern neighbourhood, with the notable exception of Georgia, where a long-term trend towards the development of this sector is underway. Secondly, the region is relatively less dependent on EU tourists, in particular to those coming from euro area countries, a pattern that is partly explained by the more important role played by tourists from the Russian Federation. These factors coalesced to make the Eastern neighbourhood relatively less dependent to the euro area crisis through the tourism inflows channel. Together with the absence of the Arab Spring factor, this explains why tourism inflows have been more resilient to the EU crisis in the Eastern neighbourhood over the last few years, although the industry suffered a blow during the 2009 global crisis partly due to the knock-on effects the crisis had in Russia, the leading source of tourism inflows for the Eastern partners.

1.4. REMITTANCES

Although there is no clear evidence in the literature that remittance inflows generate investment and growth, remittances can provide a buffer in times of domestic crisis, in case the crisis is not affecting the remittance source country as well (Frankel, 2009). Indeed, remittances often have a countercyclical, buffering aspect as migrants send home more money when the home country experiences a downturn. In these cases, they provide the population with an additional source of financing to alleviate the fall in income, helping to maintain consumption and increasing fiscal policy space by sustaining tax inflows to the government. However, when the crisis affects the source country and the destination country simultaneously, as experienced during the global financial crisis in 2009, remittances can have a shock amplifying effect. Thus, in 2009, the fall in remittances exacerbated the effects of the global recession in Armenia, Georgia and Moldova by depressing domestic consumption and investment and tightening the balance of payments constraint.

Having said that, there is evidence suggesting that remittances, like tourism flows, are a relatively resilient type of external flows (see Ratha, 2003). While, other things being constant, the volume of remittances does tend to fall when the host country (in our study, the euro area or the EU) enter into a recession (Frankel, 2009), their elasticity to economic conditions in the host country tends to be smaller than that of the host country's imports. ([30]) This means that although a high dependence on remittances (or tourism flows) from

([30]) Possible factors explaining this, include the efforts of migrants to maintain a stable flow of income to their families in the home country, the fact that part of the remittances are financed by pensions, the decision of migrants to return to the home country, bringing saved capital with them, or simply to repatriate funds from a risky banking system when the host country enters into crisis.

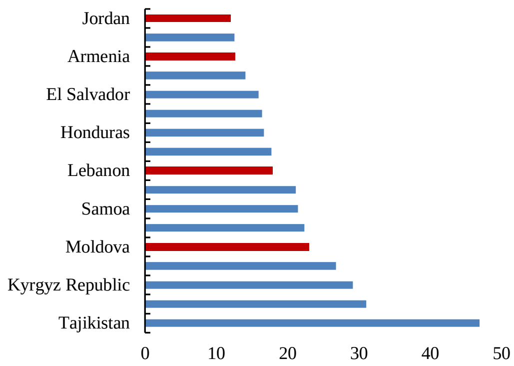
the EU tends to increase exposure to the euro area crisis, it does so by less than if the dependence was due to a similarly large concentration of merchandise exports on the euro area.

1.4.1. Dependence on remittances

With a large part of its labour force working abroad, the European neighbourhood is one of the regions receiving the largest remittances inflows in the world, rendering it therefore vulnerable to the downturns in the host countries (see Graph III.1.14). Remittance inflows to the neighbouring countries have been expanding rapidly over the last decade, reaching USD 58.4 billion (or 8% of GDP) in 2011.

Graph III.1.14: **Top recipients of remittances in the world, 2011**

(in % of GDP)



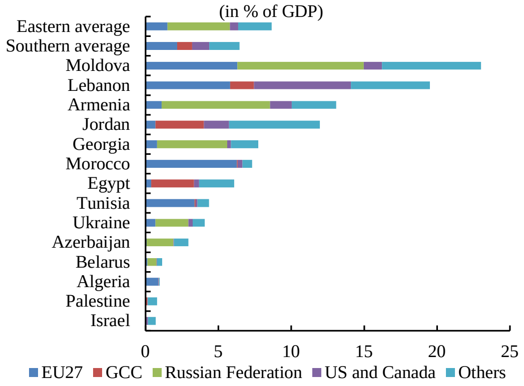
Source: World Bank

The Eastern neighbours show on average a somewhat higher overall dependence on remittances (8.7% of GDP), but a lower dependence on EU remittances (see Graphs III.1.15 and III.1.16) given the important role played by the remittance inflows from Russia. Some Southern countries (Jordan, Lebanon, Morocco), on the other hand, are very dependent on remittances. ([31]) Also, in the Southern neighbours, an important share of remittances comes from GCC countries. Libya is also an important source of remittances for some Southern neighbours (notably Egypt and Tunisia), although the flow from Libya was interrupted during the 2011 Libyan war.

([31]) On migration flows in the Arab Mediterranean neighbours, and their links with the performance of labour markets, see European Commission (2010).

Graph III.1.15: **EU neighbours - Remittances, 2011**

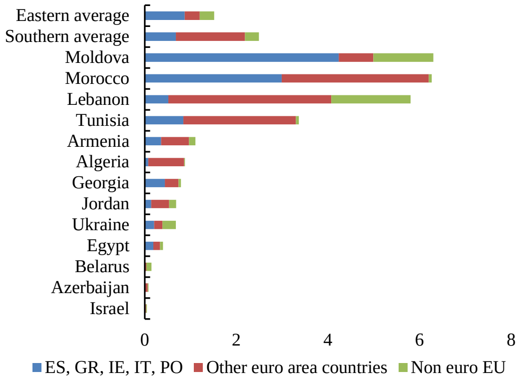
(in % of GDP)



Source: World Bank, EC calculations

By country, the EU neighbours that are most dependent on overall remittance inflows are, in this order, Moldova, Lebanon, Armenia and Jordan (see Graph III.1.15). Remittances make up to 23% of GDP in Moldova, 18% in Lebanon, 12.6% in Armenia and 12% in Jordan. The less exposed neighbourhood countries are Belarus, Algeria and Israel, where the ratio of remittances to GDP is below 1.5%. In the Southern neighbourhood, the main sources of remittances are the EU, the GCC countries and the US and Canada. In the Eastern neighbourhood, the main source countries are the EU, Russia, the US and Canada. With Russia being, as noted, more correlated with the EU economic cycle than the GCC countries, the fact that the Eastern neighbours have a higher overall dependency on remittances from the EU and Russia combined makes them, overall, more exposed to the euro area crisis through this channel than the Southern neighbours.

Graph III.1.16: **EU neighbours - Remittances from the EU in 2011 (in % of GDP)**



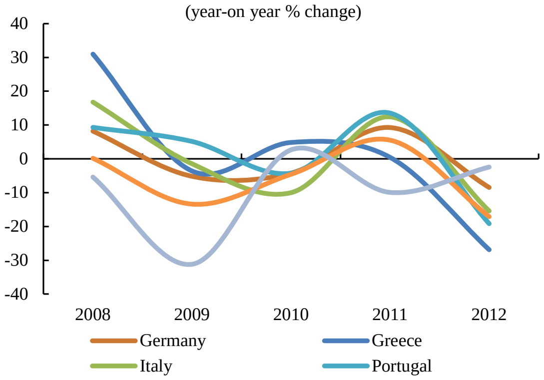
Source: World Bank, EC calculations

Most vulnerable to a decline in remittance inflows from the EU are Moldova, Lebanon and Morocco, where inflows from the EU countries form 6.3% of GDP, and, to a lesser extent, Tunisia. These are also the countries that are the most exposed to remittances from the euro area periphery ([32]), which are the most impacted by the sovereign debt crisis.

1.4.2. Recent trends

The 2009 global crisis, with its weak output growth and high unemployment rates, had a clear negative impact on overall remittance outflows from the EU countries. In 2010-11, overall outflows recovered somewhat, but they fell again significantly in 2012 as the euro area crisis intensified (see Graph III.1.17).

Graph III.1.17: **EU - Remittance outflows**
(year-on year % change)

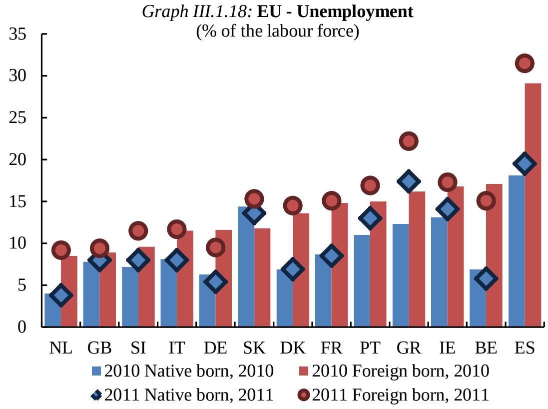


Source: IMF Balance of Payments statistics

Furthermore, in most euro area countries migrant unemployment rates have been increasing more rapidly that unemployment among the native population. ([33]) Graph III.1.18 illustrates this for the period 2010-11. This is especially true for Greece, Portugal and Spain. This tended to increase the impact of the euro area crisis on remittances flows via its effect on unemployment.

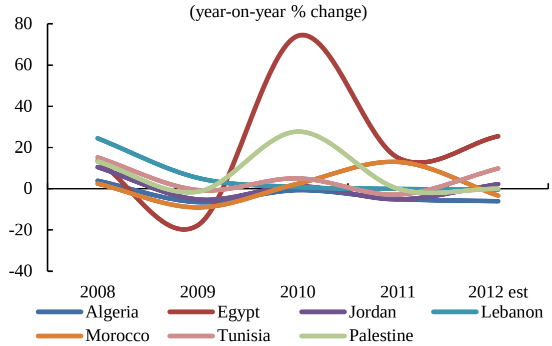
Data on remittance inflows into the ENP countries broadly (but not exactly) reflect those on total outflows of EU remittances (marked decline during the 2009 global crisis, recovery in 2010 and new deceleration or, in some cases, moderate decline in 2011-12). Graphs III.1.19 and III.1.20 show that the global crisis affected much more strongly the Eastern neighbours than the Southern ones, as one would expect. They also show, in general, a stronger recovery of remittances in the Eastern neighbours in 2010 (the main exception being Egypt) and significant resilience in both regions in 2011 and 2012 although in the context of a downward trend.

Graph III.1.18: **EU - Unemployment**
(% of the labour force)



Source: OECD International Migration Outlook, 2012

Graph III.1.19: **Southern neighbours - Remittance inflows**
(year-on-year % change)



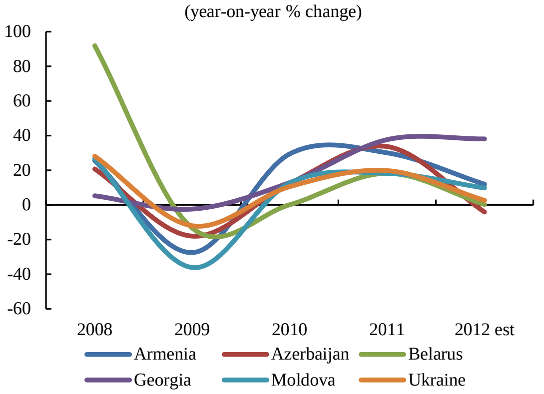
Source: World Bank

The relative resilience observed in remittances flows to the Southern neighbours in 2011-12 (especially if the negative effect of the Libyan war on remittances to Egypt and Tunisia in 2011 is excluded) is basically explained by the buffering role of remittance inflows from the GCC countries, which were not influenced by the global or European financial crises. This was particularly the case for the countries in the Mashrek (Egypt, Jordan, Lebanon) (see Graph III.1.19). The case of Egypt, where remittance inflows increased by 38% in 2010-12 despite the temporary effect of the Libyan war in 2011, is of particular interest. This increase is largely explained by the buffering role

([32]) Greece, Ireland, Italy, Portugal and Spain.
([33]) OECD (2012), "Employment", International Migration Outlook, 2012.

of remittances from the GCC countries, where many Egyptians work. It seems to reflect in particular effort by migrants to send to their families in Egypt funds to help them weather the country's difficult economic and political situation. Although the Libyan war produced a marked deceleration in remittance inflows to Egypt in 2011, the country managed to continue to see its remittances inflows grow on that year. By contrast, in Algeria, where remittance from the EU, mostly France, make up 90% of the total inflow, remittances contracted by 5.5% on average in 2011 and 2012. Similarly, in Morocco, where also most remittances come from the EU, growth rates decelerated markedly in 2012.

Graph III.1.20: **Eastern neighbours - Remittance inflows**
(year-on-year % change)

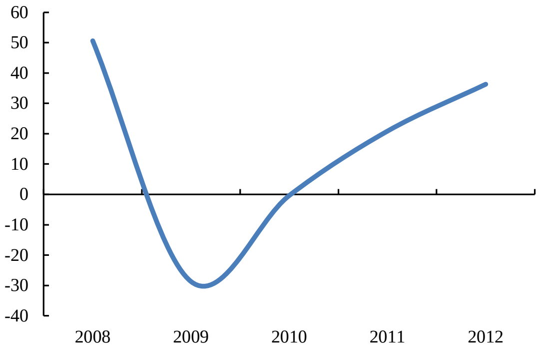


Source: World Bank

In the Eastern neighbourhood, remittance inflows had been recovering, as noted, since the end of the 2009 global crisis, when most of the countries saw a sharp decline in remittance inflows, Moldova and Armenia being the hardest hit with drops of 36% and 28%, respectively. This seems explained by the fact that Russia, the other main source of remittances for the Eastern neighbours, suffered a deep recession that year, which seriously affected its overall remittance outflows (see Graph III.1.20).

After recovering markedly in 2010, remittances into the Eastern partners have, as noted, shown a decelerating trend but significant resilience despite the slowing of remittances from the EU due to the euro area crisis. In 2011, their growth actually picked up pace in some countries, while in 2012 remittances continued growing despite a general deceleration. This resilience seems explained by the good performance of the Russian economy in 2011 and in the first half of 2012, which led to a strong increase in total remittance outflows in both years (see Graph III.1.21), and perhaps also by the lower sensitivity of remittances to the business cycle in the host countries (the euro area) compared to other external flows.

Graph III.1.21: **Russia - Remittance outflows**
(year-on-year % change)



Source: IMF Balance of Payment Statistics

In Armenia, the average growth of remittance inflows from Russia in 2011-12 reached 22%. Georgia, which showed the highest growth in remittance in the Eastern neighbourhood during this period (38%), also benefitted from a sharp increase in inflows from Russia. In Moldova, remittance inflows increased on average by 14% during 2011-12. Remittance inflows from EU countries to the neighbourhood, in particular Greece and Italy despite their crisis, increased as well. This however could be a short-term trend explained by the confidence crisis in the banking sector of these countries that could lead to a migrant capital outflow translated into remittances.

However, with the economic slowdown in Russia deepening towards the end of 2012, a weakening of remittance flows from Russia to the Eastern neighbourhood countries should be expected. To this, the negative impact of increased unemployment levels in the euro area will be added.

1.4.3. Conclusions

The ENP countries on average are highly dependent on remittance inflows. This is particularly the case for the Eastern neighbours and for some Southern neighbours (Jordan, Lebanon and Morocco). The diversification of the remittance source countries (and in particular the counteracting role of remittances from GCC countries and Russia) seem to have buffered the decrease in remittance flows from Europe during the period of sovereign debt crisis. Nevertheless, the indirect effect of the European crisis on Russia is expected to eventually exacerbate the overall decrease of financing through remittances in the Eastern neighbours. Southern neighbourhood from the Mashrek sub-region continue to rely substantially on the remittance inflows from the GCC countries, which are relatively less affected by the euro area crisis, thus providing a welcome source of resilience. In some countries (Egypt in particular), the countercyclical behaviour of migrants as they endeavour to help their families in home countries undergoing difficult political and economic transitions, has further contributed to stabilise remittances. Overall, remittances to the EU neighbours have been affected by the euro area crisis less markedly than exports to the euro area.

1.5. CAPITAL FLOWS AND FINANCIAL SECTOR EXPOSURE

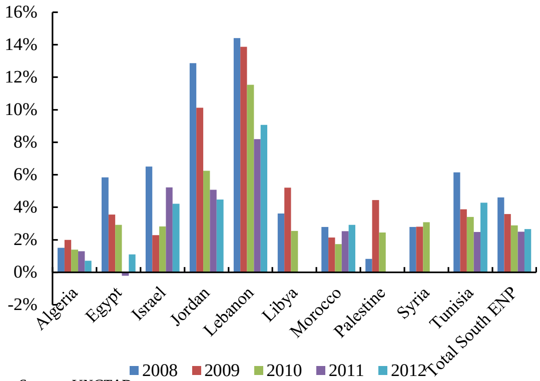
Theoretically, there are several financial channels through which external developments, and in particular the euro area crisis, could impact ENP countries: (i) FDI inflows could dry up; (ii) EU financial institutions could reduce their exposure to ENP countries, either by curtailing their funding to the local financial sector, forcing it in turn to deleverage, or by reducing their direct lending to non-financial firms; and (iii) portfolio flows from EU to ENP countries could decline. This section focuses on the first two of these financial channels.

1.5.1. Foreign Direct Investment

Exposure

A relatively high dependence on FDI should, in principle, be welcome since FDI generally provides a more stable and productivity-enhancing source of foreign capital. At the same time, a high reliance on FDI inflows from the EU can increase vulnerability to the euro area crisis. The reliance of ENP countries on FDI, as measured by the FDI/GDP ratio, varies substantially from one ENP country to another. ([34])

Graph III.1.22: **FDI inflows into Southern neighbours**
(in % of GDP)



Source: UNCTAD

Among the Southern neighbours, the countries that are most dependent on FDI are by far Lebanon (where FDI inflows accounted for 11.4% of GDP over 2008-12) and Jordan (7.8% of GDP over the same period) (see Graph III.1.22). Next stands Israel, where FDI accounted for 4.2% of GDP over that period. In all other Southern neighbours, FDI inflows represented no more than 4% of their respective GDP. The reliance of Algeria on foreign investment is particularly limited, with FDI inflows representing only 1.4% of GDP – a reflection of the fact that the Algerian economy (the third largest in the region in terms of GDP, after Israel and Egypt) is a closed economy. FDI inflows in Algeria, which are mainly driven by investments in the hydrocarbon sector, remained stable at a relatively low level over the 2008-11 period – between USD 2.3 billion and USD 2.7 billion annually – and decreased to USD 1.5 billion in 2012. The limited willingness by Algerian authorities to open their economy to outside investors is reflected in recent legislation, which since December 2009 imposes a 49%

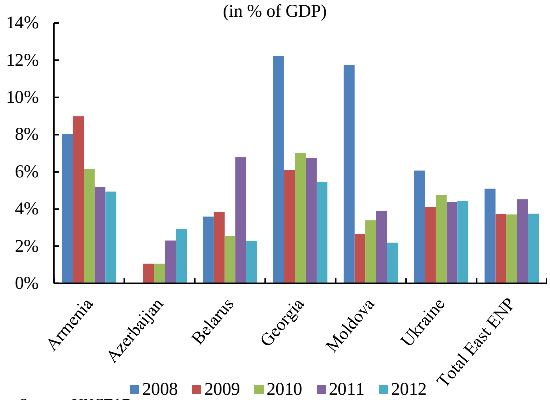
([34]) This Chapter uses the OECD Benchmark Definition of FDI, third edition, as a basis. As per this definition, FDI is the category of international investment made by an entity resident in one economy to acquire a lasting interest in an enterprise operating in another economy. The lasting interest is deemed to exist if the direct investor acquires at least 10% of the voting power of the direct investment enterprise. FDI flows include equity capital, reinvested earnings and intra-company lending. FDI stocks include equity capital and reinvested earnings (i.e. the value of the capital of the enterprise, including reserves accumulated from past reinvested earnings) and other FDI capital (stock of debts).

ceiling on foreign investors' ownership of assets in FDI projects, a requirement extended since 2010 to foreign participation in investments in the financial sector.

Among the Eastern neighbours, the countries recording the highest FDI inflows as a percentage of their GDP over 2008-12 were Georgia and Armenia (average of 7.5% and 6.6% of GDP, respectively), Moldova, Ukraine and Belarus coming next with FDI inflows/GDP ratios averaging 3.8% to 4.8% of GDP over the same period (see Graph III.1.23). Azerbaijan is the least open economy in terms of inward FDI, which averaged 1.5% of its GDP over 2008-12.

Graph III.1.23: **Eastern neighbours - FDI inflow**

(in % of GDP)



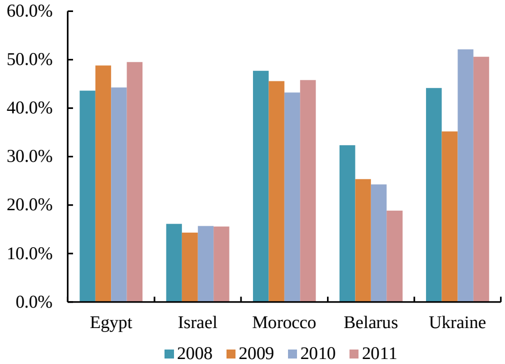
Source: UNCTAD

Graphs III.1.22 and III.1.23 show that, on average, FDI inflows were somewhat higher in the period 2008-12 in the Eastern neighbours (4.2% of GDP) than in the Southern neighbours (3.3%), suggesting that the Eastern neighbours rely more on FDI than the Southern ones.

The vulnerability of ENP countries to changes in FDI provoked by the euro area crisis depends on the weight of the EU in total FDI. Unfortunately, comparable aggregate data from Eurostat on EU FDI stocks and flows exists for only five countries: Egypt, Morocco, Israel, Ukraine, and Belarus. For these countries, FDI data include FDI undertaken through Special Purpose Entities located in five EU countries. [35] These Entities often hold companies created for tax reasons and, in countries such as Luxembourg, account for 85-90% of total FDI inflows and outflows. The share of EU FDI going through these Special Purpose Entities can be very high (in the case of Ukraine, FDI stocks from the EU originated from these Entities accounted for more than half of total FDI stocks from the EU in 2010-11). [36]

Graph III.1.24: **FDI stocks from the EU**

(% of total FDI stocks)



Source: Eurostat, UNCTAD, Staff Calculations

Eurostat data show that countries such as Egypt, Morocco and Ukraine, with FDI stocks from the EU representing close to 50% of total FDI stocks over the 2008-11 period, are significantly more dependent on EU FDI than Israel and Belarus, where the same ratio averaged 15% and 25%, respectively, over the 2008-11 period (see Graph III.1.24). The picture is confirmed if one looks at FDI stocks from the EU as a percentage of these countries' FDI (see Graph III.1.25).

The analysis based on Eurostat data suggests that although the Southern neighbours are, on average, somewhat less dependent on total FDI inflows as a source of financing than the Eastern neighbours, their dependence on EU FDI is significant.

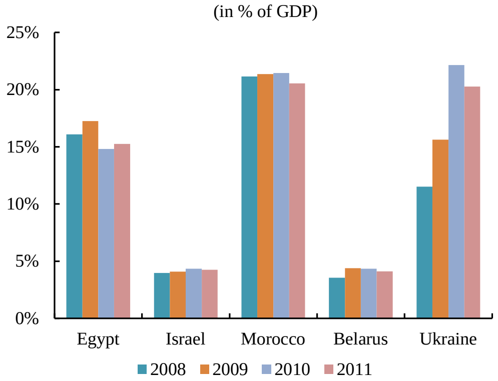
This picture is confirmed by information obtained from national ENP sources. For example, data published by the Egyptian Ministry of Finance shows that the share of the five largest EU investors in Egypt (UK, France, Germany, Netherlands and Spain) consistently accounted for 27% to 58% of total annual FDI inflows in the country over the 2007-11 period. Also, data published by the Tunisian Foreign Investment Promotion Agency, shows that in 2012, 42% of total FDI inflows into Tunisia came from the EU, with France, Italy and Germany, in this order,

(35) Austria, Cyprus, Hungary, Luxembourg, the Netherlands

(36) Source: Eurostat, OECD, Commission Staff calculations

being by far the most important EU investment partners([37]) The EU also accounts for a significant share of FDI flows into Algeria, according to national data. This high exposure of some Southern neighbours to EU FDI (notably in the Maghreb region but also in Egypt) may be partly explained by the historically close links between the EU and South Mediterranean countries. Besides, it is supported by the conclusion of free trade agreements with the EU, which facilitate investments by EU investors and which are much more advanced than in the Eastern neighbours ([38]). For the Southern neighbours such as Israel and Jordan, which either have more open economies or where the GCC countries are important investment partners, exposure to changes in EU FDI is more limited.

Graph III.1.25: **FDI stocks from the EU**
(in % of GDP)



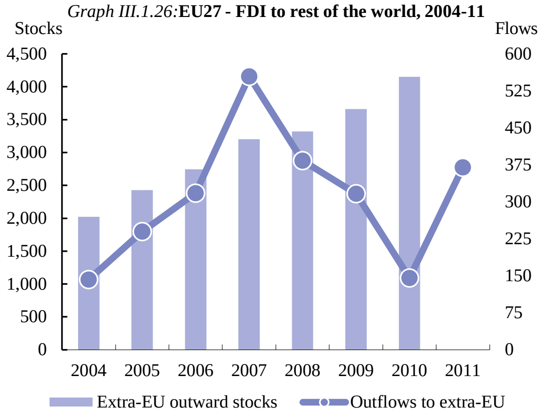
Source: Eurostat, IMF, Staff Calculations

The exposure of the Eastern neighbours to EU FDI also varies significantly across countries. In the region, Ukraine is clearly the country most exposed to changes in EU FDI. In fact, the largest FDI inflows in Ukraine in 2010 (in terms of equity capital invested, i.e. excluding reinvested earnings and intra-company loans) came from the EU (54%) and from Russia (16%). ([39]) Exposure of other neighbours (e.g. Belarus) to EU FDI is more limited, notably because of the importance of other regional investors, including Russia.

Recent trends

The global financial and economic crisis already had a strong negative impact on EU investment flows towards the rest of the world. After peaking at EUR 554.4 billion in 2007, EU FDI outflows to non-EU countries decreased by 31% to EUR 383.5 million in 2008 and by an additional 17% in 2009 (see Graph III.1.26). This negative trend was subsequently exacerbated by the euro area crisis. FDI outflows to non-EU countries more than halved in 2010. Although this downward trend was partly reversed in 2011, EU FDI outflows to non-EU countries remained at EUR 370 billion, significantly below their 2007 peak.

Graph III.1.26: **EU27 - FDI to rest of the world, 2004-11**



Source: Eurostat

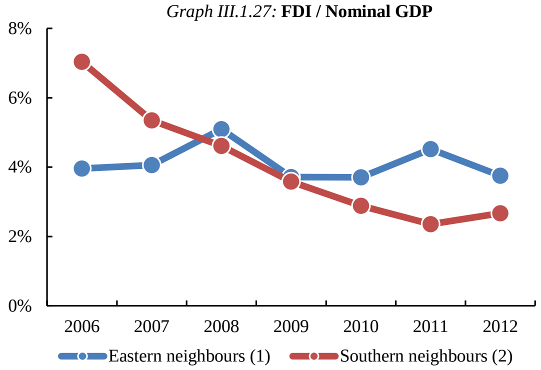
Other events unrelated to the euro area crisis also had a major impact on EU and non-EU FDI to ENP countries. While the average FDI inflows/GDP ratio in the Eastern neighbours has been rather stable over the last few years, oscillating between 3.7% and 5%, the ratio in the Southern neighbours steadily declined from 7% in 2006 to 2.4% in 2011, rebounding only slightly to 2.7% in 2012 (see Graph III.1.27).

This more pronounced decline in FDI inflows into the Southern neighbourhood seems due to the fact that this region has been affected not only by external shocks, such as the global crisis and the euro area crisis, but also by domestic factors, namely the political and economic turmoil resulting from the Arab Spring. The decline in FDI inflows in 2011 was particularly stark for Egypt,

([37]) See Foreign Investment Promotion Agency (2013), "Bilan de l'investissement étranger de l'année 2012" (Tunis: FIPA).
([38]) Association Agreements with the EU, foreseeing the creation of bilateral free trade areas, have entered into force with Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine, and Tunisia. In the Eastern neighbourhood, by contrast, no Association Agreement has yet been concluded. They are under negotiation with Moldova, Armenia, Georgia, and an Association Agreement has been initialled with Ukraine but has not yet been signed.
([39]) Source: Ernst & Young, Ukraine FDI report 2011.

presumably as a result of the instability related to its complex political transition. According to UNCTAD data, FDI inflows to the country turned negative in 2011, compared to an average of about USD 7.5 billion over the preceding three years. FDI inflows in Tunisia also decreased sharply (by 25%) in 2011, ostensibly as a result of the political and economic instability associated with the Tunisian revolution. In Libya, where annual FDI had fluctuated between USD 2.0 billion and USD 3.8 billion during the five years preceding the civil war, FDI inflows are thought to have virtually stopped with the start of the conflict. The same is true for Syria. Conversely, comparatively more stable South Mediterranean countries such as Morocco and Algeria benefited from stronger FDI inflows in 2011, when compared to 2010.

Graph III.1.27: **FDI / Nominal GDP**

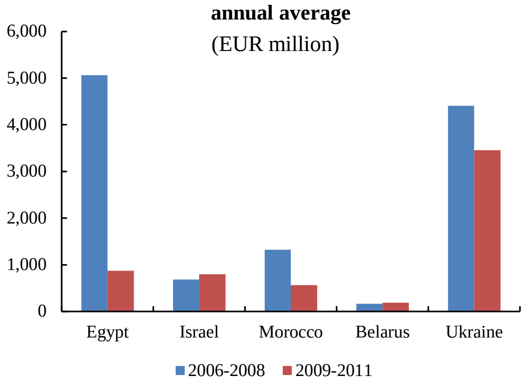


(1) Armenia, Azerbaidjan, Belarus, Georgia, Moldova, Ukraine
(2) Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria, Tunisia
Source: UNCTAD

Total FDI inflows in the Eastern neighbours were more volatile over the period 2008-11 (see Graph III.1.23). This is partly explained by the fact that, except for Ukraine and to a lower extent Belarus, the absolute FDI numbers are relatively small. One or two large transactions are therefore sufficient to significantly alter the trends in FDI flows. Besides, since FDI flows reflect intra-company lending in addition to equity capital investment and re-invested earnings, it is also likely that difficulties with raising funds from third parties such as commercial banks obliged some foreign affiliates to rely on intra-company loans from their parents to maintain or develop their operations.

Looking specifically at FDI inflows from the EU to the Southern neighbours, they declined significantly in the two South Mediterranean countries for which data is available. In Egypt, FDI inflows from the EU drastically decreased from an annual average of EUR 6.1 billion over the period 2006-08 to an annual average of EUR 0.9 billion over the period 2009-11. In Morocco, FDI inflows from the EU also decreased markedly over 2009-11 (see Graph III.1.28). In view of this contraction in EU investments, national authorities in some countries have been stepping up efforts to attract other investors not faced with such difficulties, such as Gulf countries' investors, and notably their sovereign wealth funds. For example, in 2011, the Moroccan authorities established, in partnership with the sovereign wealth funds of Qatar, the United Arab Emirates and Kuwait, a fund that aims at investing USD 2.5-4 billion in tourism projects in Morocco. This kind of efforts enabled Morocco, whose inward FDI flows had gradually decreased from a peak of EUR 2.8 billion in 2007 to EUR 1.6 billion in 2010, to reverse this negative trend, with inward FDI flows recovering to EUR 2.8 billion in 2012.

Graph III.1.28: **FDI inflows from the EU, annual average**
(EUR million)



Source: Eurostat, Staff calculations

Conversely, FDI inflows from the EU to Israel have been on an upward trend over the last few years, averaging nearly EUR 800 million annually over the period 2009-11, to compare with EUR 686 million over the period 2006-10.

As regards the Eastern neighbours, statistical analysis conducted by the EBRD of 33 Eastern European transition countries, including the EU's six Eastern neighbours, shows that FDI flows into these countries have been affected over the previous decade predominantly by economic conditions in the source country rather than by prevailing or past growth rates in the recipient states. ([40]) This suggests that the euro area crisis has had a negative impact on EU FDI flows to neighbouring countries in the East. This is confirmed by actual figures on Ukraine: annual FDI inflows from the EU to Ukraine decreased from an average of EUR 4.4 billion in the 2006-08 period, to an average of EUR 3.5 billion in the 2009-11 period. As regards Belarus, annual FDI inflows from the EU increased only slightly between these two periods (see Graph III.1.28).

1.5.2. Banking flows

Financial institutions faced with funding difficulties and/or market or regulatory pressure to reduce the size of their balance sheets or improve their credit quality, may modify their international lending activity as follows: (i) they may sell their foreign subsidiaries, or reduce their equity investment in financial institutions located abroad; (ii) they may reduce their funding to their foreign subsidiaries, which in turn will reduce their domestic lending; or (iii) they may reduce their direct cross-border lending to domestic borrowers, whether or not financial institutions.

There is evidence that banks in developed countries indeed behaved in that way during the global financial crisis of 2008-09, curtailing their lending to emerging markets. Thus, a study by Cetorelli and Goldberg (2009) showed that lending supply in emerging markets was affected during the global crisis through three separate channels: (i) a contraction in direct, cross-border lending by foreign banks; (ii) a contraction in local lending by foreign banks' affiliates in emerging markets; and (iii) a contraction in lending supply by domestic banks, as a result of the funding shock to their balance sheet induced by the decline in interbank, cross-border lending. ([41]) This section will analyse whether the euro area financial crisis had a similar impact as the global financial crisis, looking more specifically at ENP countries.

Exposure

Obviously, the more a national financial system is integrated globally, the more it risks being impacted by an external banking crisis. One measure of global integration of a national financial system is the ownership of domestic banks by foreign banks. Data on the percentage of total bank assets owned by foreign banks ([42]) in ENP countries shows that, while the level of integration through foreign ownership varies widely from one country to another, foreign banks play in many countries a significant role in their national banking markets. Also, in both the Southern and Eastern neighbours, there has been an unprecedented increase in foreign ownership of local banks since the mid-1990s, which accelerated in the late 2000s: the percentage of foreign banks among total banks in twelve ENP countries ([43]) increased from an average of 15% in 1995 to an average of 32% in 2004, and then to 50% in 2009. ([44])

Table III.1.6 shows that foreign banks are more largely established in the Eastern neighbours than in the Southern neighbours, which is consistent with the often held view that international financial integration in the Southern neighbours is relatively less advanced, a factor which is sometimes alleged to have contributed to explain their relative resilience to the global financial crisis of 2009. Thus, whereas foreign banks held in 2009 about 45% on average of total bank assets in the Eastern neighbours, they only held 22% of total bank assets in the seven Southern neighbours analysed.

Among the Southern neighbours, Libya (with no foreign ownership at all) and Algeria (with only 14% of foreign ownership of bank assets in 2009, another indicator of the limited financial openness of this country) stand as those where the presence of foreign banks is the smallest. Conversely, the role of foreign banks is strong in Morocco (34% of foreign ownership of bank assets) and Lebanon (35% of foreign ownership), a country with the largest banking system in the region relative to the size of the economy (with bank assets accounting for about 300% of GDP).

([40]) EBRD Transition Report (2012). The study is based on a panel regression of annual bilateral flows from six large euro area countries to transition countries between 2001 and 2010. The study finds that a 1% increase in the source country's growth rate increases its stock of FDI in the receiving country by 5.9%.
([41]) Cetorelli and Goldberg (2009).
([42]) Foreign bank being defined as bank that is 50% or more owned by foreigners.
([43]) Algeria, Egypt, Jordan, Lebanon, Morocco, Tunisia, Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine.
([44]) Claessens and van Horen (2012).

Table III.1.6:
EU neighbours - Percentage of foreign bank assets in total bank assets

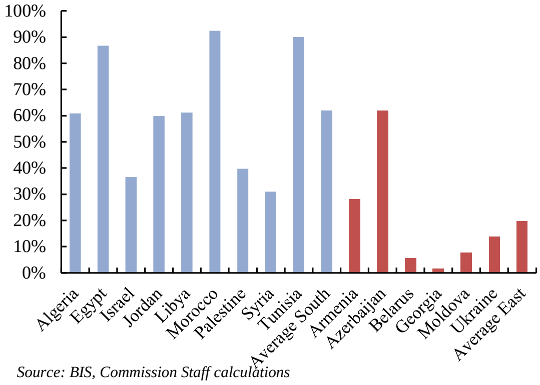
	2004	2005	2006	2007	2008	2009
Southern neighbours						
Algeria	5	8	8	7	8	14
Egypt	10	12	21	25	25	23
Jordan	2	14	16	17	22	23
Lebanon	n.a.	n.a.	n.a.	33	35	35
Libya	0	0	0	0	0	0
Morocco	n.a.	n.a.	n.a.	19	18	34
Tunisia	20	29	27	27	28	n.a.
**Average Southern*	*n.a.*	*n.a.*	*n.a.*	*18*	*19*	*22*
Eastern neighbours						
Armenia	n.a.	46	58	65	70	79
Azerbaijan	1	1	1	3	2	3
Belarus	n.a.	14	12	19	19	18
Georgia	13	32	66	66	66	64
Moldova	31	30	31	38	45	49
Ukraine	28	28	42	46	58	n.a.
**Average Eastern*	*n.a.*	*25*	*35*	*40*	*43*	*43*

** To calculate the average in 2009, the figures for Tunisia and Ukraine in 2008 were used, since the figures for 2009 were not available*

Source: Claessens and Van Horen (2012)

Among the Eastern neighbours, while the presence of foreign banks in countries such as Azerbaijan and Belarus remains limited (foreign ownership accounted for 3% and 18% of total assets in 2009, respectively), foreign banks are predominant in other countries. In Moldova, Ukraine, Georgia and Armenia, foreign bank assets represented between 49% and 79% of total bank assets in 2009.

Graph III.1.29: **Foreign claims from EU banks / total foreign claims (end 2012)**



Source: BIS, Commission Staff calculations

In sum, when looking at the ownership of local banking assets by foreign banks, the Eastern neighbourhood is financially more integrated than the Southern neighbourhood. This data does not, however, indicate the origin of the foreign banks owning assets in ENP countries, and specifically whether they come from the EU or another country (e.g. Russia). In order to analyse the exposure of ENP countries to EU banks, data from the Bank of International Settlements (BIS) on foreign claims of EU banks to ENP countries was used (see Graph III.1.29). ([45]) This data suggests that the Southern neighbourhood is more exposed to the European banking system than the Eastern neighbourhood, and this despite the relatively more limited foreign ownership of bank assets in the former.

([45]) BIS statistics used consolidated cross-border claims according to the nationality of banks. This means that, for example, lending by a Moroccan bank owned by a French bank to a local Moroccan firm would be recorded as a French bank's claim on a Moroccan counterpart. This dataset, however, has the disadvantage of not adjusting the changes in cross-border claims to exchange rate fluctuations.

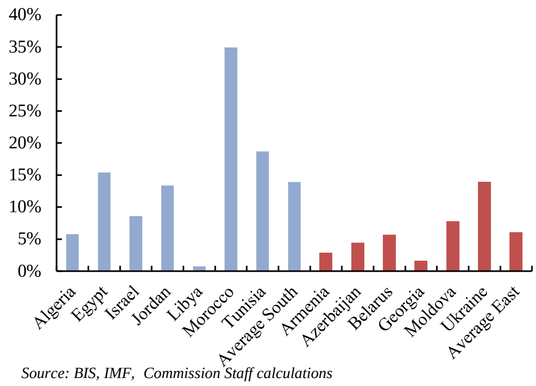
Among the Southern neighbours, the share of claims of EU banks in total international bank claims at the end of 2012 was below 50% only for three countries: Syria (31%), Israel (37%) and Palestine (40%). In Jordan, Algeria and Libya, claims from EU banks represented a large 60-61% of total international bank claims. It is, however, in Egypt, Morocco and Tunisia that claims from EU banks are predominant, representing 87%, 90% and 92% of total international bank claims by the end of 2012, respectively. In these countries, the strong historical links with some European countries are likely to have played a major role in the level of financial integration. For example, France represented 92%, 93%, 89% and 48% of EU banks' claims in Morocco, Algeria, Tunisia and Egypt, respectively, while the UK represented an estimated 63%, 54% and 29% of EU banks' claims in Jordan, Israel and Egypt, respectively. ([46])

Comparatively, the Eastern neighbours' exposure to EU banks is more limited. The share of claims from EU banks in total international bank claims at the end of 2012 was below 10% in three countries: Georgia (2%), Belarus (6%) and Moldova (8%). In Ukraine and Armenia, EU banks represented a higher 14% and 28% of foreign claims, respectively. It is only in Azerbaijan that EU banks have a dominant presence, with claims from EU banks representing 62% of total international bank claims in the country by year-end 2012. This puts in evidence the fact that other countries besides European countries (e.g. Russia) play a major role in the Eastern neighbourhood.

All in all, in 2012, claims of EU banks represented 62% of international bank claims in the Southern neighbours, to compare with a much lower 20% in the Eastern ones. This suggests a significantly higher exposure to the EU banking system in the Southern neighbourhood than in the Eastern region. However, such an analysis based on the share of EU banks in total foreign claims does not indicate the importance of the exposure to EU banks in absolute terms or relative to GDP. In other words, it might be that the share of EU banks in foreign claims in the Southern neighbours is higher because total claims of foreign banks to these countries are small. This result might also be explained by the important share of Russian and other CIS banks in claims of foreign banks in Eastern neighbours. Further analysis was therefore conducted, calculating the importance of claims from EU banks relative to the GDP of the host country (see Graph III.1.30). While the differences between the two regions are now much smaller, this indicator confirms the finding that the Southern neighbours are relatively more exposed to EU banks than the Eastern ones.

Among the Southern neighbours, claims from EU banks represented in 2012 a significant 13%, 15%, 19% and 35% of GDP in Jordan, Egypt, Tunisia and Morocco, respectively. They were more limited in Algeria (6%) and Israel (9%). Among the Eastern neighbours, Ukraine and, to a lesser extent, Moldova are the only countries where claims from EU banks represented a significant share of GDP (14% and 8% of GDP, respectively, in 2012). In Armenia, Azerbaijan and Belarus, this number was limited to 3%, 4% and 6%. The relative importance of EU banks in Ukraine may help explain why, among Eastern neighbours, only Ukraine is a member of the Vienna II Initiative ([47]), which aims at limiting the potential risks for emerging Europe stemming from the deleveraging process undertaken by EU banks.

Graph III.1.30: **Foreign claims from EU banks (in % of GDP, end 2012)**



Source: BIS, IMF, Commission Staff calculations

([46]) Source: BIS Consolidated Banking Statistics

([47]) The Vienna I Initiative was launched in January 2009, at the height of the global financial crisis, with the objective of safeguarding financial stability in emerging Europe. The Vienna II Initiative was launched as the euro area crisis intensified towards the end of 2011 and signs of a rapid deleveraging in emerging Europe multiplied. The Initiative involves various stakeholders, including home and host country authorities of the main European banking groups operating in emerging Europe, the European Commission, several IFIs and representatives of the banking groups.

Table III.1.7:

Foreign claims from EU banks in Southern neighbours

(in percent of total international bank claims)

	Algeria	Egypt	Israel	Jordan	Libya	Morocco	Palestine	Syria	Tunisia
2006	67%	70%	36%	67%	53%	91%	33%	46%	87%
2007	75%	75%	38%	73%	52%	91%	9%	43%	82%
2008	76%	83%	38%	55%	69%	96%	3%	38%	86%
2009	75%	83%	60%	69%	87%	97%	26%	48%	86%
2010	70%	77%	53%	65%	82%	95%	0%	33%	90%
2011	64%	86%	44%	60%	74%	93%	93%	37%	91%
2012	61%	87%	37%	60%	61%	92%	40%	31%	90%

Source: BIS, Staff calculations

Recent trends

European bank funding conditions significantly deteriorated towards the end of 2011, as faltering prospects for economic growth and fiscal sustainability undermined the value of sovereign and other assets and, in a negative feedback loop, adversely affected the real and perceived credit quality of European banks and, hence, their capacity to fund themselves on international capital markets. Moreover, pressures on European banks to deleverage increased towards the end of 2011, as EU regulators imposed new capitalization targets.

Bond issuance by euro area banks dwindled, deposits flowed out of banks in countries with high sovereign credit risk, and the pricing of short-term funding increased. Funding conditions somewhat improved subsequently following special policy measures directly targeted at banks (extension of liquidity by the ECB, including through non-standard measures, restructuring/recapitalization plans of some banks), as well as other more general policy responses to the euro area sovereign debt and financial crisis. These measures enhanced the perceived solvency of national banks. However, the euro area crisis put in evidence the fragility of the European banking system and the need to increase the level of capital of the weakest European banks to allow them to withstand financial crises. This has resulted in a gradual deleveraging process at many EU banks, a necessary adjustment to remove excess capacity in the financial sector and restructure balance sheets.

In its third report of the Basel III monitoring exercise on the European banking system, issued in March 2013, ([48]) the European Banking Authority (EBA) calculated the position of the 44 largest European banks towards the common equity Tier 1 (CET1) capital ratio. Its calculations showed that, as of 30 June 2012, the CET 1 capital shortfall for Group 1 banks was EUR 3.7 billion based on a target CET 1 ratio of 4.5% and EUR 112.4 billion based on a target ratio of 7.0% – a sharp decline from EUR 199 billion as of 31 December 2011 and EUR 231.3 billion as of 30 June 2011. This reflects the significant deleveraging by European banks sparked by the euro area crisis, which is the combined result of an improved capital position of European banks' (capital increased through retained earnings or raising of new capital) and a reduction in their risk-weighted assets. Based on analysis by the BIS (2012), the later reflects a broader trend among European banks towards deleveraging over the medium term. ([49])

Despite this deleveraging by European banks, the analysis below suggests that EU lending to the Southern and the Eastern neighbours has proved relatively resilient to the global financial crisis of 2008-09 and the euro area banking crisis of 2010-11. Indeed, the share of claims from EU banks in total international bank claims has remained, overall, rather stable over the last few years, implying that EU banks have not lost significant market share to other foreign and non EU banks. Among the Southern neighbours, the share of EU banks' claims in total international bank claims did not vary significantly between

([48]) Basel III monitoring exercise, EBA, March 2013.
([49]) Source: "European bank funding and deleveraging", BIS quarterly review March 2013.

Table III.1.8:

Foreign claims from EU banks in Southern neighbours

(immediate borrower basis, million USD)

	2006	2007	2008	2009	2010	2011
Algeria	3,903	4,957	5,411	5,604	6,046	6,231
Egypt	17,325	25,175	33,109	34,107	37,677	32,979
Israel	4,954	5,512	5,596	9,681	12,289	9,302
Jordan	1,398	1,916	1,789	2,700	2,563	2,397
Libya	61	213	9,127	8,498	704	183
Morocco	14,745	16,387	24,372	27,756	25,615	27,363
Tunisia	6,107	5,957	6,743	7,005	6,885	7,365
Total	50,776	62,398	88,372	97,729	93,955	88,132

Source: BIS, Staff calculations

2006 and 2012, except in Egypt where it actually increased (see Table III.1.7).

However, two periods have to be distinguished between 2006 and 2012. In a first period, from 2006 to 2009, the share of claims from EU banks in total international bank claims in the Southern neighbours gradually increased. In a second period corresponding to the euro area crisis, from 2010 to 2012, the share of claims from EU banks in total international bank claims gradually decreased, to come back to levels similar to those of 2006. For example, in Morocco, the share of EU banks in total international bank claims increased from 91% in 2006 to 97% in 2009, to then decrease to 92% in 2012. In Algeria, the same number went from 67% in 2006 to 75% in 2009, to then decrease to 61% in 2012. In Israel, the share of EU banks in total international bank claims reached 60% in 2010, then decreasing to 38% in 2012, a level similar to the 36% registered in 2006. Only in Egypt and Tunisia did the share of EU banks in total international bank claims steadily and gradually increase over the period: from 70% in 2006 to 87% in 2012 for Egypt, and from 87% in 2006 to 90% in 2012 for Tunisia.

These figures suggest that, while EU banks' exposure towards Southern neighbours remained quite stable throughout the global financial crisis, EU banks did reduce their lending to the region in 2010-12 – i.e. at the time of the euro area crisis, but also of the Arab Spring. This negatively affected their market share in Southern neighbours.

In absolute terms, the value of claims from EU banks in Southern neighbours has been on an upward trend in most countries from 2006 to 2012 (see Table III.1.8). Overall, the total value of claims from EU banks in Southern neighbouring countries nearly doubled between 2006 and 2012, from EUR 50.8 billion to EUR 92.9 billion. The increase was particularly strong in Morocco and Egypt (+112% and +96%, respectively). Only in Libya were the claims from EU banks very volatile, increasing sharply in 2008-09 only to drop in 2010-12 as a result of the civil war. The cases of Syria and Palestine are also peculiar, given the particularly low level of integration of their banking systems in the global banking system. In Syria, for example, international foreign claims represented only 1-2% of the country's GDP in 2006-10.

As regards the value of foreign claims of EU banks in the Eastern neighbours, the general trend is similar to that in the Southern neighbours: excluding Georgia, claims from EU banks in absolute terms increased in the Eastern neighbourhood by 78% between 2006 and 2012 (see Table III.1.9). However, similarly to the Southern neighbourhood, two periods have to be distinguished between 2006 and 2012. First, claims from EU banks to the six Eastern neighbouring countries increased in all countries between 2006 and 2008, sometimes dramatically (e.g. in the case of Moldova and Georgia). Overall, claims from EU banks were multiplied by 2.4 in the region as a whole between 2006 and 2008. Then, claims from

Table III.1.9:

Foreign claims from EU banks in Eastern neighbours

(Immediate borrower basis, million USD)

	2006	2007	2008	2009	2010	2011	2012
Armenia	114	143	174	221	193	284	283
Azerbaijan	883	1,400	2,093	2,031	3,114	3,203	3,056
Belarus	1,871	3,105	3,655	3,480	n.a.	n.a.	3,556
Georgia	152	226	567	505	n.a.	n.a.	n.a.
Moldova	107	254	560	620	n.a.	n.a.	560
Ukraine	15,083	33,350	36,479	28,881	32,891	27,545	24,528
Total	18,210	38,478	43,528	35,738	36,198	31,032	32,239

Source: BIS, Staff calculations

EU banks evolved differently from one country to another. While they kept increasing in Armenia (+62% between 2008 and 2012) and Azerbaijan (+46%), they were stable in Belarus and Moldova, and decreased sharply in Ukraine (-32%). ([50])

The diverging trends in the evolution of EU banks' claims towards the various Eastern neighbours can partly be explained by the different levels of development of the national banking systems. Based on an analysis of May 2012 by the EIB, the banking systems in the Eastern neighbours have developed differently since the break-up of the Soviet Union. Countries such as Armenia, Azerbaijan and, to a lesser extent, Moldova and Georgia have quite dynamic financial sectors with potential for further development of banking services to support their economic growth, while other countries such as Ukraine are constrained by the large amounts of non-performing loans inherited from the financial crisis that followed the past credit boom. In fact, prior to the global financial crisis, European banks that saw in the Eastern neighbours the opportunity for further expansion based on expectations of strong economic growth made a number of acquisitions in these countries and fuelled the region with cheap financing. This resulted in a credit boom in some countries (as evidenced by the noted surge in EU banks' claims to the Eastern neighbourhood between 2006 and 2008). This came to a halt with the global financial crisis, and then the euro area crisis, which revealed some pre-existing vulnerabilities. In fact, with the benefit of hindsight, this situation of massive and cheap funding was not healthy and resulted in a country such as Ukraine in unsustainable credit growth and, eventually, a high level of non-performing loans, making necessary some painful adjustment processes.

A study by Avdjiev, Kuti and Takàts (2012) analysed the impact of various variables on cross-border bank lending (measured by the growth rate in BIS reporting banks' cross-border claims) to 40 emerging market economies. ([51]) Running a panel regression analysis of BIS banking statistics between the third quarter of 2005 and the second quarter of 2012, they analysed the impact of (i) the host country economic growth, (ii) the host country risk, and (iii) the health of the banking systems lending to emerging market economies (using a weighted average of credit default swaps spreads and the volatility of equity prices in the home country). The study found that the health of the banking systems lending to emerging market economies (home country factor) accounted for roughly half of the explained variation in cross border bank lending, the other two factors (host country economic growth and host country risk) accounting for the other half of the explained variation.

According to the work of Avdjiev, Kuti and Takàts, the importance of home country factors increased sharply during the downturn in cross-border bank lending that took place in the second half of 2011, contributing to more than 90% of the

([50]) EIB, Banking in the Eastern Neighbours and Central Asia – Challenges and Opportunities, May 2012.

([51]) Including among the ENP countries Egypt, Israel, Jordan, Morocco, Tunisia and Ukraine.

explained contraction during this period. Further analysis showed that euro area banks were responsible for roughly 70% of the late 2011 contraction in cross-border bank lending to emerging market economies attributed to home country factors. The results suggest that banking sector stress was disproportionately more concentrated on euro area banks than on their counterparts from the rest of the world. In particular, the analysis suggests that, in the second half of 2011, euro area banks were responsible for about half of the contraction in cross border lending to emerging Middle East and Africa (Egypt, Israel, Jordan, Morocco, Tunisia and South Africa), the rest being explained in equal proportions by the health of non-euro area banks (25%) and host country factors (country risk and demand/growth).

1.5.3. Conclusions

The findings in this section confirm that the euro area crisis had a negative impact on capital flows to ENP countries. Overall, however, Southern neighbours, which are financially more exposed to the EU despite having a relatively lower degree of international financial integration, were more affected than Eastern neighbours, whose close financial links with non-EU countries worked as a buffer. It is also noteworthy that, in some Southern neighbours, the euro area crisis is not the only reason for the decline in capital flows from the EU, as the Arab Spring also played a significant role.

In terms of FDI, EU flows to Egypt, Morocco and Ukraine declined markedly in the period 2009-11, when compared to the period 2006-08. They slightly increased for the two other countries for which data is available, namely Israel and Belarus. Overall, the impact of the decline in EU FDI was more severe on some Southern neighbours, where the EU represents the lion's share of total FDI.

As regards the financial sector, euro area banks' deleveraging and the credit crunch process associated with the euro area crisis have had a significant impact on the ENP economies, in terms of reduced lending. However, this impact varied significantly from one country to another, depending, inter alia, on their relative degree of exposure to euro area banks. Morocco, Tunisia and Egypt exhibit a particularly high exposure to euro area (mainly French) banks. Within the Eastern neighbourhood, Ukraine seems the most exposed country. In the countries most exposed to European banks, national banking systems could be further affected if European banks were to experience more serious difficulties as a result of the financial crisis, leading to possibly further deleveraging and restricted cross-border lending.

1.6. EVIDENCE FROM CORRELATIONS OF GDP GROWTH RATES

The previous sections have looked separately at a number of channels through which the euro area crisis may affect neighbouring economies. A drawback of this analysis is that these partial linkages interact between themselves and with other factors in ways that are not always easy to measure. This section tries to overcome this limitation by examining the empirical evidence on actual correlations of growth. First, a correlation analysis is performed to study the business cycle linkages between the EU neighbours, on the one hand, and the EU and other key economic and financial partners, on the other. Second, the existing empirical evidence on these linkages is surveyed. Both approaches yield consistent results.

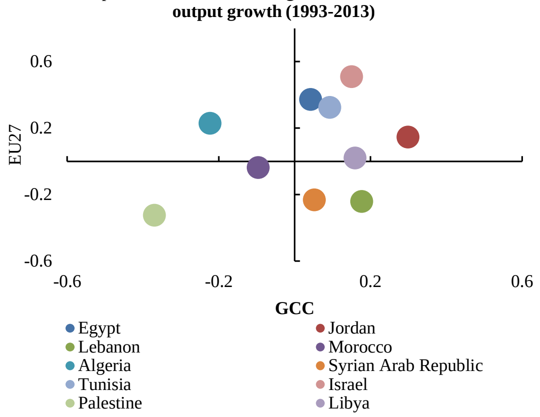
In order to assess business cycle linkages between the EU neighbours and some of their major economic partners (the EU as well as Russia for the Eastern neighbours and the GCC countries for the Mediterranean countries) a simple correlation analysis of the GDP growth rate was conducted. This was done for two periods. First, we examined correlations for a 20-year period from 1993 to 2013 (see Graphs III.1.31 and III.1.32). ([52]) Then, we looked at the period 2000 to 2013 (see Graphs III.1.33 and III.1.34) to try to detect some possible trend, notably under the hypothesis that increasing trade and financial openness and integration with the EU may have increased growth correlations.

The main results of this analysis are as follows: first, the business cycles of the Eastern neighbours have tended to converge with that of the EU since 2000, possibly reflecting their increased trade and financial openness in a context of accelerated globalisation and the mutual efforts for closer

([52]) Figures for 2013 are DG ECFIN and IMF WEO projections.

integration by the EU and its neighbours. ([53]) The latter was also driven by the EU's geographical expansion since 2004, which brought into the EU countries with which the Eastern partners had close economic links and brought the latter closer to the bloc's border. ([54]) Second, the Eastern neighbours show a much stronger correlation with the EU cycle than the Southern ones. Third, there is a strong positive correlation pattern between the Eastern neighbours and Russia, although this correlation weakens in the more recent period (2000-13 as opposed to 1993-2013). For the 20-year period, the average correlation of Eastern neighbours with Russia was as high as 0.7. This result was expected given the high historical economic interdependence between Russia and these countries and the fact that the analysis captured the transition from planned to market economies, which was a process common to all of them (and which is still on-going in Belarus). The fact that Russia's growth is also strongly correlated with that of the EU (the coefficient is 0.9 for the period 2000-13 compared with 0.6 for the GCC countries) may explain in part the fact that growth is more correlated with the EU in the Eastern neighbours than in the Southern ones.

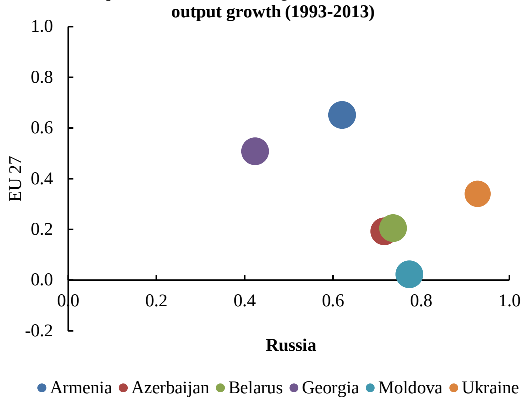
Graph III.1.31: **Southern neighbours - correlations of output growth (1993-2013)**



([53]) Almost all Eastern neighbours display high and statistically significant correlation coefficients, the only exception being Azerbaijan (although the correlation increases in the most recent period). This exception is most likely explained by the importance of the oil boom for Azerbaijan's economic performance, which has somewhat decoupled the country from the EU business cycle.

([54]) In response, the EU focused on strengthening its economic and political ties with the new neighbours through the launch of the European Neighbourhood Policy in 2004 and various regional initiatives (e.g. the Eastern Partnership in 2009).

Graph III.1.32: **Eastern neighbours - correlations of output growth (1993-2013)**



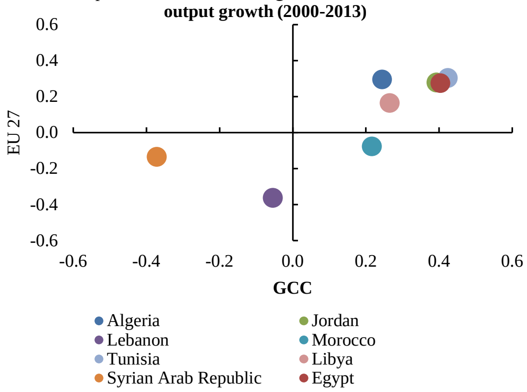
In the case of the Mediterranean neighbours, the correlation coefficients with the EU are rather small, both for the period 1993-2013 and for the more recent period (although they increased for a majority of the countries in the period 2000-13). The main exception is Israel, which shows high and rising correlations with the EU. Algeria and Tunisia also show relatively high correlations, which is consistent with other similar studies (see below) showing a relatively high convergence of the economic cycle of the Maghreb countries and the one of the EU. In this respect, Morocco's negative correlation is surprising given this country's strong trade and financial links with the EU and the observed negative impact the euro area crisis has had on it exports. ([55]) This may be explained by the significant weight of the agricultural sector on Morocco's GDP and the fact that during the 2009 global crisis (and EU recession) and the 2010 recovery it behaved in the opposite direction than the underlying economic cycle, reflecting climatic factors (a bumper harvest in 2009 and a weak one in 2010), compensating in part for the impact of the EU cycle.

A number of Southern neighbours show a significant correlation with the GCC partners. This is particularly clear in the case of Jordan and Egypt for the more recent period, as one would expect given their geographical proximity with the GCC countries and their trade and financial linkages with them. For these two countries, but also for certain others, correlations with the GCC countries are actually higher than the ones with the EU. This

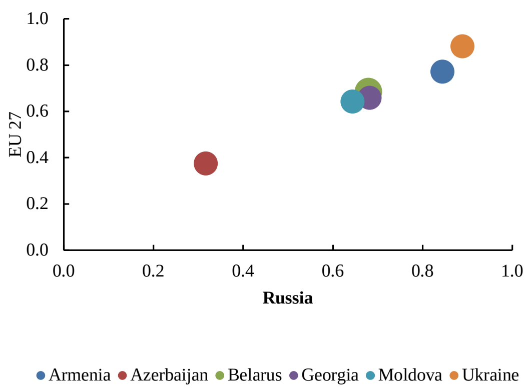
([55]) Other studies (see IMF, 2012 and IMF, 2013) do show positive and high GDP correlations between Morocco and the EU.

underlines the potential buffering role that the GCC area can play for those countries relative to economic developments in the EU. Algeria's low or negative correlation with the GCC countries' economic growth (for the period 1993-2013) is at first sight surprising, given that both are net oil exporters. However, this seems explained by Algeria's strong dependence on the EU market, where it sells most of its hydrocarbon and other exports. Algeria's stronger dependence on the EU cycle as compared to its dependence on the GCC area has also been found in other empirical studies (see Cashin et al, 2012). Lebanon and Syria show negative (or very low) correlation coefficients with both the EU and the GCC countries over both periods, which could be explained by the existence of other dominant factors, notably their unstable political situation.

Graph III.1.33: **Southern neighbours - correlations of output growth (2000-2013)**



Graph III.1.34: **Eastern neighbours - correlations of output growth (2000-2013)**



These findings are also confirmed by recent empirical studies that try to quantify the spill-over impact from the euro area crisis, but also general shocks in the global economy. Thus, Cashin and al (2012) use a Global Vector Autoregression to analyse the impact from the systemic economies to the MENA countries during the period 1979-2011. They find that the Maghreb countries are the more sensitive to a GDP shock in the euro area, noting that this is consistent with the strength of their trade, tourism, workers' remittances and FDI linkages with Europe. The strongest response to a 1% negative GDP shock in euro area growth is witnessed in Algeria and Tunisia (in both cases above 0.5). The effect on the Mashrek countries is estimated to be much lower (in this case Syria demonstrates the highest exposure). The response is particularly muted in Jordan and Egypt, which could be explained by the high reliance of these two countries on the GCC area, and in particular on Saudi Arabia. An interesting result of this study is that the influence of China on the MENA countries is increasing and is stronger on average than that of the euro area.

Another recent study by the World Bank, also finds that the Maghreb countries (and in particular Tunisia and Morocco, in this order) are relatively more exposed to a shock in euro area GDP growth. ([56]) By contrast, the impact is relatively limited in the Mashrek countries, reflecting their stronger links with the GCC countries.

Further evidence of the links of Mashrek countries with the GCC area is provided by the study Mohaddes and Raissi (2011), which focuses on Jordan. The study finds that a 10% demand-driven increase in the price of oil raises the GDP of Jordan by about 2.5% after 10 quarters. They conclude that the positive effects of oil price booms, in terms of higher exports to Jordan's GCC partners and higher remittances, tourism, grants and investments from them, more than compensate for the negative impact of higher oil prices due to the increase in import costs (Jordan being a net oil importer). Higher oil prices have favourable effects on the macroeconomic conditions of GCC countries and, indirectly, on Jordan and this is the dominating factor. As a result, Jordan's GDP

([56]) The study estimates that under a severe shock in the EU (reflected in a 1% GDP contraction in 2012) trade linkage would shed off 2 percentage points of the GDP growth in Tunisia and nearly 1 percentage point in Morocco. See World Bank (2011).

shows a high positive correlation with both the oil price and the GCC's economic cycle. ([57])

As for the Eastern neighbours, a means-adjusted Bayesian vector autoregression carried out by the EBRD shows a high and statistically significant reaction in Ukraine's and Armenia's output to changes in euro area growth. ([58]) The impact of the latter is magnified by the high impulse response of these two countries, as well as of Moldova and Georgia, to shocks in Russia. ([59]) In this analysis Ukraine emerges as very vulnerable to sudden shifts in the external environment, which is hardly surprising considering its open economy, its high share of commodity exports and its significant dependence on external financing. The country also stands out among the Eastern neighbours in a so-called 'euro area exposure' indicator constructed by the EBRD. ([60]) The index attempts to measure exposure of the transition economies monitored by the Bank to the euro area (through trade and financial channels). According to the indicator, Tunisia (mainly through trade) and Morocco (financial channel) are also among the countries that are most vulnerable to events in the euro area. ([61])

Overall, our correlation analysis and other empirical evidence show a relatively high economic dependence on the EU for many of the neighbours, which is particularly pronounced since 2000. It is stronger for the Eastern neighbourhood countries, which show on average a higher degree of both trade and financial openness, than the Mediterranean ones. Ukraine stands out as a particularly exposed country. However, in the case of the Mediterranean neighbours, two regions could be clearly distinguished: Mashrek countries, and in particular Jordan, demonstrate a much closer linkage with the GCC, which may be attributable to the significant trade, remittances, tourism, official assistance and FDI flows with the latter. The Maghreb countries (including Algeria despite being a net oil exporter), by contrast, are as a whole more exposed to the swings in the EU cycle, reflecting the stronger economic and financial links with the EU described in the previous sections of this chapter. The analysis also supports the hypothesis that economic interdependence with the EU grew in the last decade in the Eastern partners as their economies became more open towards the EU. For the South, a growing economic interdependence with the GCC area and, for a majority of countries, with the EU appears in the data but the evidence is less clear.

1.7. CONCLUSIONS AND POLICY RECOMMENDATIONS

The EU's neighbours have embarked on a rapid course of trade liberalisation since the start of the century, which has been accompanied by a gradual financial opening. This process was pronounced in the Eastern partners, while most of the Mediterranean ones opted for a somewhat less liberal trade and financial opening. As a result, both groups of countries have moved closer to the global business cycle, reaping the benefits of the boom years that preceded the 2008 global financial crisis. At the same time, they have become more exposed to global and regional downturns, as it was evident during the deep recession of 2009. In this context, and with the EU being the largest trading partner for most of the neighbouring economies and a major source of capital and remittances, it is not surprising that the euro area crisis is having a significant impact on them.

Overall, the analysis in this chapter suggests that Eastern neighbours are somewhat more exposed to the euro area problems, with Ukraine standing out among the most vulnerable countries. But some Southern neighbours, notably those in the Maghreb region, also seem particularly exposed, reflecting some of the highest trade dependence in the whole neighbourhood on export, tourism and remittances receipts from the EU, as well as a relatively high exposure to FDI and banking flows from the euro area. These overall conclusions are supported both by the partial analysis based on the examination of each of the channels of transmission and by the empirical evidence on GDP correlations presented in the previous section.

The higher vulnerability of the Eastern neighbours to economic developments in the euro area (and in the EU) is mainly due to their bigger exposure

([57]) On this point, see also IMF (2012).
([58]) See EBRD Transition Report (2012).
([59]) For analysis of how Russia affects the CIS, see Alturki, Espinosa-Bowen and Ilahi (2009).
([60]) See EBRD Transition Report (2011).
([61]) For a detailed analysis of the economic spill-overs from Europe on these two countries, see De Bock et al. (2010).

through the **trade channel**, which we believe will be the key source of impact. These countries have opted for a high degree of trade openness, which makes them more vulnerable to the downturns of their major trade partners. Together with a somewhat higher orientation of their trade towards the EU when compared with the Southern neighbours, this results in significantly higher export-to-GDP ratios to the EU. The dependence on the EU is magnified, as noted, by the spill-over from the euro area crisis to Russia. While the resilience initially shown by the Russian economy to the euro area crisis (in 2011, the country still managed to grow by 4.3%, supported by that year's increase in oil and gas prices), contributed to moderate the weakening in Eastern neighbours' exports, the Russian economy has been decelerating rapidly since mid-2012 and this should take its toll on the exports of the EU's Eastern partners. ([62])

As far as the Southern neighbours are concerned, they are less exposed to the weakening export demand in the euro area due to relatively less open economies, but also because of the important buffering role of the GCC countries, which unlike Russia do not seem much affected by the events in the EU. Still, it should be noted that export dependency on the EU varies significantly among the Mediterranean states, with the Maghreb countries (Tunisia, Morocco, Algeria and Libya, in this order) being among the most vulnerable in view of the importance of their exports to the EU as a share of their GDPs. Despite their lower exposure to the euro area crisis, however, the export performance of the Southern neighbours weakened in 2011 more than that of the Eastern neighbours, reflecting the impact of the Arab Spring and the Libyan war as well as the initial resilience of the Russian economy to the euro area crisis, which as noted, limited its indirect impact on the exports of the Eastern neighbours.

The Eastern neighbours also seem more exposed to the euro area crisis in terms of **remittances**. This impact is mostly indirect – through the effect on the Russian economy that is the dominant source of remittances for the region. Several of the Eastern neighbours (Moldova, Armenia and Georgia) rely heavily on these flows to finance their domestic consumption. The risk of an abrupt halt of remittances is somewhat mitigated by their relatively low elasticity to the business cycle in the host country. However, as the Russian economic cycle re-joins the one of the euro area, remittances to the Eastern neighbours are expected to be more seriously affected. As a whole, the Southern neighbours seem much less exposed to a steep decline in remittances from the EU, with the exception of Morocco, Tunisia and Lebanon. The last of these countries, however, benefits from a more diversified distribution of the sender countries, reducing its exposure to the EU crisis. This is also the case of Jordan and Egypt, two countries that receive significant remittances but predominantly from the GCC and other non-EU countries.

Turning to **tourism**, and in contrast with the two previous channels of transmission, the exposure to the euro area crisis is clearly skewed to the South, with Egypt, Morocco and Tunisia being particularly vulnerable. Southern neighbours receive on average more tourism revenues (in per cent of GDP) than Eastern partners and the share that comes from the EU is also higher. This partly explains why tourism inflows declined much more markedly in the former since the euro area crisis began. However, the main factor behind this decline seems to be the political instability associated with Arab Spring and the Libyan and Syrian wars.

The close **financial linkages** between the EU and its neighbours also suggest a high degree of influence of the euro area crisis. The Eastern neighbours are relatively more open financially than the Southern ones and, in particular, show somewhat higher ratios of FDI inflows over GDP and a stronger participation on foreign banks in their domestic banking sectors. However, the Southern neighbours, and in particular, those from the Maghreb, but also Egypt, are relatively more dependent on FDI and banking inflows from the EU. In the Eastern partners, Russian and regional financing also plays a significant role, acting to diminish the relative importance of financial linkages with the EU. Ukraine is an exception to this, because of its significant reliance on external financing and the considerable presence, although declining in the recent years, of European lenders in its banking sector.

([62]) Russia's GDP growth slowed down to 3.4% in 2012 and is projected to further weaken to 2.4% in 2013, according to the forecasts of Russia's Ministry of Economy.

The analysis showed that FDI and banking inflows to both regions have declined since 2010, prolonging a process that had begun with the global financial crisis. This partly reflects the euro area crisis, including deleveraging by euro area banks. However, in the case of the Southern neighbours part of the decline seems, again, to reflect the instability (macroeconomic and political) associated with the Arab Spring and military conflicts in the region. In the Eastern neighbours, the decline in FDI inflows has been replaced by debt-creating flows, contributing to increase external indebtedness. In the Southern ones, the GCC countries and other donors have stepped up their financial assistance although this was insufficient to compensate for worsening external deficits and ultimately many of the countries witnessed a considerable decline of their international reserves.

The impact of the euro area crisis will depend not only on the way it evolves, but also on the policy response by the EU's neighbours to mitigate its repercussions. Appropriate macroeconomic and structural reform policies can also increase the neighbours' resilience to future external shocks. In this respect, a number of **policy recommendations** can be put forward. From a macroeconomic point of view, it is important for countries to build overtime sufficient room for counter-cyclical fiscal and monetary policies. At present, the Eastern neighbours, although more vulnerable to developments in the EU, as shown in this chapter, stand in a better position to address the negative effects from the crisis through implementation of counter-cyclical policies. These countries have in general applied corrective macroeconomic policies following the excesses of the period that preceded the 2009 global crisis, which was paid dearly by many of them in the form of deep recessions. This post-2009 adjustment has helped their fiscal positions become much more sustainable and currently provide several of them with some room for a fiscal relaxation. Monetary policy was also strengthened during this period, including by allowing a higher degree of exchange rate flexibility, which ensures the second line of for the absorption of external shocks.

In the South, by contrast, fiscal and income policies have been significantly eased, leaving no room for a counter-cyclical response in the current situation. In fact, these policies should be tightened significantly in the near future, which could amplify the impact of weak economic activity in the euro area. In this situation, a more accommodative monetary policy might be needed. It could be accompanied by a gradual increase of the flexibility of the exchange rates and preparations for the introduction of an inflation targeting regimes.

For net energy exporters, it is also important to diversify fiscal and export revenue sources, so as to reduce exposure to fluctuations in hydrocarbon prices or demand. Also, it is advisable to put in place stabilising fiscal rules, sometimes in combination with the establishment of sovereign wealth funds, where excess oil or gas revenues can be accumulated in good times and spent in bad times.

For countries suffering from a fragile macroeconomic situation and/or wanting to restore confidence, another useful policy strategy may be to enter into programmes supported by the IMF and other IFIs or regional stabilisation funds such as the EurAsEC Anti-Crisis Fund or the Arab Monetary Fund. ([63]) This could be helpful in some cases also for countries not needing financial assistance but wishing to enter into precautionary arrangements, such as Morocco and Georgia have done with the IMF recently. Like fully-fledged financial arrangements, precautionary arrangements can help strengthen policy credibility and predictability and shore up investors' confidence, as they act as a guarantee for prudent macro-financial policies and acceleration of structural reforms.

While appropriate macroeconomic policies and buffers can provide room for an effective short-term response to external shocks, such as the euro area crisis for the EU's neighbours, in the medium to long term, structural reforms have an important role to play.

Both groups of neighbours should strengthen financial supervision and regulation, including by encouraging the build-up of solid capital bases in their banks and by limiting their exposure to foreign exchange risk, foreign borrowing and toxic

([63]) As noted, the EU may also contribute to these packages through its MFA and its budgetary support operations financed from the ENPI.

assets. Better aligning prudential rules with international standards can provide a useful framework for that. Also, de-dollarization policies should be pursued in those countries (notably some Eastern partners and Lebanon) showing an excessive share of foreign currency in banks' balance sheets. These prudential policies can increase the neighbours' resilience to a sudden reversal of capital flows or to spill-overs from financial crises occurring abroad.

Reforms aimed at improving the investment climate and regulatory framework, a challenge of particular relevance for many Southern neighbours, can also be helpful. By boosting the country's appeal to direct foreign investors, they can help develop a more stable source of capital inflows and one that promotes technological development, productivity growth and diversification.

The implications of trade integration are less obvious. On the one hand, it can promote economic growth and diversification but, on the other, it can make, as noted, countries more dependent on economic developments in its main trading partners. This raises in particular the issue of the implications of the DCFTAs that the EU is offering to neighbouring countries meeting certain pre-conditions. Indeed, it can be argued that the conclusion by neighbouring countries of DCFTAs with the EU, by further deepening trade linkages between the two, could increase exposure to the downturns in the EU. However, these agreements should also have positive trade creation effects. ([64]) They are expected to benefit the neighbourhood countries by opening the EU market for sectors in which they could have comparative advantages (namely agriculture). Further trade deepening is also likely to support foreign investments and encourage domestic competition and technological progress. These positive effects should more than compensate for the drawbacks of a stronger exposure to the euro area. The best way to avoid an excessive exposure to the EU while reaping the benefits of the DCFTAs is to undertake simultaneously other trade liberalisation efforts vis-à-vis other countries (including by joining, where appropriate the WTO, and by participating in regional integration initiatives).

([64]) For more information on the economic impact of the DCFTA between the EU and several of its neighbours see http://ec.europa.eu/trade/policy/policymaking/analysis/sustainability-impact-assessments/assessments/index_en.htm

2. THE POTENTIAL OF ISLAMIC FINANCE

2.1. INTRODUCTION

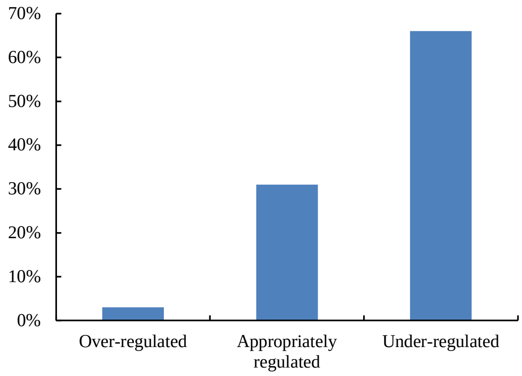
Islam's moral code and religious law, the Sharia, provides the underlying doctrine for all practices and activities within Islamic finance. The system's most prominent principles are the prohibition to pay or charge interest (*riba*), the avoidance of uncertainty (*gharar*) and speculation, the need to minimise risk and the requirement to link financial transactions to real economic activity, all of which are explained in greater detail below.

Long before the rise of Western financial institution, partnerships and investments were common in the Muslim world. However, theoretical work on 'modern' Islamic economics only began in the 1950s, with descriptions of an interest-free bank based on profit- and loss-sharing contracts. The establishment of the Mit Ghamr Islamic Bank in Egypt and the Pilgrimage Fund in Malaysia in the 1960s helped coin the modern concept of Islamic finance (Shanmugam and Zahari, 2009). The postcolonial period, which questioned established Western precepts and systems, provided a fertile ground to kindle interest in an alternative system of financial development which would be consistent with the principles of the Sharia. In the 1970s, commercial Islamic banking emerged (e.g. Dubai Islamic Bank in 1973 and the Faisal Islamic Banks in Egypt and Sudan in 1975), supported by the wealth accruing to Gulf countries as a result of the oil boom. The 1980s and 1990s saw the further spread and development of Islamic financial products also to some Western financial hubs, including for example, *Murabaha* contracts being offered in London and the establishment of an Islamic insurer (*takaful*) in Luxembourg in 1983 (Hijazi and Tarbush, 1984).

The financial problems of the 2000s, culminating in the fall of Lehman Brothers in 2008, precipitated the most important global financial meltdown since 1929. The resulting confidence crisis in the paradigm of capitalist finance galvanised in some Muslim-majority countries a shift towards Islamic finance, a system ostensibly more in line with Islamic values (Langton et al, 2011). Over the past twenty years, a number of international institutions exclusively dedicated to the regulation and standardisation of Islamic finance practices and products have developed (see Box III.2.1). Furthermore, the Arab Spring process that started in a number of Northern African and Middle Eastern countries in 2011, and the associated coming into power of Islamic governments, moved up the development of Islamic finance to the political agendas in some of them. It is in this context that one needs to understand the global spread of Islamic finance in recent years as well as the debate about the role that it could potentially play in the future.

As it grows and expands, one of the major challenges faced by industry will be the need for greater regulatory oversight. This regulatory need does not stem from excessive risk taking, in contrast with recent calls for strengthened regulations in conventional finance, but rather from the need for standardisation in order to create a more integrated Islamic finance market globally. Indeed, according to a 2010 survey of Islamic finance leaders, the industry is under-regulated (Deloitte, 2010; see Graph III.2.1).

Graph III.2.1: **Do you think that the Islamic finance industry is**



Source: Deloitte, 2010

This chapter offers a short introduction and outlook into an area that has recently been gaining more widespread attention, partly as a result of its exponential growth. We argue that notwithstanding its potential for further expansion, Islamic finance is likely to remain complementary to conventional finance for the time being. ([65]) Worldwide, the market is very small, with assets amounting to a mere 1% of total global financial assets. The

([65]) Throughout this chapter we use the term conventional finance to denote the financial system promoted by non-Islamic institutions.

chapter aims to introduce the basic principles and main products of Islamic finance. It then goes on to examine recent trends in this sector and concludes by assessing the opportunities and potential for further expansion of this emerging segment of world finance.

2.2. SHARIA PRINCIPLES AND MAIN PRODUCTS

As mentioned above, Sharia, a set of rules emanating from the Quran and the Sunnah that govern both private and public life in some Muslim-majority countries and communities, is the basis for Islamic finance, thus also known as Sharia Compliant Finance. A set of Sharia principles are central to finance and banking: firstly, Islamic finance prohibits the use of interest (*riba*), i.e. predetermined rate tied to maturity and principal ex-ante, and guaranteed regardless of the performance of the investment, sometimes explained as a prohibition of making money from money. In addition, it prohibits excessive risk taking, uncertainty and gambling (*gharar*). The underlying rationale behind these prohibitions is related to the goals of Sharia to attain transparency, pre-determinability and certainty of profit generation and, in the case of *gharar*, to protect the weak from exploitation. *Gharar* exists when the buyer (seller) does not know what is being bought (sold). In general, *gharar* is the sale of probable items whose existence or characteristics are not certain, making the trade similar to gambling. *Gharar* can also exist when the object of a sale may be known, but its delivery is doubtful. Therefore, options and futures and forward foreign exchange transactions are forbidden. This also explains why the sale of an asset that is not owned by the seller (short selling) is also prohibited although, as discussed below, this principle may be waived in some exceptional cases (such as the *Salam* and *Istisna'a* contracts).

Another principle of Sharia is the principle of participation, i.e. there should be no reward without bearing some risks. This is based on the equitable sharing of profit and risk for both labour and capital, meaning that partnerships are preferred to conventional creditor-debtor arrangements. Lastly, Sharia-compliant investments may not support practices or products considered *haram* (forbidden), such as the consumption of alcohol or pork, biotechnology (e.g. genetic experimentation), arms, leisure/media etc.

A number of Sharia-compliant financial products have been developed over the years based on the above-mentioned principles. Whereas some are centuries old, others have been developed to meet more modern needs of the global financial system. While the principles of Islamic finance provide an alternative to conventional finance, they have at times been criticised for merely being conventional instruments re-devised according to Islamic precepts. ([66]) The Islamic financial sector includes commercial and investment banks, leasing companies, private equity firms, *takaful* (insurance) companies, capital markets companies (e.g. asset management), as well as microfinance institutions offering a wide variety of financial products.

One of the most widely known Islamic finance products, partly because of its recent rather rapid spread (see Graph III.2.2) primarily in Malaysia and the North of Africa, is *sukuk*, or Islamic bonds. *Sukuk* are financial certificates sold to an investor who then rents the certificate back to the issuer for a predetermined rental fee with a promise by the issuer to buy back the certificate at a future date. *Sukuk* are attached to real, tangible assets, and give the holder of the bond right to the participation in the yield of the underlying asset, as opposed to an interest rate. It is therefore an example of the key principle of Sharia-compliant finance that financial agreements should be linked to real economic activity. There are a few different types of *sukuk* that may be issued by both sovereigns and private companies or banks. Their connection with real assets makes them particularly suitable for financing infrastructure projects.

Other major products include Sharia-compliant insurance schemes and equity funds. By definition, conventional insurance schemes are incompatible with Sharia as they use uncertainty and risk to their advantage.

([66]) Hence, in order to realise the potential of an alternative system it will be necessary to abandon "the mechanical emulation of conventional instruments […] packaging them as seemingly Islamic instruments" (Mohieldin, 2012)

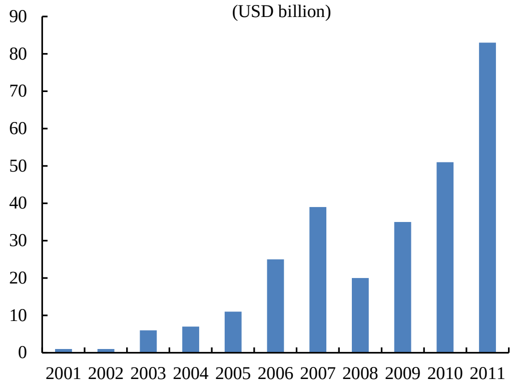
Box III.2.1: **International Islamic Finance Institutions**

Over the past two decades, a handful of **international bodies** have developed **dedicated to the regulation and standardisation** of Islamic financial markets and products. The *Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)* was created in 1990. Its main objective is to help develop global accounting and auditing standards in the Islamic financial sector; it also offers professional Islamic finance qualification programmes. Its membership is made up of central banks and Islamic finance institutions from around the world. The AAOIFI helped develop an emerging international Islamic financial market in the 1990s, but also helped expose the lack of regulatory architecture. It was not until a decade later that a more comprehensive regulatory structure emerged. In 2001, *the General Council for Islamic Banking and Finance Institutions (CIBAFI)* was established to facilitate multilateral cooperation between Islamic financial institutions and to raise global awareness and understanding of Islamic finance. Among other services, they publish a global directory annually and, like the AAOIFI, issue professional Islamic banking certificates.

The *International Islamic Financial Market (IIFM)* was established in 2002 by the *Islamic Development Bank (IDB)* working jointly with a number of central banks. Its focus is more on Islamic financial instruments, their standardization and the development of new products and services. The *Liquidity Management Centre (LMC)* was created in 2002 to meet emerging short-term liquidity needs of Islamic financial institutions by supporting the establishment of an Islamic inter-bank market. Pursuant to this goal, it facilitates the investment of surplus funds of Islamic banks into Sharia-compliant short- and medium-term financial instruments. To complement the AAOIFI's role in standardization of auditing and accounting, the *Islamic Financial Services Board (IFSB)* was established in 2003 in Malaysia by a number of central banks, the IMF and the IDB to issue guiding notes on standards and principles for the international supervision of Islamic banks, capital market actors and *takaful* operators. Since its establishment in 2005, the *Islamic International Rating Agency (IIRA)* is the only international agency dedicated to the rating and analysis of capital markets and banking sectors in predominantly Islamic countries. The *International Islamic Centre for Reconciliation and Arbitration* is active since 2007 settling financial and commercial disputes between Islamic financial institutions and third parties, including their clients.

Apart from these institutions that are solely dedicated to the development of the Islamic finance sector, major **international financial institutions** are also actively involved in Islamic finance. The *Islamic Development Bank (IDB)* is perhaps the most important one; it aims to foster economic and social development in Muslim-majority countries and communities through the provision of loans and grants in accordance with the Sharia. It also provides technical assistance to help countries develop and adopt Islamic finance regulations. The IMF and the *Arab Monetary Fund*, for their part, provide technical assistance to central banks and supervisory authorities in countries that wish to introduce or develop Islamic finance to create the necessary regulatory and supervisory framework. Within the World Bank Group, the *International Bank for Reconstruction and Development* and the *International Finance Corporation* have issued Islamic bonds (*sukuk*). The World Bank and the IDB signed a Memorandum of Understanding in October 2012 aimed at jointly supporting the development of Islamic finance on a country, regional and global basis. Lastly, the *Asian Development Bank* has co-financed Islamic finance opportunities with the IDB and others, including an *Islamic Infrastructure Fund* and the *International Islamic Liquidity Management Corporation*.

Graph III.2.2: **Global sukuk issuance**
(USD billion)



Source: UKIFS, 2012

Takaful is an Islamic substitute whereby individuals contribute money into a pooling system and guarantee each other against loss or damage. Returns from the pool are benefits payable as a share of profits in proportion to individual contributions. Islamic equity funds are similar to regular equity funds in that profit is made from increases in the value of the shares and any possible dividends (Islamicbanker.com, 2011). However, Islamic equity funds cannot contain shares from companies that are directly involved in activities considered *haram*. It is a matter of on-going debate whether and to what extent an Islamic equity fund may engage in any financial activity that involves interest, whether borrowing funds subject to interest or accumulating profits in an interest-bearing account.

As mentioned above, partnerships, based on profit-loss sharing, are favoured over conventional creditor-debtor arrangements. *Musharakah* and *Mudarabah* are examples of such partnerships. In *Musharakah* the bank, as the intermediary, jointly finances an investment project with one or more partners. The partners share profit according to a mutually agreed-upon ratio and share losses strictly based on their respective shares of capital input. All partners are entitled to participate in management of the project, but are not required to do so. In *Mudarabah*, one partner (*Rabbul* Mal or Principal) provides the capital, while the other (Mudarib or agent) invests and manages it; any profits are shared according to a pre-agreed ratio and, in case of a loss, the principal loses its capital, while the other will have lost its time and effort.

Another major financing arrangement is *Ijarah*, which is either a) a simple lease whereby the customer can benefit from the use of a product or service for a fixed price and period of time or b) a lease purchase (*Ijarah-wal-iqtina*) where part of the payments goes towards purchasing the product whose ownership is eventually transferred to the customer.

Bai' muajjal, Murabahah or Musawamah are all different types of credit sales that share some common elements. In all of them, the bank buys a product on behalf of a client and then sells it onto the client allowing it to make the payment for this product in instalments or pay the lump sum at a future date, in addition to a mutually agreed profit margin. Importantly, the profit margin is fixed and should be known to the client, and the bank is not compensated for late payments, distinguishing it from interest.

Generally, Sharia-compliant financing can only be made for existing commodities or assets that are in the ownership and possession of the seller. However, there are two exceptions to this rule: *Bai Salam*, which refers to a forward sale of a good where the price is paid on the spot but the delivery is deferred to a future date. This is often used to facilitate operations in agricultural commodities. *Istisna'a* entails the gradual payment of the price against the future delivery of the asset and is often used for naval and airplane construction and for the construction of housing or factories.

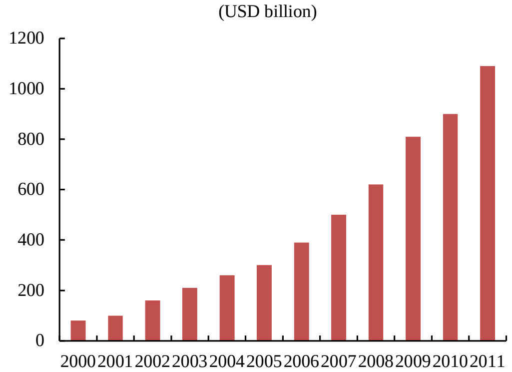
Apart from these more sophisticated arrangements, many of which are used for financing large-scale projects, many Islamic savings banks offer basic interest-free banking services to the wider public. These include *Qard Al-Hasan* (benevolent loan), which is an interest-free loan whereby the bank lends money without charging a profit margin, and *Wadiah* (Safekeeping) or *Amanah* (Trust), which are deposits held in a bank, guaranteed by the bank. While no interest can be earned by the depositor, the bank can, at its own discretion, choose to give a *Hibah* (grant) to the depositor in exchange for allowing the bank to use the deposits in other activities. Similarly, for a *Qard Al-Hasan*, the debtor may at his or her discretion offer an additional amount to the creditor out of goodwill, but is never obliged to do so.

Lastly, there are a number of Islamic financial products that are permissible in some countries (notably Malaysia), but not in others. *Bai' al 'inah* (Sale and Buy Back Agreement), *Bai' bithaman ajil* (Deferred Payment Sale) and *Ijarah thumma al bai'* (Hire purchase) all involve linking two or more transactions, which make them incompatible with Sharia according to some scholars.

2.3. RECENT TRENDS

Over the last few decades, Islamic finance has developed into a fully-fledged financial system, which offers a broad range of Sharia-compliant products and services to meet the ethical and financial needs of individuals and institutions. The overall value of Sharia-compliant financial assets, which is regularly surveyed by *The Banker Magazine*, Standard & Poor's and Ernst & Young, has grown substantially since the inception of modern Islamic finance in the 1970s. Over the past decade alone, the value of Sharia-compliant assets increased from USD 80 billion in 2001 to over USD 1.3 trillion in 2011 (see Graph III.2.3) and they are expected to reach USD 1.8 trillion by the end of 2013 (Ernst&Young, 2012-13). Of these, banking assets (including *sukuk*) account for the majority (approximately 75%), with insurance and wealth and fund management sharing the remaining quarter. Nevertheless, Islamic finance assets are estimated to amount to a mere 1% of total global financial assets.

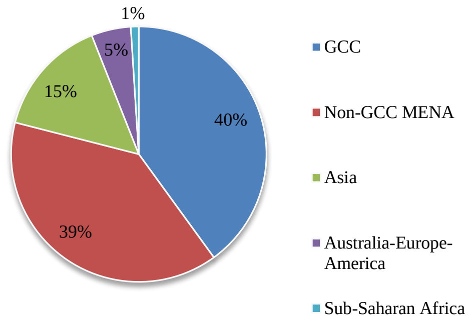
Graph III.2.3: **Global Islamic finance assets**
(USD billion)



Source: The Banker, 2012

Islamic banking and finance has spread throughout the Muslim world to more than 70 countries, in particular to members of the Organisation of Islamic Cooperation (OIC), which includes 57 Muslim-majority states situated primarily in Northern Africa, the Middle East and Southeast Asia. In 2012, OIC countries accounted for 98% of Islamic financial assets held. The Banker's survey of the Top 500 Islamic institutions highlights the following: the majority (79%) of Sharia-compliant assets in 2011 were held in the Middle East and North African (MENA) region, of which the Gulf Cooperation Council (GCC) countries held 51% (40% of the global). Asia, which is home to the world's largest population of Muslims, accounted for a 15% share of assets, whilst international financial hubs situated in Europe, America (and Australia) accounted for 5%. Sub-Saharan Africa accounted for only 1% (see Graph III.2.4) although Nigeria was one of the most rapidly expanding markets.

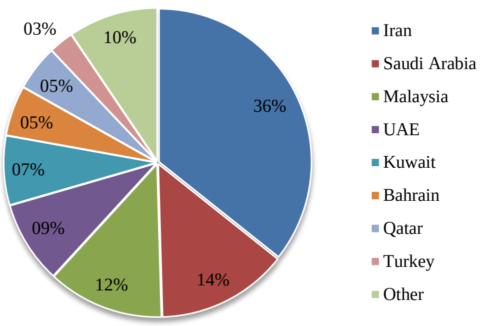
Graph III.2.4: **Islamic finance - Assets by region, 2011**



Source: The Banker, 2012

The Middle East is the main centre of Islamic finance today and institutions based in these countries have been driving growth rates over the past years. Islamic finance in the Middle East is concentrated in Iran (whose USD 388 billion made up 35.7% of total global Islamic finance assets in 2011), Saudi Arabia (13.9%), the United Arab Emirates (8.7%), Kuwait (7.3%), Bahrain (5.3%) and Qatar (4.8%) (see Graph III.2.5). Indeed, Islamic financial assets in MENA countries have grown at a compound average growth rate of 26.4% from 2006 to 2011. Recently, some of the countries participating in the Arab Spring process have introduced financial legislation to promote Islamic financial products. The motivation behind this is linked, at least in part, to the desire to expand access to previously untapped financing from the GCC countries, which favour Sharia-compliant investment opportunities. At the same time, the arrival to power of Islamic parties in some of the Arab countries in transition has provided a further political motivation to develop Sharia-compliant finance and the necessary regulatory and supervisory frameworks.

Graph III.2.5: **Islamic finance - Assets by country, 2011**

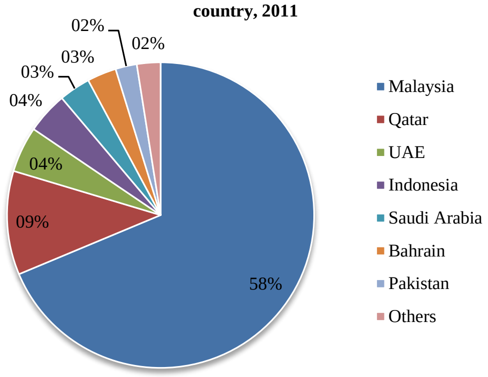


Source: The Banker, in UKIFS 2012

In 2012, the issuance of *sukuk* worldwide increased by more than 25% from USD 178.2 billion to USD 223.2 billion in 2011 (The Economist, 2012; see Graph III.2.6). In Egypt, a law was approved by cabinet in February 2013, governing the issuance of *sukuk* (Al-Masry Al-Youm, 2013). According to the Finance Minister, the law is expected to generate USD 10 billion that will help finance Egypt's large fiscal deficit (Ahram, 2011). In Libya, the banking law of 2005 was amended in 2012 to incorporate an additional section allowing the establishment of Islamic banks and putting some regulatory requirements for them. The governor of the central bank of Libya recently announced that the government will soon issue its first few licences for Islamic banks, in order to fulfil a growing demand for Islamic financial products, which are now only met through Islamic windows and branches of conventional banks (Libya-Business News, 2013). Controversially, the National Public Council (Parliament) in Libya stipulated a new decision in late 2012 to prohibit all transactions involving interest starting 1 January 2015. Hence, many conventional banks in the country are now adopting a plan to convert into Islamic banks.

Meanwhile, Tunisia is planning its first ever *sukuk* sale to the value of USD 700 million scheduled for later in 2013 (Hall, 2013). Before that, the Tunisian parliament has to pass a new law governing the issuance of Islamic finance instruments, which is likely to happen in June 2013. The Jordanian House of Representatives approved a law enabling the issuance of *sukuk* in October 2012. The aim of the new law was to broaden Jordan's sources of funding, giving it access to significant investment funds in the GCC.

Graph III.2.6: **Islamic finance - Sukuk issuance by country, 2011**



Source: The Economist, 2012

Similarly, in Morocco, the parliament approved legislation in January 2013 that allows for the issuance of *sukuk*, though at the moment there is no timeframe for the first sovereign *sukuk* issue. At the same time, the Moroccan central bank is discussing the possible creation of a central Sharia board that would regulate the Islamic finance sector in the country, which would be a first step towards a more developed Islamic financial market with full-fledged Islamic banks (Reuters Rabat, 2013). In parallel, Qatar's Finance Minister announced that his government would make additional investments in *sukuk*, if the Egyptian government starts issuing them (Ahram, 2011).

Outside the MENA region, Turkey has recently entered the Islamic finance market, raising USD 1.5 billion in its first sovereign *sukuk* issue (Oxford Business Group, 2013). The interest of the Turkish market lies in its close links to Germany and thus the possibility of tapping into the growing demand for ethical finance in Europe's second-largest Muslim community (S&P, 2012).

In Southeast Asia, Islamic banking is predominantly located in Malaysia (Kuala Lumpur), although Sharia-compliant financial services are also offered in Brunei, Indonesia, Singapore, the Philippines, and Thailand. Malaysia is the main and most sophisticated Islamic financial market in Asia, which with USD 133 billion in assets, accounts for 12.3% of the total Islamic financial market worldwide. It leads the industry in terms of maturity, has developed an Islamic banking system including ten major Islamic banks and is the world's largest issuer of *sukuk* (S&P, 2012).

Takaful is primarily used in Iran, Malaysia, Saudi Arabia and the United Arab Emirates. As an industry, Standard & Poor's estimates that it is likely to reach USD 12 billion in contributions, with an estimated 31% annual growth rate. The fact that the *takaful* market worldwide only accounts for 1% of the global insurance market, while Muslims account for 20% of the world's population, suggests that the potential for further expansion is significant.

The establishment in November 2011 of the first Islamic Interbank Benchmark Rate (IIBR) ([67]) was an important milestone: The IIBR will act as an alternative to the London Interbank Offered Rate (LIBOR) and aims to provide Islamic institutions with a benchmark calculated from expected *Murabaha* returns for Sharia-compliant interbank funding denominated in US dollars. Other Islamic finance instruments (*Mudaraba*, *Musharaka* and *sukuk*) are expected to be covered in the near future in this index. The IIBR will allow the industry to have a value of the Islamic capital market decoupled from the conventional system but within international markets. Indeed, Islamic financial products are not exclusive to Muslim-majority countries. As mentioned above, both the City of London and Luxembourg for example, have developed into important hubs and non-Muslim financial institutions such as Citibank, Standard Chartered Bank, RBS, the Australia and New Zealand Banking Group, and JPMorgan Chase all offer Sharia-compliant products and services to clients that include non-Muslims.

([67]) The IIBR was created by Thomson Reuters, the Islamic Development Bank, the Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESRIC), the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) and some of the world's largest Islamic banks.

2.4. OUTLOOK AND CHALLENGES

The evolution of modern Islamic finance has seen a remarkable expansion in recent years, leading a number of non-Muslim countries to aspire to become Islamic finance hubs, for example Hong Kong for China or London globally (S&P, 2012). The industry can no longer be understood to be a niche market and its potential becomes evident when looking at the growth of Islamic financial assets and banks over the past few years. Standard & Poor's estimates that the industry's assets are to double between 2011 and 2015 (S&P, 2012). And yet, even though asset growth has been rapid, the industry's assets continue to be dwarfed by conventional finance, accounting for a mere 1% of global finance.

Asset growth is likely to continue hand in hand with its geographic expansion. In addition to expanding within Muslim-majority countries in the Middle East, North Africa and Southeast Asia, the industry could expand into largely untapped markets (e.g. Sub-Saharan Africa) or relative niche markets, such as microcredits. The GCC countries in particular, with their large surpluses as a result of hydrocarbon sales, will look for opportunities in Arab countries in transition to achieve greater political leverage through investments. In the current post-Arab Spring context, where specific legislative measures and issuance decisions are being taken by some of the new governments, there is likely to be an increased emphasis on Islamic finance, also as a way to diversify sources of funding. Its presence in MENA countries and recent political steps taken are evidence of an attempt to 'mainstream' the system.

The demand for Islamic financial assets by the GCC countries coupled with a growing supply in Arab Spring countries is driving the growth of a clearly and outspokenly normative and value-laden financial system. The extent to which it will be able to continue this development will depend on the sustainability and coherence with which it expands. A system that is openly Islam-oriented will appeal to Muslims. Nevertheless, some of the products of Islamic finance, notably the *sukuk*, may also increasingly appeal to investors in non-Muslim-majority countries as they provide a new way to diversify their portfolios. The establishment of international standard-setting institutions and specific research divisions within major universities will help to promote systemic regulation within the industry. The extent to which it can also appeal to non-Muslims will also determine the potential for Islamic finance.

The development of instruments that could be perceived to be of a more social or ethical orientation will resonate among investors and savers at a time when the global financial crisis of 2008-09 and its aftermath has underlined some of the excesses and problems of conventional finance and the disconnection between some of its practices and the real economy. Islamic finance seeks to avoid some of the problems of conventional finance by limiting the scope for speculation, short-selling and complex derivatives. As a financial system that is primarily involved in asset-based financing activities, it is often presented as less risk-prone and potentially more resilient to market fluctuations than conventional finance.

Although a clear possibility for Islamic finance to grow further exists, its growth potential should not be exaggerated as its limits cannot be ignored. The impossibility to pay interest in the standard way or to undertake certain operations (e.g. forward sales) represents a drawback for its further development. Furthermore, for a sustainable expansion to take place, a number of challenges will need to be dealt with. Most importantly perhaps, there is a clear need for greater regulatory oversight, which would entail strengthening the standards issued by the AAOIFI and the IFSB (Islamic Financial Services Board) to the equivalent level of the standards issued by the IFRS (International Financial Reporting Standards) or BIS (Bank for International Settlements) for accounting and supervision of conventional banks. Moreover, tax treatment needs to be harmonised with those of conventional finance, while strengthening insolvency and liquidity frameworks, and establishing sound risk-management practices would be only benefit the industry’s growth (Mohieldin, 2012). Other key challenges are information and knowledge management-related (e.g. the lack of public awareness and understanding of the main Islamic banking products and their distinction from conventional banking products) and resource and capacity-related (e.g. the lack of adequate expertise and competent Islamic banking experts and professionals that can promote a better understanding of Islamic banking and finance and help strengthen the regulatory and supervisory framework for Islamic banks). Today, the system complements, rather than supersedes, conventional finance. It may provide a source of diversification and resilience to conventional finance but it is unlikely to replace it.

Part IV

Country analysis

1. ALGERIA

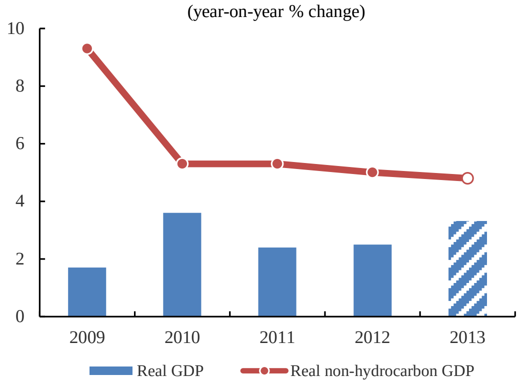
- ***High global hydrocarbon prices and government expenditure measures, partly aimed at limiting social discontent in a regional context characterised by the Arab Spring, were the two main factors influencing Algeria's economic situation in 2012.***

- ***Comfortable foreign exchange reserves and low external debt levels place the country in a financially strong position, able to weather external shocks.***

- ***Investing in human capital (education, training, employment and health) and increasing employment (notably among young people and women) will be crucial to strengthen sustainable and inclusive growth over the next years.***

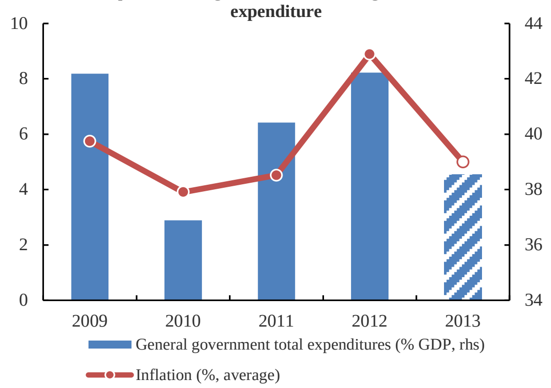
Graph IV.1.1: **Algeria - GDP**

(year-on-year % change)



Source: IMF

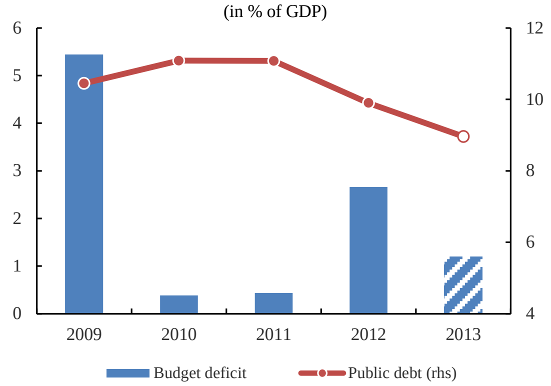
Graph IV.1.2: **Algeria - Inflation and government expenditure**



Sources: National authorities; IMF

Graph IV.1.3: **Algeria - Fiscal defiict and public debt**

(in % of GDP)



Source: IMF

Macroeconomic and financial developments

High global hydrocarbon prices and the government's attempt to limit possible spillover effects of the Arab Spring were the two main factors influencing Algeria's economic situation in 2012. Increasing gas and oil revenues were offset by a rise in fiscal expenditure, as public sector salaries rose by more than 50% over 2009-2012. Economic growth accelerated slightly to 2.5% of GDP in 2012 (up from 2.3% in 2011, but down from 3.6% in 2010). This modest growth pace will not suffice to reduce the important and growing informal labour market and the high unemployment rate among the youth, which stood at 20% in 2012.

Although a net oil and gas-exporting country, Algeria's GDP growth potential is underexploited. The country continues to be excessively dependent on hydrocarbons, which accounted for almost 35% of GDP, more than 95% of export receipts and more than two thirds of fiscal revenues in 2012. The government has been trying to promote growth in the non-hydrocarbon sector, as set out in the government's action plan of September 2012, through an ambitious public investment policy under the five-year (2010-14) development programme. This has been combined with a steep increase in public sector wages (between 10% and 40% from 2011 to 2012 alone) and social expenditure. The fiscal expansion drove up the budget deficit to 2.7% of GDP in 2012 from 0.4% in 2011.

As the deficit increased, so did the breakeven price per barrel of oil and the country's vulnerability to a fall in the global price. As in preceding years, the government aimed to stabilise prices through direct interventions (including subsidies and the suspension of VAT and custom duties on basic goods) and a prudent monetary policy. However, the surge in public spending together with international food price increases (worsened by speculation in the supply chain, the introduction of import restrictions and adverse climatic conditions) contributed to inflation, which accelerated to a 15-year high of 8.9% in 2012 from 3.9% and 4.5% in 2010 and 2011, respectively. In an attempt to tighten monetary policy by reducing liquidity, the central bank raised the required reserves rate from 9% to 11% in May 2012 and to 12% in April 2013.

The government's direct involvement in the economy is further exemplified by the official exchange rate, which is maintained through central bank interventions near a targeted level. IMF data indicate that following a slight depreciation of 0.6% in 2011, the real effective exchange rate appreciated by 5.8% in the first three quarters of 2012 (year-on-year), primarily because of the inflation differential between the country and its main trading partners. The unofficial exchange rate is approximately 40% higher than the official one.

High hydrocarbon prices balanced lower real exports of hydrocarbons resulting in a current account surplus of 5.9% of GDP in 2012. In December 2012, the foreign exchange reserves held by the central bank equalled USD 194 billion, equivalent to 3.3 years of imports. This, together with large foreign exchange reserves held by the *Fonds de Regulation des Recettes*, the fund where the government channels hydrocarbon receipts obtained when the oil price exceeds a reference value (USD 139 per barrel as of July 2013), placed the country in a financially strong position, able to weather external shocks. External debt remains low, representing only 0.9% of GDP at the end of 2012.

FDI to the country dropped by 15% to USD 1.7 billion. FDI remained limited for different reasons, including the volatile situation in the region. The 49-51% investment rule ([68]) instituted in 2009, which limits foreign ownership and participation, has also been identified as a potential deterrent to investors. Algeria would benefit from structural reforms aimed at improving the business climate. The country ranked 152 (out of 185) in the 2012 World Bank's 'Doing Business' index, far below the MENA average, which stood at 98. The government has been working to foster private sector growth through a number of measures, including the setting up of a national council to analyse the situation. So far, measures have not been sufficiently wide-ranging. The January 2013 attack of the In Amenas gas installation, near the Libyan border, may also discourage capital inflows to the country.

Public banks account for the majority of Algeria's banking sector. In 2012, Algerian banks continued to benefit from growing deposits. However, although banks are well capitalised and profitable, bank intermediation and private sector credit remains low, partly as a result of the 2009 ban on consumer lending (loans to households account for less than 10% of credit to the economy). In 2011, the ratio of NPLs stood at 14.2%. Public banks, which lend primarily to state-owned enterprises, suffered from higher levels of NPLs (16%), than private ones (4.2%). Algeria's bond and equity markets are shallow and integration with international financial markets remains low, leaving the private sector with little access to funds to finance projects and limiting investment possibilities further.

Structural reform challenges

Over the past decade, the Algerian authorities have attempted a number of legislative and regulatory reforms aimed at modernising and diversifying the economy. Additional efforts to diversify and privatise the Algerian economy further would reduce the excessive dominance of the hydrocarbon sector and the state's high share in it, which not only increases its exposure to

([68]) Since December 2009, FDI legislation imposes a 49% ceiling on foreign investors' ownership of assets in FDI projects. In 2010, this requirement was extended to foreign participation in investments in the financial sector.

fluctuations in hydrocarbon prices and affects its medium-term growth potential, but also tends to produce Dutch disease effects, attracting labour and capital resources away from alternative sectors.

Not only the economy continues to depend heavily on the hydrocarbon sector, but state ownership dominates several sectors, such as energy and banking (nearly 90% of banks are state-owned) or the vehicle sector, where all companies are public. Moreover, the privatisation process has lost steam. Other infant sectors of the economy with significant potential, such as the chemical industry, agriculture, tourism, retail trade, communications and innovation/research need to be further developed, including by supporting SMEs, a key source of employment. The agricultural sector, for example, contributes less than 8% to GDP and although it employs approximately 20% of the active population, it is not in a position to meet domestic demand. Algeria is thus a net food importing country. The underdevelopment of the agricultural sector, despite the fertile land in the North, good climatic conditions and proximity to the EU market illustrate, like the underdevelopment of the tourism sector despite an attractive Mediterranean coast and the country's historical sites, Algeria's unexploited potential for diversification.

In order to promote economic diversification and private sector development, it is essential to improve the investment climate. Algeria's negative scores in the main surveys of business conditions and competitiveness, partly reflect heavy tax, customs and other regulations, which impose a significant burden on enterprises (see Box on Doing Business in Part II). This regulatory burden also encourages the development of the informal sector (estimated at 40-60% of the economy). This large informal economy, in turn, limits the non-hydrocarbon tax base and contributes to social inequality as it leaves a significant part of the labour force out of the social security and health systems.

The labour market represents another major structural challenge: the state is by far the first source of employment in the country, and there is a large pool of potential workers that could benefit from job creation in the private sector. The employment rate (employment to population ratio) is only 37.6% at the national level (63.3% for men, 11.5% for women), while the official unemployment rate is 10%. Participation rates are particularly low among women and young graduates. Labour market reforms and improvements in the educational system (to reduce skill mismatches) would be therefore particularly helpful.

It is important for Algeria to move to a more inclusive growth model consistent with a better distribution of income. However, this should be based less on the expansion of civil service wages and current social expenditure (as was the case of the fiscal easing undertaken in recent years), but rather, rely to a larger extent on social expenditure with durable poverty-reduction and growth-enhancing effects such as spending in education and health. It will also be important to gradually replace the existing generalised food and energy subsidies with means-tested transfers targeted on the poorest households. Finally, measures are needed to support the development of the private sector (including through a more ambitious privatisation policy), improve the business climate, attract foreign investments and foster trade integration. The large public investments in infrastructure (roads, railways, housing, water, electricity gas) over the last years will only pay off if the investment climate improves and the private sector is given a chance to develop further. Trade policy, in particular, has an important role to play.

Algeria's trade regime is similar to that of other MENA countries in terms of average tariff rates. The country's most important trade challenges are trade facilitation and the country's non-integration with its geographical neighbours. The EU is Algeria's main trading partner, absorbing half of Algerian exports. Between 2007 and 2012 and driven by rising oil exports, EU-Algeria trade volumes increased by more than 40%. Although an EU-Algeria Association Agreement entered into force in September 2005, setting the framework for trade relations, this has not been complemented by ensuing talks for a free trade area. In 2012, and following a request by the Algerian authorities, the deadline for tariff dismantling, which was to be accomplished in 2017, was extended to 2020. Algeria is not a WTO member, although it is in the process of resuming serious discussions to accede.

Risks and outlook

Algeria has exhibited a strong resilience to the weaker global and regional economic environment with solid GDP growth rates and a strong external and budgetary position due to abundant hydrocarbon revenues and relatively low trade and financial integration. As a major oil and gas exporter, the country has benefited from higher hydrocarbon prices since 2010, enabling it to recover from the global financial crisis and contributing to a strong reserve position and significant budgetary savings. This has helped Algeria to moderate the impact of the euro area crisis and regional (Arab Spring-related) crises on the domestic economy. However, behind this apparent success at the macroeconomic level, there are serious challenges that need to be addressed, notably on the structural reform front.

The Algerian economy remains too dependent on the hydrocarbon sector and the state. This non-diversified economy is susceptible to destabilisation through the volatile global hydrocarbon and food markets, highlighting a precarious situation notwithstanding its relative macroeconomic stability. In recent years, the combination of an ambitious public investment programme and an expansion of current expenditure have further increased the exposure of the fiscal position to a downward correction in hydrocarbon prices. Liberalising and privatising the economy further, promoting greater trade openness and a more friendly investment environment would contribute to realise Algeria's growth potential. An enabling business environment goes hand in hand with effective competition. Current policies seeking to ensure the long-term growth of the country's economy, such as the need for a 51% national participation in all FDI projects, may have at least in the short run, the contrary effect. Another key economic challenge for Algeria is creating more employment, so as to reduce the persistently high rates of unemployment (notably among young people) while raising participation rates (notably among women).

The government's attempt to curb possible spill-overs from neighbours through public sector salary increases contributed to a 15-year peak in the inflation rate in 2012. Social discontent, however, is widespread and the government will be hard-pressed to implement reforms that promote private sector growth and employment and establish an economic model in which the wealth stemming from the hydrocarbon sector is more equitably distributed among the population. The fear of social unrest has driven Algeria's politics for the past few years and is one of the main reasons why structural reforms have not been advanced. Algeria would need to break out of a circle in which the economy is based on one main source of income and living conditions are dependent on government subsidies.

Table IV.1.1:
Algeria - Main economic indicators

	2009	2010	2011	2012	2013 projection
Real sector					
Real GDP (% change)	1.7	3.6	2.4	2.5	3.3
Real non-hydrocarbon GDP (% change)	9.3	5.3	5.3	5	4.8
GDP nominal (USD, billion)	137.6	161.8	198.8	207.8	210.5
GDP per capita (USD)	3,943	4,567	5,528	5,694	5,683
Inflation (%, end-period)	5.8	3.6	5.2	9.0	5.0
Inflation (%, average)	5.7	3.9	4.5	8.9	5.0
Social indicators					
Unemployment rate (survey based, %)	10.2	10.0	10.0	9.7	9.3
Population (million)	35.3	36.0	36.7	37.5	37.8
Fiscal sector					
General government revenues (% GDP)	36.7	36.5	40.0	39.6	37.3
General government non-hydrocarbon revenues (% GDP)	18.1	18.3	19.6	21.3	19.4
General government total expenditures (% GDP)	42.2	36.9	40.4	42.2	38.5
General government balance (% GDP)	-5.4	-0.4	-0.4	-2.7	-1.2
Non-hydrocarbon general balance (% GDP)	-44.8	-39.8	-45.8	-44.6	-39.6
Gross government debt (% GDP, end-period)	10.5	11.1	11.1	9.9	9.0
Monetary sector					
Key policy rate (%, end-period)	4.0	4.0	4.0	4.0	4.0
Credit to the private sector (% change)	14.7	12.5	12.5	14.9	n.a.
Broad money (% change)	4.8	13.5	19.9	11.5	9.0
External sector					
Trade balance (% GDP)	5.6	12.4	14.0	13.1	12.3
Current account balance (% GDP)	0.3	7.5	10.0	5.9	6.1
Net FDI (USD billions)	2.5	2.0	2.0	1.7	1.9
Net FDI (% GDP)	1.8	1.3	1.0	0.8	0.9
Gross external debt (% GDP, end-period)	3.8	1.2	0.9	0.9	n.a.
Gross official reserves (USD billion, end-period)	149.4	162.9	182.2	193.9	208.6
In months of next year's imports	35.2	33.9	38.2	40.2	41.7
Exchange rates					
Exchange rate (dinar per USD, average)	64.6	72.7	74.4	72.9	77.5
Exchange rate (dinar per EUR, average)	93.1	97.1	96.3	96.2	103.4

Sources: Algerian authorities, IMF, World Bank

2. EGYPT

- ***Egypt's political transition, initiated in early 2011, continued to negatively impact economic output throughout 2012 as growth remained muted at 2.2% in fiscal year 2011/12, following a depressed 1.8% the year before.***

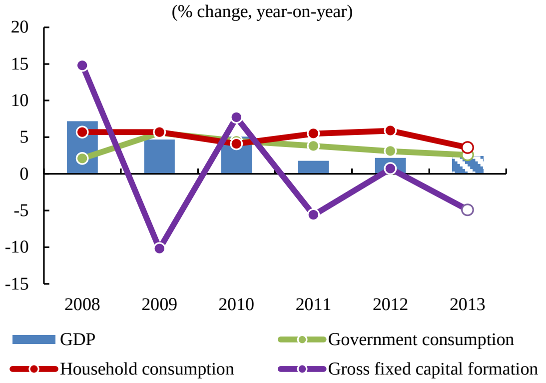
- ***Whereas by November 2012 a stabilisation of macroeconomic aggregates and an agreement on an economic reform programme, supported by the international community, set the basis for a much-awaited economic turnaround, Egypt's backtracking led to a period of macroeconomic instability that lasted well into 2013.***

- ***Facing an unsustainably high fiscal deficit and a vulnerable external position, Egypt cannot afford further delays in implementing fundamental, if socially sensitive, economic reforms, as further postponements will only add to the necessary cost of adjustment. The difficulties in the political transition, highlighted by the situation created following the events of July 2013, make this task more challenging but also more important.***

Macroeconomic and financial developments

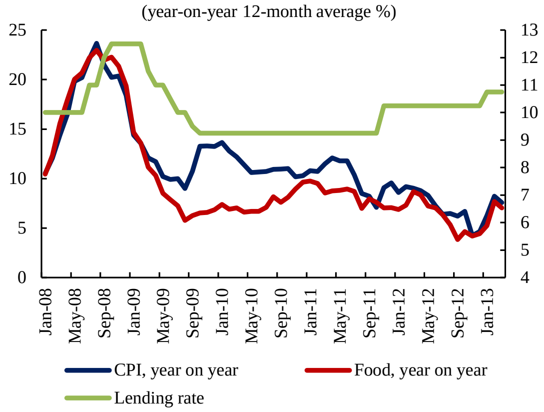
Two and a half years on from the January 2011 uprising, the Egyptian economy has yet to initiate a period of economic recovery. The political instability and uncertainty related to the Arab spring, combined with relatively high international energy and food prices, brought the economy to a standstill for much of 2011, with GDP growth decelerating to 1.8% for the fiscal year (FY) 2010/11 (ending in June 2011). Despite a protracted political transition, the economy picked up some speed in 2012, supported by a low base of comparison. Some early signs of stabilisation were visible from the middle of the year, a process that was facilitated by some easing of political tensions and a moderate recovery of tourism inflows. Growth in FY 2011/12 reached 2.2% and 2.3% in the first nine months of FY 2012/13 (year-on-year). However, this moderate pick-up of growth is expected to suffer from the renewed political instability.

Graph IV.2.1: **Egypt - GDP**
(% change, year-on-year)



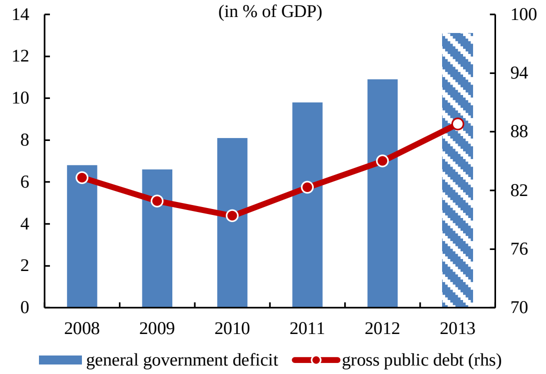
Sources: Ministry of Finance; IMF

Graph IV.2.2: **Egypt - Inflation and monetary policy stance**
(year-on-year 12-month average %)



Source: Central Bank of Egypt

Graph IV.2.3: **Egypt - General government deficit and gross public debt**
(in % of GDP)



Source: Ministry of Finance; IMF

The Egyptian economy's inability to meet the employment demands of a young population, in the context of a social revolution, remains a fundamental concern. Unemployment rose to 13% of the labour force by end-2012, up from 9% prior to the revolution. Unemployment affects disproportionately women (rate of 24.7% unemployment despite a low participation in the workforce), the youth (77.5% of those between 15 and 29 years of age are unemployed) and those with higher qualifications (31.4% of university graduates are unemployed, 85.4% if those with intermediate certificates and above are included). There are also significant regional disparities in unemployment.

Egypt has traditionally suffered from high inflation (annual CPI inflation averaged 12% from 2008 to 2012), reflecting in part supply-side market inefficiencies and uncompetitive market practices. While inflation had followed a downward path (averaging 4.6% in 2012) since the middle of 2011 reflecting a negative output gap, it accelerated in early 2013 owing mainly to the depreciation of the Egyptian pound. As a result, the central bank of Egypt's accommodative monetary policy started to be reversed in November 2011, when the Bank increased the key policy rate by one percentage point to 10.25%. The tightening of monetary policy continued in March 2013 as the rate was raised further by 50 basis points. Despite the central bank's efforts, inflation is projected to increase in 2013 as the negative output gap narrows and the expected reform of the energy subsidies system – which takes about ¼ of public expenditure – allows the price of subsidised gasoline to progressively edge upwards.

By the end of 2012, the Egyptian pound had seen a moderate 5% depreciation relative to the pre-revolution rate. However, renewed political instability at the end of 2012 prompted a rapid build-up of external pressures leading to a fast depreciation of the currency that continued well into 2013, amid increasing pressures of dollarization of the domestic economy. In this context, the central bank established a series of controls on the use of foreign currency and introduced a new auction regime for foreign exchange, which sought to limit the loss of reserves while introducing some exchange rate flexibility and preventing the development of a black market for foreign exchange. Occasionally, larger auctions were allowed to facilitate the import of essential commodities. There is a clear risk that, if the Egyptian pound continues to depreciate, further inflationary pressures will build up.

Weaker economic growth, higher energy and food subsidies, increases in social expenditure to assuage social tensions and higher interest payments had the effect of raising an already high fiscal deficit before the crisis. In FY 2010/11, the first post-revolution budget, the deficit rose to 9.8% of GDP (up from 8.1% a year earlier), which was followed by a new increase in the deficit in FY 2011/12 to 10.9%. The FY 2012/13 fiscal deficit is estimated to have exceeded by a significant margin the level (10.4%) targeted under a programme agreed with the IMF at staff level in November 2012. By the end of FY 2012/13, the budget sector gross debt-to-GDP ratio is estimated to have risen by nine percentage points from the 79% ratio in FY 2009/10.

Egypt's external position has mirrored the political developments during this time. The current account saw a moderate deterioration of the deficit to 3.1% of GDP in FY 2011/12. The deterioration of the two first post-Revolution years reflects a combination of factors, including higher import price of commodities, namely oil, but also a significant drop in tourism receipts. Oil imports alone doubled in two years, from USD 5.2 billion in 2009/10 (2.4% of GDP) to USD 10.5 billion in 2011/12 (4.2% of GDP). Most of the original difficulties in the external sector emanated from the capital and financial account.

These balance of payments pressures started to ease as of mid-2012 owing to the moderation of international energy prices, the resilience of profits from the Suez Canal and a gradual pick-up of revenues relating to tourism and remittances. For FY 2012/13, the current account deficit is expected to have declined to 2% of GDP. Also, the drying up of outflows of portfolio investments and a moderate recovery (although from low levels) of FDI had allowed the capital and financial account to return to a more comfortable position.

While the external position was therefore pointing to certain stabilisation in the second half of 2012, Egypt's external vulnerability was further tested in the context of the political instability that started in

November of that year. By end-June 2013, the international reserves position was very vulnerable, with reserves at USD 14.9 billion, down from USD 36.2 billion prior to the revolution, despite generous contributions by Qatar (USD 7 billion), Saudi Arabia (USD 1.5 billion), Libya (USD 2 billion) and Turkey (USD 1 billion) since 2012.

Negotiations with the IMF on a 22-month USD 4.8 billion Stand-by Arrangement (SBA) concluded successfully in November 2012, further to prior attempts in the middle of 2011 and in early 2012. However, in December 2012, President Morsi suspended some previously announced fiscal measures, which were agreed with the Fund, and decided to withhold temporarily the request for IMF assistance. By early 2013, the Egyptian economy was suffering, as noted, from fresh turbulence, with external pressure building up, which prompted the Egyptian authorities to renew their request for assistance to the IMF in the spring. On the basis of a newly-approved economic programme, technical talks were re-launched with the IMF in April 2013, which served to advance, but not conclude the negotiations. While both parties were committed to reaching an agreement, political pressures, including the delay of the legislative elections, thwarted any compromise.

In July 2013, a new phase of Egypt's historical transition was initiated with the destitution of the democratically elected President and the appointment of the head of the Constitutional Court as President of a transitory administration, in a context of deep polarisation. It remains to be seen what reform programme the new authorities will put in place, and whether an agreement with the IMF will finally materialise.

Such an agreement would unlock further financing by the World Bank, the African Development Bank and MFA and Budget Support from the EU. Egypt has officially requested MFA from the EU to complement the funds to be made available under the IMF programme. This request is under consideration by the EU, pending the completion of negotiations with the IMF (see also Annex 1 in Part II).

Meanwhile, following the appointment of a new administration in July 2013, some GCC countries immediately indicated their willingness to provide additional financial support to Egypt in the amount of USD 11 billion. This includes USD 5 billion from Saudi Arabia, USD 4 billion from Kuwait and USD 3 billion from the United Arab Emirates.

Structural reform challenges

Provided that a national consensus is built around a structural economic reform programme that guarantees macroeconomic stability and fiscal sustainability, Egypt has the potential to bring up its growth potential to pre-crisis levels. However, in contrast with the pre-crisis years of high economic growth, which resulted in little employment creation and deepened the unequal distribution of income, Egypt's future economic model needs to support a job-friendly, inclusive, economic environment, led by the private sector, which meets the economic aspirations of a young, and growing, population.

In addition to the abovementioned pressing macroeconomic problems, the Egyptian economy suffers from a number of structural weaknesses and market distortions, which have constrained for decades the country's capacity to grow and generate employment opportunities for its fast growing population. The labour market, in particular, is inefficient owing to rigid laws for hiring and firing, a large informal sector, low participation of women in the labour force, and significant skill mismatches between supply and demand, not helped by a poorly developed educational system. Public finance management standards are weak, in particular relating to budget transparency, statistical coverage and governance, public procurement, internal and external audit. Egypt must reform its inefficient system of energy and food price subsidies while strengthening the social safety net. There is also the need to reform the tax system in order to increase tax collections while increasing progressivity.

Two waves of financial sector reforms carried out since 2004 were successful in consolidating and strengthening the banking sector. At the same time, however, financial intermediation in Egypt is still underdeveloped, and corporate lending is uncompetitive, having traditionally focussed on large bankable projects, at the expense of SME financing. In addition, some industrial sectors where oligopolistic market structures prevail –

mining, textiles, cement or steel – have benefited from implicit subsidies through under-priced energy inputs (recently eliminated) and from below market rate loans.

The difficult political transition process has limited progress with these structural reforms. A window of opportunity opened after the democratic election of a new President and his appointment of a Cabinet in the summer of 2012, and the Egyptian authorities' determination to come up with a home-grown economic programme that would be the basis of the arrangement with the IMF. Indeed, the programme agreed with the IMF at staff level in November 2012 included reform measures in the tax area (e.g., the harmonisation and broadening the income tax, the unification of the corporate tax rate, and the reform of the general sales tax with a view to introducing a value added tax in due time). It also included a two-stage reform of the energy and food subsidies system, starting with some relatively uncontroversial prior actions, before a full reform of the gasoline and mazout subsidies system would be launched in April 2013. These reforms would have been accompanied by a revised social safety nets system, supported by the World Bank and other donors, to limit the impact of the reforms on low income households. However, the implementation of much this reform strategy has, as noted, been delayed and now it remains to be seen what strategy the new administration will put in place.

Risks and outlook

Despite multiple challenges, Egypt's economy had managed to regain some stability by the autumn of 2012. Crisis management measures had allowed Egypt to avoid falling into recession – Egypt recorded only one quarter of negative growth (Jan-Mar 2011) – and to prevent the development of a black market for foreign currency, a bank run on domestic deposits, or a disorderly depreciation. Given the circumstances, these were no small achievements.

However, by mid-2013, political instability, the backtracking on the economic reform programme and the postponement of the SBA with the IMF steered the economy back into a vulnerable state. International reserves levels are critically low despite generous contributions from foreign donors, the fiscal targets for FY 2012/13 are estimated to have been missed by a considerable margin, the financing of government debt is becoming increasingly expensive, and two and a half years on, the aspirations of a population hungry for jobs and economic inclusiveness are yet to be met.

Egypt is now, more than ever, faced with an urgent need to implement measures that both ensure macroeconomic stability and set the ground for sustainable and inclusive growth in the medium term. The outlook for the Egyptian economy hinges on the country's capacity to manage its complicated political transition in a peaceful manner and the determination of the interim and future administrations to address the vulnerable macroeconomic situation as well as the underlying structural economic problems. The main risks to the outlook relate to further potential delays in adopting robust economic adjustment reform measures, in concluding the programme with the IMF. While the large fresh assistance pledged by the GCC countries can provide a welcome breathing space until such a programme is put in place, it cannot substitute for it. Another significant risk stems from the intensification of the political tensions in the region, possibly as a result of the prolongation of the Syrian conflict and the intensification of its spill-overs on neighbourhood countries. Such a scenario could also hurt Egypt by pushing up oil prices. Finally, despite its economic and financial links with the GCC countries, which play a buffering role, Egypt is exposed to a protracted period of weak growth in the euro area economy as elaborated in Part III.

Table IV.2.1:
Egypt - Main economic indicators

	2009	2010	2011	2012	2013 projection
Output and prices					
Real GDP (% change)	4.7	5.1	1.8	2.2	2.4
GDP nominal (USD billion)	188.6	218.5	235.7	255.0	257.3
GDP per capita (USD)	2,366	2,694	2,857	3,032	3,005
Inflation (average, %)	11.8	11.1	10.1	7.2	8.2
Social indicators					
Unemployment rate (survey based, %)	9.4	8.9	12.4	13.0	n.a.
Population (million)	79.7	81.1	82.5	84.1	85.6
Fiscal sector					
General government revenues (% GDP)	27.1	22.2	19.3	19.7	21.8
General government expenditures (% GDP)	33.7	30.3	29.3	30.5	34.8
General government balance (% GDP)	-6.6	-8.1	-9.8	-10.9	-13.1
Gross government debt (% GDP, end-period)	80.9	79.4	82.3	85.0	88.8
Monetary sector					
Key policy rate (%, end-period)	9.25	9.25	10.25	10.25	10.75
Domestic credit to the private sector (% change)	5.1	7.7	1.0	7.1	7.2
Broad money (M2% change)	8.4	10.4	10.1	8.3	15.4
External sector					
Trade balance (% GDP)	-11.9	-11.5	-11.5	-12.3	-12.1
Current account balance (% GDP)	-2.4	-2.0	-2.6	-3.1	-2.0
Net FDI (% GDP)	3.6	3.7	2.3	0.8	0.2
Gross external debt (% GDP)	17.8	15.4	14.8	13.5	16.9
Gross official reserves (USD billion, end-period)	31.2	35.1	26.6	15.5	n.a.
In months of next year's imports	5.8	6.9	4.7	2.7	n.a.
Exchange rates					
Exchange rate (EGP per USD, average)	5.55	5.63	6.10	6.07	6.82
Exchange rate (EGP per EUR, average)	7.72	7.46	7.98	7.83	9.07
Real effective exchange rate (% change, + is appreciation)	20.9	8.0	0.9	2.0	n.a.

** Fiscal year ends in June 30th*
Sources: Central Bank, Ministry of Finance, Central Agency for Public Mobilisation and Statistics, IMF, EIU, Commission calculations

3. ISRAEL

- ***GDP growth slowed down in 2012 on weaker global economic activity.***

- ***Export growth moderation due to weak foreign demand, together with a drop in investment, suggests a subdued growth in 2013-14.***

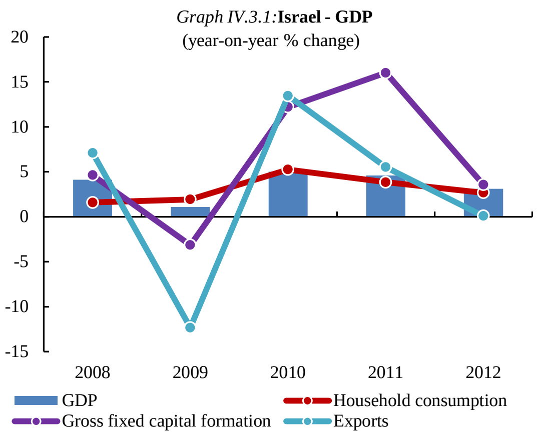
- ***Deviation from the fiscal consolidation path due to shrinking revenues delays social reform agenda.***

Macroeconomic and financial developments

GDP growth moderated to 3.2% in 2012 from 5.0% in 2010 and 4.6% in 2011. The slowdown was mainly due to external factors (relatively weak global growth and stagnant global trade flows). Domestic factors, including private consumption and investment, partly counteracted the adverse external pressures.

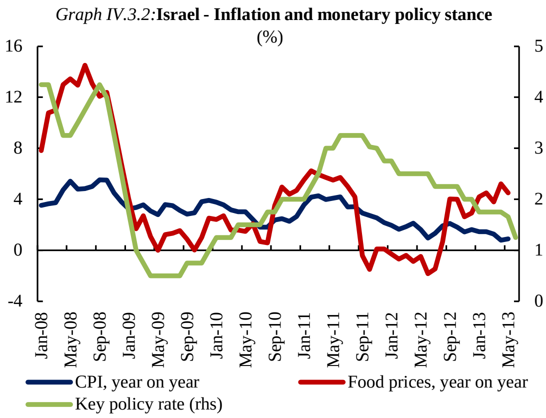
In 2012, private consumption showed sustained growth, expanding by 2.7%. Demand for durables decreased by 3.9%, however. Fixed capital formation grew by 3.6% in 2012, a significant slowdown from the double-digit increases seen in the previous two years (16.0% in 2011). The moderation in investment growth was mainly due to a drop in investment in industries that may be an indicator of a further slowdown in economic activity. Exports in 2012 broadly remained at their 2011 level, increasing by 0.1% after growing by 13.5% and 5.5% in the previous years.

From the production side, the increase in the output of business activities was leading the overall growth. It expanded by 3.1% in 2012, moderating from a 5.1% rise in 2011. The sustained growth was mainly due to the increase in output in finance and business service sector, which grew by 4.3% in 2012. However, this sector showed an important slowdown in the second part of the year on a quarter-to-quarter basis. The manufacturing and construction sectors expanded by 2.8% and 4.3%, respectively, in the year as a whole.



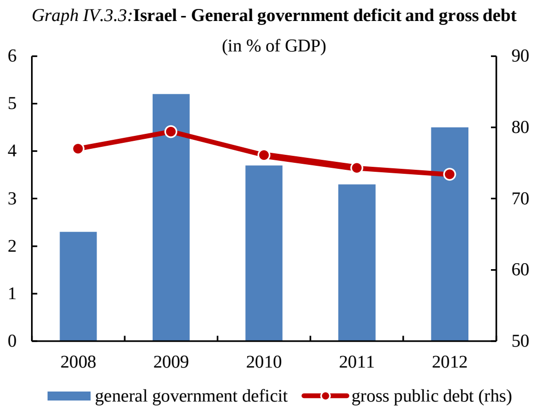
Graph IV.3.1: **Israel - GDP**
(year-on-year % change)

Source: National authorities



Graph IV.3.2: **Israel - Inflation and monetary policy stance**
(%)

Source: National authorities



Graph IV.3.3: **Israel - General government deficit and gross debt**
(in % of GDP)

Source: National authorities

In the first quarter of 2013, growth remained subdued (to 2.7% year-on-year), mainly reflecting a further weakening of investment.

The unemployment rate was relatively low and stable in 2012, edging up to 6.9% from 6.8% in the end of 2011. The participation rate further increased, but with a slowing tendency in the end of the year. In 2012, it reached 63.6%. The Arab and ultra-orthodox communities continued to show the lowest participation rates.

The inflation rate was on a clear downward path, reflecting the slowing economic activity and the stabilising global commodity prices in the first half of the year. Lower growth was recorded in housing and food prices, but it returned on the upward path in the beginning of 2013. The average inflation rate dropped by 1.8 percentage points year-on-year to 1.7% in 2012, and it maintained the slowing trend in 2013, with annual inflation reaching 0.9% in May. Despite a deceleration since the end of 2012, housing prices remain at historically high levels (high house prices and rents were one of the triggers of the social protests in the summer of 2011). The central bank assesses that their level is currently in line with the fundamentals in the housing market, but further increased activity and sustained price growth expectations could create a risk of formation of a new price bubble.

Reacting to the moderate growth in economic activity and low inflationary pressures, the central bank lowered its key policy rate four times in 2012 (by a percentage point in total) and by an additional half a percentage point (to 1.25%) in the first half of 2013. At the same time, however, it announced home loan limits in October 2012 reacting to the housing price bubble risk.

The shekel appreciated against the currencies of Israel's main trading partners by about 0.8% in 2012; it strengthened by 2.3% against the USD and 0.4% against the EUR. However, exchange rate developments during the year were not uniform. There was an overall depreciation trend of the shekel in the first half of 2012 (it depreciated by 5.5% reaching the lowest level since mid-2009). It was replaced by an appreciation trend in the second half mainly due to the easing of geopolitical tensions and the weakening of the USD against other currencies. The shekel`s value increased by 7.3%. This appreciation was maintained in the first half of 2013. After the surprise announcement in May of an interest cut by the Bank of Israel, this trend was cut short, but resumed in June and July.

In the fiscal area, the budget deficit increased in 2012, reversing a two-year trend of contraction. The fiscal gap totalled NIS 36 billion in 2012, or 3.9% of GDP, overshooting substantially the government's initial forecast (a deficit of 2% of GDP). This was almost entirely due to lower-than-planned revenues, which were negatively affected by the weaker-than-expected economic activity. At the same time, expenditures were higher than the initial projections.

Due to the slowing of the fiscal revenues and increased spending, in June 2012 the government approved an increase in the deficit target for 2013 by 1.5 percentage points of GDP compared to the 1.5% of GDP deficit defined by the law. ([69]) According to the new outline, the path of decrease in deficit would reach 1.5% of GDP in 2019 (instead of in 2013). Government debt is expected to deviate from the planned debt reduction trajectory. In 2012, it is estimated to have slightly decreased to 73.4% of GDP from 74.3% of GDP a year earlier.

Uncertainty over fiscal policy rose in the last quarter of 2012 as the government called for early elections (which took place on 22 January) after being unable to reach a consensus over the 2013 budget. This decision, while introducing an extra dose of political uncertainty to the budgetary and economic policy decisions, did not cause a rise in government bond yields, suggesting that markets remained confident in the future direction of fiscal policy.

The 2013-14 state budget, which was submitted to parliament in June, foresees a fiscal deficit of 4.7%

([69]) The current fiscal policy framework in Israel is regulated by the Deficit Reduction and Budgetary Expenditure Limitation Law passed by the Knesset in 2010. This framework sets limitations on both the budget deficit and government spending, with the ultimate objective of reducing the debt-to-GDP ratio to 60% by 2020. The framework includes fiscal deficit targeted of a maximum of 2% of GDP in 2012 and 1% of GDP in 2014. According to the expenditure rule introduced in 2010, the growth of general government expenditure in real terms may not exceed the average real GDP growth over the previous ten years multiplied by the ratio of the target debt-to-GDP ratio (60%) to the latest available annual debt-to-GDP ratio.

of GDP for 2013 and of 3% of GDP for 2014. It includes expenditure cuts (for example in defence expenditures) and increases in tax rates (VAT, marginal income taxes) to contain the deficit as economic activity remains weak.

Israel's foreign trade continued to slow down in the course of 2012. Significantly slowing exports volume growth reflected weakening foreign demand. Imports remained relatively strong, however, growing by 3.4%. Fuels mainly contributed to the overall import growth, while import of investment goods decreased. The current account has remained broadly stable since 2011, posting a slight deficit in 2012. FDI inflows remained strong in the year, although sloping downwards.

The financial system in Israel is dominated by banks and insurance companies. There is also an active market in shares and bonds. The banking sector is relatively unexposed to the financial constraints in other parts of the world, as it is mostly domestically owned and focuses its activities on the local market. The banking system is well capitalised, with the overall capital ratio having increased to 14.4% by mid-2012. Non-performing loans are relatively low, reaching 2.9% of total loans in 2012, and banks are generally well provisioned. The IMF staff, in its latest Financial System Stability Assessment (see IMF, 2012) concludes that Israel's financial regulation and supervision is strong and the financial sector robust.

Structural reform challenges

In view of the strained fiscal situation, the reform agenda, which was adopted at the end of 2011 after mass social protests in which people demanded a more equal distribution of earnings, lost its urgency and did not progress in 2012. Therefore, the intended measures aimed at reforming the tax system, increasing social and health spending, putting in place targeted schemes to encourage Arab and ultra-orthodox communities to participate in the work force and cuts in defence expenditure, did not take place to the extent initially envisaged.

In the business sector, liberalisation of the market has been introduced in the cellular communications market, resulting in an increase in market participants and enhanced competition, which has contributed to lower service prices.

The Israel economy is highly competitive, though in 2012 Israel's ranking in the World Bank's Doing Business indicator decreased, showing a negative tendency in seven of the ten indicators, especially for starting business, obtaining construction permits and getting electricity.

Risks and outlook

Despite a challenging global and regional environment, the Israeli economy has shown in recent years a relatively good macroeconomic performance, notably in terms of growth and labour market performance. However, growth further decelerated in 2012 and Israel faces considerable fiscal challenges if it is to comply with its fiscal rules while addressing the social demands expressed since the summer of 2011.

While GDP growth is expected to accelerate to 3.6% in 2013, this reflects a one-off effect from the launch of a natural gas field. The Bank of Israel estimates that, without the contribution of the natural gas drilling activity, GDP growth will remain moderate. Main factors influencing the downward pressures on growth rates are the significant slowing in investment and weak foreign demand.

Inflation is expected to remain limited in the short and medium term. The appreciation of shekel at the end of 2012, moderate wage growth, the stagnation of global activity and the stabilisation of the global commodity prices will all act to restrain upward price pressures in 2013.

Main risks to the growth outlook are mainly on the downside. They are largely external – a persistently weak global economy, an intensification of the euro area crisis, an abrupt fiscal restraint in United States, and the risk of a military confrontation in the region (notably one involving Syria or Iran). A further appreciation of shekel could weigh on economic activity by constraining export growth even further. On the domestic side, the fragility of the coalition government formed after the elections, fiscal policy uncertainty and geopolitical tensions in the region are the main risks.

Table IV.3.1:
Israel - Main economic indicators

	2009	2010	2011	2012	2013 projection
Output and prices					
Real GDP (% change)	1.1	5.0	4.6	3.2	3.6
GDP nominal (USD billion)	194.9	217.7	243.7	246.8	260.4
GDP per capita (USD)	26,333	28,643	31,643	30,970	32,674
Inflation (average, %)	3.3	2.7	3.5	1.7	1.9
Social indicators					
Unemployment rate (survey based, %)	7.7	6.7	6.8	6.5	6.4
Population (million)	7.4	7.6	7.7	8.0	8.0
Fiscal sector					
General government revenues (% GDP)	27.1	26.7	28.8	29.2	27.2
General government expenditures (% GDP)	32.4	31.5	33.6	33.1	31.9
General government balance (% GDP)	-5.3	-4.8	-4.7	-3.9	-4.7
Gross government debt (% GDP, end-period)	79.4	76.1	74.3	73.4	75.6
Monetary sector					
Key policy rate (%, end-period)	1.01	2.00	2.75	2.00	1.25
Domestic credit to the private sector (% change)	0.3	8.6	7.1	2.5	2.0
External sector					
Trade balance (% GDP)	3.0	2.2	-0.2	-0.3	1.0
Current account balance (% GDP)	4.2	3.7	1.4	-0.1	1.7
Net FDI (% GDP)	1.4	-1.6	3.2	2.9	n.a.
Gross external debt (% GDP)	48.0	48.9	42.5	37.9	38.0
Gross official reserves (USD billion, end-period)	60.6	70.9	74.9	75.9	74.2
In months of next year's imports of goods and services					
Exchange rates					
Exchange rate (new shekel per USD, average)	3.9	3.7	3.6	3.9	3.7
Exchange rate (new shekel per EUR, average)	5.5	4.9	5.0	5.0	4.8
Real effective exchange rate (% change, + is appreciation)	-1.8	5.1	1.4	-4.3	3.0

Sources: National Authorities; IMF; Commission Staff forecasts

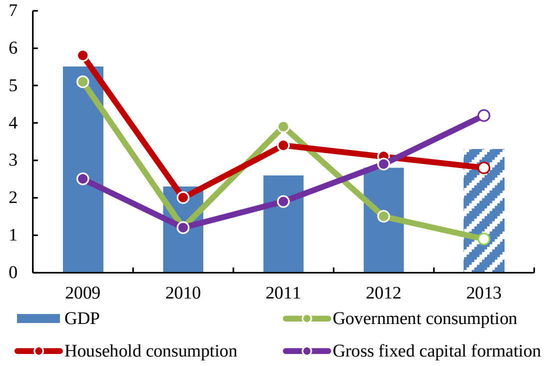
4. JORDAN

- ***Jordan has faced worsening economic conditions since 2011, due to the regional economic and political turmoil associated with the Arab Spring and the weaker global economy. These factors have negatively affected some of the main external drivers of economic growth, namely tourism and FDI.***

- ***The situation has been aggravated by repetitive disruptions of natural gas supplies from Egypt and the inflow of refugees from Syria.***

- ***The resulting fiscal and external imbalances led Jordan to request IMF assistance in mid-2012.***

Graph IV.4.1: **Jordan - GDP**
(year-on-year % change)



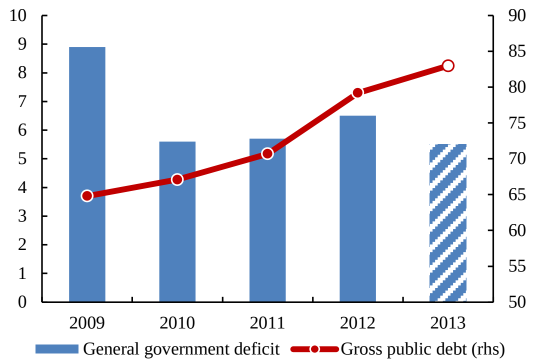
Source: IMF

Macroeconomic and financial developments

Since early 2011, Jordan's economy has been significantly affected by the domestic events related to the Arab Spring and the on-going regional unrest, notably in neighbouring Egypt and Syria. Combined with a weaker global environment, these factors have taken a heavy toll on external receipts and have strained public finances, as reflected in a deteriorating balance of payments and fiscal position. Lower tourism and FDI inflows, higher international energy prices and the repetitive disruptions to the flow of natural gas from Egypt, which forced Jordan to replace gas imports from Egypt with more expensive fuels for electricity generation, have put a drag on growth and resulted in a marked deterioration in the balance of payments. Jordan has also been affected by the intensification of the Syria crisis, notably through the inflow of refugees and its fiscal implications. These factors have also had a negative impact on the fiscal situation.

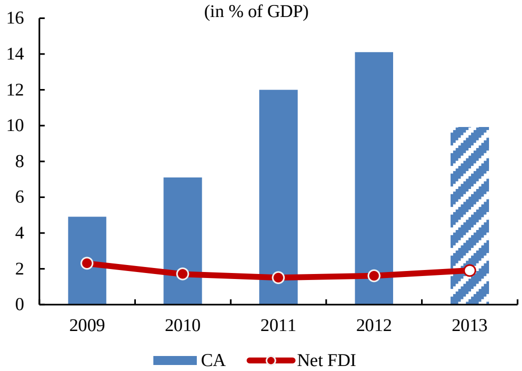
In this context, and following a period of robust economic growth averaging 6.5% during 2000-09, partly reflecting a propitious external environment, GDP growth reached 2.6% in 2011 and 2.8% in 2012. Weak performance, notably in the mining and construction sectors, partly contributed to this slowdown.

Graph IV.4.2: **Jordan - General government deficit and gross debt**
(in % of GDP)



Source: IMF

Graph IV.4.3: **Jordan - Current account and net FDI**
(in % of GDP)



Source: IMF

In 2013, real GDP growth is expected to accelerate to 3.3%, reflecting the increase in government capital spending, higher domestic consumption, and a recovery in merchandise exports and tourism.

Consumer price inflation increased slightly in the course of 2012, reaching an average of 4.8%, compared to 4.4% in 2011, as the impact of domestic fuel and electricity tariff increases was only partially offset by that of weaker domestic demand and the moderation in international food prices. The current fixed exchange rate policy (a peg to the US dollar) has also helped anchor inflation expectations. Inflation is nevertheless expected to rise further to 5.9% on average in 2013, partly as a result of the planned energy price adjustments. Since the middle of 2011, monetary policy has been tightened in order to preserve the attractiveness of Jordanian dinar-denominated assets. In July 2011, the central bank raised its policy interest rates by 25 basis points, followed by another 50 basis points rise in February 2012. In December 2012, the Overnight Window Deposit Rate was increased by another 75 basis points, while the interest rates on the Overnight Repurchase Agreement rate and the re-discount rate remained unchanged.

The external position has worsened since the beginning of 2011 due to the aforementioned shocks. The current account deficit (including grants) reached 12% of GDP in 2011 (19% of GDP excluding grants), up from 7.1% of GDP in 2010 (11.3% of GDP excluding grants), partly due to a 16.6% increase in the import bill. By the end of 2012, it had widened further to 18.1% of GDP (22.8% excluding grants), despite a 15.3% increase in tourism receipts (broadly attributed to the Arab countries) and a 3.5% increase of remittances. The projection is, however, that the current account deficit excluding grants will narrow down to 11% of GDP in 2013 (18.5% excluding grants) in view of increased export growth. The shortfall in FDI in 2011-12 further deteriorated the external position.

Financing needs for 2011-12 were largely met through foreign assistance (in particular form the GCC and the Bretton Woods institutions) and the mobilisation of international reserves, which fell significantly in 2011 (to USD 12.1 billion) and more dramatically in 2012, to reach USD 8.8 billion (4.7 months of imports) by the end of the year. The loss of reserves intensified in the final months of 2012, reflecting the social turmoil that followed the government´s decision to reform fuel subsidies in November as agreed with the IMF. In the first half of 2013, however, reserves recovered strongly (by about USD 3.3 billion), supported by disbursements of official assistance, including in particular the decision of UAE to advance to January 2013 the disbursement of the remainder (USD 1 billion) of its contribution to the USD 5 billion grant pledge made by the GCC countries for Jordan in 2011 (see below) and the release of budget support grants by Saudi Arabia (USD 300 million) and the United States (USD 200 million), as well as the domestic issuance of a US500 million foreign currency denominated bond.

Public finances have also been under strain due to the social expenditure packages adopted in 2011, the budgetary impact of the increase in energy import prices and the economic slowdown. The budget deficit, including grants and the transfer to the loss-making state-owned company NEPCO, increased from 5.6% of GDP in 2010 to 6.8% in 2011, while public debt rose to 70.7% of GDP at the end of 2011 from 67.1% a year earlier. Although the 2012 budget adopted in February envisaged a large fiscal adjustment compared to 2011, by mid-year it had become clear that this could no longer be possible, reflecting much higher than assumed fuel subsidies, a bigger wage bill due to the reform of the civil service, higher pension and health outlays, and spending on housing and medical assistance for Syrian refugees. ([70]) To mitigate debt sustainability risks and possible shortfalls in external flows, the government decided in May 2012 to take additional measures, amounting to 3.4% of GDP. The aim was to lower the overall deficit by approximately 1.5 percentage points of GDP. In this context, the government also took the decision to introduce a 6% tax on diesel and to remove subsidies from gasoline octane 90 in September 2012. The liberalisation of gasoline octane 90 took place in mid-November together with the lifting of

([70]) Jordan is facing increasing financing needs in part due to the on-going Syrian refugee crisis. With a large influx of Syrian refugees (in excess of 500,000 by mid-July 2013), Jordan is, together with Lebanon, the most affected country in the region. Since the outbreak of the Syrian conflict, budget finances have been under strain with the cost of hosting Syrian refugees exceeding EUR 600 million (around 3% of the country’s GDP). On the impact of the Syrian refugee crisis, see also Box II.1.1 in Part II.

subsidies on diesel, kerosene, and household gas prices.

In spite of these measures, the central government deficit is estimated to have increased from 6.8% of GDP in 2011 to 8.8% of GDP in 2012. For 2013, the IMF projects a further increase to 9.1% of GDP, partly reflecting delays in the adjustment of electricity tariffs (which will limit the reduction in NEPCO's operational loss), the cost of the Syrian refugee crisis and the still relatively weak economic growth.

Under the pressure of an increasing energy import bill and of the declining trend of international reserves in the first half of 2012, Jordan asked for financial support from the IMF. In August 2012, the IMF Board approved a USD 2 billion 36-month SBA for Jordan. Other large official lenders include the World Bank (which is preparing a Development Policy Loan in the amount of up to USD 250 million and an emergency loan in the amount of USD 150 million to help Jordan address the impact of the Syrian refugee crisis) and the French development Agency. Concerning official assistance in the form of grants, a USD 5 billion grant to be disbursed over five years was approved by the GCC in 2011 (equally distributed among Saudi Arabia, Kuwait, UAE, and Qatar and linked to development projects). The EU has made available EUR 293 million in grants for the period 2011-13, in addition to EUR 70 million allocated through the SPRING programme. Jordan has also requested Macro-Financial Assistance from the EU and an operation of up to EUR 180 million is under preparation.

Under the programme agreed with the IMF, substantial additional fiscal adjustment measures are planned for 2013, including increases in electricity tariffs, reductions in tax exemptions and possible, adjustments in excise taxes. The IMF programme also requires the adoption this year of amendments to the income tax law that would enter into force in 2014, increasing tax collections while moving to a more progressive regime of personal income taxation.

Structural reforms challenges

Jordan has made remarkable progress with structural reforms in a number of key areas. Over the last few years, reform efforts have been focused on the adjustment of energy prices, plans to diversify the energy supply (notably through the construction of a liquefied natural gas terminal in Aqaba, the development of the production of shale oil from domestic fields and the expansion of domestic gas extraction), measures to raise women's participation in the labour force, schemes to support SMEs access to finance, and the submission to parliament of legislative proposals on income taxation, public-private partnerships and social security reform.

Priority areas of economic reform remain the energy sector (which is important not only for fiscal sustainability but also to foster energy efficiency and security), tax reform (for which the adoption of the new income tax law is essential), social security reform, labour market reform (to reduce unemployment and encourage participation in the labour market, notably among women), financial sector development, public finance management reforms and measures to improve the regulatory framework and climate for investment.

Risks and outlook

Jordan faces serious macroeconomic vulnerabilities, stemming mainly from a persistently large current account deficit driven by a narrow export base and the dependence of the economy on the growth path of the Gulf countries. As a result of its relatively small industrial sector and lack of raw materials, Jordan has historically run large trade deficits. In this respect, the expansion and diversification of a relatively narrow export base remains paramount.

The immediate challenge for Jordan is therefore to reduce fiscal and external imbalances, so as to preserve macroeconomic stability. The country remains very vulnerable to high international energy prices and persistent gas supply problems with Egypt. Alternatives to natural gas for electricity generation (including new pipelines and ship-based liquefied natural gas imports) would be particularly helpful in cushioning the cost of energy imports over the medium term. At the same time, regional political events, including political unrest in neighbouring countries, could adversely affect economic activity through lower tourism receipts, exports and FDI, and more costly access to capital markets. Also, the political situation in Egypt could delay the normalisation of gas

Table IV.4.1:
Jordan - Main economic indicators

	2009	2010	2011	2012	2013 proj.
Real sector					
Real GDP (% change)	5.5	2.3	2.6	2.8	3.3
GDP nominal (USD billion)	23.8	26.4	28.8	31.4	33.8
GDP per capita (USD)	3,987	4,323	4,618	4,901	4,879
Inflation (average, %)	-0.7	5.0	4.4	4.8	5.9
Inflation (end-period, %)	2.7	6.1	3.3	4.4	4.2
Social indicators					
Unemployment (registered, %)	12.5	12.9	11.4	12.2	n.a.
Population (in million)	6.0	6.1	6.5	6.4	6.5
Fiscal sector					
Central government revenues (% GDP)	26.5	24.9	26.4	22.8	26.0
Central government expenditures (% GDP)	35.4	30.4	33.2	31.7	35.1
Central government balance (% GDP)	-8.9	-5.6	-6.8	-8.8	-9.1
Gross government debt (% GDP, end-period)	64.8	67.1	70.7	79.2	83.0
Monetary sector					
Domestic credit to private sector (% change)	0.5	7.2	9.6	6.7	9.0
Broad money (% change)	9.3	11.5	8.1	8.1	9.5
External sector					
Trade balance (% GDP)	-26.3	-25.7	-30.6	-33.7	-29.3
Current account balance (% GDP)	-4.9	-7.1	-12.0	18.1	11.0
Net remittances (% GDP)	2.7	2.7	2.6	2.6	2.9
Net FDI (% GDP)	2.3	1.7	1.5	1.6	1.9
Gross external debt (% GDP)	22.9	24.6	21.9	20.8	19.5
Gross international reserves (USD billion, end-period)	n.a.	n.a.	12.1	8.8	12.0
In months of next year's imports of goods and services	n.a.	n.a.	6.6	4.7	6.5
Exchange rates					
Exchange rate (JOD per USD, average)	0.7	0.7	0.7	0.7	0.7
Exchange rate (JOD per EUR, average)	1.0	0.9	0.9	0.9	n.a.
Real effective exchange rate (% change, + is appreciation)	-4.4	4.4	-1.2	1.4	n.a.

Sources: IMF

supplies from that country, while the prolongation of the Syrian conflict is likely to increase, as noted, the fiscal cost of the refugee crisis. Another key challenge is to improve labour market conditions, fight unemployment, and raise participation rates, especially among women and young people.

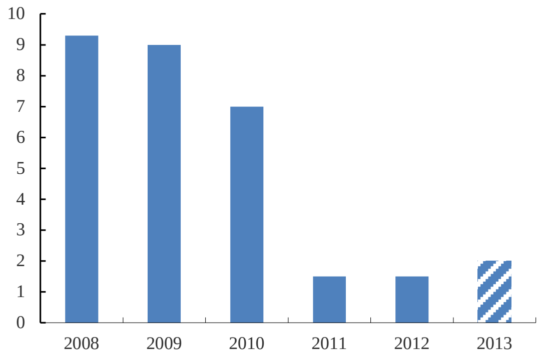
5. LEBANON

- ***The economic situation in Lebanon has been severely affected by the civil war in neighbouring Syria, evidencing the vulnerability of its economic drivers to external shocks.***
- ***However, in 2012, demand from Syria and Syrian refugees in Lebanon boosted trade and domestic consumption, partly offsetting the negative impacts of the Syrian crisis through other transmission channels.***
- ***Implementing a comprehensive and time-bound plan of fiscal consolidation, advancing with public finance management reform and promoting economic diversification remain key economic priorities for Lebanon.***

Macroeconomic and financial developments

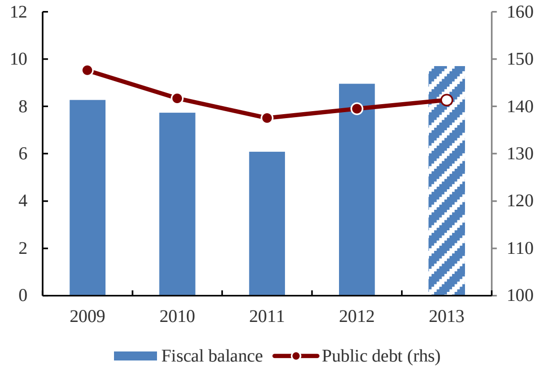
Lebanon's economic situation is being severely affected by the civil war in neighbouring Syria. Over the period 2007-10, GDP growth was remarkable for regional standards, exceeding 8%, with Lebanon being one of the EU's neighbourhood countries that showed most resilience to the 2008-09 global crisis. Nevertheless, activity weakened markedly in 2011 and 2012 with growth slowing down to 1.5% from 7% in 2010 – reflecting the weak economic situation in the region, the euro area recession (although Lebanon's exposure is lower than that of the Maghreb countries) and the tense domestic political situation, following the Syrian conflict. Financial services, tourism, trade and construction had been the economy's drivers since the early 2000s. However, since 2011, a gradual shift in economic patterns is taking place. In 2012, the increasing number of Syrian refugees partly upheld hotels' activities, the lower end of the real estate market and consumption. Growth was also sustained by bank lending to the private sector. In 2013, economic recovery is expected to be marginal, with GDP growth reaching 2%, and even this projection is dependent on political developments (i.a. evolution of the Syrian war and its implications for Lebanon) that are difficult to predict.

Graph IV.5.1: **Lebanon - GDP**
(year-on-year % change)



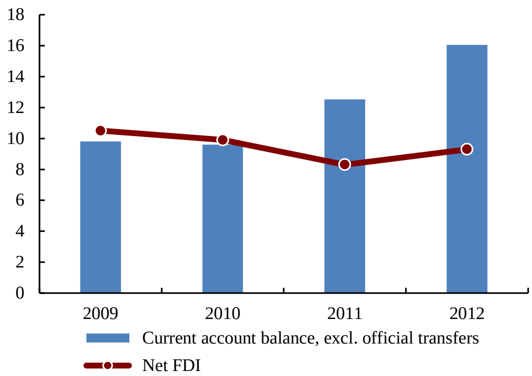
Source: IMF

Graph IV.5.2: **Lebanon - Fiscal deficit and public debt**
(in % of GDP)



Sources: National authorities; IMF

Graph IV.5.3: **Lebanon - Current account and net FDI**
(in % of GDP)



Source: IMF

Demand from Syria, where production and distribution channels have been badly disrupted, and from the Syrian refugee population within Lebanon, boosted trade and domestic consumption, partly offsetting the negative impacts of the Syrian crisis on Lebanon's traditional economic drivers. However, it also sustained inflation and caused additional strains on natural resources, basic services (notably water and electricity) and the budget.

In December 2012, inflation accelerated to 10.1% year-on-year (up from 3.1% in 2011), reflecting the strong demand from Syria for basic products and Lebanese-manufactured items, but also some changes introduced by Lebanon's statistical agency in the treatment of housing prices. In 2013, it is expected to decrease to 2.8% end-of-period.

In the past, Lebanon's monetary policy and the exchange rate peg to the US dollar supported investors' and market confidence and thus financial stability. In 2012, as the economic situation became increasingly fragile, the central bank intervened to keep interest rates stable, at the cost of a worsening balance sheet and dwindling foreign reserves. Interest rates on government treasury bills were steady following a 50 basis points rise in February 2012 that reflected the growing concern of the banking sector (which holds the bulk of the large public debt) about continuing to fund the public deficit. The government's stress on short-term borrowing further highlighted this reluctance and led the central bank to raise its share of public debt from 22.7% (end-2011) to 27.2% (end-2012).

While the share of public debt denominated in local currency remained relatively stable, slightly decreasing from 32.9% of GDP to 29.9% of GDP over the same time period, the foreign currency-denominated share jumped from 6.7% of GDP to 23.6% of GDP, as the bank used its large foreign exchange reserves to respond to the government's financing needs. The ensuing excess in liquidity in the private banking sector triggered a 10% increase in the lending portfolio to the private sector, not enough, however, to stimulate growth beyond the currently low levels. Consequently, in 2013, the central bank launched a stimulus plan to provide local banks with an additional 2.2 trillion Lebanese pounds (approximately USD 1.47 billion) in the form of loans at an interest rate of 1%. The aim is to bolster confidence and encourage lending, including for housing (56% of the envelope) and small and medium enterprises (SMEs).

The central bank's efforts to secure banks' liquidity and maintain, at least partly, investors' confidence contributed to a 6% increase in private deposits, which totalled USD 131 billion (308% of GDP) at the end of 2012. Total bank assets, for their part, grew by 8% over 2012 and amounted to 357% of GDP at the end of 2012, a very high ratio for international standards. The banks kept their robust performance, remaining profitable, highly liquid and well-capitalised. A significant proportion of their assets ([71]) are, as noted, devoted to holding a large share of the country's high gross public debt, which is one of the highest in the world.

The government's debt-to-GDP ratio improved slightly from 2009 to 2011 (due to both a relatively strong nominal GDP growth and the significant inflation rate) but increased again from 137.5% of GDP in 2011 to 139.5% in 2012 and is expected to reach 141% in 2013. In combination with large external financing needs, government debt poses a serious challenge to the country's economy. In spite of the 4.7% decrease in debt servicing requirements in 2012, these still absorbed 40.6% of total state revenues, seriously constraining fiscal room for key expenditure (e.g. social, infrastructure).

The central government's budget deficit ([72]), which stood at 6.1% of GDP in 2011, increased to 9% of GDP in 2012. In addition, and for the first time since 2006, there was a primary deficit (0.3% of GDP). Figures released by the Ministry of Finance also show a 5.6% increase in tax revenues, primarily due to a 6.3% increase of VAT receipts, but also reflecting dynamic import activity. The 2012 budget was approved by the government in July 2012, and sent to the Parliament, but remains unendorsed. Similarly, as of July 2013, the 2013 annual budget is the 8th consecutive budget that has not been endorsed by the legislative power.

([71]) 24.8% at the end of 2012. The Lebanese banking sector held approximately 54% of total public debt at the end of 2012.

([72]) I.e. excluding local authorities, local development funds, the 'Fund for the Displaced' and public enterprises.

On the expenditure side, transfers to the state-owned *Electricté du Liban* (EDL) absorbed 24% of total central state revenues in 2012, reaching 5.3% of GDP, an increase of almost 30% with respect to 2011. Energy costs will remain a drain on the government's finances, as long as no overhaul of the country's electricity system takes place (including a tariff grid review to match EDL's costs, improvements in the collection of electricity bills, and a shift towards other sources of energy. ([73])

As a net energy importer, Lebanon is particularly exposed to changes in global hydrocarbon prices. The population's reliance on private electricity generators increases the consumption of imported oil derivatives, thus aggravating the trade deficit. ([74]) Over 2010-12, the value of imports of oil derivatives increased by 60%; this rise cannot be explained by the constant power cuts and two cold winters alone. The worsening conflict and the sanctions imposed on Syria contributed to a surge in private imports of oil derivatives by Syria through Lebanon. Syria's partial collapse of state control has also led to an increase in across-the-border smuggling activities, reflected in the fact that official re-exports of oil derivatives from Lebanon only increased by 4% over the same period. As a consequence, Lebanon's trade deficit increased to 40% of GDP in 2012, up from 32% over the 2006-10 period.

Lebanon's current account has recorded large deficits during the last 15 years, averaging 12% of GDP over the 2000-10 period and 9.5% of GDP over the 2008-10 period. The widening trade deficit, combined with a negative net income due to relatively low returns on foreign reserves (when compared to the relatively high interest paid to foreigners holding Lebanese financial assets), further increased the deficit in 2011 to an estimated 12.5% of GDP. Available data for 2012 indicate an additional increase to 16.1% of GDP. Nevertheless, the central bank's large foreign exchange reserves (USD 35.7 billion at end-2012) continued to protect financial stability and gave credibility to the currency peg against the US dollar.

([73]) E.g. renewable sources and natural gas. Offshore exploration will likely only yield results over the medium term.

([74]) It also worsens pollution in urban centres.

Due to Lebanon's inflation differential with its main trading partners, the real exchange rate has been steadily rising for now two decades, thus severely affecting the competitiveness of the Lebanese economy over this period and contributing to the large current account deficit. In an effort to strengthen their price competitiveness, Lebanese employers have been progressively substituting local unskilled workers with less expensive manpower from Arab countries (Syria and Egypt) and the Indian subcontinent. In addition, the current Syrian refugee inflow (nearly 600,000 as of July 2013) is leading to a change in patterns in mid-level jobs. This has further intensified emigration abroad among those Lebanese with education, skills and family ties in foreign countries. Many unskilled people remain unemployed in the country, creating a potential source of social and political unrest. The informal sector remains large and is estimated at one third of the total economy. A study by the International Labour Organization (ILO) published in 2012 put the unemployment rate at 8.8% in 2010 (10.2% for women and 8.3% for men), underlining that the unemployment rate for the 15-24 years old was as high as 23.2% (27.7% for women and 23.4% for men), notwithstanding emigration. ([75])

The Syrian crisis has affected Lebanon's economic growth drivers (tourism and real estate) primarily in the Greater Beirut Area. On the other hand, the crisis has benefited, as noted, the import-export chain of basic goods to Syria and some manufacturers (and distributors) of basic products in peripheral areas (traditionally the poorest) of the country. The surge in imports to fulfil the needs of Syrian refugees and the Syrian market shows that Lebanon's domestic production is unable to respond to Syrian demand, challenging the economic policies followed during the past two decades, which neither developed its industry and agriculture, nor promoted diversification to expand the basis of the economy.

During the first half of 2013, Lebanon was governed by a caretaker government; socioeconomic tensions were escalating partly as a result of the Syrian crisis. As of July 2013, registered refugees alone amounted to 14% of the

([75]) The Central Administration of Statistics lacks resources to monitor the labour market; surveys are conducted by private universities and research centres.

population ([76]) and were scattered across the country, making their access to basic services extremely difficult (see Box 1 in Part II, Chapter 1). The authorities' inability to cope with a crisis that is having wide-ranging humanitarian but also political, security and socioeconomic consequences has increased risks in an already vulnerable macroeconomic situation.

Structural reform challenges

In 2012, in addition to the instability due to external factors, political disagreements both within the Cabinet and in the Parliament hindered implementation of much needed reforms in the areas of public finance management, social safety nets, civil service and public companies, rendering the fiscal situation increasingly fragile. The most debated and contentious budgetary issue was the funding of the new public salaries' grid ([77]), which spawned weeks-long demonstrations and strikes in early 2013.

There is a need for Lebanon to commit to a comprehensive and time-bound plan of public finance management reform. The government has been without an official budget since 2005. Public accounts have not been closed thoroughly since the early 1990s and Treasury accounts are deficient since 2000. Efforts are needed to make the budget exhaustive, notably by including detailed accounts of the various councils and funds. The modernisation of the public procurement law, as part of a broader effort to fight corruption and control expenses, has been on the agenda of both the public administration and the donors' community for years. The public service would benefit from reforms to attract skills and competencies so as to end the excessive use of external but permanent experts within parallel structures. A wide national consensus and a clear vision for tax reform that makes the system less distortionary and more progressive are needed. These would allow for the better collection of taxes (particularly on corporate income), bills (e.g. water and electricity) and penalties (public domain infringements, esp. maritime sector).

Last but not least, the liberalisation and privatisation of utilities face the challenge of risk-sharing between the public and the private sectors, as the private sector may not be willing to assume the financial risks related to bill collection. The privatisation of the telecommunications sector continues to be hampered by its sensitivity to security issues and by the fact that it currently provides the government with no less that 15% of total state revenues. Its privatisation presupposes, therefore, that the government is able to find alternative income sources. The recent debate on raising state revenues to finance an increase in the civil service payroll has shown, however, that a rebalancing of the tax system as well as the finding of new sources of state revenues faces considerable political opposition.

Risks and outlook

In contrast to the country's remarkable resilience to the global recession that started in 2008, the economic and political repercussions of the Syrian conflict, in spite of the official dissociation policy, are having a destabilising effect on Lebanon, reflecting its geographical proximity, and the complex linkages between the two countries. The perceived risk that Lebanon may be drawn into the conflict is adversely influencing economic activity. The current situation has evidenced the vulnerability of Lebanon's main economic drivers to internal instability and external shocks and underlined the need to diversify the economy and develop an inclusive growth model that reduces the currently high unemployment and inequality levels.

The supply of the Syrian market, the provision of basic goods and services to refugees in Lebanon, and the inflow of funds to support them has temporarily counteracted the negative impacts on the economy. However, as the Syrian conflict intensifies and the number of refugees grows, social and political tensions will increase. The fiscal impact of the refugee crisis, in combination with the economic slowdown, is exacerbating the country's fiscal and public debt problems. It may also further complicate the adoption of reforms,

([76]) Informal estimates place the number of Syrians in Lebanon at over one million already, i.e. 25% of the population.

([77]) Public salaries have not been reviewed for the past 16 years despite inflation and legal government obligations. Reforms to facilitate access to health services and pensions are also needed: less than half of the Lebanese population benefits from public health insurance and there is no pension system for the employees of the formal private sector. Discussions on a national pension scheme in 2008 were blocked at Parliament level and never pursued.

Table IV.5.1:
Lebanon - Main economic indicators

	2009	2010	2011	2012	2013 projection
Real sector					
Real GDP (% change)	9.0	7.0	1.5	1.5	2.0
Nominal GDP (USD billion)	34.7	37.1	39.0	41.4	43.8
GDP per capita (USD)	8,983	9,501	9,856	10,311	10,793
Inflation (average, %)	1.2	4.5	5.0	6.6	6.7
Inflation (end period, %)	3.3	5.1	3.1	10.1	2.8
Social indicators					
Unemployment (survey based, %)	6.4	6.0	5.8	n.a.	n.a.
Population (million)	3.9	3.9	4.0	4.0	4.1
Fiscal sector					
General government revenues (% GDP)	24.2	22.7	23.4	23.3	23.2
General government expenditures (% GDP)	32.8	30.6	29.6	32.4	33.0
General government balance (% GDP)	-8.3	-7.7	-6.1	-9.0	-9.7
Gross government debt (% GDP, end-period)	147.6	141.7	137.5	139.5	141.3
Monetary sector					
Broad money (% change) [1]	23.2	12.0	7.2	7.9	8.8
Credit to the private sector	15.1	24.8	11.0	10.0	n.a.
External sector					
Trade balance (% GDP)	-16.2	-15.9	-15.9	n.a.	n.a.
Current account balance (% GDP)	-9.8	-9.6	-12.5	-16.1	-16.1
Net FDI (% of GDP)	10.5	9.9	8.3	9.3	n.a.
Gross external debt (% GDP)	168.6	167.2	174.0	175.2	173.8
Gross official reserves (excluding gold, USD billion)	27.4	30.0	31.9	32.3	34.7
Financial sector					
Exchange rate (L£ per EUR, end-period)	2,095	2,095	2,095	2,095	2,095
Exchange rate (L£ per USD, end-period)	1,508	1,508	1,508	1,508	1,508

[1] Defined as currency in circulation plus resident and non-resident deposits (M5).
Sources: IMF, World Bank.

notably public finance management, tax and social safety net reforms.

The prospects of new income from the apparent offshore oil and gas resources are still remote: exploration will not start before the end of 2015 and revenues are not expected before 2020. In addition, experts fear that the oil and gas revenues might prevent sound public finance management system reforms, the reform of the energy sector to move towards renewable energies, and further fuel inflation, inequality and pollution levels in the country, aggravating the current factors of discontent and instability.

In sum, Lebanon's macroeconomic and structural reform challenges are being complicated by the economic spill-overs from the Syrian crisis, additionally compounded by the destabilising effect of Lebanon's current political situation. Ensuring fiscal sustainability, strengthening public finance management and diversifying the economy remain the key economic challenges for Lebanon. While the country has demonstrated in the past a capacity to live through difficult times, the current context underlines the importance of moving ahead in addressing long-term challenges.

6. LIBYA

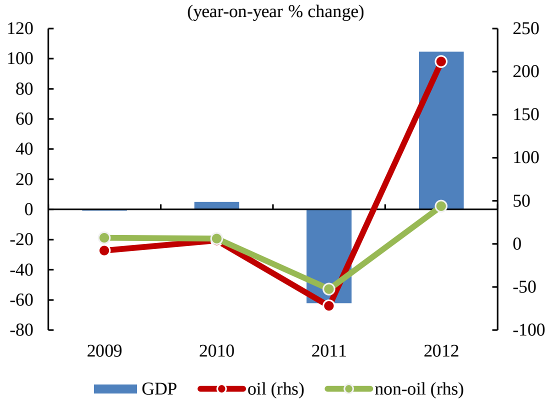
- ***The Libyan economy has recovered after the 2011 military conflict; it grew by more than 100% in 2012.***
- ***However, it remains fully dependent on hydrocarbon production, with 98% of exports and 96% of government revenues.***
- ***Development of a competitive private sector, economic diversification, improving governance and the promotion of inclusive growth remain the main challenges for the Libyan economy.***

Macroeconomic and financial developments

The Libyan economy remains fully dependant on hydrocarbon production, which accounted for 60% of GDP, ([78]) 98% of exports and 96% of government revenues, despite the fact that the non-hydrocarbon sectors gained importance in the years leading to the crisis of 2011. The conflict in 2011 triggered a 70% cut in oil production along with an estimated contraction of 53% in non-hydrocarbon output. This generated a contraction by 62% of Libya's economy in 2011.

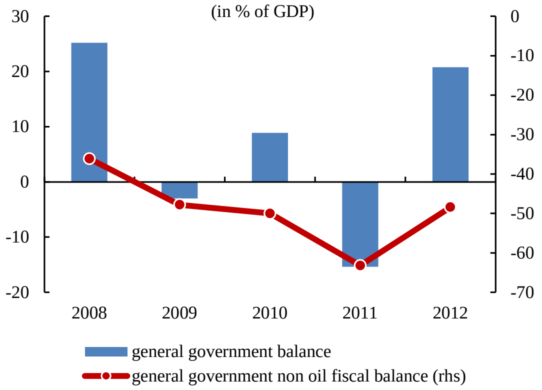
However, since then the economic shock has been largely reversed. The crude oil production has recovered faster than expected and by April 2012 nearly 90% of the level before the conflict had been reached. According to the EIA (US Energy Information Agency), Libya, a member of OPEC, produced 1.79 million barrels per day before the conflict. In April 2012 the production has been estimated to have reached 1.5 million barrels per day and remained relatively constant until the end of 2012 when it reached 1.64 million barrels per day. The recovery was heavily led by the oil production – oil GDP increased by 211% compared to 2011. As of early 2012, the country was the holder of proven oil reserves of 47.1 billion barrels, which is the largest reserve in Africa and among the ten largest globally. ([79])

Graph IV.6.1: **Libya - GDP**
(year-on-year % change)



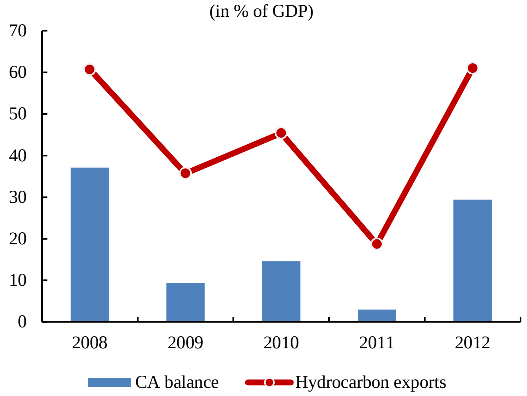
Source: IMF

Graph IV.6.2: **Libya- General government fiscal balance**
(in % of GDP)



Source: IMF

Graph IV.6.3: **Libya - Current account and hydrocarbon exports**
(in % of GDP)



Source: IMF

([78]) Libya – 2013 Article IV Consultation, IMF
([79]) Oil Market Report, U.S. Energy Information Agency, June 2012

The non-hydrocarbon economy has been boosted as well, through public spending, reconstruction and recovery in domestic demand. Overall, the GDP is estimated to have expanded by 104.5% ([80]) in 2012, reaching 77.5% of its 2010 level.

In 2011 the annual average inflation rate increased to 15.9% mostly due to the international sanctions and supply constraints. The normalisation of imports and transaction costs contributed to more moderated price growth in 2012, when the average inflation rate eased to 6.1%.

The local currency, the Libyan dinar, is pegged to the IMF`s special drawing rights, restraining the flexibility of monetary policy-making. The Central Bank of Libya lacked access to its foreign assets and was unable to provide sufficient foreign exchange due to sanctions during the 2011 crisis. Consequently, the value of the Libyan dinar in the parallel market fell to a half of its official value. Most of the international sanctions, which had frozen the country's foreign assets, were lifted in December 2011, leading to a normalisation of the exchange rate market and a recovery of liquidity of the banks. A very high level of central bank reserves (around 40 months of imports in 2012) ensured confidence in the currency and mitigated the economic impact of the conflict. The central bank's discount rate and reserve requirements have remained unchanged since the conflict at 3% and 20%, respectively.

During the 2011 crisis, government revenues declined and expenditure was limited due to financing restrictions and controlled capital flows. As a result, the budget is estimated to have recorded a deficit of 15% of GDP (compared to a surplus of 9% in 2010). However, there was a fast reversal in the fiscal position in 2012 on the back of the recovery of oil production. Revenues, including increases in public sector wages and subsidies, have surged 3.5 times in the year, while expenditures nearly doubled. Thus, the increased hydrocarbon output led to a fiscal surplus of estimated 20.8% of GDP. In the 2012 budget 13.8% of GDP was devoted to food-, fuel- and energy subsidies. The current account surplus plummeted to 3% of GDP in 2011 from 14.6% of GDP in 2010 due to the interruption of oil production. The increased hydrocarbon revenues and the slow recovery of imports have led to a current account surplus of 29.4% of GDP in 2012.

The direction of the Libyan oil exports in 2010 was mainly to the EU. Italy, France, Spain, Germany, Greece and United Kingdom received 72% of the Libyan oil.

The financial sector is mainly bank dependent. According to the IMF, it is well capitalised but shallow. Credit to the economy is very weak, as the lending possibilities to the non-hydrocarbon sectors are limited. Also the financial sector suffers from a lack of competition in the banking sector, a weak institutional framework and the fact that banks are mostly government owned. A law phasing out interest rates was passed in the beginning of 2013, as part of an effort to develop Islamic banking (see below).

Policy reforms and measures

While the Libyan government disposes of the financial means for recovering the country's economic potential, affected by the conflict, the development of a competitive private sector, economic diversification, improving governance and the promotion of inclusive growth remain crucial challenges. The economic policy in the medium term should focus on promoting overall development, increasing public investment and boosting job creation by developing the non-hydrocarbon sectors.

Several reform measures of the oil producing sector were announced in 2012. A new entity called the National Corporation for Oil Refining and Petrochemical Production is to replace the existing National Oil Corporation (NOC). The new corporation will be based in the east of the county, where most of the oil reserves are, in an attempt to decentralise power from Tripoli to other regions. The Libyan National Congress has created an energy committee, which consists of 15 members and plays a supervisory role – with the aim to make recommendations and to investigate corruption in the sector.

In the financial sector, the government is developing a framework for Islamic banking. Legislative measures have been taken to introduce

([80]) Macroeconomic data estimates used according to the IMF estimates in Regional Economic Outlook, November 2012, IMF Libya Article IV consultation, May 2013

Islamic financing in the banking law and phasing out conventional interest rates on financial transactions, indicating a clear shift towards the more vigorous application of Islamic laws. The banks are no longer allowed to pay interest to or receive interest from individuals, legal entities must cease interest based transactions by January 2015. However, without introducing a strong framework for deepening the financial sector and improving credit access to the private sector, this step risks to further delay the development of the non-hydrocarbon sectors of the economy.

The governance indicators remain very poor due to sustained low levels of corruption control, government effectiveness and regulatory quality, which are partly linked to the sharp increase in political instability and insecurity since the conflict in 2011.

Risks and outlook

Economic activity is expected to expand further, although the transition process will face delays owing to the security problems and political instability. The pre-crisis level of hydrocarbon production is expected to be reached during 2013. The investment, mainly public, will show sustained growth in the coming years as government will continue reconstruction and the further development of the economy. Private investment and imports are expected to pick up, as the economic diversification progresses.

However, upward pressures on inflation due to expansionary fiscal policy will persist. At the same time, it is expected that any pressure from an increase of global food and fuel prices would be compensated by an increase in subsidies, which, in turn, would lead to further fiscal expenditure.

Consequently, under pressure from popular expectations, the government's expenditure (both current and capital) is likely to continue growing in the coming years. Concurrently, the share of oil revenues in the fiscal income (96%) is expected to decline, as the government pursues investments in other sectors of the economy.

The inflationary pressures are expected to continue easing as the situation stabilises. At the same time, the recovery of domestic demand and wage growth are expected to lead to moderate price increases. The central bank is not likely to change the interest rate as the liquidity in the banking sector has stabilised and inflationary pressures are easing. However, it can be expected that the central bank will cut the reserve requirements in order to spur business loans and enhance the participation of the private sector in the economic activity.

The risks to Libya's growth prospects include lower global oil prices, due to the stagnating global economic growth and, more crucially, delays in normalising the security situation that would trigger political instability, as well as a further delay in strengthening the weak administrative capacity and economic governance.

Table IV.6.1:
Libya - Main economic indicators

	2009	2010	2011	2012	2013 projection
Output and prices					
Real GDP (% change)	-0.8	5.0	-62.1	104.5	20.2
Real GDP non-hydrocarbon (% change)	7.1	6.1	-52.5	43.7	24.5
GDP nominal (USD billion)	63.1	74.8	34.7	81.9	94.6
GDP per capita (USD)	9,943	11,508	5,422	12,700	14,300
Inflation (average, %)	2.0	2.5	15.9	6.1	2.0
Social indicators					
Unemployment rate (survey based, %)	20.7	20.0	n.a	n.a	n.a.
Population (million)	6.3	6.4	6.3	6.4	6.5
Fiscal sector					
General government revenues (% GDP)	52.9	64.9	50.3	72.3	72.9
General government expenditures (% GDP)	55.9	56.1	65.7	51.5	53.7
General government balance (% GDP)	-3.0	8.9	-15.4	20.8	19.2
General government non oil (% GDP)	-47.8	-50.0	-63.2	-48.4	-50.3
Monetary sector					
Domestic credit to the private sector (% change)	0.5	4.1	-2.6	4.5	1.4
External sector					
Trade balance (% GDP)	15.1	22.2	7.9	36.5	34.1
Current account balance (% GDP)	9.4	14.6	3.2	29.4	24.9
Net FDI (% GDP)	0.3	-1.3	-0.2	n.a	n.a.
Gross external debt (% GDP)	8.8	7.6	15.6	6.5	5.7
Gross official reserves (USD billion, end-period)	98.9	101.8	11.0	124.5	142.3
In months of next year's imports of goods and services	n.a	78.3	41.6	36.1	39.7
Exchange rates					
Exchange rate (dinar per USD, end -period)	1.2	1.2	1.2	1.3	n.a
Exchange rate (dinar per EUR, end-period)	1.7	1.6	1.6	1.7	n.a
Real effective exchange rate (% change)	n.a	0.3	-6.4	n.a	n.a

Sources: IMF, EIU

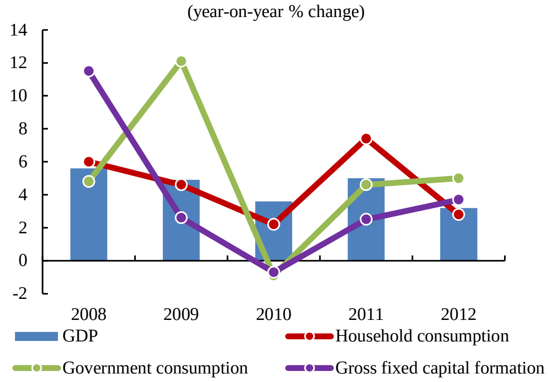
7. MOROCCO

- ***Despite sound economic policies and robust growth in a tumultuous 2011, the weak international environment and a poor harvest led to a deceleration of economic activity in 2012.***

- ***Morocco's external vulnerability accentuated further in 2012 owing to high international oil and food prices since 2011. These developments also affected the fiscal stance due to the generalised subsidies system, although the impact was somewhat contained thanks to the increase of some energy-administered prices and spending controls.***

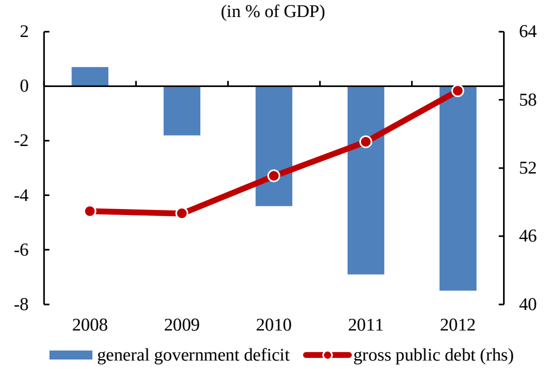
- ***Notwithstanding the stable macroeconomic environment and a precautionary agreement with the IMF confirming the soundness of economic policies and providing an insurance against further external shocks, Morocco has little room for complacency and should continue the path of economic reform in order to improve the resilience of the economy against further shocks.***

Graph IV.7.1: **Morocco - GDP**
(year-on-year % change)



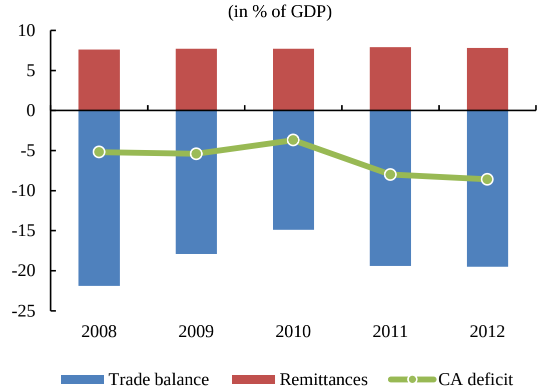
Sources: IMF

Graph IV.7.2: **Morocco - General government balance and debt**
(in % of GDP)



Sources: IMF

Graph IV.7.3: **Morocco - Current account**
(in % of GDP)



Sources: Bank al Maghrib; IMF

Macroeconomic and financial developments

Despite strong headwinds, Morocco's economic performance continued to benefit from a tradition of sound economic policy implementation throughout 2012. Morocco posted GDP growth of 5% in 2011, assisted by robust private consumption which cushioned weak external demand. This occurred in the context of a stable political transition process that saw the adoption of a new constitution in July and the holding of parliamentary elections in November leading to the formation of a new government in January 2012.

Climatic and external conditions, however, combined to prompt a slowdown in economic growth in 2012, estimated at 3.2%, although non-agricultural growth, in particular industrial output, remained robust. Growth is forecast to recover slowly in 2013 aided by a good harvest on the back of significant rainfall received in the latter part of 2012, although the weak outlook in the euro area will continue to weigh down on Morocco's economic activity, in particular through the channels of remittances and investment flows. Counter-intuitively, tourist arrivals from the EU continued to develop favourably, in particular from countries such as Spain and France, probably explained by the rerouting of tourist travel away from more politically unstable countries, although tourism spending fell in 2012.

The relatively robust macroeconomic performance helped to keep unemployment from rapidly expanding. Unemployment remained under control – 9% by end-2012 – throughout 2011-12, although significant differences persist across regions and population categories. As is customary across the region, unemployment affects disproportionately the youth (20% of Moroccans aged 15-24 and 14% for those aged 24-34) and those with higher educational degrees (17% of College graduates). Unemployment is also noticeably higher in urban areas. The gender gap is not large, with 9.2% unemployment for men, and 10% for women.

Inflation hovered, for the third consecutive year, around 0.9% in 2011, and edged slightly upwards in 2012 to 1.3% despite price increases of gasoline (+20%), diesel (+14%) and fuel oil (+27%) in June 2012. Morocco's persistently low inflation has facilitated the conduct of the monetary policy; the central bank has maintained the policy interest rate at 3.25% for a decade, except for a temporary 25 basis points increase in late 2008 owing to the outburst of the financial crisis. In March 2012, in view of weak growth prospects and contained inflationary pressures, the bank cut the policy rate further to 3%, and has kept it unchanged since. The exchange rate regime, a tightly managed float strongly linked to the euro, which has limited much of the dirham variation, also contributed to a stable monetary environment.

The financial sector remained strong and relatively unaffected by the turmoil in foreign financial markets. Capital adequacy and profitability ratios remained sound. Credit to the economy grew by 7% in 2011 driven by housing and private consumption, but credit growth decelerated to 5% in 2012, reflecting lower demand for credits to housing and corporates, whereas credit for private consumption remained strong. The decline in structural liquidity in 2012 was compensated by the money market interventions of the central bank seeking to maintain an adequate degree of credit growth to the economy.

Rising energy prices since 2011 have negatively impacted Morocco's external position. The current account deficit more than doubled, from 3.7% of GDP in 2010 to 8.0% in 2011, owing largely to the rising oil import bill, despite a good export and remittances performance. The trend was aggravated in 2012 as the import bill's growth (6.7%) doubled that of exports (3.6%), due to the continued price rises of hydrocarbon imports (+20%), as well as to rising import volumes of capital goods and food products. The export performance was driven by the good progression of the aerospace and automotive sectors, although the quasi-stagnation of the phosphate sector as well as the fall in exports of textile and leather products, and electronics, affected the export performance. The services balance surplus was unable to finance the trade deficit, as remittances and tourist revenues fell by 4% and 2% respectively, each representing nearly 7% of GDP.

Despite a healthy performance of the financial account, the external pressures from the current account led Morocco's international reserves position to weaken considerably in the last two years; the country's gross international reserves fell by over USD 6 billion to USD 17.6 billion by end-2012, equivalent to about four months of imports.

Starting in 2011 strong expenditure pressures relating to the rise in energy prices and to the social demands of the Arab Spring, drove up the fiscal deficit. A generalised subsidies system of energy products and foodstuffs in the context of rising prices of these products led to expenditure outlays in 2011 of about 5.5% of GDP, more than double the budgeted amount. To this were added further expenditure pressures in the context of the February social protest movement, including an increase of the wage bill. Despite strong offsetting measures, the combined effect of these developments was to bring the deficit up from 4.4% of GDP in 2010 to 6.9% in 2011. These pressures continued to be at work in 2012 thereby prompting an acceleration of expenditure, despite renewed efforts at reducing discretionary spending, and a good revenue performance. Expenditure in general subsidies stood at about 6.6% of GDP in 2012, despite the increase in prices in June. Higher than planned investment and the sustained increase in civil service wages led Morocco's fiscal deficit to deteriorate to 7.5% of GDP in 2012, whereas it was aimed to fall to 6.1% in the context of the IMF programme. The public debt-to-GDP ratio is estimated to have increased in two years by seven percentage points to nearly 60% at the end of 2012. The authorities remain committed to reducing the deficit below 3% of GDP by 2016.

Morocco benefits since August 2012 from a two-year Precautionary Liquidity Line (PLL) from the IMF worth USD 6.2 billion. This instrument is available to countries with sound economic fundamentals and a good track record in policy implementation although subject to vulnerabilities. By its very adoption, the PLL is helping to strengthen investors' confidence in Morocco's economy and facilitate the country's access to financial markets. In addition, the PLL grants an insurance-type benefit, as it offers access to financing in the event that sudden external needs arise. To date, Morocco's continued access to domestic and international financial markets, without having effectively tapped the PLL resources, is demonstrated by Morocco's USD 1.5 billion bond issuance in December 2012, carrying a relatively low risk premium. The success of the December emission prompted Morocco to plan a further bond issuance of USD 750 million.

Policy reforms and measures

Against a background of high energy prices and weak external demand which exposed Morocco's external and fiscal vulnerabilities since 2011, and is still subject to important downside risks, Morocco's stable economic policy record facilitated its access to a precautionary IMF arrangement.

There is, however, little room for complacency. Morocco should continue to work to reduce its external vulnerability through increasing its export potential by improving the business climate, investing in education and training, and further attracting foreign investment. The establishment of a DCFTA with the EU will provide further impetus in this regard. In the meantime, the successful foreign bond issuances will serve to soften the domestic liquidity constraints and prop up the country's foreign exchange position. In parallel, Morocco should reach a national consensus on reforming the generalised subsidy system in order to reduce its cost, improve social targeting and create the fiscal space to increase investments in human and physical capital while ensuring fiscal sustainability over the medium term. Budget execution figures for the first few months of 2013 reinforce the urgency of this reform. At the same time, although much progress has been achieved in social indicators over the past decade, further efforts need to be made in the fight against poverty, unemployment, illiteracy and access to infrastructure, basic health, and education. Morocco ranks 130th (out of 187 countries) in the United Nations' Human Development Index – the lowest of the ENP South countries. This exemplifies its low human development relative to countries with similar GDP per capita levels.

Risks and outlook

Provided that further downside risks do not materialise, in particular a re-intensification of the euro area crisis or further unexpected increases in international oil prices, and that Morocco continues to push through reforms that ensure the stability of the public finances, the country is forecast to slowly close the output gap and reach pre-crisis growth rates. Furthermore, if the planned structural reforms continue apace, Morocco could even raise its potential output. The outlook will be facilitated by the contention of social pressures and the accompaniment of an IMF precautionary programme, which provides a guarantee of sound economic policies and an insurance against downside risks.

On the external side, Morocco should strive to reduce its external vulnerability. Even in the event that international oil prices stabilise over the medium term, financing of the import bill will be challenging. In 2002, exports could finance 66% of imports. By 2012, this ratio had fallen to 47%, owing, to a large degree, to the rise in the energy import bill. Income from tourism, remittances and foreign assistance will continue to be insufficient to cover the import needs, hence keeping the current account deficit high. It will be fundamental that Morocco continues to pursue policies that raise its export potential, as well as improves energy efficiency and diversification, and gradually removes the insulation of the domestic price of energy relative to the international price.

Table IV.7.1:

Morocco - Main economic indicators	2009	2010	2011	2012	2013 projection
Real Sector					
Real GDP (% change)	4.9	3.6	5.0	3.2	4.5
GDP nominal (USD billion)	90.9	90.8	99.2	97.5	104.8
GDP per capita (USD)	4,546	4,683	4,844	4,725	5,018
Inflation (average, %)	1.0	1.0	0.9	1.3	2.4
Inflation (end-period, %)	-1.6	2.2	0.9	2.3	2.5
Social indicators					
Unemployment rate (survey based, %)	9.1	9.1	8.9	9.0	n.a.
Population (million)	31.6	32.0	32.3	32.6	33.0
Fiscal sector					
General government revenues (% GDP)	29.3	27.5	27.8	27.7	28.2
General government expenditures (% GDP)	31.1	31.9	34.6	35.2	33.7
General government balance (% GDP)	-1.8	-4.4	-6.9	-7.5	-5.5
Gross government debt (% GDP, end-period)	48.0	51.3	54.4	59.6	61.2
Monetary sector					
Key policy rate (%, end-period)	3.25	3.25	3.25	3.00	n.a.
Domestic credit to the private sector (% change)	6.9	5.1	7.0	5.1	6.1
Broad money (% change)	7.0	4.8	6.5	3.3	7.9
External sector					
Trade balance (% GDP)	-17.9	-14.9	-19.4	-19.5	-19.7
Current account balance (% GDP)	-5.4	-3.7	-8.0	-8.6	-6.6
Net remittances (% GDP)	7.7	7.7	7.9	7.8	7.5
Net FDI (% GDP)	1.7	0.8	2.3	2.3	2.8
Total external debt (% GDP)	23.3	24.7	23.6	26.4	27.5
Gross official reserves (USD billion, end-period)	23.6	23.6	20.6	17.6	n.a.
In months of next year's imports of goods and services	7.1	5.7	5.1	4.1	n.a.
Exchange rates					
Exchange rate (MAD per USD, average)	8.06	8.40	8.04	8.61	8.65
Exchange rate (MAD per EUR, average)	11.22	11.13	11.31	11.07	11.51
Real effective exchange rate (% change, + is appreciation)	1.9	-4.1	-1.7	n.a.	n.a.

Sources: Ministry of Economy and Finance, Bank al Maghrib, IMF, EIU, Commission calculations

8. PALESTINE

- ***Economic growth in Palestine decelerated in 2012 on the back of a major donor shortfall and a slowdown of the easing of restrictions on movement and access imposed by Israel.***

- ***At the beginning of 2013, Palestine experienced a severe fiscal crisis which was the result of donor shortfalls, higher-than-expected expenditure and lower-than-expected revenue. This was exacerbated by measures imposed by Israel in response to Palestine's successful bid at the UN.***

- ***Private sector development is central to the growth potential of Palestine. However, this remains contingent on the removal of Israeli restrictions as well as a functioning Legislative Council and apposite policies by Palestine.***

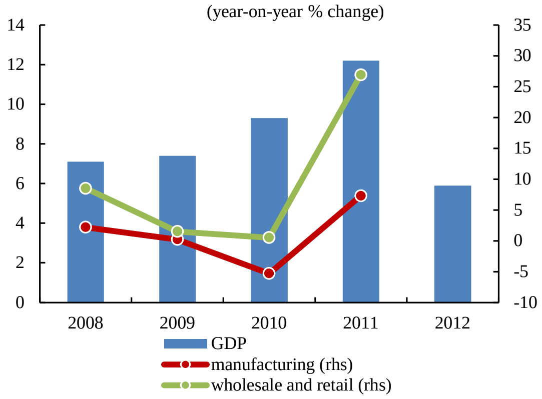
Macroeconomic and financial developments

Real GDP growth in Palestine moderated to 5.9% in 2012 after several years of strong recovery (12.2% in 2011). This deceleration mainly reflects a slowdown in the easing of restrictions imposed by Israel, as well as a decline in donor aid. In Gaza, growth was very strong in 2010 and 2011, at 19.5% and 23% respectively, following the easing of the Israeli blockade in 2010. However, the momentum has ceased in 2012 with growth slowing to 6.6% in Gaza and 5.6% in the West Bank.

Growth in the construction and services sectors in Gaza was considerable, at 24.7% and 14.6% respectively due to easing of restrictions on construction materials since 2010 and an increase in tunnel trade. Conversely, the agriculture and fishing sector contracted by 32.8% due to the Israeli ban on agricultural exports to Israel and on the movement of products to the West Bank. In addition, estimates by the authorities show that tunnel trade between Gaza and Egypt was reduced to only 10% of what it was during the first half of 2012 as a result of a crackdown by the Egyptian government following the attack on Egyptian troops in the Sinai in September 2012.

Graph IV.8.1: **Palestine - GDP**

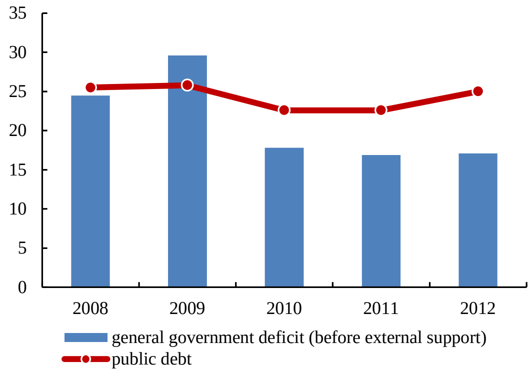
(year-on-year % change)



Sources: National authorities; IMF

Graph IV.8.2: **Palestine - General government deficit and gross debt**

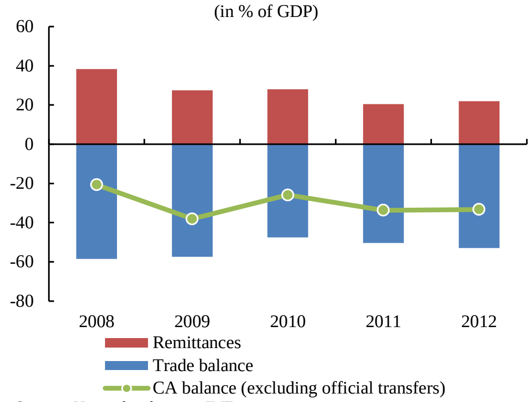
(in % of GDP)



Sources: National authorities; IMF

Graph IV.8.3: **Palestine - Current account**

(in % of GDP)



Sources: National authorities; IMF

Unemployment is high and rising. It increased from 21% in 2011 to 23% in 2012. This is largely a consequence of Israeli restrictions in Area C in the West Bank, which constrain potential expansion in labour-intensive sectors such as manufacturing and agriculture, as well as the blockade in Gaza. Restrictions on the number of West Bank Palestinians who can work in Israel further exacerbate unemployment. The number of workers from the West Bank employed in Israel dropped from 21% of the overall Palestinian workforce before the outbreak of the Second Intifada in 2000 to on average 12-14% since then. The equivalent rate in Gaza was 13% before 2000 and has been 0% since 2006. Low labour force participation remains a particular challenge at 43.9% in 2012. The overall female labour participation rate was particularly low at 17.9%.

Inflation has remained quite low in the past few years and decelerated slightly in 2012 to 2.8% (average) from 2.9% in 2011. Inflation in Palestine is largely imported from its main trading partners. As food carries the highest weight in the CPI, world food prices have a large impact as well, as do the exchange rates of Palestine's different currencies. The economy relies on the use of three major foreign currencies, namely the Israeli shekel, the Jordanian dinar and the US dollar. The absence of a single currency leaves the Palestine Monetary Authority without important monetary policy tools, such as Open Market Operations, that are necessary for liquidity management purposes and for stimulating the economy.

The Palestinian Authority's (PA) fiscal crisis is acute and worsening. In 2012, significant donor shortfalls, higher-than-expected expenditure (pensions and net lending) and lower-than-expected revenues left a large financing gap of more than USD 200 million, which had to be covered by further accumulation of arrears and increased indebtedness to the banking sector.

Net lending from domestic banks raised the stock of government debt to the banking system to USD 1.4 billion at the end of 2012 (equal to 112% of banks' equity). In addition, it has accumulated a large stock of arrears (approximately 6% of GDP) to private suppliers, the public pension fund and public sector wages, which has a stifling effect on private sector activities. Due to delays in public sector wage payment, bank credit to PA employees increased from USD 300 million at end-2010 to USD 700 million at end-2012.

The fiscal crisis has been further exacerbated by Israel's measures following Palestine's successful bid for non-member observer status at the UN. Clearance revenue, collected and transferred to the PA by Israel, make up around 75% of total revenue. In December 2012 and again in January and February in 2013, Israel withheld these revenues in response to Palestine's UN bid. While the revenue due in December was used to pay back private debt to the Israeli electricity company accumulated within Palestine, revenue due in January and February was later released with a delay. However, this unreliability of revenue collection makes budget planning extremely difficult and has a destabilising effect on the economy as a whole.

In addition, donor aid tends to be unpredictable as well. Arab states were slow to realise their promise of a USD 100 million a month 'safety net' in response to the measures; it was not until mid-January that Saudi Arabia transferred USD 100 million to the PA. Moreover, the US Congress withheld USD 200 million in external aid to Palestine in response to the UN bid, though that sum was later transferred to Palestine in March 2013 during President Obama's visit to the region. ([81])

The 2013 budget was approved by the now former cabinet under Prime Minister Fayyad and President Abbas in late March. It foresees a recurrent budget deficit of 11.8% of GDP, down from 14.6% in 2012. This projection includes external budget support of USD 1 billion, leaving a financing gap of around USD 400 million. Considering the many downside risks to the budget, including unpredictable donor support and clearance revenue, the authorities have discussed a possible contingency plan with the IMF that would include a wage and promotion freeze, a cap in the rise in transfers and a rationalisation of selected allowances. In addition, a mobilization of additional donor aid from international partners,

([81]) Meanwhile, the EU has paid in full its committed financial aid in 2012 (EUR 300 million) and has announced a EUR 100 million top-up of its commitment of EUR 200 million for 2013.

including from Arab countries, could help alleviate the considerable pressure the PA is under.

The external sector is extremely weak. The trade deficit worsened markedly in 2012 and continues to be very high at 53% of GDP, illustrating Palestine's reliance on imports combined with a weak export sector. This translates into a high current account deficit, albeit mitigated to some extent by positive net unilateral transfers and net factor payments (mainly compensation of workers abroad). It decreased only slightly in 2012 to 33.3% of GDP from 33.7% of GDP in 2011, excluding official transfers (23.9% and 23.6% when including official transfers). Official reserves, though improving significantly in 2012 and in the first half of 2013 (USD 671 million at end-May 2013 compared to USD 498 million at end-2011), are very low, covering less than two months of imports.

Despite several challenges, the Palestinian banking system is performing well, mainly due to limited exposure to global markets, but also due to conservative practices in private sector lending. Private sector lending has increased in the past two years, triggered by improvements in the financial market structures. Measures included an increase in the minimum capital requirements, new rules regarding reserve requirements and quarterly stress tests on banks. The Palestine Monetary Authority has also developed a road map for the implementation of Basel II/III standards and made some progress towards its implementation. The non-performing loan ratio has decreased gradually from 8% in 2008 to 3.3% at the end of 2012. Main challenges include the increased exposure of domestic banks to PA lending and the absence of the Legislative Council, which is hindering the formulation of an effective legal framework for the financial sector.

Policy reforms and measures

The most pressing structural reform priority for Palestine is private sector development, given the PA's dependency on external aid and on the clearance revenue collected by Israel. However, much of the reforms needed are dependent on actions by Israel. In fact, the restrictions imposed on economic activity in Area C, which covers around 60% of the West Bank, and the continued blockade of Gaza remain the main obstacles. Area C is key to economic cohesion and access to natural resources and has the potential to spur growth in private investments. Other major challenges to private sector development include problems with access to visas and residence permits for potential investors issued by Israel. Still, many issues are under the remit of the Palestinian side as well, including the absence of the Palestinian Legislative Council as well as key structural reforms (see below).

As regards reforms of public finance management, progress has been substantial in the last five years. Before 2007, the PA had a weak public finance management system with little control over aid inflows, fragmented banking arrangements and an underdeveloped budget and fiscal reporting procedure. With the introduction of a Single Treasury Account and a Financial Management Information System in 2008 and a Commitment Control System in 2010, the Ministry of Finance is now in control of expenditure and revenue flows. Since 2010, the State Audit and Administrative Control Bureau audits previous years' accounts. However, the liquidity constraints of the PA threaten to erode the substantial progress in PFM that has already been achieved.

Other key structural reforms include pension and civil service reforms, strengthening the social safety net, commercializing the electricity distribution, enhancing the regulatory framework facing businesses, reinforcing the revenue administration and implementing the public procurement law approved in late 2011.

Risks and outlook

The growth outlook for Palestine in 2013 and beyond is highly dependent on the actions of Israel going forward, in light of the restrictions imposed on economic activity in some parts of the West Bank and the blockade on Gaza. If the current sanctions were to remain in place long term, it would likely lead to reduced growth and increased unemployment and poverty. A reduction in the number of work permits and a reduction in movement and access would have a detrimental effect on growth and employment, and, in turn, on the social, political and security situation. Moreover, as Palestine's main trading partner, Israel's continued demand for Palestinian exports is vital for the Palestinian economy. The growth

Table IV.8.1:
Palestine - Main economic indicators

	2009	2010	2011	2012	2013 projection
Output and prices					
Real GDP (% change)	7.4	9.3	12.2	5.9	4.3
GDP nominal (USD billion)	6.7	8.3	9.8	9.9	11.1
GDP per capita (USD)	1,708	2,061	2,345	2,316	2,510
Inflation (average, %)	2.8	3.7	2.9	2.8	2.8
Social indicators					
Unemployment rate (survey based, %)	24.5	23.7	20.9	23.0	22.0
Workers in Israel to workers total (%)	10.2	10.5	10.0	13.0	n.a.
Poverty rate (%)	22.6	25.7	25.8	n.a.	n.a.
Population (million)	3.9	4.0	4.2	4.3	4.4
Fiscal sector					
General government revenues (% GDP)	23.8	22.6	20.9	20.8	21.0
General government expenditure (% GDP)	47.5	36.8	34.0	35.5	32.8
Public sector wage bill (% GDP)	21.8	19.3	18.2	17.8	17.0
Non-wage expenditure (% GDP)	20.1	14.7	14.3	14.9	14.6
Net lending (% GDP)	5.6	2.8	1.4	2.8	1.2
General government balance after external support (% GDP)	-3.5	-2.5	-6.8	-7.7	-5.1
General government balance before external support (% GDP)	-29.6	-17.8	-16.9	-17.1	-14.9
Total external support incl. for development (% GDP)	26.1	15.3	10.1	9.4	9.8
Gross public debt (% GDP)	25.8	22.6	22.6	25.0	n.a.
Monetary sector					
Domestic credit to the private sector (% change)	22.9	31.1	23.8	14.2	13.2
External sector					
Trade balance (% GDP)	-57.4	-47.5	-50.4	-53.0	n.a.
Current account balance (% GDP) (excluding official transfers)	-38.1	-25.9	-33.7	-33.3	-29.7
Net remittances (% GDP)	27.5	28.0	20.5	21.9	n.a.
Net FDI (% GDP)	4.7	1.2	2.6	2.5	n.a.
Gross official reserves (USD billion, end-period)	0.5	0.5	0.5	0.7	n.a.

Sources: IMF, national authorities

outlook also depends on the stability and viability of the government institutions, which in turn are contingent on the collection and timely transfer of clearance revenue which is the main source of revenue and therefore vital for the payment of public sector salaries.

At the same time, the relationship with Israel is linked to Palestine's internal developments, not least the reconciliation between Hamas and Fatah. If and when a unity government is formed, this will lead the way to much-awaited parliamentary and presidential elections in order to form a stable and representative government that would be able to normalise relations with Israel. All the while efforts by the United States to revive peace talks in 2013 are on-going. Needless to say, Palestine is at a critical juncture. Many difficult decisions will need to be taken and implemented before Palestine will be able to pursue the necessary steps towards ensuring both fiscal and macroeconomic stability.

9. SYRIA

- ***Since violence started in March 2011, the conflict in Syria has escalated into a full-fledged civil war, which has led to a serious humanitarian crisis.***

- ***While available statistical data are limited, the conflict has produced an important deterioration in the domestic macroeconomic situation, with growth, the fiscal position and the balance of payments all being very negatively affected.***

- ***Syria is now running a war economy, with the majority of the budget being spent on its military and civil service in an attempt to keep the government going.***

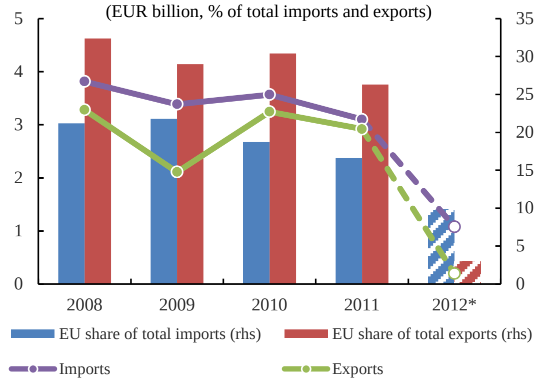
- ***Diminishing imports, destroyed infrastructure and the decrease in agricultural production, have also contributed to inflationary pressures with a steep increase in the cost of living.***

Macroeconomic and financial developments

Since violence started in March 2011, the conflict in Syria has escalated into a full-fledged civil war and has produced a severe and protracted humanitarian crisis. The conflict is having a strong negative impact on growth and other macroeconomic indicators. Syria is running a war economy and the majority of the budget is spent on its military and civil service in an attempt to keep the government going. The government is also subsidising some basic items (e.g. bread) but raising the cost of others (e.g. diesel), fuelling inflation. The economic situation is unsustainable, with the government seeking to cope with decreasing public revenues, and the consequent strain on public finances, whilst waging a war.

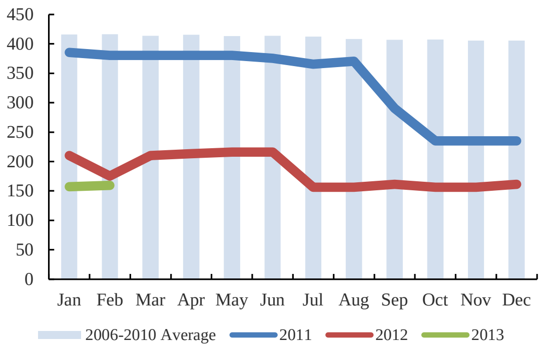
According to the United Nations, the conflict had claimed more than 94,000 lives, as of July 2013. Out of an estimated population of 20.9 million (2010), more than 1.6 million have fled to neighbouring countries (Lebanon, Jordan, Turkey, Iraq, Egypt) and are registered refugees or awaiting registration; an estimated 6,000 Syrians are leaving the country daily. The number of internally displaced persons (IDPs) has reached 4.25 million. The Arab League, the EU, the United States, Turkey, Japan, Canada, Norway, Australia and Switzerland have imposed restrictive measures on Syria in response to the repression of anti-government protests and human rights' violations (see section below on sanctions). ([82])

Graph IV.9.1: **Syria - Trade with the EU**
(EUR billion, % of total imports and exports)



**2012 data are for Q1 to Q3 only*
Source: European Commission, IMF

Graph IV.9.2: **Syria - Effects of crisis on oil supply**
(thousand barrels per day)



Source: U.S. Energy Information Administration

When the conflict started in early 2011, Syria's economy was relatively diversified according to regional standards, with services (including tourism) making up more than 50% of GDP, industry (including oil production) 25% of GDP, and agriculture 18% of GDP. Exports and FDI were on the rise, with net FDI as a stock growing

([82]) As of July 2013, the UN Security Council had not agreed on sanctions against Syria.

up to 2009 ([83]), as Syria appeared to emerge from a prolonged autarkic situation with modest economic growth. The country had been undergoing reforms towards the transformation from a centrally planned to a more liberalised economy from the early 2000s. Progress had been achieved in a number of areas (e.g. finance, trade, investment), although the economy required significant additional legislative and administrative reforms. In view of the current war, significant post-war economic rehabilitation and reconstruction will be needed, as the repercussions will be manifold.

No reliable data are available from 2011 onwards, but the effective end of tourism, private investment and the destruction of infrastructure and agriculture, compounded by economic sanctions – principally geared towards the oil and financial sectors – by the EU, the United States and the Arab League, have had a strong negative impact on the macroeconomic situation and effectively suppressed economic growth. According to some estimates, GDP contracted by almost 20% in 2012, although calculations should be treated with caution in view of the lack of data. The services sector is in standstill. From 2006 to 2010, four consecutive droughts had affected Syria, placing great strains on the agricultural sector, leading to a drastic reduction in production, and forcing an estimated 1.5 million people to move from rural to urban areas. The situation was compounded by the beginning of the conflict, which initially spread from the government's violent crackdown on protesters in urban areas to rural areas, thus further deteriorating the prospects of the country's agricultural sector– on the back of a near collapse in grain output. Social discontent and high unemployment rates (officially at 8%, but likely closer to 15%) were some of the reasons behind the uprisings in early 2011. Reports and anecdotal evidence suggest a quintupling in the unemployment rate as of mid-July 2013. Employment figures need to be put into a context of large numbers of IDPs and refugees leaving the country.

In 2011, Syria's main trading partners were the EU, Iraq, Saudi Arabia, China, and the United Arab Emirates, which together accounted for 60% of total trade. The economic sanctions (and the energy infrastructure damage) have led to a significant decrease in trade, with the consequent loss in export revenues and custom duties. The year-on-year variation in total trade from 2011Q1 to 2012Q1 was -28.9% for exports and -19.4% for imports, according to European Commission data.

Syria's oil production has been seriously affected by the EU's ban oil imports from Syria. Prior to the ban, Syria was producing approximately 350,000 barrels per day (bpd) (potential of 380-400,000 bpd). Syria's refining capacity was approximately 250,000 bpd. Even at its peak, Syria's contribution to global oil production and exports was limited, averaging 1% and 3% respectively. In December 2011, Syrian Oil Minister Sufian Alao announced that the country had reduced production by 30 to 35%. In October 2012, oil output was estimated at 153,000 bpd, a nearly 60% decline since March 2011. The US Energy Information Administration estimates total production shut-ins totalled 220,000 bpd as of November 2012.

Diminishing imports, destroyed infrastructure and the decrease in agricultural production, have all contributed to inflationary pressures with a steep increase in the cost of basic items. According to the Syrian Central Bureau of Statistics (whose website is, as of July 2013 no longer accessible), consumer prices rose by more than 40% year-on-year in September 2012. The rise mainly consisted of price increases in food, housing, utilities and fuel due to a combination of sharp reductions in their supply and alleged printing of money by the central bank to pay for state salaries. Taking into consideration black market and official exchange rates, the Cato Institute's 'Troubled Currencies Project' estimated that inflation had accelerated to more than 225% by mid-July 2013, fuelled by the currency's sharp depreciation.

In October 2012, the Finance Minister announced an increase of 4 percentage points in the 2013 government budget, which appeared an unrealistic increase in view of the hyperinflation. ([84]) No details of the budget were published and thus no information on revenue, deficit or military expenses. Current expenditures were expected to go up by 13%-16% relative to the 2012 budget, largely due to salary increases and the alleged

([83]) As a GDP share only up to 2008.

([84]) In 2010, Syria ran a fiscal deficit of 4.8%.

creation of new public sector jobs. Subsidies (food, fuel, electricity and agriculture) would be also increased by 25%, whilst government investment would be reduced by 25%. While Syria was planning a reform of its price subsidy system before the conflict, the war has apparently led to the shelving of those plans. Gross public debt was 29.4% of GDP in 2010 and is believed to have doubled in 2012. The government has been drawing on its foreign reserves, on income from Syria's two mobile phone companies and (allegedly) on credit lines from Iran, Russia and China, in order to finance its spending, including military costs, the eventual rises in public sector salaries and subsidies. In July 2013, Syria's regime ratified a 5% tax surcharge as "contributions to national reconstruction".

The Syrian Pound (SYP) was pegged to the IMF's SDR (Special Drawing Rights) since 2007 and was tightly managed by the central bank. Exchange rate stability was a priority. At the end of 2010, the foreign exchange reserves cover was around 13 months of imports, giving sufficient leeway to the central bank to support the peg. However, between March 2011 and September 2012, the SYP depreciated by 44% against the euro. As of early July 2013, the currency had depreciated by 75% since the beginning of the conflict, further dropping to SYP 330 to the US dollar as of mid-July 2013 (85% depreciation). The central bank has repeatedly attempted to intervene in the financial market to control this depreciation as Syria's balance of payments worsens and inflation soars.

The current level of Syria's foreign exchange reserves is difficult to estimate. The central bank claimed in October 2012 that foreign exchange reserves amounted to USD 15.1 billion at end-August 2012, which would have entailed a modest USD 4.7 billion drop since June 2011, the latest available IMF data. Nevertheless, considering the sharp drop in export revenue combined with an increase in import costs since June 2011, as well as the absence of any major net capital inflows, the drop in reserves should have been significantly larger, with foreign currency reserves ranging between USD 2 and 5 billion according to some estimates.

It is clear that the conflict and the sanctions imposed by the EU, the Arab League and others, have had a strong negative impact on Syria's balance of payments position. Syria's exports have been directly disrupted by the conflict and the need to provide for the local market, while the disorganisation of domestic production has obliged Syria to replace many products with imported ones. Tourism has collapsed. As a result, Syria's current account deficit (at 3.3% of GDP before the war) is likely to have widened considerably.

Syria has been accumulating arrears on some of its external debt. Since November 2011 and as of July 2013, Syria accumulated arrears towards the EIB for an amount of more than EUR 70 million; even though an exemption on the EU's sanctions makes payments possible. The Economist Intelligence Unit (EIU) estimated the external debt stock in Syria at 18.4% of GDP in 2012. The debt service-to-export ratio also remains low at an estimated 2%, and, except for the EIB loans and according to the EIU, the country continues to service its debt.

EU and international sanctions

In May 2011, Syria's most important trade partner, the EU, suspended the draft Association Agreement and all bilateral cooperation programmes under the European Neighbourhood Policy (ENP). The EU's sanctions ([85]) also included an embargo on arms and related equipment; an import ban on crude oil and petroleum products; the freeze of central bank assets and a ban on the provision of new banknotes and coins; restraint on commitments for financial support for trade and a ban on new long term commitments of EU Member States; a ban on new commitments for grants, financial assistance and concessional loans; a prohibition for the European Investment Bank (EIB) to make certain payments; and an asset freeze on entities, persons and bodies associated with the regime. The impact of these sanctions is evident, with a 90% fall in imports by the EU from 2011 to 2012. Prior to the ban, the EU was the main importer of Syrian oil, with oil sales to Italy, Germany and Spain, in particular, being among the main sources of revenue for the government, contributing approximately one quarter in 2010.

([85]) Council Decision 2012/739/CFSP, Council Regulation (EU) No 36/2012, Common Position 2005/888/CFSP, Council Regulation (EC) No 305/2006.

In April and May 2013, the EU introduced a number of derogations to its sanctions' regime to be granted by competent authorities in Member States and introduced for economic measures in the oil and gas sectors. These would allow European participation (loans and credits) in the Syrian oil industry (production or refining), the import of oil and petroleum products, and exports of equipment and technology (for oil and gas) provided that the Syrian National Coalition for Opposition and Revolutionary Forces had been consulted in advance and that the activities do not benefit persons close to the El-Assad regime. In addition, the EU amended the arms embargo against Syria so as to allow for the provision of non-lethal equipment and technical assistance to the Syrian Opposition Coalition for the protection of civilians.

Nineteen of the 21 member states of the Arab League (86) have also applied sanctions. The countries include Saudi Arabia, the United Arab Emirates and Kuwait, which together accounted for 14% of Syria's exports in 2011. The sanctions comprise bans on transactions with the central bank; commercial exchanges with the Syrian government; a freeze of government assets; and a ban of commercial flights between Syria and the League's member states. On the other hand, both neighbouring Iraq and Lebanon, which accounted for more than 40% of Syria's exports in 2011, voted against and are not enforcing the Arab League's sanctions. Other key trade partners not imposing sanctions include China, Iran, and Russia.

Outlook

The outlook of Syria's economic situation is difficult to assess, given the significant disruption caused by the on-going conflict on all economic factors and the scarcity of reliable figures and the difficulty to predict the duration of the conflict. (87) Economic challenges include growing budget and trade deficits, trade barriers, decreasing oil production and exports, the continued depreciation of the Syrian pound and the current hyperinflation. Economic recovery will only be possible once the civil war is over.

The provision of post-war assistance should be informed by a detailed understanding of the needs, 130including a Post Conflict Needs Assessment and coordinated international support on economic and asset recovery, including from the international financial institutions. Coordination among donors is necessary to develop a comprehensive programme for economic and social stabilisation. The Syrian conflict is having significant humanitarian, economic and political effects also on its neighbours, including through the refugees crisis (see Part II).

Syria's most pressing current problems are humanitarian. Short-term priorities should include: water and sanitation, health, housing, education, employment, economic fairness and inclusion. The destruction of physical and institutional infrastructure will have to be addressed and the rebuilding of the economy will be crucial for a sustainable and secure peace process.

(86) Syria's membership is currently suspended.
(87) The conflict is likely to continue into December 2013 and possibly further, as El Assad keeps a military hold on the country despite partial state collapse.

Table IV.9.1:

Syria - Main economic indicators	2008	2009	2010	2011	2012
Real sector					
Real GDP (% change)	4.5	5.9	3.4	n.a.	n.a.
GDP nominal (USD billion)	52.6	53.9	60.0	n.a.	n.a.
GDP per capita (USD)	2,386	2,343	2,656	n.a.	n.a.
Inflation (%, period average)	15.2	2.8	4.4	n.a.	n.a.
Social indicators					
Unemployment (officially registered)	10.9	8.1	8.6	n.a.	n.a.
Population (million)	21.3	21.1	21.4	n.a.	n.a.
Fiscal sector					
General government revenues (% GDP)	20.1	23.8	21.8	n.a.	n.a.
General government expenditures (% GDP)	23.0	26.7	26.6	n.a.	n.a.
General government balance (% GDP)	-2.9	-2.9	-4.8	n.a.	n.a.
Gross public debt (% GDP, end-period)	37.4	n.a.	n.a.	n.a.	n.a.
Monetary sector					
Domestic credit to the private sector (% change)	25.8	18.0	20.0	n.a.	n.a.
Broad money (M2% change)	19.0	9.4	12.6	n.a.	n.a.
External sector					
Trade balance (% GDP)	-3.9	-5.8	-5.3	-5.7	n.a.
Current account balance (% GDP)	-1.3	-3.6	-3.3	n.a.	n.a.
Net remittances (% of GDP)	1.7	1.5	1.3	n.a.	n.a.
Net FDI (% GDP)	4.2	3.7	3.2	n.a.	n.a.
Gross official reserves (USD billion, end-period)	17.1	17.4	19.5	n.a.	n.a.
Import cover of reserves (months)	9.4	10.7	9.4	8.4	n.a.
Gross external debt (% GDP)	14.1	14.6	14.4	n.a.	n.a.
Financial sector					
Exchange rate (S£ per USD, end-period)	46.5	45.6	46.7	46.9	n.a.
Real effective exchange rate (% change, + is appr.)	9.0	n.a.	n.a.	n.a.	n.a.

Sources: IMF, World Bank.

10. TUNISIA

- ***Throughout 2011, the Tunisian economy was significantly affected by the domestic political unrest and the conflict in neighbouring Libya. Although the macroeconomic situation partly improved in 2012, uncertainty remains high and risks to the short-term outlook are large and tilted to the downside.***

- ***The crisis in the euro area represents one of them, given Tunisia's close financial and economic links with several countries of Southern Europe. The Tunisian economy has also been negatively affected by the increased political uncertainty and impasse that followed the assassination of an opposition leader in February of 2013.***

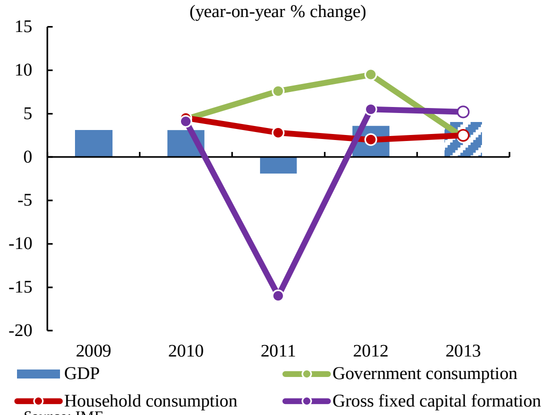
- ***In this context, the Tunisian authorities agreed in mid-April 2013 on a financial programme with the IMF to help cover their financing needs and implement their reform agenda.***

Macroeconomic and financial developments

Following the recession of 2011, when the Tunisian economy contracted by nearly 2%, reflecting the domestic political unrest, the Libyan conflict, and the economic slowdown in the euro area, real GDP growth picked up to 3.6% in 2012. On the supply side, this rebound was mainly due to the recovery of services, particularly tourism, and non-manufacturing industries. Investment and exports were the main drivers of growth on the demand side. Tourism receipts increased by 60% in 2012 in comparison to the previous year (but still remained below their 2010 level), while FDI recorded an increase of nearly 85% compared to 2011 and even exceeded its pre-crisis level. FDI mainly targeted the sectors of tourism, real estate, agriculture, manufacturing, and energy.

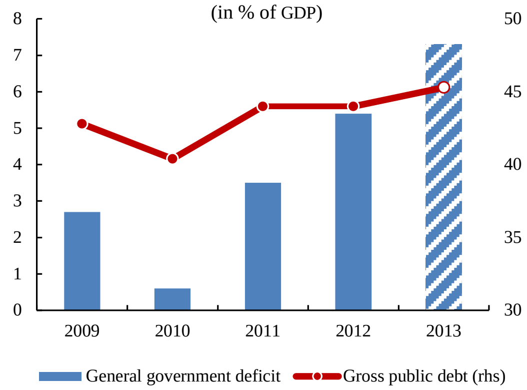
For 2013, the authorities expect an even higher GDP growth of 4.5%, based on assumptions about the performance of the manufacturing and tourism

Graph IV.10.1: **Tunisia - GDP, 2009-13**
(year-on-year % change)



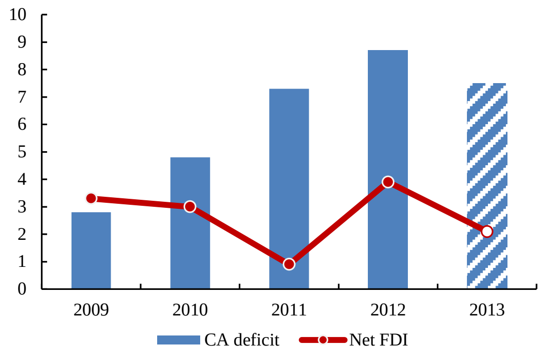
Source: IMF

Graph IV.10.2: **Tunisia - General government deficit and gross debt, 2009-13**
(in % of GDP)



Source: IMF

Graph IV.10.3: **Tunisia - Current account and net FDI, 2009-13**
(in % of GDP)



Source: IMF

industry on the supply side and exports on the demand side.([88])

Inflation pressures have re-emerged since the beginning of 2012, partly due to increases of raw material prices, the depreciation of the dinar, the rebound of internal demand and supply-related factors. Consumer price inflation intensified in the second half of the year reaching its peak in December (nearly 6%). Average inflation was 5.6% for the whole year. In this context, the central bank started tightening monetary policy already in January 2012, allowing an increase in the one-month average interbank rate by about 0.5%, followed by a rise in its key policy rate by 25 basis points in August (to 3.75%). Average inflation is expected to increase moderately to 6% in 2013, reflecting stronger demand and the reform of the energy subsidy schemes, which might require a further tightening of the monetary policy. For the last years, Tunisia has been considering moving to an inflation targeting regime, including with technical assistance from EU member states.

On public finances, the government adopted in May 2012 a supplementary budget foreseeing a deficit of 6.6% of GDP for the year (3.5% of GDP in 2011) to enable higher spending on development projects and job creation, although a lower deficit of 5.4% of GDP was finally realised, basically due to higher-than-expected revenues and under-execution of the investment budget. Despite the modest fiscal adjustment that is envisaged under the programme for 2013, the budget deficit is projected to increase to 7.3% of GDP in 2013, mainly reflecting the cost of the planned recapitalisation of banks and the repayment of arrears. The public debt remained at 44% of GDP at end-2012, but is projected to increase slightly to 45% of GDP by the end of 2013, mainly due to higher borrowing.

The rebound in domestic demand during 2012 contributed to a widening of the current account deficit (to 8.1% of GDP from 7.3% of GDP in 2011). The increase in FDI inflows only partially compensated for this effect, leading to a worsening balance of payments position. Foreign exchange reserves had to be partly mobilised in the first half of 2012. They recovered in the summer months and more significantly in December, when they reached USD 8.6 billion (3.8 months of imports) compared to USD 7.5 billion (3.4 months of imports) at end-2011. More recently, however, reserves have started declining again, broadly reflecting the drop of external receipts that accompanied the heightened political instability that followed the assassination of an opposition figure (Mr. Belaid) in February 2013. Reserves dropped to USD 6.3 billion at end-May 2013 (just below their sustainability threshold of 3 months of imports). This alarming trend was one of the main reasons behind the IMF programme agreed in mid-April 2013.

While financial market indicators have recently showed some signs of stabilisation, Tunisia's financial sector situation remains vulnerable, notably with regards to the banking sector. In this respect, on important part of the programme agreed with the IMF is aimed at addressing banking sector fragilities, including by undertaking special audits of public banks, strengthening bank supervision and aligning prudential norms with international standards. In view of the prolonged political uncertainty and the longer-than expected transition period, Tunisia's sovereign ratings were last downgraded by Standard & Poor's (from BB to BB-) and by Moody's (from Baa3 to Ba1) in February 2013, following the downgrading by Fitch last December.

In light of these difficulties, the Tunisian authorities reached in mid-April 2013 an agreement with the IMF on a 24-month SBA in the amount of USD 1.75 billion, which was approved by the IMF Board in June. The main objectives of the programme are: a) to maintain macroeconomic stability, partly through the implementation of structural reforms and the selective recapitalization of banks; b) to support inclusive growth; c) to reduce external vulnerabilities; and d) to strengthen investor and donor confidence.

Apart from the programme, financing needs in 2013 will be met by a number of donors, including the EU, the World Bank, Arab countries, Turkey and the USA. The authorities also intend to draw TD 1 billion from the Japanese market (Samurai bonds) with guarantees from the Japanese Cooperation Agency. The issuance of bonds in the

([88]) The IMF projects 4% growth due to renewed political uncertainty in Tunisia and the economic situation in the EU.

US and Qatari market and in international markets using official loan guarantees, possibly from the World Bank is also foreseen.

Structural reform challenges

A comprehensive set of structural reforms and prudent macroeconomic policies would be essential to put Tunisia on a higher growth path over the medium term. On the macroeconomic policy side, there is a clear need for fiscal consolidation while, at the same time, attaching priority to social expenditure and public investment. Gradually replacing generalised subsidies for food and energy with means-tested transfers targeted on the poorest households would be a step forward.

Another major challenge for policymakers is to address high structural unemployment, while raising participation rates. Despite some reduction in 2012, unemployment currently stands at nearly 17% and it is even higher among women and the educated youth. In this context, putting in place active employment policies and eliminating skill mismatches would bring in positive results.

Other major challenges represent improving the business environment and governance (including through the new investment code and efforts to simplify administrative procedures); strengthening the banking sector; promoting foreign trade and economic integration; fighting poverty, including through widening social coverage; developing sectorial policies; and eliminating regional disparities.

Risks and outlook

Given the domestic and external conditions, the short-term economic outlook for Tunisia remains strained. Tunisia is very dependent on the EU economy (nearly 75% of its exports go there and a large share of its tourism inflows, worker remittances and investments also come from the EU). The crisis in the euro area, therefore, is weighing on the country's economy and represents a risk factor going forward.

Although signs of an economic rebound have emerged already in early 2012, risks to the short-term outlook are large and tilted to the downside, including a longer than anticipated recession in the EU, an escalation of domestic social tensions, capacity constraints and delays in external financing.

Table IV.10.1:

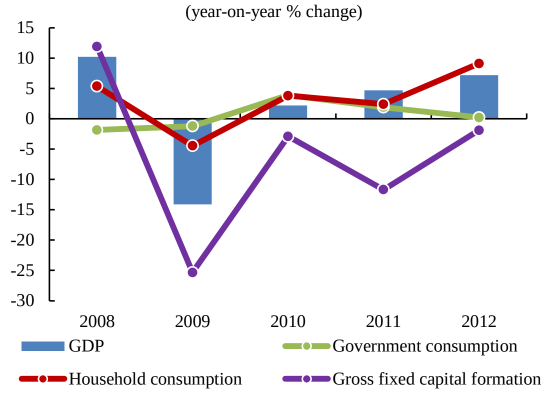
Tunisia - Main economic indicators	2009	2010	2011	2012	2013 projection
Real sector					
Real GDP (% change)	3.1	3.1	-1.9	3.6	4.0
GDP nominal (USD billion)	43.5	44.3	46.0	46.1	48.0
GDP per capita (USD)	4,171	4,199	4,320	4,284	4,409
Inflation (average, %)	3.5	4.4	3.5	5.6	6.0
Social indicators					
Unemployment rate (survey based, %)	13.3	13.0	18.9	16.7	n.a.
Population (million)	10.4	10.5	10.7	10.8	10.9
Fiscal sector					
Government revenues, excl. grants and privatization (% GDP)	23.1	23.3	24.2	23.1	23.8
General government expenditure and net lending (% GDP)	25.8	23.9	27.7	28.5	31.1
General government balance, excl. grants and privatization (% GDP)	-2.7	-0.6	-3.5	-5.4	-7.3
Gross government debt (% GDP)	42.8	40.4	44.0	44.0	45.3
Monetary sector					
Key policy rate (%, end-period)	4.50	4.50	3.50	3.75	4.25
Domestic credit to the economy (% change)	10.3	19.6	13.5	5.7	n.a.
Broad money M3 (% change)	13.0	12.1	9.2	10.8	n.a.
External sector					
Trade balance (% GDP)	-8.5	-10.3	-10.4	-11.1	-11.4
Current account balance (excl. grants, % GDP)	-2.8	-4.8	-7.3	-8.1	-7.5
Net FDI (% GDP)	3.3	3.0	0.9	2.5	2.8
Gross external debt (% GDP)	49.4	48.3	47.8	51.2	55.0
Gross official reserves (USD billion, end-period)	11.1	9.5	7.5	8.6	7.4
In months of next year's imports	6.6	5.1	3.8	4.0	n.a.
Exchange rates					
Exchange rate (Dinar per USD, average)	1.35	1.43	1.41	1.40	n.a.
Exchange rate (Dinar per EUR, average)	1.85	1.88	1.95	2.00	n.a.
Real effective exchange rate (% change, + is appreciation)	-1.2	-0.5	-1.7	n.a.	n.a.

Sources: Central Bank of Tunisia, IMF.

11. ARMENIA

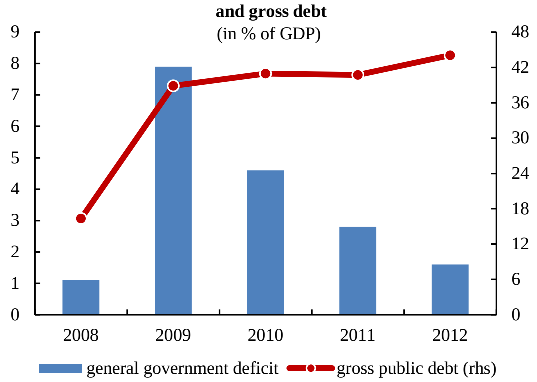
- ***The Armenian economy experienced strong recovery; the GDP grew by 7.2% in 2012.***
- ***The growth is expected to slow due to sluggish growth in Russia and weak global demand.***
- ***The international community continued to support Armenia to address its external financing needs.***
- ***Armenia still faces important structural challenges, such as significant and persistent poverty rates, high level of corruption and low competitiveness of business sector.***

Graph IV.11.1: **Armenia - GDP**
(year-on-year % change)



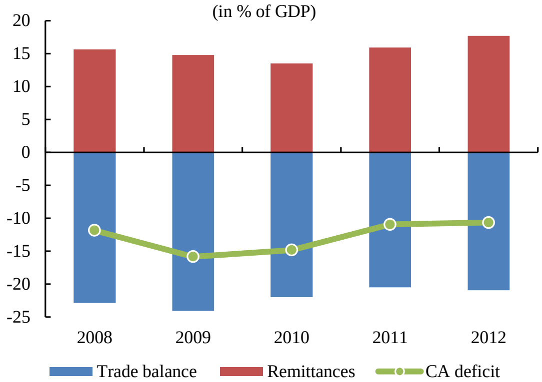
Source: National authorities

Graph IV.11.2: **Armenia - General government deficit and gross debt**
(in % of GDP)



Source: National authorities

Graph IV.11.3: **Armenia - Current account**
(in % of GDP)



Source: National authorities, Commission Staff calculations

Macroeconomic and financial developments

After a large shock that affected the Armenian economy in the global financial crisis in 2009, the economic activity started its gradual recovery in 2010. In 2012, the recovery strengthened. GDP growth reached 7.2%, accelerating from 4.7% in 2011. It remained strong in the beginning of 2013 (7.5% in first quarter of the year).

The strengthening of growth in 2012 was mainly driven by an increase in consumer demand and net exports. Private consumption growth accelerated in 2012, reaching 9.1%, compared to 2.4% in 2011. Exports also expanded, though at a slower pace than in 2011, growing by 10.7%. At the same time, imports went down by 3% in 2012. On the negative side, the investments, both domestic and foreign, continued to weaken, pointing at slowing growth prospects in Armenia. The gross fixed capital formation decreased by 1.9% in 2012 after dropping by 11.7% in 2011.

Particularly strong growth in value added was registered in agriculture (where it was driven by favourable weather conditions), mining and financial and transportation services. In 2012 output in these sectors grew by 9.5%, 16.7%, 23% and 13.4%, respectively. In the first quarter of 2013, the growth in agriculture slowed, while the economic performance of the services and manufacturing sectors remained strong.

After reaching a peak of 19.0% in 2010, the unemployment rate fell to 18.4% in 2011. Led by strong economic activity in 2012, the jobless rate remained on the downward track at a stronger pace in 2012, falling to 17.3%. Youth unemployment remains very high, having reached almost 40% in 2011.

As a result of the strong economic growth and declining unemployment rate, the poverty level most likely declined in 2012, although it remained high. In 2011, it was estimated at 35.0%, a minor improvement from the 35.8% in 2010.

After inflation rates around 8% in 2010 and 2011, consumer price growth moderated steeply in 2012 as a result of favourable food price dynamics on global markets and a bumper harvest in the country. By May 2012, CPI inflation eased to 0.5% year-on-year, but it rebounded following the increase in world energy prices and accelerating economic activity growth. The average inflation rate in 2012 reached 2.6%. In the beginning of 2013 inflation increased, reaching in April 3.9%. Moderate inflationary pressures are expected to persist in the medium term. The Central Bank of Armenia has kept the policy rate steady at 8% since September 2011.

The authorities pursued the fiscal consolidation. The budget deficit is estimated to have declined to 1.6% of GDP in 2012, from 2.8% in 2011 and 4.6% in 2010. The decreasing deficit mainly reflects spending restraint. The revenue performance remained weak. Tax revenues increased by 0.6 percentage points supported by increases of revenues from the personal and corporate income taxes and the excise tax. However the tax-to-GDP ratio remained low at 17.1%. At the same time, the public debt remains on an upward path, reflecting on-going borrowing from international financial institutions. It is estimated to have reached 44.1% of GDP at the end of 2012, up from 40.7% a year earlier. A recent Debt Sustainability Analysis conducted by the IMF concluded that Armenia's public debt dynamics are sustainable; nevertheless, a rapid accumulation of public debt since the beginning of the global financial crisis calls for further fiscal consolidation. Furthermore, close to 90% of the debt was formed by external liabilities, indicating significant exchange rate vulnerability. Armenia is due to reduce the level of its debt to the IMF by close to USD 300 million in 2013-2014 (after repaying USD 100 million in 2012). Accordingly, the public debt service ratio is due to increase from 4.2% of exports in 2011 to 9.6% in 2012, 15.6% in 2013 and 10.0% in 2014.

The external situation remains therefore fragile. Despite a significant adjustment since 2009, the current account deficit remains large, 10.6% of GDP in 2012 (10.9% in 2011), underlining a critical need to strengthen the competitiveness of the economy. Remittances increased, though at a slower pace, due to the subdued growth in Russia. In 2012 they grew by 7.7%, well below the 24.6% increase in 2011. Export receipts, mostly driven by mining and agriculture, increased by 3.5% in 2012 (in 2011 the export growth was 24.3%). The trade deficit reached 20.9% of GDP. Further narrowing the current account deficit is crucial as the FDI inflows remained weak; in 2011 they shrank by 7.8% and in 2012 by 6.9%.

The net international reserve position targets (set within the IMF financing arrangement) were missed in 2012 due to heavy interventions in order to curtail the volatility of the national currency (dram) in a weaker than expected external environment. The heaviest interventions were made in May-June 2012 when the dram came under significant pressure to depreciate. Foreign exchange reserves dropped to 3.7 months of next year`s imports at the end of 2012 (from 4.5 months of imports in 2011). Despite the interventions after relative stability since the end on 2010, the dram depreciated to its historically lowest point.

The banking sector remains fairly robust and well capitalised. A Financial System Stability Assessment (FSSA) was completed by the IMF in June 2012. The FSSA mission concluded that the banking system showed resilience through the global financial crisis due to low levels of exposure to problematic sectors and sound policies. The major risks to the banking sector remain the external imbalances of the overall economy (large current account deficit and a high level of dollarization both in deposits and credits, around 70%), increasing the vulnerability to a potential current account shock. The capital adequacy ratio diminished from 27.5% at the end of 2008 to 16.8% in the end of 2012, a level well above minimum requirements. The lending growth persisted in 2012 and the credit to the economy increased by 27.2% (year on year), mostly driven by credits in foreign currencies (34.5%). However, growth of foreign currency denominated credits slowed significantly in the beginning of 2013: In April it was 18.6% (also year on year), bringing overall credit growth down to 18%. The level of non-performing loans remained moderate (around 6% of gross loans); yet it was above the pre-crisis levels.

The current financing arrangement with the IMF under the combination of the Extended Fund Facility (EFF) and the Extended Credit Facility (ECF) signed in 2010 expired in early July 2013. The authorities' economic programme supported by the arrangement remained broadly on track throughout its duration. The arrangement supported Armenia's economic development putting an emphasis on structural reforms to improve business environment and on decrease of external imbalances.

Policy reforms and measures

Armenia faces important structural challenges, including promoting inclusive and sustainable growth, diminishing poverty rates, improving business environment, decreasing corruption, diversifying the economic activity while facing its difficult geopolitical situation (being a landlocked country with borders closed with two of its neighbours out of four).

In 2012 the authorities pursued to implement structural reforms focused on business environment improvements and deregulation. Armenia has been successfully conducting legislative reforms and strengthening the relevant administrative capacities. In February 2012 the laws on technical regulation, standardization, accreditation and measurement were adopted. They would support export diversification and competitiveness. In the area of tax administration the authorities implemented measures to simplify and streamline the reporting process. The competition committee has proceeded with the preparation of the amendments to the competition act to step up enforcement efforts; the legal changes in the competition area are expected to be proposed to parliament shortly.

In the financial sector a number of reforms have been introduced lately. In the banking sector greater provisioning and risk weighting of foreign assets was introduced to limit further dollarization. Pension reform implementation is on track; the new system is scheduled to be fully in place in 2014. Banking sector deepening is a priority for the authorities as pension reform and other policy measures are being introduced to promote the presence of institutional investors and product innovation.

The country's market-friendly reform efforts have been recently acknowledged by the World Bank, which rated Armenia 32nd (out of 185 states) for the ease of doing business. The country thus advanced 18 positions in the ranking due to strong improvements in the areas of availability of electricity to the business sector, investor protection and tax payments.

In order to sustain high growth rates in an unfavourable external environment, the authorities should build on the good structural reform pace and pursue an even more ambitious agenda to further improve the business environment and enhance competitiveness. They should also focus on trade deepening. A positive step in this direction was made in 2012, when Armenia launched negotiations with the EU on the establishment of a DCFTA, which was the starting point in the country's reform process, especially in the areas of sanitary and phyto-sanitary controls, technical barriers to trade and protection of intellectual property rights.

Risks and outlook

The growth is expected to slow down in 2013 as the economic activity in Armenia's main trading partners – the EU and Russia – remains weak. Inflation is expected to accelerate slightly due to commodity price pressures in the course of 2012 but remaining within the CBA's target of 4% ±1.5 percentage points in 2013 and 2014. The overall risks to the macroeconomic performance in the short and medium term are tilted downwards, main possible challenges being fragile global economic growth perspectives and geopolitical developments in the region, especially the on-going conflict with Azerbaijan over Nagorno Karabach and the situation in Iran. High external imbalances mean high vulnerability to external shocks.

Table IV.11.1:
Armenia - Main economic indicators

	2009	2010	2011	2012	2013 projection
Output and prices					
Real GDP (% change)	-14.1	2.2	4.7	7.2	6.0
GDP nominal (USD billion)	8.6	9.3	10.1	9.9	10.9
GDP per capita (USD)	2,703	2,894	3,168	3,050	3,355
Inflation (average, %)	3.4	8.2	7.7	2.6	4.0
Social indicators					
Unemployment rate (survey based, %)	18.7	19.0	18.4	17.3	16.5
Population (million)	3.0	3.3	3.3	3.2	3.2
Fiscal sector					
General government revenues (% GDP)	20.9	21.2	22.1	21.5	22.1
General government expemditures (% GDP)	28.6	26.2	25.0	23.1	24.7
General government balance (% GDP)	-7.9	-4.6	-2.8	-1.6	-2.5
Gross government debt (% GDP, end-period)	38.9	41.0	40.7	44.1	42.2
Monetary sector					
Key policy rate (%, end-period)	5.0	7.3	8.0	8.0	8.0
Domestic credit to the private sector (% change)	13.7	26.0	35.2	27.8	13.3
External sector					
Trade balance (% GDP)	-24.1	-21.9	-20.5	-20.9	-20.6
Current account balance (% GDP)	-15.8	-14.7	-10.9	-10.6	-10.5
Net remittances (% GDP)	14.8	13.5	15.9	17.7	18.7
Net FDI (% GDP)	8.4	6.1	4.4	4.8	4.9
Gross external debt (% GDP)	58.1	67.9	72.9	77.0	75.5
Gross official reserves (USD Billion, end-period)	2.0	1.9	1.9	1.6	1.5
In months of next year's imports of goods and services	5.7	4.7	4.5	3.7	3.4
Exchange rates					
Exchange rate (dram per USD, average)	363.3	373.7	372.5	401.8	n.a.
Exchange rate (dram per EUR, average)	507.4	496.0	518.7	516.4	n.a.
Real effective exchange rate (% change, + is appreciation)	-6.0	0.5	-0.9	-4.4	n.a.

Sources: National authorities, IMF

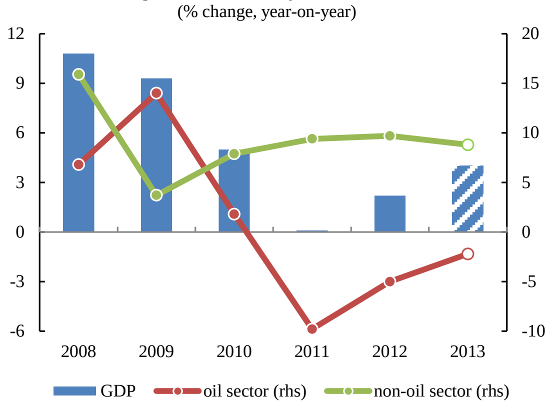
12. AZERBAIJAN

- ***GDP growth rebounded in 2012 supported by strong activity in the non-oil sector, while declining hydrocarbon output remained a drag.***

- ***The authorities continue to heavily rely on windfall gains from the hydrocarbon sector to support economic activity, raising concerns about long-term fiscal sustainability.***

- ***Encouraging of the non-oil economy should be further pursued, including through strengthening competition, ensuring more favourable business environment and trade deepening.***

Graph IV.12.1: **Azerbaijan - GDP**
(% change, year-on-year)

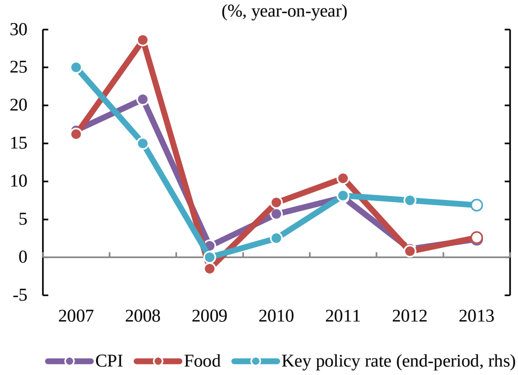


Source: Azstat

Macroeconomic and financial developments

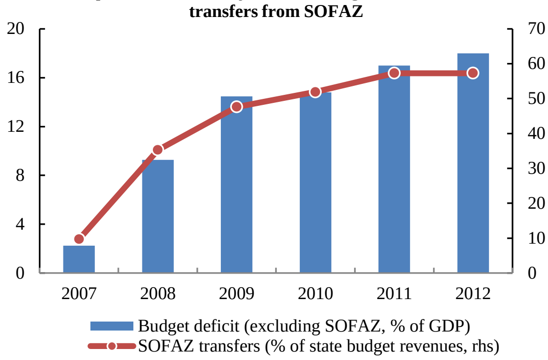
Economic activity rebounded in 2012 after the abrupt halt in 2011. GDP growth accelerated to 2.2% in 2012 from 0.1% in the previous year. The recovery was fuelled by the on-going expansion of the non-oil sector (plus 9.7%) - that remained driven by fiscal transfers from the windfall hydrocarbon sales - contributing to further diversification of the economy from the energy sector. Oil production contracted for the second consecutive year, again slowing down the economic performance. The pace of contraction moderated to 5.0% year-on-year from nearly 10% in 2011, when extraction activities were also temporarily suspended due to maintenance works. Substantial state transfers from oil and gas sales again supported investment activity and household consumption in 2012, acting as the main growth drivers. The steep disinflation throughout the year, coupled with further wage and credit growth, favoured higher consumption. At the same time, net trade had a negative contribution to GDP growth in 2012 due to a further decline of oil exports and the gradual rise of imports.

Graph IV.12.2: **Azerbaijan - inflation and monetary policy**
(%, year-on-year)



Source: Azstat

Graph IV.12.3: **Azerbaijan - State budget execution and transfers from SOFAZ**



Source: Commission staff estimates based on figures of Finance Ministry and SOFAZ

On the supply side, retail turnover grew by 9.6% year-on-year in 2012. The strongest expansion was reported in communication (16%), although the sector still has a small share in the economy. Agricultural production rose by nearly 6%. At the same time, there was a 2.3% drop of industrial output due to lower oil and gas production.

Supported by a further increase of oil-revenue transfers to the real economy, GDP growth accelerated to 5.0% in the first half of 2013. The non-oil sector expanded by nearly 11% in the period, remaining the main growth driver. The strong year-to-date performance suggests the 4% GDP growth projection of the authorities for 2013 is within reach despite the inauspicious external environment.

The pick-up of economic activity in 2012 affected positively the labour market and contributed to a further decline of the survey-based unemployment rate to 5.2% from 5.4% a year earlier. Wages retained their fast growth pace in the year despite the fact that inflation declined to very low levels. Their growth was 9.1% in 2012; close to the one witnessed a year earlier.

Robust real wage growth and significant state investments failed to translate in higher inflation. On the contrary, there was a steep disinflationary trend during the entire year, with the average CPI inflation coming at only 1.1%, its lowest level for more than ten years, from 7.9% in 2011. The reason was the fall of food prices on international markets and the good local harvest. Inflationary pressures are likely to re-emerge in 2013 due to high government spending and a likely rebound in food prices. Still, the tightly managed exchange rate of the local currency will ensure these are relatively subdued. The Central Bank of Azerbaijan (CBA) reduced its key refinancing rate by cumulative 50 basis points in December 2012 and in February 2013 to 4.75%, utilising the low inflationary environment to encourage economic activity.

As a result of the growing reliance on hydrocarbon proceeds to finance investments in the non-oil sector, the state budget expenditures again expanded at a double-digit pace in 2012. However, their growth moderated markedly, to 11% year-on-year from more than 30% in 2011, as the authorities adopted prudent spending policies at the end of the year. This also seems to be necessitated by falling proceeds of the sovereign oil wealth fund SOFAZ, mainly due to lower production. The state budget finished the year with a surplus of 0.3% of GDP, better than the target for a slight deficit. However, the non-oil deficit (excluding transfers from SOFAZ) is estimated to have further expanded, reaching 18.0% of GDP (up from 17.0% in 2011). Thus, the growing reliance on windfall oil revenues to finance expenditure weakens the budget fundamentals and raises concerns about the long-term sustainability of the public finances. ([89]) These seem to be somewhat mitigated by the high fiscal flexibility, as nearly half of the expenditures is directed to capital spending.

The authorities continued to follow expansionary fiscal policies in early 2013. This is evidenced by the 60% year-on-year surge in state expenditures in January-April. At the same time, revenues grew by a much lower 25% in the period despite a substantial increase of fiscal transfers from SOFAZ. The accommodative budgetary policies precede the presidential elections that will take place in October 2013.

Supported by hydrocarbon sales, Azerbaijan’s external position remains comfortable with annual current account surpluses of above 20% of GDP. However, reduced oil output in 2012, coupled with stagnation in crude oil prices, resulted in a decline of the surplus to 22% of GDP in 2012 from 28% on average for 2007-2011. The narrowing of the oil trade surplus was the key factor behind the contraction, but worsening of the current transfers also added to this. The latter was mainly due to increased remittance outflows. The deficit of the financial account doubled year-on-year to USD 8.0 billion in 2012 due to rising investments abroad by the oil fund. FDI inflows, which are mainly directed in the energy sector, rose by 20% year-on-year to USD 5.3 billion (or 7.7% of GDP), but the net figure was below USD 1 billion due to significant investment repatriation.

The high current account surplus enabled Azerbaijan to continue building up foreign exchange reserves, although at a slightly slower pace than in 2011, due to falling oil proceeds and growing transfers to the budget. The combined assets of SOFAZ and the central bank rose by USD 5.6 billion in 2012 to USD 45.8 billion at the end of the year, or 67% of GDP. The sound reserve position, coupled with a low level of public debt, significantly mitigates the risks stemming from the

([89]) Transfers from SOFAZ accounted for approximately 57% of the state budget revenues in 2012 compared to less than 10% in 2007). Overall, oil-related proceeds form more than 70% of the budget revenues.

volatility of oil prices, providing enough space for countercyclical policies in case of external shocks. It also instils stability in the local currency by ensuring that the central bank has sufficient resources to defend the exchange rate, if needed.

Following relatively subdued credit expansion in 2010 and 2011, bank lending growth accelerated strongly in 2012 as a result of strong demand by both businesses and households, to exceed 20% year-on-year. Thus, the share of overdue loans declined slightly throughout the year to approximately 6%, but stronger oversight and prudential policies by the CBA will be needed to avoid worsening of the asset quality in the future. The Bank has already introduced a number of prudential measures in an attempt to curtail the fast expansion of retail lending and plans more restrictive moves if needed.

Overall, the banking sector remains liquid and well capitalized although its performance is negatively affected by high provisioning expenses and a weak capital position of the International Bank of Azerbaijan, which accounts for about a third of the total assets. The state intervened in early 2012 to help the bank to meet the minimum capital requirement. However, the planned privatisation of the lender, needed to improve management practices, strengthen competition in the sector and reduce contingent liabilities on the state, has come to a halt. In a move to strengthen the capital base of the banking system, the CBA raised the minimum capital requirements to 50 million manat from previous 10 million. The new rule, which will be applicable as of 2014, is expected to also contribute to consolidation of the sector.

Policy reforms and measures

Azerbaijan has achieved significant progress in improving the business environment, with notable advance in areas such as tax payment, investor protection and starting a business, according to the World Bank's Doing Business 2013 report. Progress was also made in improving the quality of public services by the encouragement of the e-government and the recent introduction of a state agency (ASAN) that acts as a one-stop shop for provision of various public services. However, much more active policies should be pursued in the area of trade integration, where the country is among the weakest performers. These would support trade diversification from the dominant role of the oil industry at present. The diversification has been largely successful for now and efforts should be focused on making it more self-sustainable by gradually downscaling state support, which is benefiting from windfall oil proceeds. This should be done by re-enforcing market reforms to improve the business environment and by strengthening the judicial system as the country scores high in corruption perception rankings. ([90]) More resolute measures to reduce the role of oligopolistic structures and improve access to financing will also boost the country's appeal for investors and support business activity.

Resolute reforms are also needed in the area of public finance management to enable Azerbaijan to build sufficient buffers for the time oil and gas reserves start diminishing, as well as to ensure fair distribution of the oil wealth among generations. These reforms could include the introduction of fiscal rules that would ensure public spending is not dependent on oil price dynamics. This will also lead to higher credibility and transparency of the fiscal policy.

Risks and outlook

GDP growth is likely to further consolidate in 2013, again driven by the non-oil economy that will continue to benefit from generous state transfers of energy proceeds. Oil production is projected to grow not earlier than in 2014 when new capacities are expected to be launched. The main risk for the Azerbaijan's economy stems from its high reliance on oil exports that makes it exposed to a potential fall of energy prices. Another threat is slower-than-expected progress with development of oil and gas finds and transport corridors for their exports. The global environment is also a major risk, as weaker activity could negatively weigh on crude oil prices. The geopolitical situation also poses a threat due to the unresolved dispute with Armenia over Nagorno-Karabakh as well as the on-going tensions between Israel and Iran.

([90]) Azerbaijan ranks 139th (out of 176 countries) in the 2012 corruption perception ranking of Transparency International. Thus, the country is the worst performer in the Eastern Neighbourhood after Ukraine.

Table IV.12.1:
Azerbaijan - Main economic indicators

	2009	2010	2011	2012	2013 projection
Real sector					
Real GDP (% change)	9.3	5.0	0.1	2.2	4.0
Real non-hydrocarbon GDP (% change)	3.7	7.9	9.4	9.7	8.6
GDP nominal (USD, billion)	44.3	52.9	64.8	68.7	74.3
GDP per capita (USD)	5,018	5,922	7,156	7,491	7,930
Inflation (%, average)	1.5	5.7	7.9	1.1	2.4
Social indicators					
Unemployment rate (survey-based, %)	5.7	5.6	5.4	5.2	5.1
Population (million)	8.9	9.1	9.2	9.3	9.4
Poverty ratio (population below national poverty line, %)	10.9	9.1	7.6	6.0	5.8
Fiscal sector					
State government revenues (% GDP)	29.0	26.9	30.7	32.0	33.3
State government revenues (excl. SOFAZ transfers, % GDP)	15.2	12.9	13.1	13.7	n.a.
State government total expenditures (% GDP)	29.7	27.7	30.1	31.7	35.0
State government balance (% GDP)	-0.7	-0.9	0.6	0.3	-1.7
State government balance (excl. SOFAZ transfers, % GDP)	-14.5	-14.8	-17.0	-18.0	-19.5
Monetary sector					
Key policy rate (%, end-period)	2.00	3.00	5.25	5.00	4.75
Domesti c credit to the private sector (% end-period)	25.6	6.6	18.1	20.8	17.4
Broad money (M3, % change)	-0.3	24.3	32.1	20.7	n.a.
Dollarisation of total deposits (%)*	63.1	58.0	54.7	52.7	50.0
External sector					
Trade balance (% GDP)	29.3	34.0	32.9	28.1	26.0
Current account balance (% GDP)	23.0	28.4	26.5	21.7	16.0
Net FDI (% of GDP)	0.3	-0.6	1.4	1.2	1.6
Gross official reserves (USD billion, end-period)	5.2	6.4	10.5	11.7	13.3
Assets held by SOFAZ (USD billion, end-period)	14.9	22.8	29.8	34.1	34.0
External debt (% of GDP, end-period)	n.a.	7.4	7.3	10.6	n.a.
Exchange rates					
Exchange rate (Manat per EUR, average)	1.1	1.1	1.1	1.0	1.0
Exchange rate (Manat per USD, average)	0.8	0.8	0.8	0.8	0.8
Real effective exchange rate (% change, + is appreciation)	-5.2	10.6	-0.4	4.1	n.a.

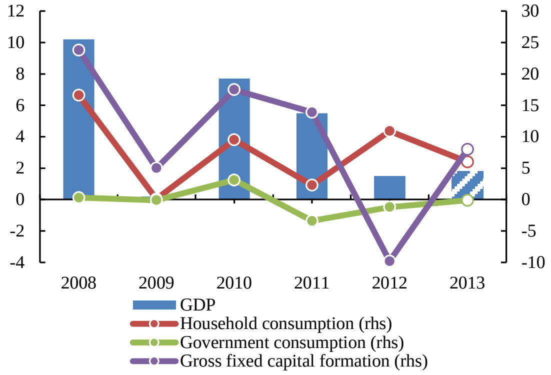
*Sources: National authorities, IMF, Commission estimates; * - incl deposits of non-residents and central government*

Despite the high vulnerability from its oil price dependence, the country is in a very comfortable position due to the huge pile-up of assets in the last few years and their prudent management. Reforms that will encourage competition, including through trade deepening, could be an important channel for higher potential growth in the long term. In this respect, efforts to accelerate the country's entry in the WTO and possibly enable it to expand trade relations with the EU, through an agreement on a DCFTA, should be followed to support productivity and growth. Successful reforms of quasi-fiscal entities and of the pension system will also improve the outlook for the country as will efforts to enhance the efficiency of capital expenditures, which currently absorb nearly a half of the state spending. Strengthening of the monetary policy transmission mechanism, including through allowing a greater exchange rate flexibility and expanding the tools available to the central bank, would be also important for sound economic policy management in the future.

13. BELARUS

- ***Tight policies and currency depreciation contribute to impressive, although temporary, current account adjustment in 2012.***
- ***But also lead GDP growth sharply down.***
- ***Inflation slows down steeply, but pressures re-emerge in early 2013 following significant income policy relaxation.***
- ***Authorities fail to use improved macroeconomic environment to kick-start major structural reforms required for moving towards a fully-fledged market economy.***

Graph IV.13.1: **Belarus - GDP**
(year-on-year % change)



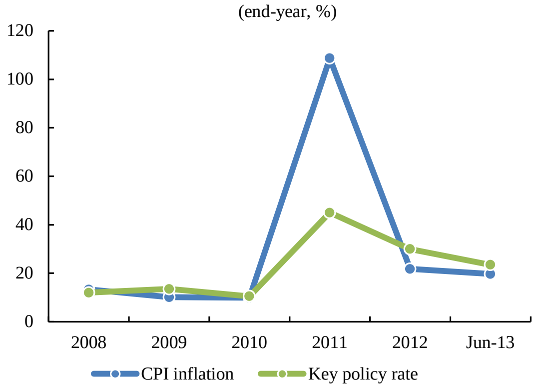
Sources: National Statistical Committee; Commission Staff forecast for 2013

Macroeconomic and financial developments

The strong policy tightening required to contain the 2011 balance of payments crisis and tame inflation, helped the Belarusian authorities restore macroeconomic stability in 2012, although this came at the expense of a significant weakening of the economic activity. GDP growth slowed down to 1.5% in 2012 from 5.5% in 2011 and 7.7% in 2010. In addition to the policy tightening, weakening demand by the country's key export markets, the EU and Russia, also contributed to the moderation of activity. This was especially pronounced in the final quarter of the year when GDP contracted by 1.5% year-on-year despite the low base.

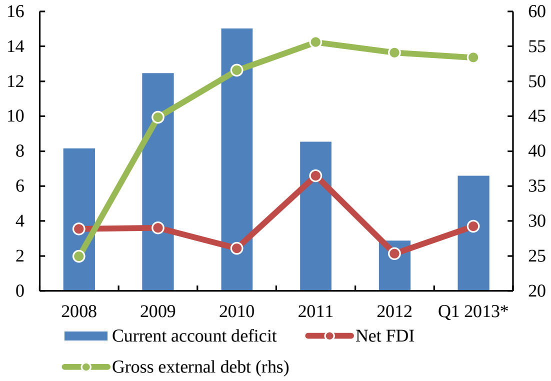
On the demand side, net trade became the main growth driver in the first months of 2012 as a result of an impressive export boom that was supported by favourable terms of trade, increased supply of crude oil by Russia (that is re-exported to other markets) and the positive impact from the 2011 devaluation. Imports were kept subdued by weak purchasing power, but also by limited investments by both the state and businesses. Private consumption was weak in the first half of the year but gradually gained strength following a significant relaxation of the income policies and recovering credit growth. On the production side, industry expanded by 6.3%, while agriculture by 6.0% in 2012. However, they were held back by the nearly double-digit contraction of the construction industry.

Graph IV.13.2: **Belarus - Inflation and monetary policy**
(end-year, %)



Source: National Statistical Committee

Graph IV.13.3: **Belarus - Current account and debt**
(in % of GDP)



Source: National Bank of Belarus; * - annualised

Economic activity remained weak in early 2013, negatively affected by the unfavourable external environment (namely the recession in the euro area and the slowdown in Russia), as well as by the erosion of the competitive gains from the 2011 devaluation. The limited room for fiscal manoeuvre (in view of the significant increase in external debt service and the inflationary environment) also acted as a drag on economic activity. As a result, GDP growth amounted to only 1.1% in January-May, leaving the authorities' ambitious 8.5% official growth target for the year out of reach.

Household consumption and investments were the growth drivers in early 2013, reflecting accommodative monetary and income policies. At the same time, net trade had a strong negative impact as exports dropped by 20% due to weak external demand. Looking forward, expansionary policies may support economic activity in the short term. However, in the absence of resolute structural reforms, they would only serve to further weaken the macroeconomic fundamentals of the country, raising the risk of another self-induced crisis.

The year 2012 was marked by very expansionary income policies, mostly ahead of the September parliamentary elections. As a result, the average wage increased by 22% in real terms during the year, exceeding productivity growth by a large margin (estimated at 4%). This contributed to the worsening trade dynamics evident since mid-2012, but also to the persistently high inflationary expectations and renewed depreciation pressures on the exchange rate. The possible continuation of this accommodative income policy represents a major risk for the Belarusian economy as it could easily bring back to the fore external vulnerabilities and hinder the inflation moderation that the authorities have been seeking.

Consumer inflation decelerated markedly in 2012 (from more than 100% year-on-year in January to less than 22% at the end of the year) due to tight monetary and fiscal policies, significant intervention by the state in price setting, as well as base effects. In response to the improved inflationary outlook and exchange rate appreciation in the first half of 2012, the central bank gradually eased its tight grip, cutting the key refinancing rate by 15 percentage points to 30% in September. It temporarily suspended the policy easing due to renewed inflationary pressures and concerns about the expansionary wage policies and currency depreciation. Rate cuts resumed in March 2013, with the key policy rate being reduced to 23.5% by June. The central bank pledges a prudent stance throughout the year in its objective to ensure price stability. This will be a challenging task in view of the still high inflationary expectations, excise tax hikes and the gradual increase of the subsidised utility tariffs, which suggest the 12% official inflation forecast could prove optimistic.

On a more positive note, fiscal policies remain prudent and there are no signs of relaxation for the time being. The fiscal easing undertaken in 2010 was among the factors that led to the 2011 balance of payments crisis. However, public finances were tightened afterwards and remained on a cautious path in 2012, with the general government recording a surplus of 0.7% of GDP. ([91]) For 2013, the authorities target a balanced budget that will be supported by a tightening of the budget constraints of the state-owned enterprises and an increase of the recovery rates for utility and transport tariffs from their very low current levels. Excise tax increases should provide a boost to the revenue side as well. Risks for the budget stem mainly from an overly optimistic growth projection as well as a significant increase of public sector wages and pensions. Overall however, the fiscal stance remains prudent. If it is combined with a reduction of the quasi-fiscal operations, this will ensure public debt remains under control. The general government public debt-to-GDP ratio is estimated to have declined from 46% at the end of 2011 to 36% at the end of 2012 and is likely to hover around this level in 2013.

On the external front, there was a remarkable adjustment in 2012 as the current account deficit was brought down to only 2.9% of GDP from 8.5% in 2011 and 15.0% in 2010. This was the result of the strong export growth that was fuelled by the currency devaluation, windfall gains from exports of solvents, and significant improvement in the terms of trade. ([92]) Weakening imports,

([91]) These figures should be treated with caution as they do not include quasi-fiscal operations and contingent liabilities arising from directed lending.

([92]) The latter was mainly due to a lower energy delivery prices agreed with Russia at the end of 2011.

reflecting the tightened policy stance also added to this. However, these favourable conditions had largely disappeared by the end of 2012, following a significant relaxation of demand policies that largely eroded the competitiveness gains from the 2011 devaluation. Relatively high domestic inflation resulted in a 14% appreciation of the real effective exchange rate in 2012. A trade dispute with Russia over exports of solvents also contributed to the worsening export performance, which became especially pronounced in early 2013. As a result, the annualised current account deficit jumped to 6.6% of GDP already in the first quarter. On the financing side, net FDI more than halved in 2012 as privatisation came to a halt, while other investments recorded an outflow due to company deleveraging, in particular in the first half of the year. At the same time, international reserves have stabilised around USD 8 billion, or two months of imports (a relatively low level), despite the growing external debt repayments.

The increase in foreign debt service, which is projected to double in 2013, will be a key policy challenge in the medium term. The authorities seem to have sufficient financing space for the time being as they can rely on the USD 880 million that remain of the bailout loan of the Eurasian Anti-Crisis Fund (although this lending is subject to relatively tight conditionality) and foreign currency borrowing from the domestic market. ([93]) Further soft loans by Russia and China should not be excluded either, although such support may not come without economic and political strings. In the future, a new agreement with the IMF could significantly ease the risks arising from the significant external debt bill and the high current account deficit. However, the IMF Board seems to remain reluctant to enter into a financial arrangement with Belarus without a bolder macroeconomic adjustment and a systemic reform programme.

The external debt position of the country also remains a source of vulnerability despite the moderate decline in the debt-GDP ratio in 2012. Gross external debt accounted for 54% of the GDP at the end of 2012, more than twice the 25% ratio seen at the end of 2008. Within this, state external debt more than tripled in four years. The high share of short-term indebtedness (almost 40%) is also a cause for concern. It affects mostly state-owned companies and could act as a serious impediment to their investment activity, but also poses contingent liabilities for the state.

The Belarusian banking system weathered well the 2011 crisis, but remains exposed to the fragile macro-economic situation. A recent surge in foreign-currency lending, mainly to unhedged borrowers, poses a serious risk for the sector and underlines the need for the central bank to strengthen prudential controls. Although the controversial state-subsidised lending through commercial banks has been significantly downscaled, it remains in place and there are risks that the Development Bank could be used as a new channel for such non-market practices. Although the central bank has improved its monitoring of the banking system, risks remain due to the dominance of state-controlled banks that still do not operate entirely on market principles.

Structural reform challenges

Progress with structural reforms was very limited in 2012, as the authorities focused their efforts on achieving, and then retaining, macroeconomic stability. They also did not show enough determination to utilise the favourable window of opportunity for accelerating reforms arising from the stability gains and the favourable gas deal with Russia. In fact, there was some retreat in privatisation with the abolishment of the 2011-13 sell-off list and the *de facto* nationalisation of two confectionery producers. Moreover, a draft presidential decree foresees reinstating state control over privatised companies, even if the company is fully in private hands. Price controls and state subsidies remain, while, as noted, lending under government programmes is still not completely abolished, which leads to an inefficient allocation of financial resources and creates contingent liabilities for the state.

Other structural issues that have to be addressed include the restructuring of the state-owned enterprises, including by tightening budget constraints and moving to a more flexible way of planning of their production strategy. The authorities consider economic modernisation as

([93]) Belarus agreed on a USD 3 billion bail-out programme with the Eurasian Anti-Crisis Fund (EurAsEC) in the middle of 2011. As of June 2013, USD 2.1 billion have been disbursed.

their top priority in 2013. However, progress in that direction has been very modest and would require some resolute steps in terms of strengthening corporate governance, changing the ownership structure, facilitating access to financing by the private sector and ensuring a level playing field for all business actors. Improving the investment climate and focusing on the still nascent SMEs sector is also a must. In the monetary and financial area, reforms are needed to encourage competition, privatise the state-dominated banking sector and further strengthen the independence of the central bank. There was some progress with the latter in early 2013, when amendments to the law on the central bank entered into force. In another positive development, some price and foreign exchange restrictions were lifted, while a differentiated scheme for household utility bills was introduced with the objective to raise recovery rates and ease fiscal costs for the state.

The two economic crises Belarus experienced in less than four years clearly indicate the authorities should focus on a gradual transformation of the current growth model that has become exhausted. Priorities should be given to improving productivity through encouraging private sector development and to restructuring and privatising state companies as well as to fostering an investor-friendly and transparent business environment. This would enable the country to reduce its reliance on Russia's energy subsidies required for keeping afloat energy-intensive, and sometimes inefficient, industries.

Risks and outlook

In the short-term, risks are on the downside due to insufficient policy predictability, excessive focus on meeting quantitative targets as well as an unfavourable external environment due to weak activity in the euro area and Russia. The poor policy track record with structural reforms, as well as the historically high inflation and the low level of international reserves, at a period when Belarus faces significant external debt repayments, also tilt the risks in the negative direction. At the same time, the arrangement with the EurAsEC not only mitigates the risks stemming from debt payments but can also be a source for reforms in view of its relatively tight conditionality. This goes especially for privatisation, which could not only ensure significant proceeds (also beefing up the weak foreign exchange reserve position) but could also act as a source of technology transfer and productivity growth.

In the medium term, the major risk stems from the inability, or unwillingness, of the authorities to seek deep and comprehensive structural reforms that would ultimately change the current growth model of the country. The on-going strong economic reliance on Russia (through soft loans and large-scale energy subsidies) tends to perpetuate Belarus' structural problems (such as low energy efficiency and high dependence on imported energy).

At the same time, the Customs Union with Russia and Kazakhstan could be used in a beneficial manner by institution strengthening and improving weaknesses in areas such as competition legislation. Further trade deepening could be also supportive for growth in the longer term. In this respect, recent moves by the authorities for a faster accession to the WTO are welcome.

Table IV.13.1:

Belarus - Main economic indicators	2009	2010	2011	2012	2013
Output and prices					
Real GDP (% change)	0.2	7.7	5.5	1.5	1.8
GDP nominal (USD, billion)	49.2	55.1	58.8	63.2	65.5
GDP per-capita (USD)	5,178	5,810	6,212	6,674	6,931
CPI inflation (%, average)	13.0	7.8	53.2	59.2	18.3
CPI inflation (%, end-period)	10.1	9.9	108.7	21.8	14.5
Average wage (% real change)	0.1	15.0	1.9	21.9	7.0
Social indicators					
Unemployment (%, registered, end-period)	0.9	0.7	0.6	0.5	0.5
Population (million, end-period)	9.5	9.5	9.5	9.5	9.5
Fiscal sector					
Total revenue (% GDP)	45.7	41.5	38.7	40.7	42.8
Total expenditure (% GDP)	46.4	43.3	35.9	40.0	42.5
General government balance (% GDP)	-0.7	-1.8	2.8	0.7	0.2
Gross public debt (% GDP)	34.9	42.0	43.4	36.9	n.a.
Monetary and financial indicators					
Key policy rate (%, end-period)	13.5	10.5	45.0	30.0	15.0
Broad money M3 (% change)	23.1	31.9	121.2	45.1	3.7
External sector					
Trade balance (% GDP)	-11.4	-13.6	-2.0	4.6	n.a.
Current account balance (% GDP)	-12.5	-15.0	-8.5	-2.9	-8.5
FDI (net, USD billion)	1.8	1.3	3.9	1.3	3.0
FDI (net, % GDP)	3.6	2.4	6.6	2.1	4.6
Gross external debt (% GDP)	44.8	51.5	55.6	54.1	53.0
Gross reserves (USD billion, end-period)	5.7	5.0	7.9	8.1	8.0
Reserves (months of next year's imports)	1.8	1.3	1.9	2.0	2.1
Exchange rates					
Exchange rate (rouble per EUR, average)	3,885	3,950	6,432	10,713	11,400
Exchange rate (rouble per USD, average)	2,793	2,978	4,623	8,336	8,750
Real effective exchange rate (- appreciation)	-4.5	-5.0	-17.8	3.8	n.a.

Sources: National authorities, IMF, Commission Staff estimates for 2013.

14. GEORGIA

- ***Signs of economic weakening emerge as of end-2012 due to uncertainty associated with political transition and an unfavourable global environment.***

- ***New government maintains cautious fiscal stance, but some flexibility might be needed in view of weak economic performance in early 2013.***

- ***External position remains a major source of vulnerability due to a high current account deficit and declining FDI.***

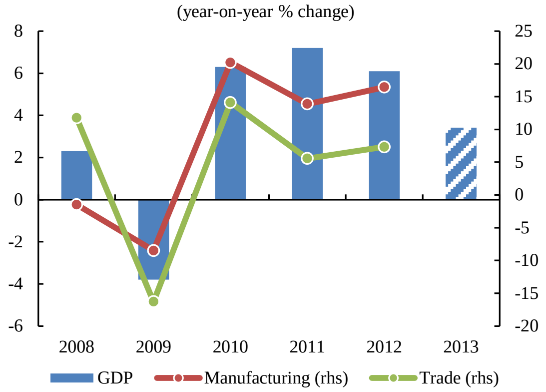
Macroeconomic and financial developments

Georgia's economy demonstrated a remarkable recovery after the 2008-09 dual shock, ([94]) recording a 6.5% annual average growth in 2010-12. This was underpinned by sound macroeconomic policies and market-oriented reforms. Significant donor assistance pledged in the aftermath of the conflict with Russia was also instrumental to that end. However, economic activity moderated significantly in the final quarter of 2012, reflecting a worsening global environment, but also uncertainty arising from the unexpected change of power following the October parliamentary elections. The latter was accompanied by the 'wait-and-see' approach by both businesses and households. As a result, GDP growth slowed down to 6.1% in 2012 from 7.2% a year earlier.

The main growth driver in 2012 remained buoyant investment activity driven by large-scale infrastructure projects financed by the state and through borrowings from IFIs. Household demand also had a positive contribution, reflecting growth in real incomes (a combination of further wage increases and a steep inflation slowdown), rising remittances, robust lending activity as well as high consumer confidence for most of the year. The booming tourist sector was also supportive of the good economic performance in 2012. On the other hand, net merchandise trade had a negative impact on GDP dynamics as imports rose at a high pace to

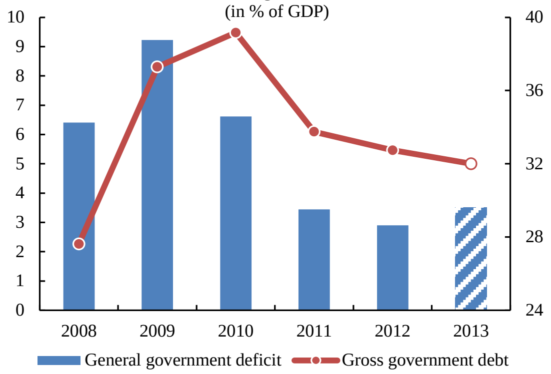
([94]) The shocks from the August 2008 military conflict with Russia and the 2009 global recession.

Graph IV.14.1: **Georgia - GDP**
(year-on-year % change)



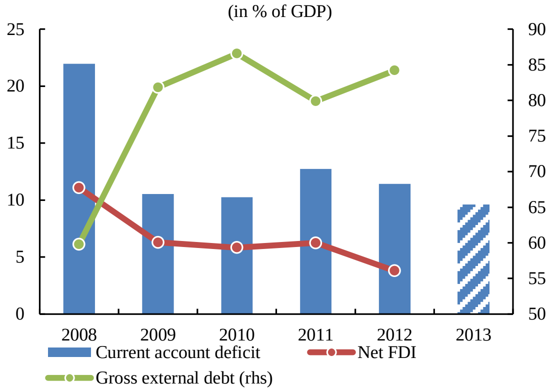
Sources: Geostat; Commission Staff forecast for 2013

Graph IV.14.2: **Georgia - General government balance and gross debt**
(in % of GDP)



Source: Ministry of Finance; IMF; Commission Staff forecast for 2013

Graph IV.14.3: **Georgia - Current account and debt**
(in % of GDP)



Sources: National Bank of Georgia; Commission Staff forecast for 2013 finance robust investment demand. On the supply side, manufacturing, construction and financial intermediation recorded a rapid expansion. At the same time, agriculture witnessed a slight contraction following the bumper harvest in 2011.

The economic weakening, which started with the elections, continued in early 2013, with GDP growth moderating to only 2.3% in the first five months of the year. The reasons include elevated political tensions (highlighted by the incessant verbal attacks between the President and the Prime Minister), which hinder investment activity, but also delay with the implementation, and poor communication, of some of the economic measures announced by the new government ([95]). Furthermore, the authorities put a brake on capital expenditures, which led to a sharp contraction in construction activity in early 2013. Investment spending is expected to gradually pick up speed throughout the year but to be overall downscaled from the previous very high levels in line with the welcome policy shift by the new government towards social policy. Political tensions are expected to gradually subside, contributing to a rebound in economic activity in 2014.

Strong economic growth in 2011-12 has positively affected labour market developments. The jobless rate fell by 1.3 percentage points to 15%, but more importantly, employment growth reached 6% in these two years. These developments came in contrast with the pre-2008 period, when very high growth rates were entirely due to productivity gains. Despite the recent positive dynamics, it should be noted that the labour market still manifests significant weaknesses, as indicated by the dominance of self-employed (more than 60%) and the very high unemployment rates in urban areas (26%). Furthermore, poverty rates remain high, in particular in the rural areas where people are predominantly occupied with subsistence farming. In this respect, the policy change by the new administration in favour of r a more inclusive growth model and higher social protection of the most vulnerable is welcome. However, these objectives should not compromise with the goal for continued fiscal consolidation.

In marked contrast with the high inflationary environment in the previous two years, there was an impressive disinflationary trend in 2012 that was mainly due to lower food prices worldwide. Demand-side pressures remained subdued as economic growth was largely driven by investment activity. The CPI was in the deflationary area for most of the year, with the average price decline reaching 0.9% in 2012. Inflation is expected to rebound in 2013 on growing food prices. However, the economic slowdown and a price cut of utility tariffs negotiated by the new cabinet will likely keep inflation well below the 6% target of the central bank. In the absence of any inflationary pressures in 2012, the Bank continued its easing cycle and reduced the key policy rate by cumulative 150 basis points to 5.25% at the end of the year. More cuts, to a record-low 4%, followed in the first half of 2013 as the central bank attempted to boost economic activity. However, the monetary policy transmission mechanism remains constrained by the high dollarization ratio.

On the fiscal front, the new cabinet put on a freeze capital spending after coming in power. This brought the general government deficit to only 2.9% of GDP in 2012, well below the 3.5% initial target. The 2013 budget envisages a further reduction of the deficit to 2.8% of GDP based on a streamlining of administrative costs and infrastructure spending. At the same time, social expenditures (for pension increases and universal health coverage ([96])) will be on the rise, which will limit room for a counter-cyclical fiscal policy in case of downside risks. In view of the weak economic activity in early 2013, and the plans of the cabinet to adhere to its expenditure-side commitments, there is a high probability that the 2.8% of GDP deficit target will be exceeded. Still, in the medium term prudent fiscal policies would be underpinned by the entry into force of the Economic Liberty Act in 2014. This law will introduce a set of fiscal thresholds, including a fiscal deficit ceiling of 3% of GDP, a public debt

([95]) Debates on the approval of a new Labour Code, which strengthens employees' rights, lasted nearly seven months and contributed to the uncertainty over the direction of economic policy. The ambiguity about the establishment of various funds to co-finance foreign and domestic investment projects acted in a similar way.

([96]) The basic pension for people aged up to 67 was raised in February 2013. There will also be a 20% across-the-board increase in September. In February, the cabinet started providing health insurance to the entire population. It widened the coverage of the insurance package in July.

cap of 60% and a government spending cap of 30% of GDP. The fiscal consolidation efforts in the last few years have allowed a reduction in the public debt ratio to approximately 34% of GDP at the end of 2012 from 40% of GDP two years earlier.

Turning to the external sector, the sizeable current account deficit remains a major source of vulnerability for the country. The gap amounted to 11.4% of GDP in 2012, fuelled by a widening merchandise trade deficit (at 26% of GDP) on the back of growing imports of investment goods. This was mitigated by further growth in proceeds from trade in services due to the booming tourist industry as well as a significant decline of the net income outflow (most likely the result of lower profitability by foreign companies operating in the country). Furthermore, workers' remittances continued growing, although at a weaker pace. The financing of the current account gap was ensured at the expense of rising debt capital inflows. ([97]) At the same time, net FDI fell by a third in 2012 and remains well below the levels before the conflict with Russia. As a result, the current account coverage by net FDI dropped to only 33% from about 100% in 2007. Growing reliance on debt financing also led to increase of the already high gross external debt of the country, which reached 85% of GDP at the end of 2012.

These external vulnerabilities are to some extent alleviated by recourse to considerable donor financing, a relatively favourable debt maturity structure as well as a two-year precautionary programme approved by the IMF in April 2012 (see Annex 1 in Part II). Also, the EU adopted in July 2013 a decision providing MFA to Georgia in the amount of up to EUR 46 million. Moreover, it should be noted that a considerable part of the external debt reflects intercompany financing, which is likely to be easily rolled over. The on-going increase of international reserves, which are close to four months of next year's imports, should also act as a cushion. However, in the future the authorities should seek a long-term solution to the high external imbalances, by allowing a greater flexibility of the local currency, encouraging export-oriented sectors and better utilising the comparative advantages the country could have in areas like agriculture, tourism and hydropower production.

([97]) This reflects mainly USD 750 million (or 4.7% of GDP) Eurobond placements by the state railway company and the state oil and gas corporation. Another factor was a steep rise in non-resident deposits due to high interest rates on savings

Structural reform challenges

Georgia is among the leading reformers in the economic field worldwide, which has contributed to the growing investor appeal of the country. This is also recognized by the World Bank, which estimated the country was a frontrunner in terms of improving its business environment since 2005 (see Box II.2.1 in Part II). The Bank ranks Georgia 9th among 185 economies in its 'Doing Business 2013' report. The country scores among the top ten in areas such as registering a property, launching a business, dealing with construction permits and getting credit. Reforms were also successful in the areas of taxation and public finance management. Significant progress was achieved in trade deepening, as Georgia is advancing at a fast pace with negotiations on the establishment of a DCFTA with the EU. The new government plans to fight oligopolistic structures and to encourage competition. It also intends to set up various investment funds (including in the agriculture sector) in order to boost investment activity although, as noted, there is still insufficient information about these funds.

Future policies should focus on stimulating export industries and promoting job creation, including through supporting the SMEs. Despite strong growth for most of the last decade, unemployment and poverty remain at high levels. It should be also noted that the real picture of the labour market is disguised by high employment in agriculture (about half of the total), which reflects mainly subsistence farming. Further fiscal consolidation and reforms to strengthen the efficiency and credibility of the central bank's policies are required in view of the significant external imbalances and the unsettled global environment.

Risks and outlook

The main short-term risks for the Georgia's economy stem from high political tensions and possible instability due to the difficult co-habitation between the President and the new government, but also to policy uncertainty and an inconsistent implementation of reform measures.

Table IV.14.1:

Georgia - Main economic indicators

	2009	2010	2011	2012	2013 projection
Real sector					
Real GDP (% change)	-3.8	6.3	7.2	6.1	3.4
GDP nominal (USD, billion)	10.8	11.6	14.4	15.9	16.6
GDP per capita (USD)	2,455	2,623	3,231	3,520	3,689
Inflation (%, period average)	1.7	7.1	8.5	-0.9	-0.6
Inflation (%, end-year)	3.0	11.2	2.0	-1.4	1.8
Social indicators					
Population (million)	4.4	4.4	4.5	4.5	4.5
Unemployment rate (%, ILO definition)	16.9	16.3	15.1	15.0	14.8
Poverty ratio, %*	21.0	22.7	23.0	22.4	22.0
Fiscal sector					
Total revenue (% GDP)	29.3	28.3	28.2	28.8	28.2
Total expenditure (% GDP)	38.5	34.9	31.8	31.8	31.7
General government balance (% GDP)	-9.2	-6.6	-3.6	-3.0	-3.5
Gross government debt (% GDP)	37.3	39.2	33.8	32.3	32.1
Monetary and financial sectors					
Key policy rate, end-year	5.0	7.5	6.8	5.3	3.5
Domestic credit to private sector (% change, end-period)	-13.4	20.8	23.9	12.4	13.5
Broad money (M3, % change)	7.7	30.1	14.5	11.4	13.0
Non-bank deposit dollarisation, end-year	68.5	68.0	59.0	64.1	61.0
External sector					
Current account balance (% GDP)	-10.5	-10.2	-12.7	-11.4	-9.6
Trade balance (% GDP)	-19.1	-17.8	-19.0	-19.6	18.5
Net remittamces (% GDP)	6.6	6.9	7.8	8.6	8.6
Net FDI (% GDP)	6.3	5.8	6.2	3.8	n.a.
Gross external debt (% GDP)	81.8	86.6	79.9	84.2	86.0
Gross reserves (USD billion)	2.1	2.3	2.8	2.9	3.2
Import cover of reserves (months)	4.1	3.4	3.8	3.8	3.9
Exchange rates					
Exchange rate (lari per EUR, average)	2.3	2.4	2.3	2.1	2.2
Exchange rate (lari per USD, average)	1.7	1.8	1.7	1.7	1.7
Real effective exchange rate (% change, + is appreciation)	0.0	-4.6	9.8	1.9	n.a.

* - share of population under 60% of median consumption

Sources: National authorities; IMF, Commission staff estimates for 2013

In fact, these risks seem to have been already materialising in the weakening investment and credit activity at the end of 2012 and in early 2013. Another risk comes from the weak global environment that could affect the economy through various channels such as trade and capital flows, remittances and tourism. At the same time, signals for improved cooperation with Russia, while retaining the path for further strong integration with the EU, reduce geopolitical risks and open opportunities for new export destinations.

The IMF agreement should serve as a buffer that could absorb a potential negative shock for the country, while contributing to ensure that the economic policy strategy remains prudent. Macroeconomic risks stem, as noted, from the high external vulnerabilities manifested by the double-digit current account deficit and very high, and growing, external debt. Efforts should be focused to address these weaknesses through continuation of the sound macroeconomic policy mix, but also reforms that will support the development of the export base. Diversifying exports, while strengthening competitiveness in areas where Georgia has competitive advantage, should enable the country to benefit from its policy course for deepening trade integration, including through the establishment of a DCFTA with the EU. This could also lead to more inclusive growth, which is needed to address the country's relatively high level of economic inequality.

15. MOLDOVA

- ***After a robust recovery in 2010 and 2011, the Moldovan economy slowed significantly in 2012 due to a weak external environment combined with a sharp decline in the agricultural sector resulting from unfavourable weather conditions at home.***

- ***Despite the economic slowdown, the government pursued its effort of fiscal consolidation. The budget deficit was reduced to 2.1% in 2012 from 2.4% of GDP in 2011.***

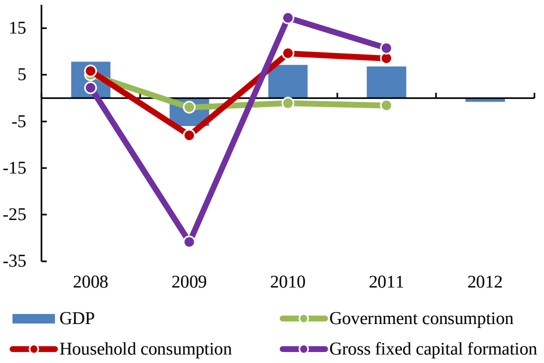
- ***The business climate improved in 2012. However, renewed efforts are needed when it comes to structural reforms, in particular as regards banking sector supervision.***

Macroeconomic and financial developments

Economic activity slowed significantly in 2012 as a result of negative external shocks including weaker export demand from the EU and adverse weather conditions – a harsh winter and a summer drought – that hit the large agricultural sector severely. GDP contracted by 0.8% in real terms in 2012 (after growing by 6.8% in 2011) as a result of a sharp moderation of domestic demand, investment activity and exports, which grew by a mere 0.2% year-on-year in 2012. At the same time, the negative impact on GDP from net trade was reduced due to slowing import growth that reflected weaker household and investment demand.

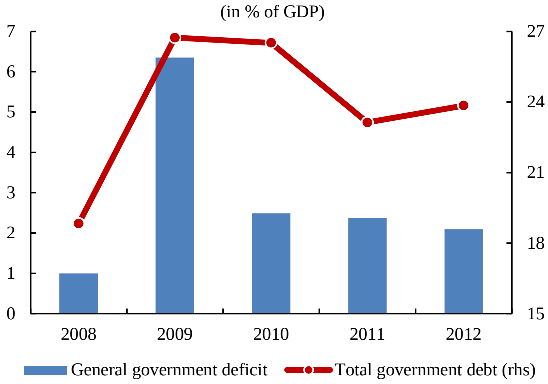
On the supply side, the slowdown was broad-based. The industrial sector was among the worst performers, reporting only 0.5% growth in 2012, compared to a 10.2% expansion in 2011. Transport and communication expanded by 2.8%. The highest growth (4.2%) was in wholesale and retail trade, which benefited from rising remittances, which in turn grew by 11% in 2012, and growth in real wages. On the other end of the spectrum was agriculture, which contracted by 23.3% in 2012. As the agricultural sector rebounds in 2013, it is expected to drive economic recovery during the year. The government has adjusted its projection to 4% GDP growth, which is in line with the IMF forecast.

Graph IV.15.1: **Moldova - GDP**
(year-on-year % change)



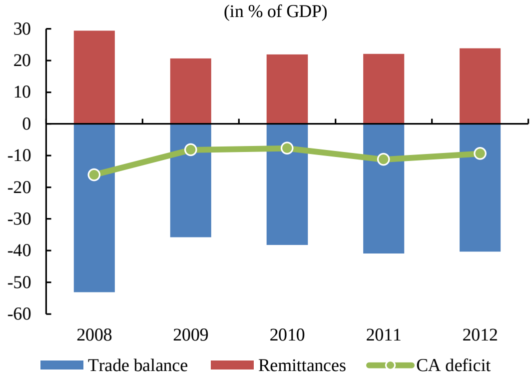
Source: National authorities; IMF

Graph IV.15.2: **Moldova - General government deficit and debt**
(in % of GDP)



Source: IMF

Graph IV.15.3: **Moldova - Current account**
(in % of GDP)



Source: National authorities, IMF

The unemployment rate decreased markedly in 2012, from 6.7% to 5.5%, a continuation of a downward trend since the middle of 2010 that was driven mainly by reduced numbers of jobless people in rural areas. At the same time, the employment rate fell significantly as a result of weakening economic activity across many sectors. The real average wage rose by 4.1% in 2012 compared to 2011, mainly as a result of public sector wage increases.

Weakening domestic demand coupled with a fall of food prices on global markets contributed to a steep disinflation in the first half of 2012. The headline inflation bottomed out at 3.7% year-on-year in June after peaking at 9.2% in August 2011. However, the negative impact on food prices from the summer drought as well as rises in administered prices and indirect taxes resulted in a reversal of the downward trend that continued until the end of the year. CPI and core inflation stood at 4.7% and 3.7% respectively at the end of 2012.

The improved inflationary outlook at the start of 2012 enabled the National Bank of Moldova (NBM) to cut rates aggressively by cumulative 400bps in January and February of 2012; in April 2013, in light of weak economic activity, the NBM cut the rates by a further 100 bps. However, despite the low rates, credit demand remains constrained as a result of weakening economic activity and growing uncertainty that make both households and businesses less willing to borrow. In 2012, the local currency depreciated against the USD by 3%, while appreciating against the EUR by 4%.

Irrespective of the negative shocks, the authorities continue to focus on improving fiscal sustainability. In July 2012, the parliament approved a budget revision, which aimed to correct the significant fiscal slippages arising at the start of the year due to the economic slowdown, collection problems, unbudgeted expenditure commitments and delays in external assistance. Despite these corrective measures, the deficit target for 2012 was increased to 1.3% of GDP from previous 0.9% and the actual deficit (2.1% of GDP) fell short even of this target, as a result of lower-than-expected revenue. The 2013 budget was adopted by parliament in November 2012 with a fiscal deficit target at 1.1%. Revenue growth this year should be supported by a new wave of indirect tax increases, including excises on tobacco and alcoholic beverages and VAT on natural gas and agricultural products. In the medium term, the completion of reforms in social assistance, the allocation of agricultural subsidies and heating assistance will support fiscal sustainability.

The prudent fiscal policies pursued by the authorities were supportive of a gradual reduction of the public debt to 23.8% of GDP in 2012 (from 26.5% of GDP in 2010). However, the debt accumulated by Transnistria, Moldova's break-away region, towards Russia's gas company Gazprom, estimated at about 35% of Moldova's GDP, represents a significant contingent liability that would materialize in case of settlement of the Transnistria conflict.

On the external front, the current account deficit decreased from 11.3% of GDP in 2011 to 9.4% in 2012. The weakening economic activity and deceleration of domestic demand slowed the pace of import expansion leading to a slight reduction in the trade deficit to 40.3% of GDP in 2012 from 40.9% in 2011. The growing surplus in net income and net unilateral transfers, a reflection of resilient remittances, further contributed to the narrowing of the current account deficit. Overall, remittances rose by 11% in 2012 to USD 1.8 billion, or 24% of GDP. Notwithstanding these positive developments, the current account deficit is large and will remain the main source of vulnerability in 2013.

In the financial account, there was some worsening as net FDI declined to just 1.9% of GDP in 2012, mainly as a result of lower re-invested earnings due to reduced profitability of foreign companies operating in the country. Another source of vulnerability is the high, and growing, external indebtedness, which edged up to 84.5% of GDP in 2012 from 77.6% in end-2011. These external risks were somewhat mitigated by the NBM's market interventions in the second and third quarters of 2012 to replenish the official reserves, which reached a record high USD 2.5 billion at end-2012 (still maintained in July 2013), covering almost five months of imports. The IMF arrangement, which lapsed in April, helped to reduce external risks.

The country's banking system remains well capitalised (24.9% capital adequacy ratio at end-

April compared to 16% minimal requirement), albeit with a high proportion of foreign-currency-denominated loans and deposits (44% and 43% respectively) that heighten exchange rate vulnerability. The NPLs ratio increased in 2012 from 10.9% in 2011 to 14.5% at the end of the year. This sharp increase was largely due to the sharp deterioration of the loan portfolio of Moldova's second largest bank, Banca de Economii (BEM). The NPLs ratio has since decreased to 12.9% at end-May 2013, but the troubles of the BEM experiencing severe liquidity problems remain, and there is a large need for recapitalisation and restructuring of the bank. Worryingly, a new raider attack, ([98]) this time against Moldova's largest bank, Moldova Agroindbank, has been confirmed by the NBM. Both of these banks are systemic banks, accounting for approximately 13% and 20% of total assets respectively. In light of these recent events, resolute efforts are needed to improve ownership transparency overall in the banking sector and a strengthening of the supervisory role of the NBM. This would also reinforce credibility in the sector and contribute to financial deepening.

Structural reform challenges

Structural reforms were advancing in 2012, in particular those aimed at enhancing macroeconomic and financial stability and promoting export-led growth. The political situation, which stabilized after the election of a new president in March 2012, deteriorated again in 2013, culminating in early March with the resignation of the tri-partite government led by Prime Minister Filat. During its time in office, between September 2009 and March 2013, the Filat government showed commitment to advancing both structural reforms and the European integration agenda, as witnessed by the good progress in the negotiations of both the Association Agreement and the Deep and Comprehensive Free Trade Area. The authorities also completed the transition to a system of means-tested social assistance in 2012. A new coalition government was formed in late May with a new Prime Minister, Iurie Leanca, from the same political party as Filat. The new government has announced European integration as its top priority and has a similar government programme as its predecessor. It has also resumed discussions with the IMF on a follow-up programme, following the one that expired earlier in the year. ([99]) It remains to be seen how stable and reform driven this new government will be in practice.

Indeed, a number of structural reforms need to be undertaken. One of the most critical is, as mentioned above, banking sector supervision, but privatisation and restructuring plans for several state-owned enterprises, including Moldtelecom, Air Moldova and Railway of Moldova, should also be a top priority in 2013, as should the resolution of the large payment arrears in the energy sector. As for private sector development, Moldova reported a slight improvement in the World Bank's "Doing Business Report 2013" to 83rd place from 86th a year earlier with a sizable improvement in investor protection. Similarly, Moldova advanced six places in the World Economic Forum's "Global Competitiveness Report" for 2012-13 to 93rd place among 144 countries. However, it is still lagging behind most countries in Eastern Europe and the former Soviet Union. Overall, the most problematic factors for doing business in Moldova are considered to be corruption, political instability, an inefficient bureaucracy and weak access to finance.

Risks and outlook

Though GDP growth is expected to pick up in 2013, this still hinges on positive external developments, particularly in the euro area, Russia and Ukraine, which are by no means guaranteed. Still, agriculture is expected to recover from the harsh conditions of 2012, which will give a boost to overall growth. The main sources of risk include a worsening of the euro area crisis, which would affect Moldova through trade and remittances channels, both directly and indirectly, via its impact on Russia. The large current account deficit and growing gross external debt increase vulnerabilities further. However, these risks would be mitigated by a follow-up agreement with the

([98]) A raider attack, or hostile takeover, is an unfriendly acquisition attempt by a company or raider that is strongly resisted by the management and the board of directors of the target firm or bank.

([99]) The last tranche under the programme was not released as the final programme review could not be completed amid political crisis in Moldova.

Table IV.15.1:
Moldova - Main economic indicators

	2009	2010	2011	2012	2013 projection
Output and prices					
Real GDP (% change)	-6.0	7.1	6.8	-0.8	4.0
GDP nominal (USD billion)	5.4	5.8	7.0	7.3	7.9
GDP per capita (USD)	1,524	1,631	1,971	2,037	2,218
Inflation (average, %)	0.0	7.4	7.7	4.7	4.6
Social indicators					
Unemployment rate (survey based, %)	6.4	7.4	6.7	5.5	6.2
Poverty rate (%)*	26.3	21.9	17.5	n.a.	n.a.
Population (million)	3.6	3.6	3.6	3.6	3.6
Fiscal sector					
General government revenues (% GDP)	38.9	38.3	36.6	38.2	37.7
General government expenditures (% GDP)	45.2	40.8	39.0	40.3	39.8
General government balance (% GDP)	-6.4	-2.5	-2.4	-2.1	-2.1
Gross government debt (% GDP, end-period)	26.7	26.5	23.1	23.8	22.5
Monetary sector					
Key policy rate (%, end-period)	5.0	7.0	9.5	4.5	3.5
External sector					
Trade balance (% GDP)	-35.8	-38.2	-40.9	-40.3	-40.8
Current account balance (% GDP)	-8.2	-7.7	-11.3	-9.4	-10.0
Net remittances (% GDP)	20.7	21.9	22.1	23.9	24.5
Net FDI (% GDP)	2.5	3.3	3.7	1.9	2.5
Gross external debt (% GDP)	80.2	82.3	77.6	84.5	n.a.
Gross official reserves (USD billion, end-period)	1.5	1.7	2.0	2.5	2.7
In months of next year's imports	3.9	3.4	3.8	4.6	n.a.
Exchange rates					
Exchange rate (MDL per USD, average)	11.1	12.4	11.7	12.1	n.a.
Exchange rate (MDL per EUR, average)	15.5	16.4	16.3	15.6	n.a.
Real effective exchange rate (% change, + is appreciation)	1.7	-6.0	6.1	3.9 (proj)	0.5

IMF, and further integration into the EU single market through a DCFTA.

A stall or reversal of structural reforms would have a negative impact on the business climate and the prospect of fiscal sustainability. The central bank forecasts disinflation from the second half of 2013 into the first half of 2014. However, the formation of a new pro-European government in May brings hope that Moldova will continue to progress with the reform agenda with a steady eye towards the Eastern Partnership Summit in Vilnius in November and a possible initialling of the Association Agreement, which includes a Deep and Comprehensive Free Trade Area.

16. UKRAINE

- ***Following a strong recovery in 2010 and 2011, Ukraine's economy entered recession in the second half of 2012 amidst a weak external environment and a slowdown of investment.***

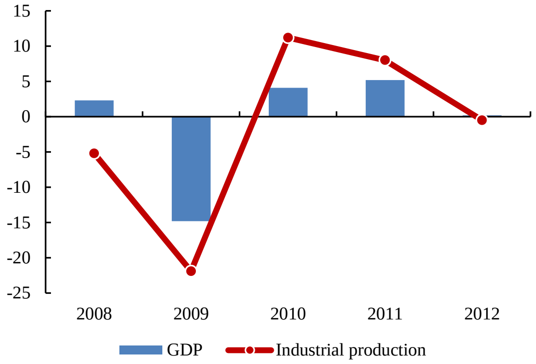
- ***Ukraine faces the challenge to address the widening twin deficits of the government budget and the current account, while high import prices for Russian gas and the absence of IMF funding drive up external financing needs.***

- ***The operating environment for businesses has failed to improve with the onset of a new government in 2010, with corruption, red tape and a lack of transparency in dealings with the administration still hampering economic development.***

Macroeconomic and financial developments

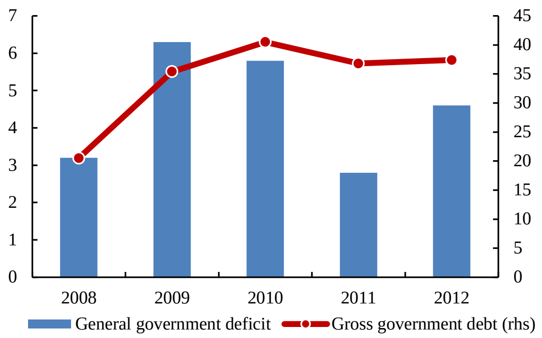
Ukraine's real GDP growth slowed significantly in 2012 to 0.2% from 5.2% in 2011 and 4.1% in 2010. This disappointing growth performance, which continued through the first quarter of 2013 with a contraction of 1.3% year-on-year, is mainly a consequence of the more challenging global economic environment, tight monetary policy, and worsening domestic business climate. The economy would presumably have entered recession if the government had not sustained public investment in the run-up to the Euro 2012 football championship and loosened fiscal policy before the October 2012 parliamentary elections. Still, construction plummeted by 13.8% year-on-year, and industrial production declined by 1.8%. Agricultural output decreased by 4.5% in 2012 after a bumper harvest in 2011. Growth is expected to stay flat in 2013, before only a slow recovery in 2014 as the external outlook and the slow progress with improving the business environment cloud growth prospects and make the 3.4% GDP growth forecast of the Ukrainian government for 2013 appear too optimistic.

Graph IV.16.1: **Ukraine - GDP and industrial production**
(year-on-year % change)



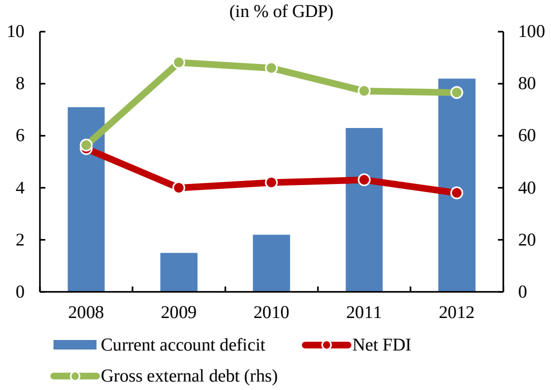
Source: National authorities; IMF

Graph IV.16.2: **Ukraine - General government deficit and debt**
(in % of GDP)



Source: IMF

Graph IV.16.3: **Ukraine - Current account, FDI and debt**
(in % of GDP)



Source: National authorities, IMF

Inflation remains at its lowest level for a decade, reaching -0.4% year-on-year in May 2013, as demand pressures were subdued, food prices declined, administrative tariffs were kept flat, and as the central bank kept the refinancing rate high at 7.5% (the key policy rate was cut only in June 2013 by 50 bps), with a view to limiting downward pressure on the exchange rate. However, a likely devaluation of the local currency (hryvnia) in the second half of 2013, to help trim the large current account deficit in light of slow growth, dwindling foreign direct investment and large external debt, means inflation is likely to pick up in 2013-14. Price dynamics will also depend on whether the central bank's focus will shift to inflation targeting in the medium term. Its current focus on supporting the currency has resulted in a decline of the foreign exchange reserves to USD 24.5 billion, or 2.9 months of imports, at end-May 2013. While administrative measures and market interventions to stabilize the hryvnia provided some short-term relief, the currency peg is unsustainable in the medium term against the background of the persistently large current account deficit and slowing growth. As a consequence of the central bank's restrictive approach to providing refinancing to banks, overnight inter-bank interest rates exceeded 45% in the third quarter of 2012, resulting in prohibitively high interest rates on credits to households and businesses. However, at the end of 2012 they declined to about 25% and even further in the first quarter of 2013 as the liquidity situation in the banking system improved somewhat.

Hopes for a positive impact of the Euro 2012 football championship on the Ukrainian economy materialised only partially. While investment and construction related to the championship are estimated to have had a cumulative impact of about 2.5% of GDP between 2008 and 2012, the fiscal cost was considerable at about 8% of GDP (USD 13 billion), as most of the investment was shouldered by the public rather than the private sector. After Ukraine managed to rein in its budget deficit following the 2008-09 crisis, recent trends have been less positive, and the overall budget deficit is expected to have reached 5.5% of GDP in 2012 (3.8% excluding Naftogaz) after 4.3% in 2011. Apart from fiscal loosening ahead of the 2012 parliamentary elections, an important factor contributing to the deficit is the state-owned oil and gas company Naftogaz, which sells natural gas to households and utilities at prices which are significantly below cost-recovery levels. Naftogaz's deficit reached about 1.7% of GDP in 2012, and will continue to remain at similarly high levels unless the government implements the gas price increases recommended by the IMF. The draft 2013 budget, adopted in late December 2012, is relatively conservative regarding the revenue and expenditure forecasts. However, the budget is based on a real GDP growth forecast of 3.4% which will be very difficult to reach in the current macroeconomic environment.

The public debt ratio has increased significantly in recent years, to approximately 37% of GDP at the end of 2012 from only 12% of GDP in 2007. Although it remains at a relatively manageable level, delays in the adjustment of gas prices and the slowdown in economic activity may result in a future increase in the debt ratio.

The balance of payments situation continued to deteriorate in 2012, with the current account deficit widening to 8.2% of GDP from 6.3% a year earlier as a result of higher energy import prices and weak external demand for traditional Ukrainian exports, mainly steel, and despite a pickup of agricultural exports. There are also significant risks to the financial account if foreign banks continue to deleverage and as FDI inflows remain subdued as a consequence of the deteriorating business climate. Slightly up as compared to 2011 (USD 7.2 billion), net FDI inflows reached USD 7.8 billion in 2012, out of which, however, at least USD 5 billion were invested through Cyprus (essentially circular investments for tax reasons rather than genuine FDI). Overall, Ukraine's vulnerability to external shocks, such as a new oil price spike or a slump in steel prices, remains high.

Financing the current account deficit, and thus reining in the accelerated loss of currency reserves, remains a formidable challenge. Although Ukraine re-accessed the international capital market in 2012 and 2013, placing government bonds at rates judged as affordable (latest placement occurred in April 2013 of USD 1.25 billion at 7.5%) and thus alleviating fears of debt repayment, an agreement with the IMF would considerably improve market sentiment while making the country less dependent on lending from Russia (and increasingly China), which comes with the need to make policy concessions in other areas. Ukraine needs to roll over a large portion of its sovereign debt, about USD 9 billion, in 2013, out of which about USD 6 billion owed to the IMF.

The main sticking point in negotiations with the IMF on a possible new programme (the previous one, a SBA, expired in December 2012) remains the issue of further increases in the gas prices for households and utility companies, after an initial 50% hike implemented in August 2010. The authorities' declared strategy is to secure discounts on the price for import gas purchased from the Russian Gazprom instead of adjusting gas tariffs. However, the IMF is insisting on the adjustment of domestic gas prices for households, which currently pay a mere 15% of import prices, even if a significant reduction of import prices was achieved. In addition, there is disagreement on exchange rate flexibility as well as on some of the parameters of Ukraine's 2013 budget. Failure to unblock the IMF SBA would also prevent from unblocking the possible complementary assistance from the World Bank (USD 500 million) and macro-financial assistance from the EU (the agreement on the economic conditions for the EU loan of EUR 610 million was signed at the beginning of 2013).

Policy reforms and measures

Despite an ambitious Programme for Economic Reforms for 2010-14, implementation of key structural reforms remains below expectations. Notwithstanding the declared policy goal of an improved business climate in Ukraine, there are a number of adverse trends, such as an increase of corruption (at least, increased perception of corruption), insufficient progress in public finance management reform, and increased pressure on business from tax and customs administrations.

Close links between business and politics continue to adversely affect both good governance and the business climate. A number of government re-shuffles appear to have weakened business tycoons who dominated the Ukrainian economy over the past decade, although there are indications that a new group of politically well-connected businesspersons are gaining influence over key sectors of the economy. These challenges are reflected in Ukraine's low ratings, by regional standards, in a number of comparative studies, including the World Bank's Doing Business Index (137th out of 185), the Transparency International Corruption Perceptions Index (144th out of 176), the Economic Freedom Index of Heritage Foundation (161st out of 177) and the Press Freedom Index of Reporters Without Borders, (126th out of 179).

At the same time, positive structural changes are taking place, albeit slowly, in some areas of the economy. Ukraine has decreased its dependence on the export of steel products somewhat, with the share of total exports declining from 40% in 2002 to 28% in 2012, while agribusiness and retail became more significant.

Risks and outlook

Overall, 2012 was a disappointing year for Ukraine both in terms of economic growth and the return to international creditworthiness. Unfortunately it looks as though the economy will not start to pick up until 2014. Over the short-to medium term, Ukraine's government needs to deliver on key reforms, improve fiscal sustainability while addressing the investment climate, rein in corruption, and diversify the economy. The exchange rate policy needs to be adjusted in order to avoid a further widening of the current account deficit and a drain of the country's international reserves.

Table IV.16.1:

Ukraine - Main economic indicators	2009	2010	2011	2012	2013 projection
Output and prices					
Real GDP (% change)	-14.8	4.1	5.2	0.2	0.0
GDP nominal (USD billion)	117.2	136.4	163.4	176.2	181.6
GDP per capita (USD)	2,550	2,980	3,584	3,877	4,015
Inflation (average, %)	15.9	9.4	8.0	0.6	0.8
Social indicators					
Unemployment rate (survey based, %)	8.8	8.1	7.9	8.0	8.2
Population (million)	46.0	45.8	45.6	45.5	45.2
Fiscal sector					
General government revenues (% GDP)	42.3	43.2	42.9	44.6	43.5
General government expenditures (% GDP)	48.6	49.0	45.6	49.3	48.0
General government balance (% GDP)	-6.3	-5.8	-2.8	-3.8	-4.5
Gross government debt (% GDP, end-period)	35.4	40.5	36.8	37.4	42.2
Monetary sector					
Key policy rate (%, end-period)	10.3	7.8	7.8	7.5	7.0
Domestic credit to the private sector (% change)	-2.2	1.0	9.4	2.3	4.8
External sector					
Trade balance (% GDP)	-1.7	-2.9	-6.1	-8.4	n.a.
Current account balance (% GDP)	-1.5	-2.2	-6.3	-8.2	-8.2
Net FDI (% GDP)	4.0	4.2	4.3	3.8	3.5
Gross external debt (% GDP)	88.2	86.0	77.2	76.6	79.0
Gross official reserves (USD billion, end-period)	26.5	34.6	31.8	24.5	22.0
In months of next year's imports	4.3	4.2	3.6	2.8	2.6
Exchange rates					
Exchange rate (hryvnia per USD, average)	7.8	7.9	8.0	8.0	n.a.
Exchange rate (hryvnia per EUR, average)	10.9	10.5	10.1	10.0	n.a.
Real effective exchange rate (% change, + is appreciation)	-17.6	6.0	0.1	2.6	n.a.

Sources: National authorities; IMF; Dragon Capital; Commission staff estimates

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