

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

This publication focuses on the Southern and Eastern neighbouring countries of the EU, describing recent economic, monetary and financial developments in these two regions. The paper covers all of the countries that are part of the European Neighbourhood Policy (ENP) framework: the "Southern neighbours" - Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Palestine, Morocco, Syria and Tunisia and the "Eastern neighbours" - Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine, all of which are also part of the EU's Eastern Partnership (EaP) initiative.

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 crisis in the EU, with which many of the countries 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. 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 activity in several Eastern neighbours. They are also being affected by the rapid slowdown of the Russian economy since the second half of 2012.

The paper is structured into four parts. Part I starts with a comparison of the economic situation and outlook in the Southern and Eastern sub-regions of the EU's neighbourhood, before turning to selected economic policy issues drawing on the detailed analysis contained in subsequent parts of the report. Part II presents and analyses recent macroeconomic developments separately for the Southern and Eastern neighbours. It also describes the response of the EU and the international community to the Arab Spring process in the Southern neighbours and discusses in detail the need for reform of the food and energy subsidies that are prevalent in many of the ENP countries. Part III consists of two thematic chapters. The first discusses the exposure of the EU's neighbours to the sovereign debt and banking crisis in the euro area, focusing on several transmission channels such as exports, tourism, remittances and capital flows. It analyses recent trends and provides policy recommendations for reducing the possible negative impact for the region from the weak economic activity in the EU. The second part provides an overview of the main principles of Islamic Finance and discusses its increasing role in the Mediterranean region. Finally, Part IV delivers a country-by-country analysis of the economies in the EU's neighbourhood; including the real sector, monetary policy, public finances, the external sector, the financial sector, and the structural reform agenda.