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Directorate-General for Economic and Financial Affairs

European Neighbourhood Policy:
Economic Review of EU Neighbour Countries

EUROPEAN ECONOMY Occasional Papers No 40

ABBREVIATIONS

AA	Association Agreement
AP	Action Plan
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EITI	Extractive Industries Transparency Initiative
ENP	European Neighbourhood Policy
ENPI	European Neighbourhood and Partnership Instrument
EIU	Economist Intelligence Unit
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GCC	Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE)
GDP	Gross Domestic Product
GNI	Gross National Income
GSP	General System of Preferences
HDI	Human Development Index
ILO	International Labour Organisation
IMF	International Monetary Fund
JOD	Jordanian dinar
MAD	Moroccan dirham
MED	Mediterranean Countries
MEI	Main economic indicators
MENA	Middle East and North Africa region
NDF	National Development Fund
NEER	Nominal Effective Exchange Rate
NIP	National Indicative Programme
OECD	Organisation for Economic Co-operation and Development
oPt	occupied Palestinian territory
PA	Palestinian Authority
PPP	Purchasing Power Parities
SMEs	Small- and Medium-sized Enterprises
SPPRED	State Programme on Poverty Reduction and Economic Development
UAE	United Arab Emirates
UN	United Nations
UNDP	United Nations Development Program
USD	US dollar
VAT	Value Added Tax
WB	World Bank
WDI	Word Development Indicators
WTO	World Trade Organisation
yoy	year-on-year

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FOREWORD

This is the fourth issue of the Economic Review of EU Neighbour Countries[1]. This year the review includes a special focus on a topical issue: the macroeconomic policy reactions to soaring (food) prices in Mediterranean countries, Russia, the CIS and the GCC.

In addition to country-specific chapters, this review includes two overviews of the recent macroeconomic developments in the Mediterranean and the EU Eastern neighbourhood regions. These chapters are structured along the main areas of reform: macroeconomic developments, trade liberalisation and economic opening, business climate, public institutions and public finance management, and social development and poverty.

This Occasional Paper has been prepared by a team led by José Leandro and Andreas Papadopoulos including Ronald Albers (Lebanon), Nico Beinema (statistics), Stylianos Dendrinos (Israel, Jordan, Libya, Syria and Tunisia), Inmaculada Montero Luque (overview of the Mediterranean countries, Morocco, occupied Palestinian territory), Anja Nielsen (secretarial), Marga Peeters (Algeria, Egypt, study on soaring prices, editorial), Steven Smolders (statistics), Agnieszka Skuratowicz (Jordan, Lebanon), Kiril Strahilov (Armenia, Azerbaijan, the study on soaring prices), Sirpa Tulla (Georgia, Ukraine) and Lúcio Vinhas de Souza (Belarus, Russia). Sophie Bland, Ivan Buck, Douglas Jenks, Jonathan Marten and Chris Maxwell reviewed the paper.

The authors are grateful to the following persons for their useful comments: Thomas Brinkmann (DG AIDCO), Marie Corman (DG ENTR), Anders Calmfors (DG MARKT), Zachary Abraham, Bernard Brunet, Jaromir Levicek, Bettina Kotzinger, Christoph Wagner (DG RELEX), Benoît Lefort, Olivier Sautière, Blanka Studnickova, Ruta Zarnauskaite (DG TRADE), Wolfgang Plasa, Ingrid Schwaiger (EC Delegation Algeria), Christophe Besse, Ghada Mostafa (EC Delegation Egypt), Martin Klaucke (EC Delegation Georgia), Dr. Eyal Inbar (EC Delegation Israel), Hervé Busschaert (EC Delegation Jordan), Charles Abdallah (EC Delegation Lebanon), Timo Hammaren, Alexander Kravchuk, Marina Ronina, Barbara Stacher (EC Delegation Moscow), Simon Bojsen–Moller, Ahmad Shihadeh (EC Delegation Syria), Fabian Seiderer (EC Delegation Tunisia), Mark Gallagher (ECTAO-Jerusalem), Fabrice Gras, Rosemary Montgomery (ESTAT), Era Dabla-Norris (IMF) and Diana Shtylla (Banka e Shqipërisë).

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[1] The report covers all countries that are part of the European Neighbourhood Policy initiative: Algeria, Armenia, Azerbaijan, Belarus, Egypt, Georgia, Israel, Jordan, Lebanon, Libya (potential partner), Moldova, Morocco, occupied Palestinian territory, Syria, Tunisia and the Ukraine. Russia is not an ENP country, but has a strategic partnership with the EU, based on four "common spaces", including an economic space. Russia is included in this issue, not least because of its economic importance for the CIS region.

Part I

Thematic issues

1. MACRO-ECONOMIC POLICY REACTIONS TO SOARING FOOD PRICES IN MEDITERRANEAN COUNTRIES, RUSSIA, THE CIS AND THE GCC

1.1. INTRODUCTION [2]

A strong upward trend in inflation started to emerge worldwide in the course of 2007. Consumer prices have been pushed up by soaring energy prices, exacerbated also by fixed exchange rate regimes in combination with huge capital inflows.

Food prices have also surged. The observed price movements are the result of a complex combination of both structural and temporary factors. In a nutshell, an increasing world population, a growing demand for higher ”value added” food (including meat and dairy products) in emerging economies and the emergence of alternative market outlets, in particular biofuels, have contributed to dynamic demand for agricultural commodities outstripping the growth in global supply. This has led to tighter agricultural markets than in the past with historically low levels of international stocks that have apparently been unable to absorb major weather-related supply shortfalls in important producing countries. Further contributing factors have been the surge in energy prices, export restrictions imposed by a number of countries to avoid domestic shortages and the depreciation of the US dollar. Speculation has also been mentioned as a potential factor, although there is no conclusive evidence on its impact on food prices so far.

Almost all European Neighbourhood Policy (ENP) and Barcelona process countries are suffering from the higher food prices. Being by and large middle income countries they spend a relatively large share of their income on food. In some countries the situation has been difficult. Shortages on the primary food product markets (such as bread and rice) immediately and drastically have been affecting the ability of households under the poverty line to meet their basic needs. In addition to these problems, the soaring consumer prices force countries to make strategic policy choices.

The inflation of agricultural commodities (“ag-flation”) has macroeconomic policy implications for all EU neighbour countries. Firstly, those fiscal authorities that subsidise agricultural commodities (such as bread and rice) are facing higher fiscal expenditures due to the higher cost of these primary food products. These additional outlays worsen their fiscal balances. Secondly, monetary authorities with a price stability mandate are pushed towards monetary tightening. If the increasing inflationary pressures are mainly caused by rising food prices, this policy may not be effective due to the fact that it is hard to reduce spending on primary food products.

The aim of this study is to analyse the price developments and to compare national macro-economic policies in response to the soaring prices across the ENP-countries, the other Barcelona countries[3], Russia, the Gulf Cooperation Council (GCC) countries and the euro area. In our analyses we focus primarily on ag-flation, but we analyse also the capital inflows in view of income levels in the EU's neighbour countries.

Our analyses unambiguously show that food inflation is currently considerably higher than in previous years (2005-2006). Agricultural commodity price inflation is evidently pushing up total inflation, even despite the provision of food subsidies by national authorities.

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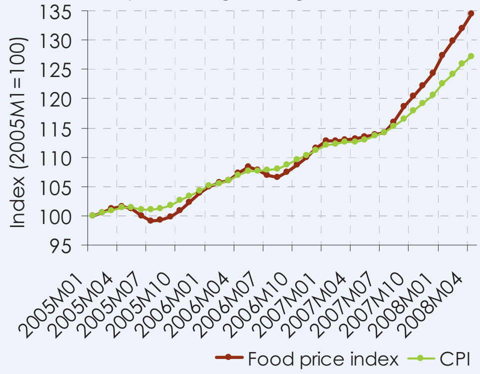
[2] This study was conducted by Marga Peeters and Kiril Strahilov thanks to contributions and comments from, but without implicating them, Ronald Albers, Nico Beinema, Stylianos Dendrinos, José Leandro, Inmaculada Montero Luque, Andreas Papadopoulos, Sirpa Tulla and Lúcio Vinhas de Souza. We also thank Oliver Dieckmann, Michael Grams, Mary McCarthy and Michal Narozny for their useful comments. All remaining errors are ours.

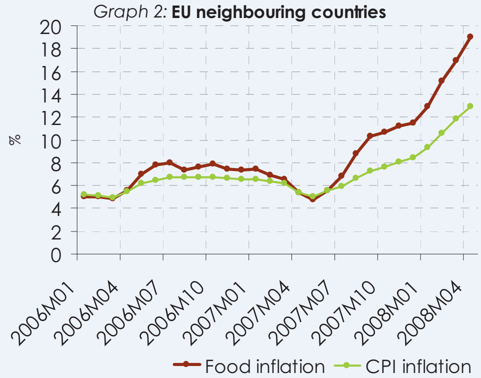
[3] We include here Albania and Mauritania that became part of the Barcelona process in 2007.

Box I.1.1: **EU neighbours & euro area – Price developments**

Graph 1: **EU neighbouring countries**



Graph 2: **EU neighbouring countries**

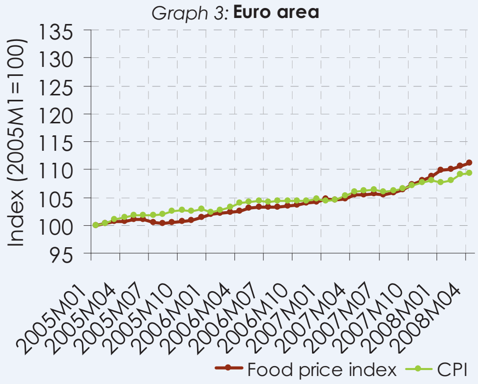


The average price indices (graph 1) and average inflation (graph 2) are calculated as the simple averages of the national price index and inflation of EU neighbouring countries, respectively. The underlying national indices and inflation rates are presented in Box 1.1.2 and Box 1.1.3. Here, 13 countries are included where prices for the full period from January 2005 until and including April 2008 were available at the moment of this publication: Albania, Algeria, Belarus, Egypt, Georgia, Israel, Jordan, Moldova, oPt, Russia, Saudi Arabia, Tunisia and Ukraine. The measurement of "food" here mostly includes non-alcoholic beverages, but excludes alcoholic beverages and tobacco.

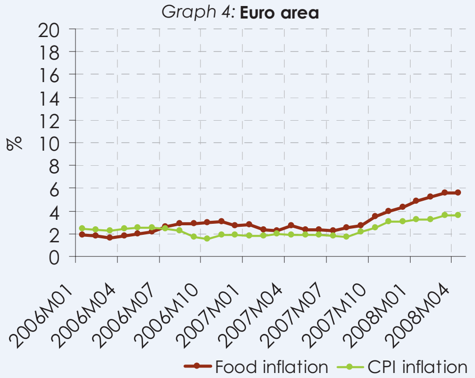
The coefficient of variation for the CPI inflation is 51-55% and for food inflation 42-53% in the first four months of 2008.

Sources: National Offices of Statistics of the respective EU neighbour countries and the Consultation and Research Institute (Lebanon).

Graph 3: **Euro area**



Graph 4: **Euro area**



The price index for the euro area is the official Harmonised Index of Consumer Prices (HICP) for the whole euro area (with currently 15 countries). Food prices include both unprocessed and processed food.

The coefficient of variation for the CPI inflation is 26-28% in the first four months of 2008.

Source: ECB.

With the exception of Kazakhstan, all EU neighbour countries under consideration in our analyses face severe inflation of which well over 50% was due to food inflation at the beginning of 2008. This holds for the countries that import agricultural commodities (such as Egypt and the occupied Palestinian territories (oPt)) as well as for most of the countries that export agricultural commodities (for example Ukraine and Russia). The countries with a fixed currency regime seem to be suffering even more from inflation under the current circumstances (Jordan, Lebanon, GCC apart from Kuwait). Also, countries differ in their macro-economic policy reactions in response to similar developments (e.g. Egypt and Tunisia). Some countries ease the fiscal stance and tighten monetary policy (Egypt). Some exporting countries resort to price ceilings or agricultural commodity export bans (Kazakhstan, Ukraine).

The outline of this chapter is as follows. Section 2 presents stylised facts of price developments at the national level, such as the contribution of food to total inflation, the income level and the balance of payment characteristics. Section 3 outlines the macro-economic policy reactions in some of the EU neighbour countries. Finally, section 4 summarises findings and overviews the macro-economic policy options that are available, at both the national and the global levels.

1.2. STYLISED FACTS

We observe a general increase in headline or total inflation, usually measured by the growth rate of the consumer price index (CPI).[4] At the same time there is a growing wedge between the developments in the total/headline inflation and the “core” inflation, that excludes the (volatile) energy and food prices. These two features are shared by the EU neighbour countries and the euro area.

In particular, average total inflation in the EU neighbour countries was just above 6% in July 2007 and it increased to 13% in April 2008. This was caused by the sharp rise in food prices from almost 7% to 19% during this 10-months period (Box I.1.1.). Due to the transition that the EU neighbour countries are undergoing, they face a far higher economic growth as well as higher inflation than the euro area. Headline consumer price inflation in the euro area also doubled in the same period from 1.8% to 3.6% while the increase in food inflation more than doubled, from 2.3% to 5.6%.

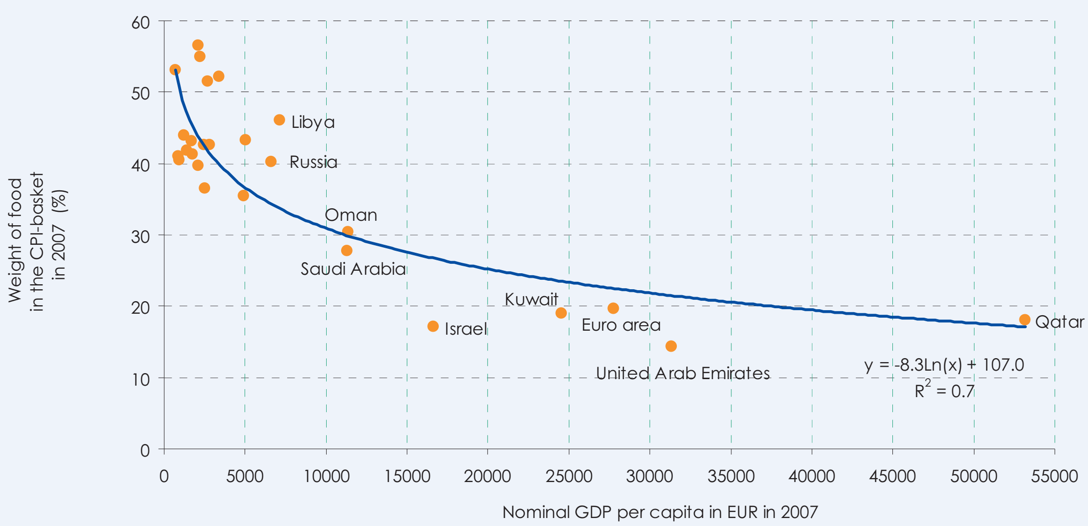
While agricultural commodity prices are rising sharply in the euro area as well as in the EU neighbour countries, there are visible divergences in price developments across the latter. Food prices in Egypt, Georgia, Israel, Jordan, Lebanon and the oPt have shown stronger increases (Box I.1.2). In these countries, net food-importers, a large share of disposable income is spent on food; these countries are therefore directly affected by the current supply shortages on the world markets. High government subsidies on food products (among others Egypt, Morocco and Tunisia) are masking the actual underlying price developments. So, actual agricultural commodity prices will have soared even more than is visible in Box I.1.3.

Some big agricultural commodity producers (like Russia and Ukraine) have restricted their exports of agricultural commodities, hoping that this would keep domestic food prices at a reasonable level.

Nonetheless, the agricultural commodity exporters Russia and Ukraine have been experiencing soaring national inflation (see Box I.1.2). All in all, the EU neighbour countries under consideration with the exception of Kazakhstan are facing sharply rising food prices. Kazakhstan has been suffering far less from food inflation due to direct price controls.

[4] The EU neighbour countries often use the term “total” inflation while the euro area uses the term “headline” inflation.

Graph I.1.1: **EU neighbours - Income & food weight in CPI-basket**



Sources: EUROSTAT, ECB, IMF, National Offices of Statistics of the EU neighbour countries.

As stated before, the extent to which food price inflation translates into total inflation depends partly on the share of food in the total basket of goods and services. Most EU neighbour countries spend 35 to 55% of their total expenses on food (Graph I.1.1)[5]. The exceptions are Israel and some GCC countries that spend around 20%, which is similar to the euro area.Food prices pushed up total consumer prices significantly during the last year (see Box I.1.3). At the beginning of 2008, between 60% and 80% of total inflation could be ascribed to food inflation in Albania, Algeria, Belarus, Egypt, Lebanon, Mauritania, Morocco, oPt, Tunisia and Ukraine. In Algeria and Ukraine this percentage reached even 85% in April 2008.

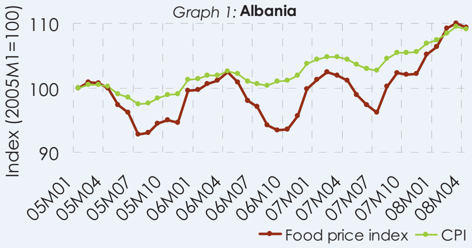
Other factors that have currently been pushing total inflation upwards are the soaring energy prices, the weak dollar (as it concerns non-dollar imports) and capital inflows. Energy price developments have a direct impact on food prices, like on most other goods, due to higher costs for agricultural inputs, transportation and processing. However, the share of food in the CPI-basket that is the direct pass-through, is more than double the share of energy for all these countries. The continuing sharp upward trend of the current food price developments is in general therefore more prominent. It is also more worrying, as the high food prices are directly connected with food shortages (i.e. humanitarian first needs).

For those countries that have their domestic currency pegged to the US dollar (notably the GCC countries except Kuwait, but also Jordan, Lebanon, and until recently *de facto* Ukraine) the weak dollar makes imported goods in other currencies more expensive. Moreover, the monetary easing in the US has forced them to lower interest rates domestically, which stimulates domestic demand and further fuels price rises. In addition to food price inflation, this causes additional pressure on consumer prices (see Table I.1.1).

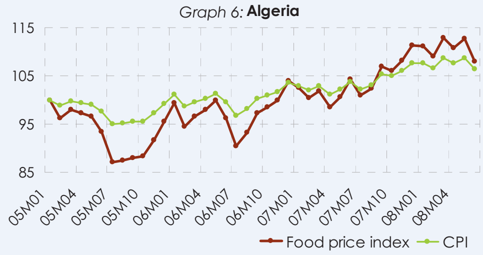
[5] The countries that are shown in Graph I.1.1 with GDP per capita less than EUR 6 000 that spend more than 30% of their total expenses on food are Albania, Algeria, Armenia, Azerbaijan, Belarus, Egypt, Georgia, Jordan, Kazakhstan, Lebanon, Libya, Mauritania, Moldova, Morocco, OPT, Syria, Tunisia and Ukraine. Bahrain is not included.

Box I.1.2: **EU neighbours – Price developments per country**

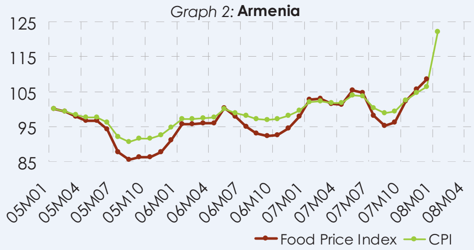
Graph 1: **Albania**



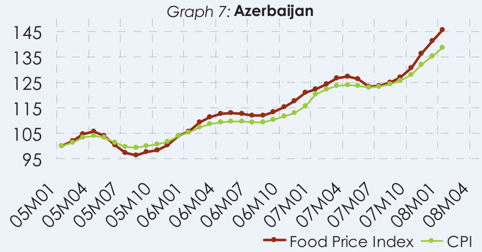
Graph 6: **Algeria**



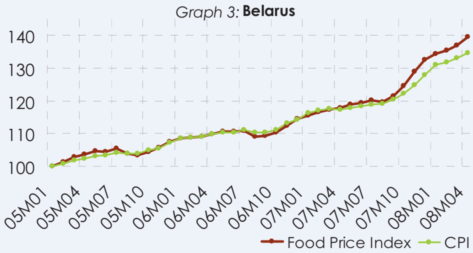
Graph 2: **Armenia**



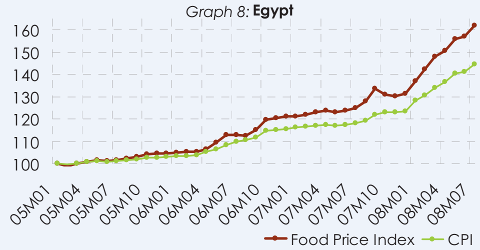
Graph 7: **Azerbaijan**



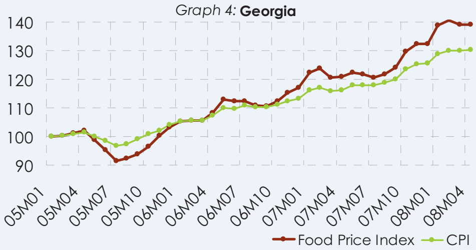
Graph 3: **Belarus**



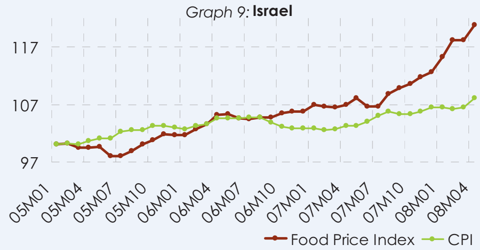
Graph 8: **Egypt**



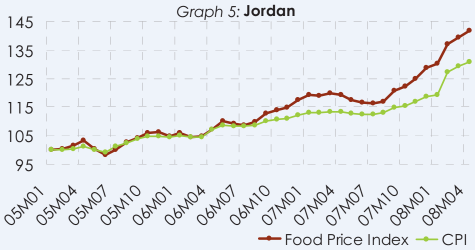
Graph 4: **Georgia**



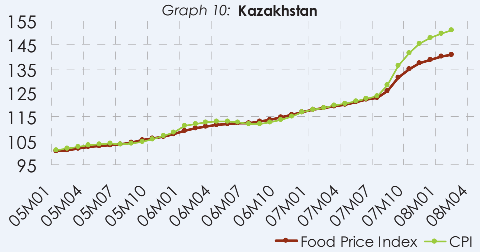
Graph 9: **Israel**



Graph 5: **Jordan**



Graph 10: **Kazakhstan**



Sources: National Offices of Statistics of the respective EU-Neighbour Countries and the Consultation and Research Institute (Lebanon).

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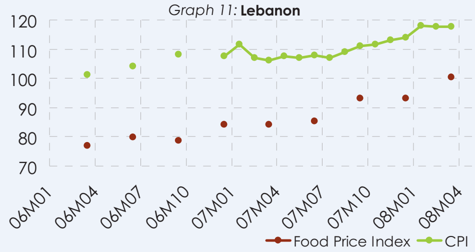
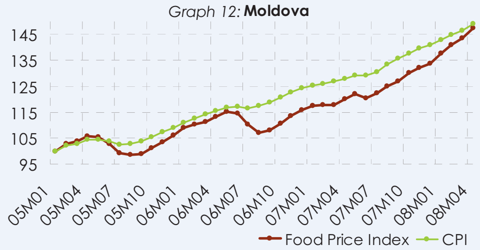
Box (continued)

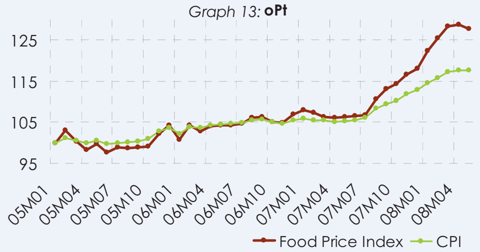
Graph 11: **Lebanon**



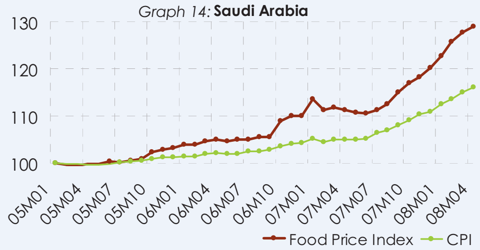
Graph 12: **Moldova**



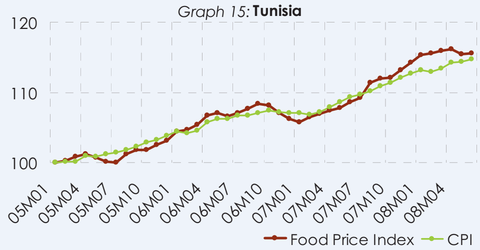
Graph 13: **oPt**



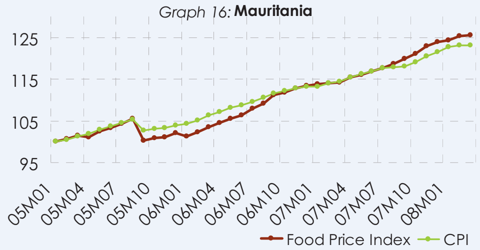
Graph 14: **Saudi Arabia**



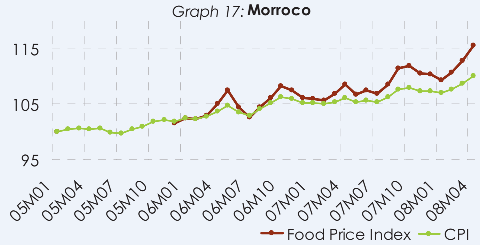
Graph 15: **Tunisia**



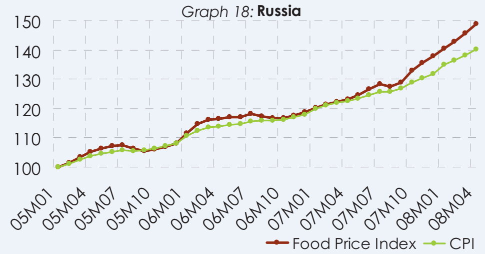
Graph 16: **Mauritania**



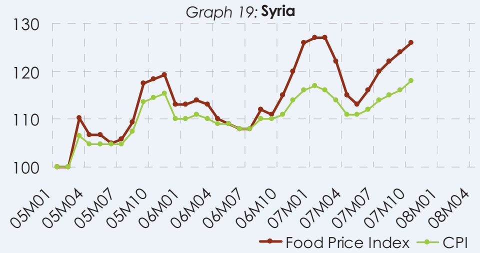
Graph 17: **Morroco**



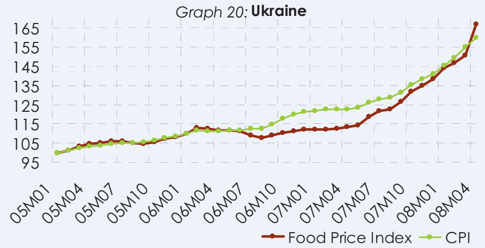
Graph 18: **Russia**



Graph 19: **Syria**



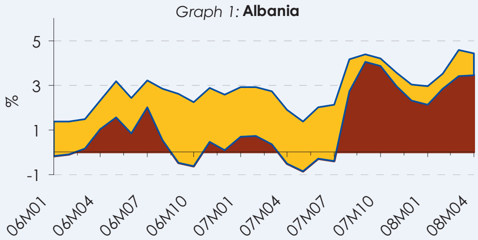
Graph 20: **Ukraine**



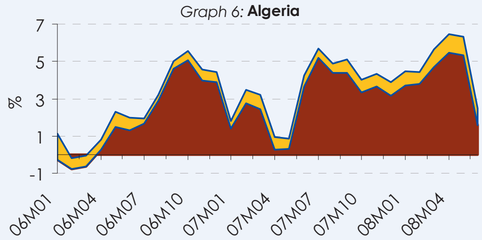
Sources: National Offices of Statistics of the respective EU-Neighbour Countries and the Consultation and Research Institute (Lebanon).

Box I.1.3: EU neighbours - Food contribution to inflation

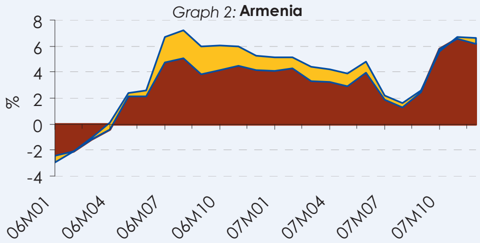
Graph 1: **Albania**



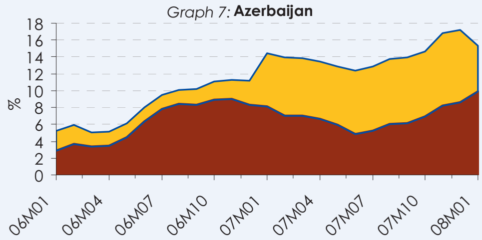
Graph 6: **Algeria**



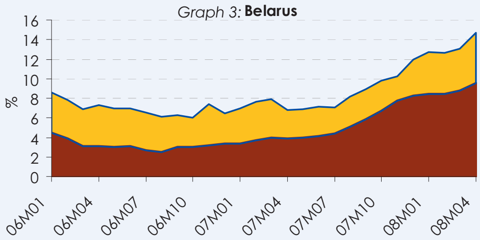
Graph 2: **Armenia**



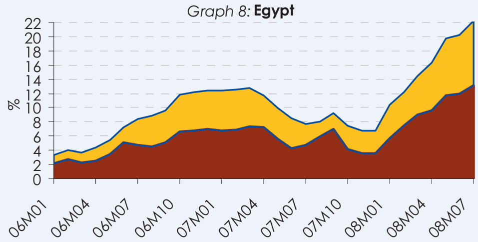
Graph 7: **Azerbaijan**



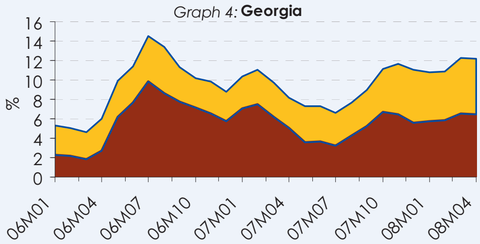
Graph 3: **Belarus**



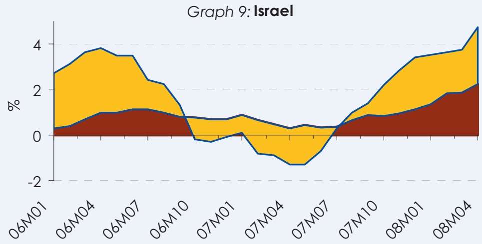
Graph 8: **Egypt**



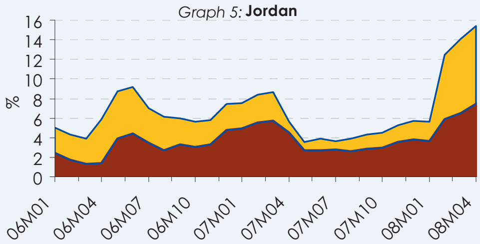
Graph 4: **Georgia**



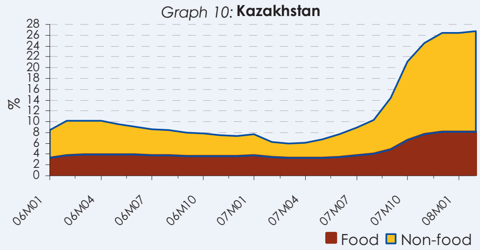
Graph 9: **Israel**



Graph 5: **Jordan**



Graph 10: **Kazakhstan**



Sources: EC Staff calculations from CPIs and food price indices as presented in Box 1.1.2. with the weights of food in the basket as presented in Graph 1.

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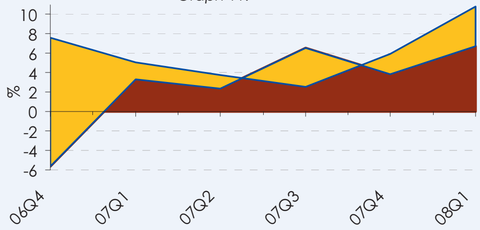
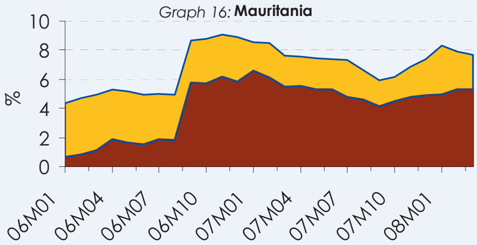
Box (continued)

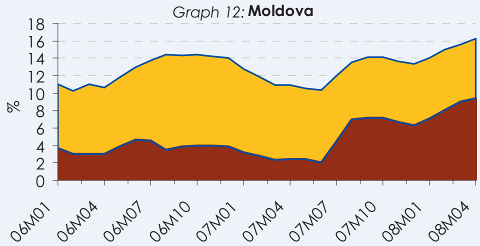
Graph 11: **Lebanon**



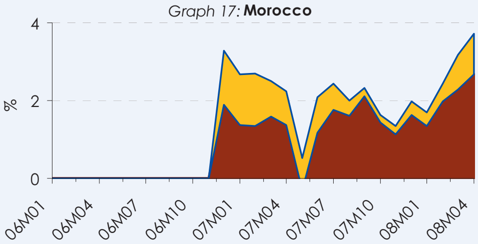
Graph 16: **Mauritania**



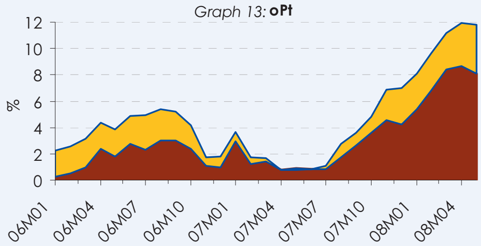
Graph 12: **Moldova**



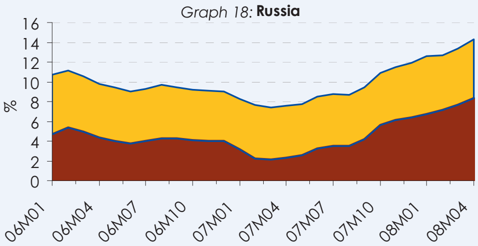
Graph 17: **Morocco**



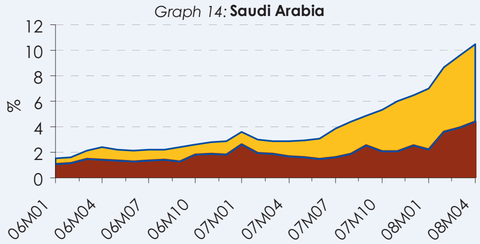
Graph 13: **oPt**



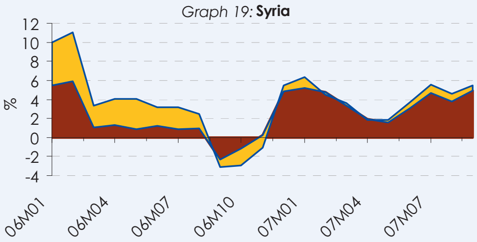
Graph 18: **Russia**



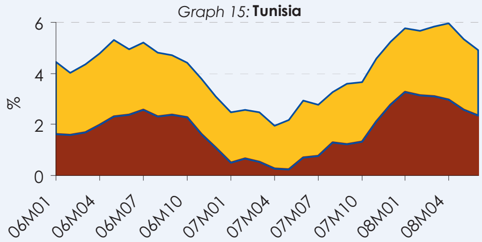
Graph 14: **Saudi Arabia**



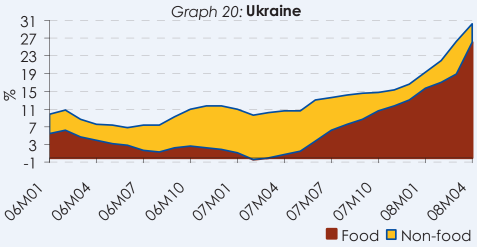
Graph 19: **Syria**



Graph 15: **Tunisia**



Graph 20: **Ukraine**



Sources: EC Staff calculations from CPIs and food price indices as presented in Box 1.1.2. with the weights of food in the basket as presented in Graph 1.

Table I.1.1:
EU neighbours - Overview exchange rate policies

	Income group	Exchange rate regime as of January 2008	Current account % GDP, 2007	Capital/financial account % GDP, 2007
ENP-Mediterranean countries				
Algeria	lower middle	managed float	**23.6**	-1.1
Egypt	lower middle	full float	*1.4*	*3.7*
Israel	high	flexible	3.6	-3.2
Jordan	lower middle	fixed peg to USD	-14.0	9.6
Lebanon	upper middle	fixed peg to USD	-10.7	
Libya	upper middle	fixed peg to SDR-basket	**33.2**	*1.3*
Morocco	lower middle	fixed peg to basket	-0.1	
oPt	lower middle	fixed peg to shekel	-7.7	
Syria	lower middle	fixed peg to SDR basket	-5.8	0.9
Tunisia	lower middle	peg to basket (euro has 2/3rd)	-2.5	*5.1*
ENP-CIS and Russia				
Armenia	lower middle	managed float	-6.2	
Azerbaijan	lower middle	managed float	**24.6**	
Belarus	lower middle	fixed peg to USD	-5.0	
Georgia	lower middle	managed float	-19.7	
Moldova	lower middle	flexible	-17.0	
Russia	upper middle	managed float	5.9	
Ukraine	lower middle	*de facto* peg to USD	-4.2	
Non-ENP CIS				
Kazakhstan	upper middle	managed float		
GCC				
Bahrain	high	fixed peg to USD		
Kuwait	high	peg to basket	**47.4**	
Oman	upper middle	fixed peg to USD		
Qatar	high	fixed peg to USD		
Saudi Arabia	high	fixed peg to USD	**26.8**	
United Arab Emirates	high	fixed peg to USD	**21.6**	
(Other) Barcelona process countries				
Albania	lower middle	float	-9.5	**9.3**
Mauritania	low	fixed peg		

Sources: National authorities, IMF and EIU - see also the MEI-tables in the country articles

While imbalances can be caused by the surge in energy prices and currency pegs in combination with capital inflows, it is soaring agricultural commodity prices that have profound economic and social consequences for societies with high poverty rates. In countries where on average 50% of disposable income is spent on food, the majority of the population live below the poverty line. This part of the population spends even a greater share of income on food. As agricultural commodities are daily needs, the steep upward trend in agricultural prices makes it vital that governments act fast.

Moreover, it is likely that higher food and thus higher total inflation will have second round effects in the EU neighbour countries. These effects will be stronger than in the euro area, due to the lower credibility of central banks. Indeed, price stability is not necessarily the primary objective in some of the EU neighbour countries. In this case there is a risk of second round effects such as wage-price spiralling.

1.3. CURRENT MACRO-ECONOMIC POLICY RESPONSES AT THE NATIONAL LEVEL

EU neighbour countries have directly or indirectly taken action to fight inflation, in particular food inflation. The following direct policy reactions can be listed:

Monetary tightening;

Imposing price controls by setting a ceiling for the selling prices of final agricultural products;

Temporarily increasing the supply of certain final products by offering (qualitatively lower) substitutes at lower prices;

Temporarily increasing subsidies for low-income consumers on final agricultural products;

Diminishing or abolishing import tariffs on grains;

Temporarily imposing an export tax on grains produced domestically;

Temporarily banning the exports of certain grains produced domestically;

Temporarily banning the exports of non-agricultural products produced domestically;

Subsidising the agricultural production of basic grains for the longer-term;

Allowing the domestic currency to float more freely vis-à-vis foreign currencies;

Allowing the domestic currency to appreciate faster (by interventions in the foreign exchange market, i.e. buying domestic currency in exchange for foreign currency);

Increasing wages (in the public sector)

Below follows a concise description of measures that have been taken at the national level in some of the EU neighbour countries.[6]

Egypt

Egypt relies heavily on imported grains, such as wheat. At the beginning of 2008 bread riots resulted in several deaths. The army was immediately requisitioned to bake and distribute extra loaves in 300 locations across the country. The Egyptian authorities also took a number of other steps in response to the surge in food and notably wheat prices. A plan was adopted to stimulate domestic wheat production. Local wheat prices are gradually raised to the levels comparable to global prices. This creates incentives for local production, decreasing dependency on foreign wheat imports. To this end, the Egyptian Ministry of Agriculture, the Ministry of Finance, the Ministry of Trade and the Ministry of Social Insurance agreed on a mechanism to define the minimum price for purchasing wheat from small farmers. The government also slashed import tariffs on foodstuffs and intensified food subsidies. In addition, it imposed temporary controls on exports of certain goods, notably rice but also cement, to meet the seasonal increase in demand for construction materials during the summer. It can thus be seen that intervention in the food market is triggering intervention in non-food markets.

In a reaction to the loss in purchasing power due to high inflation, the president ordered a 30% pay rise for all government officials and public sector employees. In reply to this, in order to raise fiscal revenues to compensate the additional government outlays, the fiscal authorities raised taxes on fuel and cigarettes, increased the payments for car licenses, and cancelled the tax exemption on free zone hydrocarbon. In this way, the government maintains the objective of limiting the general government deficit in the fiscal year 2008 of 6.9% of GDP.

The Central Bank of Egypt reacted early to the surge in inflation by tightening monetary policy, in view of its mandate to achieve and maintain price stability. However, raising interest rates and thus making borrowing more expensive may alleviate inflationary pressures by curbing demand (apart from the demand for the very basic food products) - may at the same time damage growth opportunities. The high inflation also triggered the switch in the exchange rate policy towards a fully flexible regime that should help alleviate domestic inflation, while allowing for the strengthening of the domestic currency.

Kazakhstan

Kazakhstan, the world's sixth largest wheat exporter, is (also) a key grain supplier in the Central Asian region. Last year, unlike other grain exporters, Kazakhstan did not suffer from a poor harvest. To combat rising domestic prices, authorities of several Central Asian countries set up stabilisation funds to purchase grain and manage supplies, and local officials have been ordered to monitor prices. In September 2007 Kazakhstan moved to control exports, introducing a licensing system. Exports have slowed since, hitting its neighbour countries, in particular Central Asian countries dependent on Kazakh grain exports. This led to sporadic protests and riots, for instance in Uzbekistan.

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[6] For more elaborate descriptions of recent policy actions, see the country chapters.

Kazakhstan suffers from a high inflation, where relatively little comes from food because of the cheap food policies of the government. Substantial parts of the price increase come from high energy prices and the domestic credit boom. As a reaction to the high inflation the central bank revalued the official exchange rate.

There is a need for agricultural reforms in order to make the Kazakh farms more adequately equipped with modern machinery. Also, the policies concerning the State Food Corporation should be reconsidered. This Corporation maintains strategic reserves of grain that are sold at below-market prices. The delivery process by farmers to this Corporation is reportedly distorted by corruption. The time seems ripe to liberalise the grain market, where prices will be fully determined by market supply and demand forces.

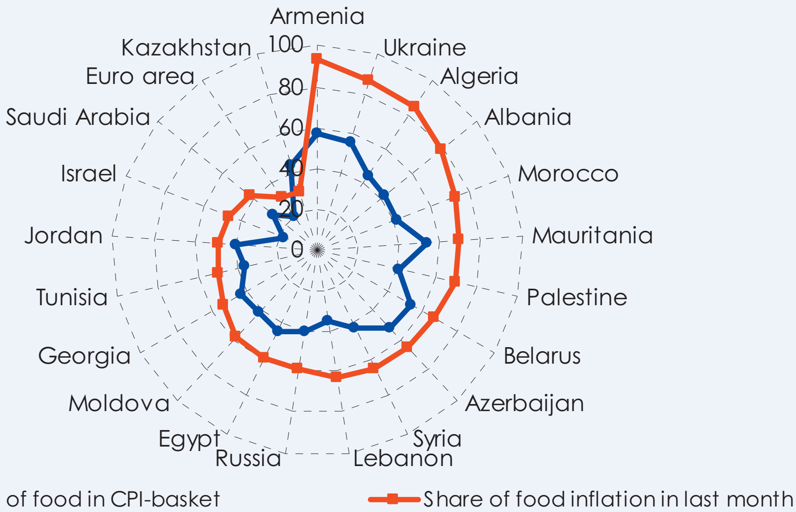
Russia

The largest share of total CPI increases observed in Russia during the past few years is indeed attributable to food price increases. Nevertheless, this is, to a degree, an "artefact" arising form the large share of food in the Russian CPI basket, which, as indicated above, considerably exceeds what should be expected given its GDP per capita level. In terms of *actual* CPI increases, services surpassed food in the period January 2006-April 2008 (a cumulative 40% raise, as opposed to 36%), driven largely by energy-related costs (gas and electricity, up respectively 66% and 48% during the same period). In any case, food price increases led to some short run administrative measures (a largely ineffective agreement with several large food retailers to freeze prices in some basic foodstuffs –milk, eggs, oil, bread– initially introduced in October 2007 and abandoned in May 2008, the reduction of import taxes and the increase in export taxes for some agricultural products). As to wheat, the Russian Government decided not to renew the export taxes after May 2008.

In the ongoing policy debate within the Russian government of "(high) inflation versus (high) growth" (which opposes the traditionally more conservative Ministry of Finance to the –equally traditionally more spendthrift– Ministry of Economic Development), the politically dominant Russian Ministry of Finance seems to focus on the monetary and fiscal causes of inflation (and, therefore, on monetary and fiscal solutions), supported in this by the Central Bank of Russia.

On the one hand, there is arguably a significant relationship in Russia between the dynamics of *monetary aggregates* (which are themselves driven by the external surpluses, regardless of the origin of those surpluses, i.e., either capital or the current account) and CPI inflation. A look at the correlations between CPI developments for both

Graph I.1.2: **EU-neighbours: Share of food & weight in basket**



the periods 2001-2008 *and* 2007-2008 shows that there is a almost 92% correlation between the monthly year-on-year (yoy) growth of CPI and the lagged monthly yoy growth of money supply, money, money plus quasi-money and M2 (this peak correlation is obtained by money plus quasi-money lagged between 9 and 12 months, and is only slightly smaller for larger monetary aggregates like M2). These results are also mostly supported by "naive" regressions of CPI inflation and different monetary aggregates and also by Granger causality tests. On the other hand, the relationship between *fiscal expenditures* and inflation (measured by the quarterly growth rates of nominal government expenditure and the CPI quarterly changes) seems not to be so straightforward, with simple correlations indicating a strong positive relationship, if one uses time series for the period 2001-2008 (+52%), but a negative one if just the last two years are used (-30%).

Saudi Arabia and the GCC

Saudi Arabia has huge revenue from its oil exports. In order to mitigate the volatility of government revenues, Saudi Arabia pegs its domestic currency (riyal) to the US dollar. Annual inflation reached 9.6% in March 2008, which is in sharp contrast to figures of less than 1% during the previous five years. Much of the current inflationary pressure is caused by strong monetary growth, stemming from the government that injects large parts of the country's record oil export revenues into the local economy. In fact, the money supply has continued to rise sharply with broad money and demand deposits (M1), rising by 26% year-on-year in February 2008. The fixed exchange rate to the depreciating US dollar has aggravated the situation. Foreign capital inflows have increased also in line with expectations for an exchange rate revaluation.

Although not the main reason for the increasing prices in Saudi Arabia, food prices have contributed to the high inflation figure in the country. Local factors such as structural shifts in patterns of consumption and use of agricultural products, a cut in agricultural subsidies, higher fertilizer prices and cold winters have contributed to increased food prices. Higher global commodity prices, yet, was the main reason for the rise in food prices.

National authorities have already committed to large-scale investments in infrastructure, education and health, which would make it politically difficult to rein in spending significantly. Anchoring inflationary expectations also seems difficult: the government has agreed to give public sector workers and state pension recipients a new cost of living allowance equivalent to 5% of their annual salary during 2008, 2009 and 2010. As a reaction to the high inflation the government cut the customs duties payable by importers on 180 items, including food and beverages and building materials.

Last, but not least, supply bottlenecks have contributed to the high prices in the country. This holds in particular for housing and the construction sector. Also skilled labour supply shortages have contributed to the price surge in Saudi Arabia.

The other GCC-countries - Bahrain, Kuwait, Qatar, Oman and United Arab Emirates (UAE) - show similar features as Saudi Arabia. Also in these countries consumer prices have been soaring lately, because of large capital inflows, higher food prices and prices of other imported goods, higher fuel prices, and the developments in the real estate and construction sector. The countries suffer also from imported inflation because of the fixed exchange rate regime. This holds even for Kuwait that unlike the other GCC-countries does not have a fixed peg to the US dollar, but to a currency basket (in which the US dollar is represented). GCC policy reactions to the high inflation range from increasing subsidies, to raising wages and to lifting import duties.

Tunisia

The agricultural sector is one of the most important sectors in the economy, accounting for roughly 12% of its GDP and employing half of its workforce. Food is the main component of Tunisia's CPI (36.5%). Local food costs have been soaring due to the high costs of imported agricultural commodities. The Tunisian government has reacted to the higher inflation by providing incentives to increase production and raising subsidies, while attempting to stick to the budget deficit target of 3.0%. Prices are nonetheless expected to increase by 6.9% on average in 2008, assuming that domestic harvest will not be negatively affected by weather conditions. Although agriculture is prominent in the Tunisian economy, this sector lacks modern infrastructure and is rain-fed. This also holds for wheat and barley.

Ukraine

Ukraine is traditionally a net grain exporter, among the top ten exporters globally. Since late 2006 Ukraine has, however, resorted to export quotas on wheat, barley and maize which in fact constituted an export ban until May 2008 when remaining restrictions on grains were lifted in the expectation of a record high 2008 harvest. Other restrictions include an export tax on sunflower seeds and an export quota on sunflower oil. Export restrictions were badly managed, damaging both producers and traders, and tainting the general business climate. Traders reportedly had to dump in the Black Sea some USD 100 million worth of grain that could not be exported and had begun to rot. Ukraine's WTO accession (May 2008) and the negotiations on a free trade area with the EU (launched in February 2008) are instrumental in promoting globally responsible trade policies in Ukraine, but unfortunately the currently difficult political co-habitation is not conducive to policy-making, especially in the presence of vested interests.

The export restrictions had little if any impact on food price inflation. The CPI increased by 30.2% year-on-year in April 2008, including soaring food prices at 47.2%. Monetary policy is geared toward maintaining a *de facto* peg to the US dollar. Therefore, in the face of strong inflows of foreign capital (mostly to the banking sector) fuelling credit growth, the National Bank of Ukraine has had few effective tools to control money supply as growth in money demand seems to be saturating. A revaluation of the hryvnia by about 4% was decided in May 2008 after a pause in the Central Bank's interventions in the foreign exchange market. Fiscal spending on the other hand is on the increase given the political instability and election promises. With no political consensus to support a tightening of the fiscal spending, administrative controls on humanitarian important goods such as bread have been the government's policy response to growing inflation. The lack of competition, especially at a local level, is also receiving some attention from the authorities. Although the impact would not be immediate, structural reforms in the agricultural sector, including functioning land markets, are a necessity.[7] In a sense, Ukraine is now paying the price for the delays in agricultural and energy sector reforms.

1.4. SUMMARY AND MACRO-ECONOMIC POLICY OPTIONS

There has been a steep upward trend in consumer prices in Mediterranean countries, in Russia, in the CIS-countries and in the GCC region. Soaring agricultural commodity prices have fuelled total inflation. Even despite the high and increasing food subsidies that the governments have been providing in many of the countries covered in this study, we clearly observe soaring food prices. Our analysis shows that in most EU neighbour countries much more than 60% of domestic inflation is attributable to food prices.

At the national level, policy makers in the EU neighbour countries started reacting to these new developments in various ways. In some countries the soaring food prices gave rise to humanitarian aid (Egypt), which led the national government to temporarily provide food by increasing supply of cheap food, subsidise basic commodities for low income groups and abolish import tariffs. Some agricultural commodity exporting countries, on the other hand, imposed taxes or even banned the exports of some agricultural commodities to mitigate the additional price rises at the national level (Kazakhstan, Russia and Ukraine). The monetary authorities in some countries increased the interest rate or revalued their currency to combat inflation. Some governments even raised wages in the public sector.

7 Ukraine's has potential to significantly increase net exports of agricultural commodities – if appropriate structural reforms are pursued. See EBRD/FAO (2008) *Fighting Food Inflation through sustainable Investment*. World Bank (2008) *Competitive agriculture or state control: Ukraine's response to the global food crisis*.

Both net food exporters and importers among the EU neighbour countries took protective measures applying to other commodities than agricultural commodities. From an international perspective these direct interventions in commodity markets, either on quantities or on prices are not ideal. Export taxes or bans further reduce supply of (agricultural) commodities on the world market and accelerate international price rises. If agricultural commodity exporting countries attempt to secure stable domestic prices by *beggar-thy-neighbour policies,* agricultural commodity importing countries will necessarily suffer as a result. Furthermore, market interventions like export restrictions distort price signals and reduce incentives for domestic farmers to expand production. Moreover, protective measures in some segments of the markets could spill over to other segments leading to more and more shortages on the international goods markets.

Part of the solution to the mismatch in demand and supply of agricultural commodities lies at the international level. Population growth and the expected continuing strong upward trend in the demand in emerging economies for added value products means a continuing demand for agricultural commodities. To meet this growing demand an enhanced sustainable productivity growth in agriculture will be needed, for example through sufficient investment in agricultural research and innovation. Furthermore, policies pursuing environmental objectives can only be sustainable if they also reflect social and humanitarian needs. Thus, biomass-based energy should preferably be based on feedstock that is less demanding for arable land and therefore less in direct competition with food production such as second-generation biofuels.

Another part of the solution to the mismatch on the agricultural commodity markets lies at national levels. Resolving domestic market imperfections, further liberalising domestic product markets and breaking import monopolies will significantly reduce the pressure on market prices. Prices have, so far, been high because of the absence of a fair and level playing field on the agricultural commodity markets. New suppliers should have easy access to the domestic markets. As to the stimulation of agriculture, as mentioned earlier in the international context, national governments should adhere to the international approach to stimulate agriculture. Kazakhstan, Ukraine and Russia, among others, could benefit vastly from the international market situation as they have potential to quickly increase the amount of land under cultivation (for grain in particular). There is also considerable scope for improving land productivity. These agricultural commodity exporting countries could transform themselves from losers to winners in this situation and even enjoy windfall gains. In addition, national governments should refrain from intervening in the trade of agricultural commodities domestically – as long as there are no humanitarian reasons to do so - and across borders. All export bans should be lifted. In general terms, national governments should aim at an efficient functioning of the food supply chain and abolish any existing distortions.

In addition, for those countries facing high inflation due not only to soaring food price, but also to capital inflows, under the current circumstances, there may be scope for a reconsideration of their currency regime (notable all the GCC countries except for Kuwait). The domestic currencies of most of these countries are undervalued, and would appreciate under a more flexible exchange rate regime. Imported goods would consequently become cheaper and this would result in less domestic inflation.

Last but not least, fiscal authorities that currently fight for lower prices for such agricultural commodities as bread and rice by way of price subsidies and that already face high fiscal expenditures because of the higher prices of these primary food products, should gear as much as possible these subsidies towards the expansion of the production and targeted social safety nets. Only these structural solutions will stimulate agricultural commodity production in the medium to longer term. The phasing out of the government price subsidies should remain the ultimate objective, if the humanitarian and economic situation permits.

Part II

Regional issues

1. OVERVIEW OF RECENT ECONOMIC DEVELOPMENTS IN MEDITERRANEAN COUNTRIES

1.1. SUMMARY

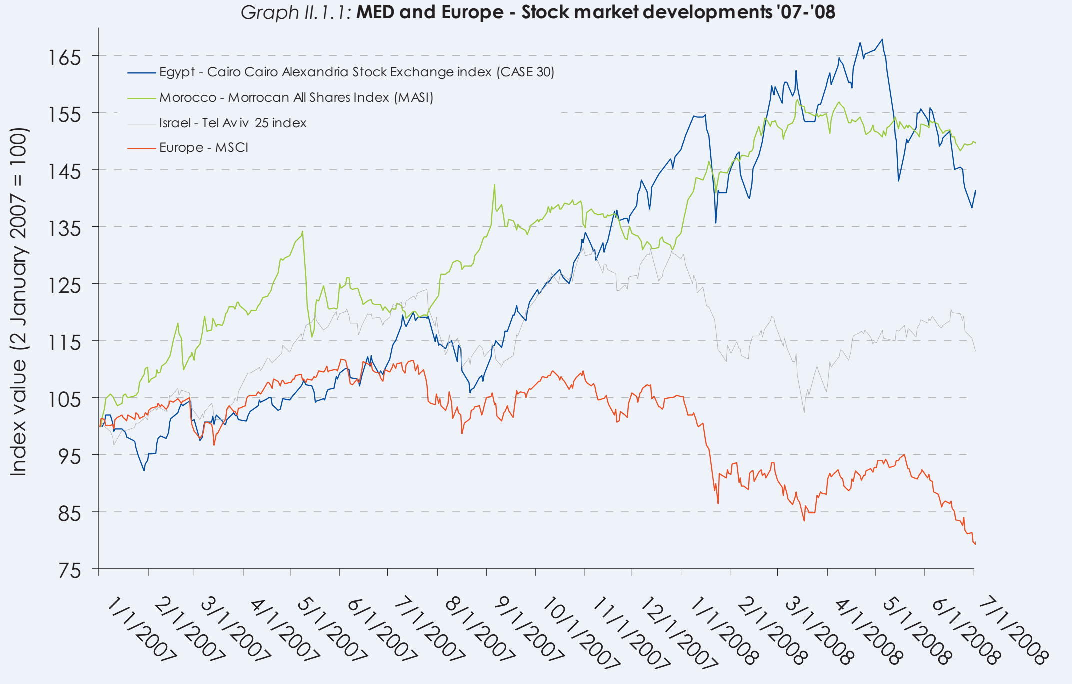
Economic relations between the EU and its European Neighbourhood Policy (ENP) Mediterranean partners are strengthening year after year.[8] They are increasingly intensive, cover a broad agenda of economic policies and sectors and, for some countries, are a crucial element of their development strategy and integration into the world economy. Major economic reforms are being implemented in most countries covered by this report; however, their speed, sequence and depth vary from country to country depending on a range of factors such as political will, domestic factor endowments, the social framework, and the vagaries of the international economic scene.

[8] The terms Mediterranean countries or MED countries in this paper refer, unless stated otherwise, to the Mediterranean countries participating in the Euro-Mediterranean Partnership. These are Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and the occupied Palestinian territory. Libya, a potential ENP Mediterranean partner, is also covered.

The present document provides an overview of recent economic developments in the Mediterranean ENP partners. It describes in detail the main reform efforts in each of the four priority areas adopted in Skhirat in 2005 and highlights the areas where further progress needs to be accomplished. Although progress is not linear, economic policy reforms have usually consolidated over time, reinforcing the reform momentum. Also, countries rarely have gone backwards on previous efforts.

Mediterranean countries maintained an **average real growth rate** close to 5% in 2007, consolidating a long period of substantial economic growth. Growth dynamics in the region were largely shaped by conditions in international markets and regional politics. Oil exporters' growth was boosted thanks to the spectacular rise in oil prices (from USD 26 in early 2000 to USD 73 in 2007). The difficult security environment resulting from the Middle East conflict as well as the terrorist incidents in some countries also adversely affected the reform climate and slowed down growth rates in the occupied Palestinian territory (oPt) for a second consecutive year. Economic recession

Graph II.1.1: **MED and Europe - Stock market developments '07-'08**



came to a halt in the oPt in 2007 with the reestablishment of normal economic relations with the West Bank in June. **On a per capita basis**, the region as a whole grew by an average 3.4%, bringing about a modest improvement in income levels and moderately reducing the gap with incomes observed in the EU.

Sustained economic growth and accelerating rates of job creation contributed to **falling average unemployment rates** (12.3% in 2007 down from 13.8% in 2004) in spite of increasing rates of the labour force in the region (3.4% per year over the period 2000-2005). More importantly, the crucial role of the private sector in employment generation has alleviated the tensions on the public and the agricultural sectors as buffers for labour force increases.

Average **inflation** kept increasing in the region and reached 5% during 2007, fuelled by a combination of strong domestic demand, high capital inflows in oil-exporting countries, the surge in global food and energy prices, and rising housing costs. Food and oil subsidies contained inflation rates in most countries but had pernicious effects on fiscal budgets. **Average fiscal balances** remained negative at 2.7% of GDP but improved slightly owing to buoyant oil export revenues in oil-exporting countries and the consolidation of fiscal reforms particularly among oil-importers. Improved fiscal balances helped to reduce the burden of public debt in 2007, with the average **gross government debt** contracting to 64.8% of GDP. However, international food price increases coupled with strong food import demand had a generalised negative impact on the current accounts of Mediterranean countries, resulting in a rising average current account deficit (1.4% of GDP).

Mounting **trade flows** between the Mediterranean countries and their European partners partially reflect trade reform efforts undertaken by the region over the period 2000-2006, and the conclusion of a growing number of FTAs with countries across the world. Implementation of the provisions of the Association Agreements concluded by the Mediterranean ENP countries with the EU proceeded during 2007, including the dismantling of tariffs on industrial products under the Free Trade Agreements (FTAs). A further step in the liberalisation process was taken by Ministers, who agreed at the last Euro-Med Trade Ministerial Conference in October 2007 to work towards the establishment of deep and comprehensive free trade agreements (DFTAs) covering all trade in goods and services between the EU and its Mediterranean partners as well as strong legally-binding provisions on the implementation of trade and economic regulatory issues. Overall, FDI in the region remained relatively strong during 2007, owing to country efforts to improve the business environment, the creation and expansion of banking and insurance networks and a sharp acceleration in funds coming from the Gulf area.

Over the period 2006-2007 Mediterranean countries kept on introducing reforms conducive to improving the **business environment**. Countries have focused first on relatively simple reforms, such as, for instance, easing the conditions for starting a business, reducing the time and documents needed for trading across borders, and paying taxes. However, investment climate constraints continue to undermine the competitiveness and productivity of private businesses in the region, such as inefficient government bureaucracies, access to financing, corruption, and tax rates and tax regulations. Inefficient labour markets and low educational outputs also appear to be hampering regional competitiveness.

Finally, countries in the region have made some efforts towards **combating corruption** by improving their legal and institutional framework and by committing to abide by international agreements. However, these efforts have not been translated yet into more transparent economies due to problems in implementing the existing laws.

1.2. MACROECONOMIC DEVELOPMENTS

The limited direct exposure of the region to the negative effects of the global financial market turmoil (see also GraphII.1.1) helped to maintain **an average GDP growth rate** close to 5% in 2007, consolidating a long period of substantial economic growth. The main drivers of growth have been revenues, record levels of FDI, mainly originating in the Gulf, and solid European demand coupled with strong domestic demand. Most countries in the region grew at rates close to or above 4% and growth levels are forecast to accelerate in 2008 raising the regional average to 5.4%. Among oil-exporting countries in the region (Algeria, Libya, Syria and Egypt), economic growth is still largely founded on hydrocarbon revenues, but private sector investment has also contributed to rising growth rates thanks to recent large FDI inflows from neighbouring Arab countries. Some oil-importing countries (Tunisia, Jordan) also registered impressive growth rates, reflecting growth in non-traditional sectors, an abundance of liquidity and strong domestic demand. In 2007, **regional average income per capita** stood at USD 5 456 (a figure masking huge regional divergences, with Israel leading the list at USD 22 518 and the oPt closing it at just USD 1258). However, in real terms **average GDP per capita** rose by just 3.4% in 2007, faster than in Northern Mediterranean partners but insufficient to substantially dent the current income level gap.

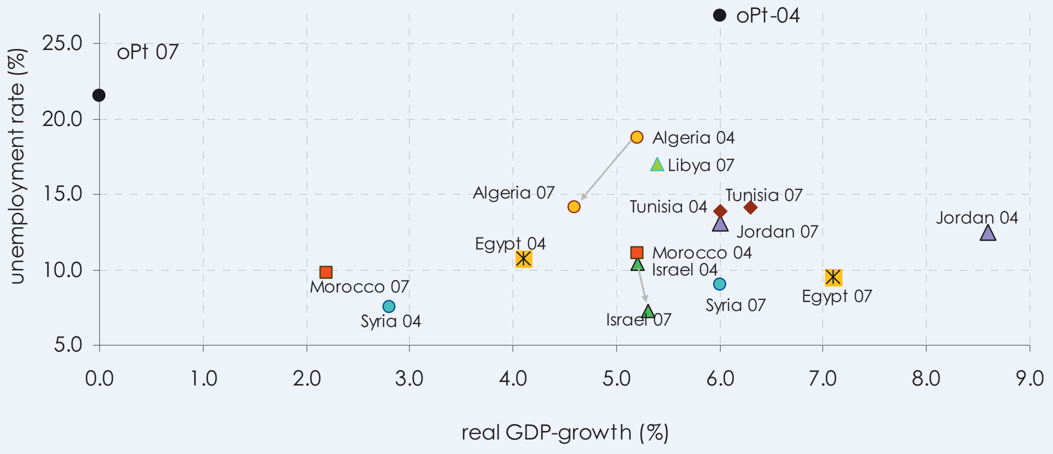
Overall, the economic expansion has improved the situation of labour markets in the region (Graph). Some countries have experienced high rates of job creation and falling unemployment rates since 2000, with an increasing role of the private sector in employment generation. This is all the more remarkable because the Mediterranean region has the highest, albeit decreasing, rate of labour force growth compared to any other region in the world, excluding sub-Saharan Africa (3.4% per year over the period 2000-2005 and estimated to moderate slightly to 3.0% per year in 2005-2010). Accelerating average job creation rates have contributed to **falling average unemployment rates** (2004: 13.8%, 2007: 12.3%[9]), narrowing the unemployment gap with other developing regions. However, regional aggregates conceal wide diversity. According to the official figures, unemployment rates fell by over 40% in Algeria[10] over the period 2003-2007 to a level of around 14%, and came down more moderately in five countries, particularly in Morocco, Israel and Syria. This should not mask the fact that in 2007 unemployment rates were equal to or above 9% in almost all Mediterranean countries, which is still high. Particularly worrisome is the case of Tunisia, Jordan and Syria, with high and growing unemployment rates in spite of consistent growth rates over the last five years.

The **private sector has been key to employment generation in recent years**, alleviating the pressure on the public sector,

[9] These figures exclude Libya, for which unemployment rates are only available for 2007.

[10] Falls in unemployment in Algeria are due to a large expansion of employment in “work at home,” as well as temporary employment programmes [Op. cit., p.16.]

Graph II.1.2: **MED - GDP versus unemployment in 2004 & 2007**



Sources: National Offices of Statistics

Box II.1.1: **Subsidies in Mediterranean countries**

Subsidies are a regular feature of many Mediterranean countries' economies. Government oil and food subsidies have so far shielded the population from the global hike in international cereal and oil prices, and helped to keep social unrest in check. However, from an economic point of view, consumption subsidies are not an effective means of alleviating poverty. They benefit poor and rich alike, encourage corruption and waste, distort relative prices and pose a substantial fiscal burden. This is particularly true with fuel subsidies, of which the middle and upper classes (whose per capita fuel consumption is typically higher) take full advantage.

Overall, subsidies are widely present in the Mediterranean region but in some countries they are becoming a heavy load on national budgets. In Egypt, subsidies standing at E£54 billion accounted for 25% of total central government expenditures in the fiscal year 2007 (over 7% of GDP) and the fiscal year 2008 budget estimates subsidies to increase to E£56 billion (USD 10.1 billion). In Syria, subsidies are expected to reach USD 5 billion in 2008 (about 12.5% of GDP). Food and petroleum subsidies in Morocco reached over USD 2 billion in 2007 (2.3% of GDP), accounting for 12% of total government expenditures. In Tunisia subsidies amounted to 1.3% of GDP in 2007. With crude oil prices expected to remain well over USD 100 per barrel in 2008 and commodity prices spiralling upwards, countries are experiencing mounting fiscal difficulties as subsidies demand a growing share of the national budget; those undergoing ambitious fiscal and budget policy reforms are particularly vulnerable.

The complete removal of subsidies might not be a politically feasible option for most countries in the region, particularly in the short run. However, gradual phasing-out is increasingly gaining support in some countries such as Egypt, Morocco, and Syria, particularly if accompanied by compensatory measures which target the vulnerable groups of the population and mitigate the impact of higher inflation rates on low and middle income groups.

In October 2007, Egypt announced the phasing-out of industrial energy subsidies (mainly fuel) over a three-year period, implying that by 2010 all companies falling in the energy-intensive industry category will be paying the market price, while subsidies for non-energy intensive industries will continue until 2013. Egypt is also considering eliminating blanket subsidies and replacing them with subsidies targeted at the poorest population segments.

In Morocco, the government has started reflecting on alternatives to its fuel-subsidy programmes and might consider similar changes to its food-subsidy programme later on with the goal of progressively eliminating current subsidy schemes. Replacing oil and food subsidies with cash transfers (income subsidies) is under consideration for some products, along with other measures such as the progressive reduction of edible oil and flour subsidies.

Syria took the first step to eliminate fuel subsidies by increasing the oil price to USD 0.54 per litre (from USD 0.15) and the price of petrol to USD 0.87 per litre, leaving the price of oil still subsidised by 50%. Although subsequent savings in the budget are estimated to reach USD 2 billion, they would be partially offset by the 25% increase in salaries of public sector employees and pensioners, at an estimated cost of around USD 1.2 billion. The authorities have also introduced vouchers for families that entitle them to 1,000 litres of petrol at below market cost.

The only case in the region where the elimination of government subsidies has been achieved is Jordan. Although the budget impact of this removal has been negligible (the compensatory social measures implemented in parallel had an estimated cost of between 6.1% and 10.4% of GDP), the Jordan Government has managed to directly target the intended beneficiaries. Direct income support, indexation and other structural measures are the backbone of the new social safety net in Jordan. Salaries and pensions in the public sector have been increased in line with the inflation rate. Cash assistance has been increased to the poorest benefiting from the National Aid Fund, and a one-off cash subsidy for the families of all non public sector employees or retirees with a per capita income of up to JD 1000 per year has been provided in order to enable them to face the 2008 price increase. As of 2009, the monthly salary of civil servants, military and security agencies personnel will be adjusted annually by the inflation rate (full indexation) as well as a productivity indicator. Additional specific measures have been envisaged to compensate for high food prices.

which together with the agriculture sector had traditionally absorbed labour force increases. In the period 2000 to 2005, the private sector contributed to total employment growth in Egypt (over 90% of jobs generated), and Algeria (over 50%), although in Jordan half of total employment growth was still generated in the public sector. The services sector accounted for the vast majority of jobs, although agriculture still accounted for two-fifths of new jobs in Egypt and Morocco and one-fifth in Algeria over the same period. The shift from government to private sector employment is expected to continue in view of the planned or ongoing reforms in the public sector in many countries such as Algeria, Egypt, and Morocco.

Overall, the Mediterranean region has suffered from inflationary pressures fuelled by a combination of strong domestic demand, high capital inflows in hydrocarbon-exporting countries (Algeria, Egypt, Libya and Syria), the surge in global food and energy prices, and rising housing costs.[11] **Average inflation increased** to 5.0% in 2007, up from 4.5% in 2006, reflecting accelerated inflation in oil-exporting countries and mild inflation containment in oil-importing countries. Consumer Price Index (CPI) inflation has risen substantially in Algeria (3.5%), Libya (5.9%), Egypt (11% up from 4.2% in 2006) and Syria (12.2%). In contrast, other countries managed to keep inflation under control. Morocco at 2%, Tunisia at 3.1% and the oPt at 2.7% were the countries in the region experiencing the lowest inflation.

Average inflation in the region would have been higher in 2007 if food and oil subsidies had not been widely used. Populations have been shielded against rising international food and oil prices by subsidies that keep prices artificially low. However, the negative impact of raising subsidies on budgets has forced governments to reconsider current subsidy schemes (see box II.1.1on subsidies in Mediterranean countries). Forecast inflation for 2008 in the region stands at 7.2%, reflecting persistent high food and energy prices and the first effects of removal of subsidies as in the case of Jordan (Box).

The **average general government budget deficit** widened in the region to 1.9% of GDP, up from 1.5% in 2006 (Box). Excluding both Libya (+34.7%) and the oPt (-32.8%) from calculations as outliers, we obtain a more refined regional average at -2.7%, shrinking from last year (2006: -2.9%), highlighting individual country efforts to consolidate their fiscal position. The forecast deficit for 2008 points to a further decline to -2.5% of GDP on average (again excluding the outliers).

In oil-exporting countries fiscal positions remained solid (+11.8% of GDP in Algeria and +34.7% in Libya), owing to buoyant oil export revenues, although the non-hydrocarbon fiscal balance remains negative (-38% in Algeria, -32% in Libya); oil revenues have been used to increase government spending, including rises in civil servants' wages, fund ongoing infrastructure projects, facilitate the expansion of credit to the private sector and reduce public debt Among oil-importing countries, fiscal reform efforts kept producing positive results. In Morocco, the government budget approached balance at -0.2% of GDP (2006: -2%) thanks to the excellent performance of fiscal revenues resulting from recent tax cuts and other tax-related policy measures (which promoted private sector development and revenues), and the reduction in numbers of state employees due to the ongoing public sector reform. In Egypt the deficit was contained to 6.9% of GDP in the fiscal year 2007 thanks to buoyant economic growth and substantial privatisation revenues including the sale of the Bank of Alexandria (equivalent to 1.3% of GDP). In contrast, the rising public deficit in Jordan (5.4% in 2007, up from 4.4% in 2006) was the result of increases in military spending, the implementation of social safety measures (including public sector wage increases) to compensate the removal of fuel subsidies, and debt service.

[11] In most Mediterranean countries food price rises have been magnified by bad governance and surviving monopolies. For many basic products people do not pay free market prices, but monopoly prices (i.e. sugar in Morocco, and oil, rice, meat and sugar in Egypt and Jordan). Food prices increased inflation around the world, but particularly in poor countries, where food accounts for half or more of the consumer-price index (in contrast with around one-tenth in rich countries), leading to a larger impact on inflation. For a more detailed analysis refer to Chapter 1.

Box II.1.2: **MED – GDP, fiscal balance and public debt**

Sources: See MEI-tables in country articles.

Improved fiscal balances have helped **reduce the burden of public debt** in most Mediterranean countries. At end-2007, the regional gross public debt averaged 64.8% of GDP (72.4% excluding Libya), consolidating a steady contraction trend (2004: 80%). Oil revenues in oil-exporting countries and privatisation revenues among oil-importers have played a key role in reducing debt-to-GDP ratios. Privatisation revenues reached 2.4% in Jordan, 1.4% of GDP in Egypt, 0.8% in Tunisia, and 0.5% in Morocco, contributing to public debt reductions from 81.5% to 75.4% (Jordan), from 99% to 88.5% (Egypt), from 54% to 51.5% (Tunisia), and from 57.6% to 55% (Morocco). On a negative note, public debt remains at unsustainable levels in Lebanon (171% of GDP) although prospects for 2008 point to a notable improvement to 143% on account of expected privatisation revenues.

Excluding Libya from regional averages, the region continues to display a **negative average current account balance** (-1.4% in 2007 down from -0.1% in 2006). International food price increases coupled with strong food import demand have had a strong impact on current accounts. Reduced current account surpluses among oil-exporters and growing current account deficits among most oil-importers account for a growing average current account deficit. Last year, Algeria and Libya ran large, albeit decreasing, current account surpluses (23.6% and 33.2%, respectively), on account of big trade surpluses resulting from high oil exports. In some oil-importers, trade deficits have mounted more steeply (+37% of GDP in Morocco and +23.5% in Jordan) so that the traditional offsetting inflows from tourism and remittances from workers abroad have fallen short, resulting in negative current balances (-0.1% of GDP in Morocco and -14% in Jordan). Although diversified exports prevented the trade deficit from growing in Tunisia in 2007, the country saw its current account deficit deteriorate to 2.5%. The huge current trade deficit in the oPt (50% of GDP) resulting from the closure policy is reflected in an estimated current account deficit (excluding official transfers) of 33.8% of GDP by the end of 2007.

During 2007 several countries in the region stepped up efforts to keep implementing reform policies aimed at improving their **public finance management systems**. Among those, the oPt deserves special recognition: the Palestinian Authority managed, under very difficult circumstances, to rebuild the Central Treasury Account (CTA), to develop a system for government accounting in the West Bank and to adopt a Palestinian Reform and Development Plan (PRDP), which is the first effort in years to match planning and budgeting activities. Other countries in the region also made the Single Treasury Account operational (Jordan, Lebanon and Egypt), and streamlined cash and debt management (Lebanon and Egypt). In Jordan, the authorities continued preparing the ground for the introduction of the medium-term expenditures framework (MTEF), to improve budget classification and prepare for results-oriented budgeting. Morocco made progress towards including the regional dimension in the General Budget, improved control over public expenditures and introduced a tri-annual medium-term fiscal framework. Egypt increased fiscal transparency by publishing a detailed budget for the year ahead on the Ministry of Finance's website.

1.3. TRADE LIBERALISATION AND ECONOMIC OPENING

Over the last few years, the Mediterranean region has made **progress towards trade liberalization**. Tariffs applied to goods have contracted as the implementation of FTAs with the European Union gained speed, which has been reflected in growing volumes of trade flows between the Mediterranean countries and their European partners. Total Mediterranean exports to the EU have grown by 10% per year on average during 2000-06. The main drivers of this growth have been Algeria and Egypt at 17%, but also Tunisia, Syria and Jordan at 6%. Mediterranean imports from the EU have also increased but at a slower pace (around 4%) during 2000-06. Total Euro-Mediterranean trade (excluding Turkey) reached € 120 billion in 2006, which represents more than 5% of EU's external trade. In contrast, trade in services and investments remained modest over the same period, thus reflecting both a lack of diversification and a vast potential for gains especially following the future liberalisation of trade in services.

Mounting trade flows reflect trade reform efforts undertaken by the region over the 2000-06 period, and the conclusion of a growing number of FTAs with countries over the world. Within the region, Egypt has been at the forefront of efforts **to ease trade flows** (26th position worldwide in 2007 up from 86th in 2006);[12]

Tunisia has also made progress compared to last year (28th position). In contrast, Syria (127th) and Algeria (122nd) remain very difficult countries to trade with. In spite of trade reform efforts, the region still displays a high level of protection, topping again the world trade protection list. Trade barriers are still prevalent in several countries such as Syria, Egypt and Morocco which rank 115th, 107th, and 93rd, respectively in an index measuring the prevalence of trade barriers in 128 countries.[13]

During 2007, all Mediterranean countries continued to **implement the provisions of the Association Agreements**,[14] including the dismantling of tariffs on industrial products under the Free Trade Agreements (FTAs).[15] Although trade liberalisation in goods will not be achieved with all partners by 2010, a critical mass of industrial liberalisation will be completed by this date, while agreed dismantling schedules will continue to be implemented later on; indeed, most Mediterranean partners will take between four and nine more years to make the FTA with the EU fully effective. The only country having a fully effective and implemented FTA with the EU is Tunisia (since 1 January, 2008).

Association Agreements concluded with Mediterranean partners do not establish, however, fully comprehensive FTAs. At the last Euro-Med Trade Ministerial Conference in October 2007, Ministers agreed to work towards **the establishment of deep and comprehensive free trade agreements (DFTAs)** covering all trade in goods and services between the EU and its Mediterranean partners as well as strong legally-binding provisions on the implementation of trade and economic regulatory issues, was identified as a crucial measure and should become a priority in the coming years.[16] A Senior Officials' Working Group on trade policy was launched in 2008 to draw a road map including next steps in the trade field until 2010 and beyond. Discussions will focus on diversifying and enhancing trade and investment, exploiting competitive advantages, encouraging industrial integration (through the conclusion of Agreements on Conformity Assessment and Acceptance of industrial products), and other “behind-the border” issues such as non-tariff barriers, intellectual property rights, and the impact of trade measures on access to markets, that should lead to an ambitious deepening of the Euro-Med free trade area. The elimination of non-tariff barriers, in particular through strengthened regulatory convergence would actually raise the potential of Euro-Mediterranean trade well beyond the elimination of tariffs on goods

Deeper economic integration requires also **expanding the present coverage of the current FTAs into services and the right of establishment liberalization.** This process was launched at the regional level during the Fifth Euro-Med Trade Ministerial Conference in March 2006 in Marrakech. Bilateral negotiations have started at the beginning of 2008 with Morocco, Tunisia, and Egypt and will be soon launched with Israel. Negotiations are also taking place on **liberalisation of agricultural,**

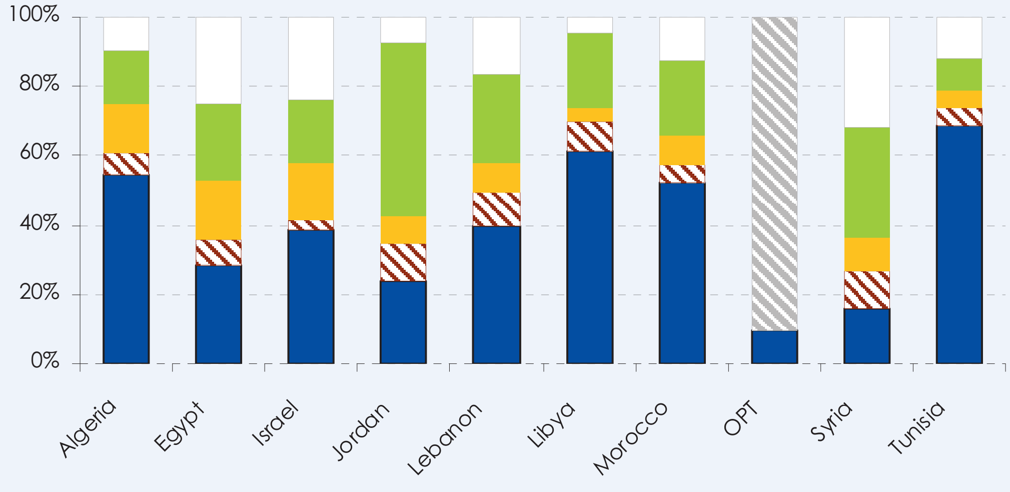
[12] By introducing one-stop shop for traders at the port, Egypt reduced the time to import and export by 7 and 5 days respectively, therefore improving Egypt’s rank to the 26th position worldwide (up from 86th in 2006). Morocco introduced a new risk-based inspection system, reducing the time to import and export by 4 and 2 days respectively.

[13] Arab Competitiveness Report 2007 published by the World Economic Forum.

[14] Association Agreements exist between the EU and all Mediterranean partners, except for Syria. The EU-Syria relations are governed by a 1977 Co-operation Agreement, pending the signature of a draft Association Agreement since 2004. Negotiations with Libya on the establishment of a formal future Framework Agreement might start soon, which might have an impact on the liberalisation of bilateral trade relations between Libya and the EU. The EU has supported Libya's bid to join the WTO, in what represents a vital first push forward in Libya's re-integration into the world trading system.

[15] The trade provisions aim at complete tariff liberalisation for industrial products after transitional periods, with differing speeds and timing according to each partner.

[16] European Commission, “A Strong European Neighbourhood Policy.” 5 December 2007. COM (2007) 774 final.



Source: EUROSTAT Euro-Mediterranean statistics 2007

Note: Algeria, Egypt, Lebanon & Syria 2004 data. Libya data of 2005

processed agricultural and fishery products. The EU concluded bilateral negotiations with Jordan in 2005 and liberalisation of trade in these products has been in force since January 2006. An agreement has also been concluded with Israel in May 2008 and will enter into force in 2009. No progress can be reported for Syria, the oPt and Lebanon. Finally, bilateral and regional negotiations are also on-going on the establishment **of a dispute settlement mechanism**.

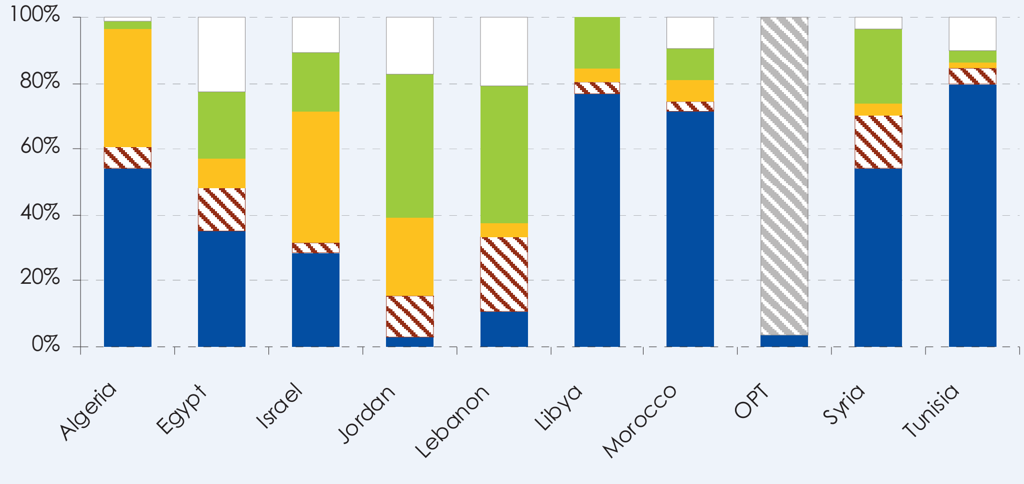
Foreign Direct Investment (FDI) in the Mediterranean region has been growing strongly for several years. According to UNCTAD, FDI inflows to the Mediterranean region grew from USD 12 billion to USD 39 billion over the period 2000-2006. Overall, FDI in the region remained relatively strong during 2007, owing to country efforts to improve the business environment (tax cuts and more transparent tax regulations, new foreign investment regulations and the creation of investment promotion agencies, among others),[17] the creation and expansion of banking and insurance networks and in the creation of funds (i.e. in Egypt, Syria and Algeria), and a sharp acceleration in funds coming from the Gulf area. Real estate and banking have attracted the lion's share of FDI, with telecommunications, energy and tourism lagging behind.[18] Within the region, Egypt has been a top recipient country, with inflows exceeding USD 10 billion both in 2006 and 2007, 80% of which concerned the expansion and greenfield projects in non-oil activities. Morocco's FDI inflows (equivalent to 5.5% of GDP) surpassed USD 5 billion in 2007, a 78% increase from previous year. Lebanon and Tunisia also attracted considerable inflows, which reached USD 2.1 billion and USD 1 billion, respectively.

Geographical proximity is becoming increasingly important in bilateral FDI relations. Mediterranean countries are absorbing larger shares of FDI originating in the Gulf, where funds have been abundant in response to rising

[17] A more detailed account of reforms conducive to improving the business environment can be found in section 4.

[18] Although minor in terms of volumes of investment compared to real-estate, the contact centres sector (call centres) is attracting growing attention on behalf of investors. The number of outsourced offshore centres in North Africa is estimated to 12,800. Morocco is the most mature market, with some USD 270 million turnover and 20,000 employees, followed by Egypt, Tunisia and Jordan.

Graph II.1.4: **Mediterranean countries - Exports by partner in 2006**



Source: EUROSTAT Euro-Mediterranean statistics 2007

Note: Algeria, Egypt, Lebanon & Syria 2004 data, Libya data of 2005

energy prices.[19] Faster liberalisation, privatisation and regional integration has lured capital that would previously have headed away from the Arab world. FDI inflows from the Gulf have mainly been invested in real estate (office towers, tourist resorts and upmarket housing projects in Morocco, Egypt, Tunis and Syria), but has also been channelled to the development of oil and gas projects and major infrastructure programmes (notably Algeria). Gulf portfolio investment has turned stock markets in Cairo, Casablanca and Amman into some of the world's hottest performers and helped to partly insulate them from the global turmoil (Graph).

However, despite renewed interest from international investors in the Mediterranean region, increased volumes of FDI will not, by themselves, have a meaningful impact on economic development unless countries become more attractive to foreign investors, which sometimes imply painful reforms. Large-scale real-estate and tourist projects will generate sustainable growth only if they stimulate the utilization of domestic factors of production, especially by increasing employment and enhancing private investment; but this cannot be taken for granted. The real challenge remains to attract not only mounting volumes but "quality FDI inflows" conducive to the strengthening and diversification of the industrial base according to national priorities, and to finance the large infrastructure needs, the lack of which is still hampering economic activity.

1.4. BUSINESS CLIMATE

Over the period 2006-2007 Mediterranean countries kept on introducing reforms conducive to improving the business environment. Reforms proceeded at a fair pace in Egypt (the top world performer), Jordan, Tunisia and the oPt, while a mixed record of reforms was observed in Morocco and Syria. Algeria defied the regional trend, having faltered reforms for the last couple of years.[20] Understandably, countries have

[19] Over the past six years, some USD700 billion in capital has gushed out of the monarchies that make up the Gulf Co-operation Council (GCC): Saudi Arabia, Bahrain, Kuwait, Qatar, Oman and the UAE. Although the largest portion of this sum still ends up in America and Europe, increasingly larger shares are staying in the region. The International Institute of Finance estimates that Asia and the Middle East absorbed 22% of the Gulf investment between 2002 and 2006.

[20] Doing Business 2008 report. The World Bank.

focused first on relatively simple reforms,[21] such as, for instance, easing the conditions for starting a business (new one-stop shops were introduced in Egypt, Jordan and Morocco), reducing the time and documents needed for trading across borders (Egypt, Morocco) and paying taxes.

As for the **ease to start a business**, Morocco is still the easiest place in the region, followed closely by Egypt, which has greatly deepened the reform effort by cutting the minimum capital required to start a business from E£50,000 to E£1,000, and halving the start-up time and cost. However, in every other country in the region (excluding Tunisia) it was still very difficult to start a business, two-thirds of countries covered still ranked within or were very close to the bottom quartile of countries worldwide. In Egypt and Morocco substantial progress has been made in facilitating **trading across borders,** but overall the prevalence of trade barriers among Mediterranean countries is still high.

Many countries reduced both the **administrative burden in paying taxes** and corporate income tax rates. This is a welcome measure because high levels of corporate tax rates have a large adverse impact on aggregate investment, FDI, and entrepreneurial activity.[22] For instance, Syria developed a large taxpayer unit to make it easier for large businesses to pay taxes. In 2006, Israel reduced the corporate income tax rate from 31% to 29%, Syria from 35% to 28% and Morocco from 44% to 35% (down to 30% in 2007). Both Tunisia and the oPt reduced consumption taxes from 35% to 30% and from 16% to 15%, respectively and Lebanon adopted a global income tax law in November 2007. In contrast, Jordan made no progress with tax reform; the draft legislation to simplify personal and corporate income tax and to streamline fiscal incentives for enterprises was withdrawn from parliament following the requested amendments. In Syria, the introduction of VAT has been postponed to 2009.

Notwithstanding these measures, several countries in the region such as Algeria, Tunisia and Morocco are among the more heavily taxed countries worldwide. Firms in Morocco bear a total tax rate (TTR[23]) neighbouring 53%, which is above the regional average at 45%. Firms in Tunisia and Algeria undergo the heaviest TTR with rates at 61% and 72%, respectively. The oPt, in contrast, ranks high worldwide (7th) with a TTR close to 17%, the lowest in the Mediterranean region.

Although the reform efforts undertaken by Mediterranean countries are promising, the region still scores poorly compared to other regions. Over half of the countries are ranked in the bottom-third of the worldwide index on the ease of doing business. Year-on-year, six out of the nine countries in the region saw their worldwide ranking deteriorate, showing that the current rate of reforms is not keeping pace with other countries' reform efforts, either in the region or worldwide.[24]

Overall, investment climate constraints continue to undermine the competitiveness and productivity of private businesses in the region. According to the Arab Competitiveness Report, the Mediterranean region seems to be in a relatively unfavourable position than other regions in the world. Although the region is host to quite competitive economies such as Tunisia,

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[21] Egypt's overall score was significantly improved in 2007 by focusing on some simple reforms such as reducing the minimum capital requirement for starting a business, lowering the fee for registering property, and simplifying administrative procedures.

[22] Some authors estimate that a 10% increase in the effective corporate tax rate reduces the aggregate investment-to-GDP ratio by 2 percentage points. Corporate tax rates are also negatively correlated with growth and positively with the size of the informal economy.

[23] The reported figures have been taken from the Paying Taxes 2008 report published by the World Bank. The total tax rate (TTR) measures the amount of taxes and mandatory contributions payable by businesses, expressed as a share of commercial profits; it therefore provides the level of tax burden facing businesses. Corporate income tax accounts only for 37% of the TTR, while labour tax and contributions borne by the employer account for 33% and other taxes account for the remaining 30%.

[24] At a country level only Egypt made a substantial jump ahead (+26 positions) in the worldwide ranking, followed by Tunisia (+5). The remaining countries either remained static (Algeria), or moved backwards, with Morocco and Lebanon both falling back the most this year (-8 in both cases).

Table II.1.1:
MED - Competitiveness performance 2007 - 2008

	Tunisia	Jordan	Morocco	Egypt	Syria	Algeria	Libya	Regional Median
Global competitiveness index	**32**	**49**	**64**	**77**	**80**	**81**	**88**	**77**
Macroeconomic stability	**72**	**100**	**94**	**124**	**98**	**2**	**4**	**94**
Higher education and training	**30**	**47**	**83**	**80**	**104**	**94**	**76**	**80**
- Quality of the educational system			90	119	102	103	124	**103**
Goods market efficiency	**31**	**48**	**68**	**76**	**81**	**92**	**121**	**76**
- Prevalence of trade barriers	51	60	97	113	119	76	67	**76**
- Total tax rate (hard data)	96		86	78		113		**91**
- Business impact of rules on FDI	37		75	98	112	81	113	**90**
Labor market efficiency	**79**	**94**	**125**	**130**	**117**	**124**	**131**	**124**
Financial market sophistication	**66**	**55**	**88**	**113**	**116**	**127**	**130**	**113**
- Soundness of banks	76	57	79	106	105	129	126	**105**
- Ease of access to loans		61	72	95	93	119	105.0	**94**
Corruption perceptions index 2007	**61**	**53**	**72**	**105**	**138**	**99**	**131**	**99**

Note: Ranking from 1 (highest) to 131. Corruption perceptions index is the main indicator from Transparancy International, with 1 being the best score out of 179 countries.
Source: World Economic Forum, Global Competitiveness Report 2007-2008

ranking 29th position in a worldwide index assessing national competitiveness against international benchmarks,[25] most of the remaining economies trail in the bottom half of the classification, with Algeria (76th) and Syria (84th) ranking last.

Four factors are consistently cited by entrepreneurs as being the most problematic for doing business: inefficient government bureaucracies, access to financing, corruption, and tax rates and tax regulations. Other factors such as inefficient labour markets and low educational outputs also appear to be hampering regional competitiveness. **Labour markets remain fairly rigid**, most countries resisting changes in labour market regulations, particularly the labour abundant economies (Egypt and Morocco).[26] Employing workers, enforcing contracts and closing businesses remain areas where reforms are costly in social and political terms. The **rigidity of employment** index which measures, among other things, the ease with which workers can be hired and fired is highest in Morocco (63 in a 0-100 index), and firing costs are high in Egypt (where workers are allowed to get 132 weeks of wages) and Morocco (with 85 weeks) compared to 4 weeks in Jordan and 17 weeks in Lebanon, Tunisia and Algeria. High unemployment and labour force growth in the Mediterranean region would require governments to overhaul excessive regulation of labour markets which still rely on public sector employment generation and migrant workers. In addition, **the quality of the education systems** is generally poor, with Libya and Egypt ranking low in the GCI (123rd and 106th position, respectively). Higher education and training programmes have not delivered the expected results, which has contributed to raising the unemployment rates among young educated people. Educational outputs remain mismatched with the needs of the business sector. This is particularly the case in Morocco, with a vast educational challenge on account of its high illiteracy rates (45% of the population).

Enforcing contracts is also particularly difficult in Mediterranean economies in terms of time and number of procedures involved. Syria is worst in enforcing contracts region-wide (ranking 171st), with Egypt (145th), Jordan (128th), and the oPt (125th) not much better. The average time to enforce a commercial contract in the region is 741 days (an increase of 100 days on last year),

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25 The World Economic Forum's Global Competitiveness Index (GCI) is built based on information about factors, policies, and institutions that support sustainable gains in productivity and economic growth. Country rankings show the performance of Mediterranean countries in terms of competitiveness against other economies in the world. The GCI 2007 includes 128 countries.

26 Interestingly, the top ten reformers worldwide in 2006/2007 undertook reforms regarding nine out of the ten indicators contemplated in the ease of doing business index. The only indicator where reforms were absent is "employing workers."

70% longer than the average in OECD countries.[27] The number of procedures is also high (43 on average), exceeding by 40% the average in OECD countries. **Closing a business** remains particularly burdensome in Egypt (125th) and Lebanon (117th), while the oPt remains the worst place worldwide to shut a business down.

1.5. PUBLIC INSTITUTIONS AND GOVERNANCE SYSTEMS

Governance is a very complex concept encompassing multiple dimensions, including the rule of law, controlling corruption, public sector efficiency and public participation, among others. Reforming bureaucracies and improving public governance are among the most difficult reforms to complete due to government inertia and strong resistance from within.

Over the last years, the Mediterranean region has accelerated efforts to improve the **quality of public administration.** Successful public administration reforms in Morocco and Egypt over the period 2000-2007 have improved the effectiveness of the public service and are inspiring other countries in the region which still remain burdened with oversized and inefficient administrations. Egypt's reform efforts during this period have outpaced 94% of the countries world wide, and Morocco and Tunisia outpaced 90% and 75% of the countries, respectively. However, the overall regional reform effort is basically similar to the world average, with some countries in the region having stumbled on reforms over the same period. On absolute terms, the situation in 2007 is less optimistic. Half of the countries in the region are clearly ranked under the world average and in spite of good performances in 2007 in Morocco and Tunisia, the regional average remains under the world average (see chart 5 on the quality of public administration).

Tangible measures aimed at fighting against corruption and improving economic transparency have been implemented. Many countries in the region have strengthened the legal and institutional framework for **combating corruption**. Algeria, Egypt, Jordan, Libya and most recently Morocco, have all ratified the UN Convention against Corruption Treaty (UNCAC), while Syria and Tunisia are still in the process. Jordan has also emerged as a leader in efforts to promote the implementation of UNCAC being the only Arab country volunteering for an UNCAC pilot review. Anti-corruption laws have been recently adopted in Morocco, Algeria, Jordan, and the oPt. In spite of these measures, all Mediterranean countries excluding Morocco saw a significant slippage in rankings from last year in the **2007 Corruption Perception Index**,[28] with Lebanon falling from 3.6 to 3.0, Egypt from 3.3 to 2.9, and Libya and Syria closing the regional classification at 2.5 and 2.4, respectively, down from the already low 2.7 and 2.9.[29] Corruption perceptions are, however, very diverse in the region, with Jordan's 4.7 score heading again the regional classification (53rd position worldwide).

Governments have also improved the **economic transparency** of public finances through the implementation of sound public finance management reforms in Egypt and Morocco ([30]).

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[27] Wide variations are present in the region as for time needed to enforce contracts; in Egypt it takes over 1 000 days while in Tunisia takes "just" 565 days.

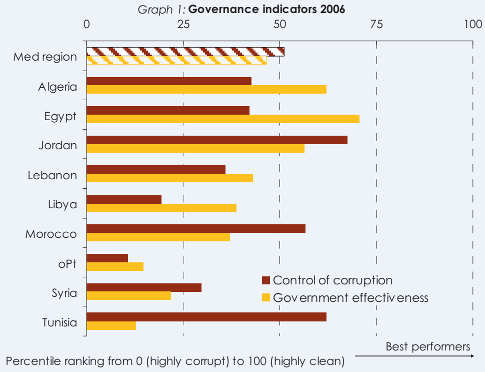
[28] The 2007 Corruption Perception Index produced annually by Transparency International looks at perceptions of public sector corruption in 180 countries and is a composite index that draws on 14 export opinion surveys. It scores countries on a scale from zero to ten, with zero indicating high levels of perceived corruption and ten indicating low levels of perceived corruption.

[29] A country's score is a much more important indication of the perceived level of corruption than a country's rank. Relative changes in rankings partly result from expanding the number of countries covered by the index year after year. However, big slippages reflect more than methodological changes related to the size of the sample. As for the MED countries, changes in scores are being reflected in deteriorating rankings; with Lebanon falling from 63rd to 99th, Egypt from 70th to 105th, and Libya and Syria closing the regional classification at the 131st and 138th position, respectively, down from the already low 105th and 93rd.

([30]) Egypt has improved access to national accounts with the publication in the Ministry of Finance website of a detailed budget on year ahead. Morocco has improved the budget transparency by planning to include the

Box II.1.3: **MED – Governance and business indicators**

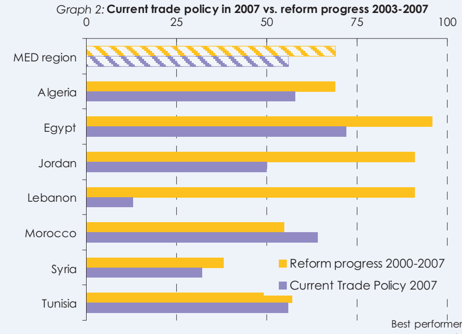
Graph 1: **Governance indicators 2006**



Percentile ranking from 0 (highly corrupt) to 100 (highly clean)

Source: World Bank, Kaufmann, Kraay and Mastruzzi, 2007

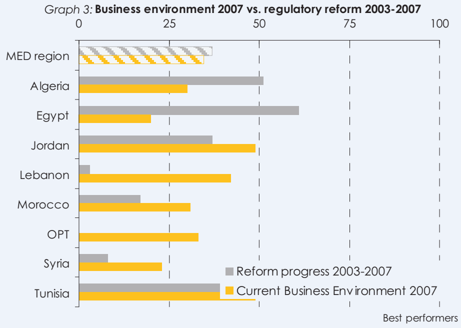
Graph 2: **Current trade policy in 2007 vs. reform progress 2003-2007**



Note: The current trade policy index is based on four major categories of trade policy indicators, expressed as a cumulative distribution function ranking worldwide economies from 0 to 100.

Source: World Bank, MENA Economic Developments and Prospects, 2008

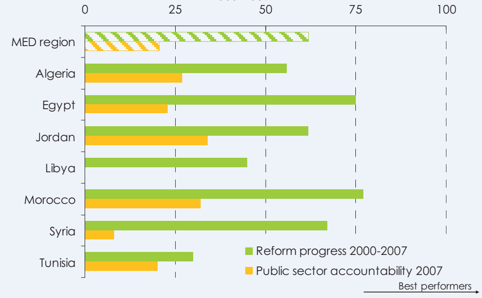
Graph 3: **Business environment 2007 vs. regulatory reform 2003-2007**



Note: The business climate index is based on eight major business environment indicators, expressed as a cumulative distribution function ranking worldwide economies from 0 to 100.

Source: World Bank, MENA Economic Developments and Prospects, 2008

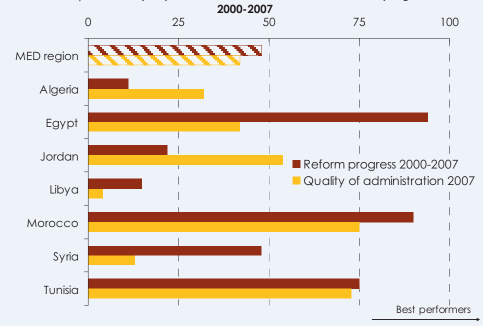
Graph 4: **Public sector accountability in 2007 vs. reform progress 2000-2007**



Note: The public sector accountability index is based on a variety of governance indicators, expressed as a cumulative distribution function ranking worldwide economies from 0 to 100.

Source: World Bank, MENA Economic Developments and Prospects, 2008

Graph 5: **Quality of public administration in 2007 vs. reform progress 2000-2007**



Note: The quality of public administration index is based on a variety of governance indicators, expressed as a cumulative distribution function ranking worldwide economies from 0 to 100.

Source: World Bank, MENA Economic Developments and Prospects, 2008

regional dimension in the General Budget and by strengthening the control of public expenditures by line ministries.

Banking efficiency and competition have improved in some countries, thanks to ongoing privatization processes in Egypt, Algeria, Jordan, and Morocco.[31] New banking and central bank laws will be soon approved in the oPt, which will increase the transparency of banking operations and help consolidate the independence of the Palestinian Monetary Authority (the future Palestinian Central Bank). However, there is still a long way to go in improving regulations affecting the business environment. In 2007, two-thirds of countries in the region slowed down reform efforts to improve the **legal framework for commercial activities,** and over half of them ranked at the bottom third on a world-wide index on the ease of doing business. Contract enforcement remained particularly difficult in terms of time and number of procedures involved, particularly in Syria, Egypt, Jordan and the oPt. Registering property and the protection of property rights remained particularly difficult in Algeria, Egypt and the oPt, and starting a business was still difficult in basically all countries excluding Tunisia and Morocco.

As regards **public sector accountability,** Mediterranean countries have outpaced the world average reform efforts in improving government accountability, leading again the reform efforts world wide (see chart 4 on public accountability). Efforts in the region are led by Morocco, Egypt and Syria, followed closely by Jordan. New press and publication laws have improved the freedom of information in Jordan and electoral processes have become more transparent in Algeria and Morocco. In Egypt, judges have been calling for a more representative democracy by requesting permission from the executive to supervise all stages of the election process. However, the absolute situation in 2007 remains problematic; on average, the Mediterranean region still ranks lowest world wide. Jordan at the 34th percentile is the best ranking country in the region in 2007.

1.6. CONCLUDING REMARKS

Sustained economic growth rates in the Mediterranean region in 2007 can be considered a good result in a year marked by serious economic tensions in international markets; although tensions have not significantly altered growth rates, they have changed the growth dynamics in the region, magnifying the differences between oil exporters and oil importers. The oil bonanza has greatly contributed to growth in the former, but at the cost of depriving these countries of the right incentives to further advance on the path of needed economic reforms. Deprived of revenue-generating natural resources, some oil-importers have been more diligent in implementing ongoing structural reforms and in diversifying the sources of growth. Overall, oil-exporters remain in worse economic shape than oil-importers: they show lower degrees of economic freedom, higher inflation, higher unemployment rates and not radically higher income levels than oil-importing countries.

So far the Mediterranean countries have managed to escape relatively unscathed from international markets turmoil. But with world growth projected to slow down again in 2008 and inflationary pressures still present in the short term, there is no space for complacency. Overall growth in the region remains insufficient to reduce poverty, which remains relatively high, or absorb unemployment on a sustained basis.

At the light of the economic developments described in this document, the economic reform agenda in Mediterranean countries remains incomplete. However, economic reforms are proceeding in most countries and this trend is incremental. The need to preserve delicate socio-economic balances has somehow delayed reforms, as in the case of oil and food subsidies, but timid reform changes are spreading in the region and need to be supported by Northern Mediterranean partners.

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[31] Egypt privatised the Bank of Alexandria in fiscal year 2007, and the second largest state bank, *Banque du Caire*, has been tendered for privatisation. In Algeria, the privatisation of the first public bank, the *Crédit Populaire d'Algérie*, was delayed at the end of 2007 but plans to sell a large number of state companies in 2008 have already been announced. In 2007, Jordan successfully launched the privatisation of the national air carrier Royal Jordanian and three electricity companies, and the Privatisation Commission is preparing a regulatory framework for public-private partnerships to attract private capitals for public investment projects.

Mediterranean economies need to continue implementing ongoing structural reforms and speed up those that are more costly in social terms in order to achieve the high and sustainable economic growth able to generate the level and quality of employment needed. Reducing dependency on oil through economic diversification and improving governance and institutional quality remain fundamental elements of the reform agenda in years to come.

Table II.1.2:

Mediterranean countries - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)					
Algeria	5.2	5.1	2.0	4.6	4.9
Egypt	4.1	4.5	6.8	7.1	7.3
Israel	5.2	5.3	5.2	5.3	3.2
Jordan	8.6	7.2	6.4	6.0	6.0
Lebanon	7.1	1.1	0.0	4.0	4.0
Libya	5.4	5.6	5.8	5.4	5.2
Morocco	5.2	2.4	8.0	2.2	6.1
OPT	6.0	6.0	-4.8	0.0	3.0
Syria	2.8	3.3	4.4	6.0	4.5
Tunisia	6.0	4.0	5.5	6.3	5.7
MED Region (GDP-weighted average)	*5.1*	*4.6*	*5.1*	*5.2*	*5.1*
Nominal GDP (EUR billion)					
Algeria	68.5	82.6	92.7	98.5	
Egypt	62.8	75.0	85.3	90.9	
Israel	98.6	104.3	111.9	118.3	
Jordan	9.2	10.2	11.4	12.0	
Lebanon	17.3	17.4	18.1	17.5	
Libya	41.4	56.0	66.2	74.1	
Morocco	45.5	47.4	52.1	53.6	
OPT					
Syria	19.9	22.5	26.2	27.7	
Tunisia	22.7	23.4	24.7	25.6	
MED Region (total)	*385.9*	*438.8*	*488.6*	*518.2*	
GDP per capita (EUR)					
Algeria	2115	2510	2770	2895	
Egypt	914	1068	1196	1228	
Israel	14475	15050	15868	16621	17080
Jordan	1718	1873	2035	2105	2152
Lebanon	4924	4916	5147	4906	
Libya	32	43	50	59	69
Morocco	1518	1572	1708	1735	
OPT					
Syria	1091	1222	1382	1427	1459
Tunisia	2287	2329	2459	2504	2601
MED Region (simple average)	*3230*	*3398*	*3624*	*3720*	
Inflation (% change)					
Algeria	3.6	1.6	2.5	3.5	4.2
Egypt	10.3	11.4	4.2	11.0	11.6
Israel	-0.4	1.3	2.1	0.5	2.7
Jordan	3.4	3.5	6.3	5.4	9.0
Lebanon	1.7	-0.7	5.6	4.1	12.4
Libya	25.1	33.7	39.9	43.0	48.6
Morocco	1.5	1.0	3.3	2.0	3.6
OPT	3.0	3.6	3.8	2.7	8.8
Syria	4.4	7.2	10.0	12.2	16.8
Tunisia	3.6	2.0	4.6	3.1	5.1
MED Region (simple average)	*5.5*	*6.2*	*7.8*	*8.4*	*11.7*

Table II.1.3:

Mediterranean countries - MEI (continued -1)

	2004	2005	2006	2007 prel.	2008 proj.
Social indicators					
Unemployment rate (%)					
Algeria	18.7	16.0	15.2	14.1	12.9
Egypt	10.7	10.5	11.5	9.5	8.5
Israel	10.4	9.0	7.7	7.3	7.4
Jordan	12.5	14.8	13.9	13.1	
Lebanon	n.a.	n.a.	n.a.	n.a.	
Libya					
Morocco	11.1	11.3	9.6	9.8	
OPT	26.8	23.5	23.6	21.5	22.0
Syria	7.5	8.0	8.5	9.0	
Tunisia	13.9	14.2	14.3	14.1	14.0
MED Region (simple average)	*13.9*	*13.4*	*13.0*	*12.3*	
Fiscal sector					
General government budget balance (% GDP)					
Algeria (Central Government)	6.9	11.9	13.6	11.8	13.9
Egypt	-8.3	-8.4	-9.2	-7.7	-6.9
Israel	-5.5	-4.8	-1.8	-0.8	-1.3
Jordan	-1.7	-5.0	-4.4	-5.4	-5.6
Lebanon	-8.6	-8.4	-11.1	-11.0	-9.2
Libya	17.4	30.0	39.1	34.7	33.7
Morocco	-3.9	-5.1	-2.0	-0.2	
OPT	-14.1	-23.4	-31.1	-32.8	-30.4
Syria (Central Government)	-4.2	-4.4	-5.7	-5.0	-5.9
Tunisia (Central Government)	-2.6	-3.0	-2.8	-2.9	-2.8
MED Region (simple average)	*-2.5*	*-2.1*	*-1.5*	*-1.9*	
Total gross public debt (% GDP)					
Algeria	36.6	27.3	23.8	19.0	15.1
Egypt	112.9	112.8	98.8	88.5	83.1
Israel	99.9	95.9	86.8	80.6	77.7
Jordan (Net Public Debt)	91.8	84.2	81.5	75.4	69.7
Lebanon	167.0	178.0	177.0	171.0	143.0
Libya	9.1	7.0	5.4	4.5	4.1
Morocco	58.8	62.6	57.6	54.9	
OPT	n.a.	n.a.	n.a.	n.a.	
Syria	82.6	35.9	35.9	37.8	41.0
Tunisia	59.4	58.3	53.9	51.6	50.8
MED Region (simple average)	*79.8*	*73.6*	*69.0*	*64.8*	

Table II.1.4:

Mediterranean countries - MEI (continued -2)

	2004	2005	2006	2007 prel.	2008 proj.
External sector					
Current account balance (% GDP)					
Algeria	13.1	20.6	25.2	23.6	24.8
Egypt	4.3	3.2	0.8	1.4	0.8
Israel	2.4	3.3	5.6	3.6	2.4
Jordan	0.0	-17.9	-11.3	-14.0	-11.9
Lebanon	-15.5	-13.6	-6.0	-10.7	-9.4
Libya	14.5	34.9	44.0	33.2	33.0
Morocco	1.7	1.9	2.6	-0.1	
OPT	-17.5	-20.1	-9.9	-7.7	-4.4
Syria	-3.2	-4.1	-6.1	-5.8	-6.6
Tunisia	-2.0	-1.1	-2.0	-2.6	-2.7
MED Region (simple average)	*-0.2*	*0.7*	*4.3*	*2.1*	
Foreign direct investment (net, % GDP)					
Algeria	0.6	1.0	1.8	1.9	
Egypt	3.2	4.3	5.6	8.2	5.5
Israel	1.6	3.6	10.1	4.4	3.0
Jordan	5.7	12.0	21.9	10.6	8.5
Lebanon	10.9	12.2	12.0	10.8	24.7
Libya	1.1	2.4	4.1	3.7	3.6
Morocco	1.5	2.6	4.5	5.5	
OPT					
Syria	1.1	1.7	1.7	2.1	3.9
Tunisia	2.1	2.6	10.4	3.0	3.4
MED Region (simple average)	*3.1*	*5.2*	*8.8*	*6.0*	
External vulnerability					
External public debt (% GDP)					
Algeria	25.6	16.7	4.9	3.5	2.5
Egypt	37.9	32.2	28.8	24.2	20.2
Israel	60.7	56.7	58.5	53.3	50.3
Jordan	66.1	56.6	51.9	47.0	41.0
Lebanon	89.0	89.0	90.0	87.0	73.0
Libya	12.9	9.8	8.7	8.1	8.0
Morocco	27.3	25.4	23.3	22.0	20.1
OPT					
Syria	73.2	23.3	19.4	17.2	17.8
Tunisia	66.5	65.4	58.3	55.6	52.9
MED Region (simple average)	*51.0*	*41.7*	*38.2*	*35.3*	

Table II.1.5:
MED - Trade, business climate and governance reform

Current trade policy and trade policy reform

	Current trade policy	Trade policy reform progress	Average tariff (%)	Average tariff (%)
	2007	2000-2007	2007	2000
Algeria	58	69	18.7	22.2
Egypt	72	96	6.9	19.9
Jordan	50	91	11.5	22.1
Lebanon	13	91	7.0	14.7
Morocco	64	55	22.3	31.7
Syria	32	38	19.6	19.6
Tunisia	56	57	26.8	33.9
MED regional average	**49**	**71**	**16.1**	**23.4**

Current business climate and business climate reform

	Current business climate		Business climate reform progress
	2007	2006	2000-2007
Algeria	30	36	51
Egypt	20	2	61
Jordan	49	59	37
Lebanon	42	40	3
Morocco	31	38	17
OPT	33	22	
Syria	23	33	8
Tunisia	49	55	52
MED regional average	**35**	**36**	**33**

Current status of governance and governance reform progress

	Quality of public adminis	Reform progress	Public sector accountability	Reform progress
	2007	2000-2007	2007	2000-2007
Algeria	32	11	27	56
Egypt	42	94	23	75
Jordan	54	22	34	62
Libya	4	15	0	45
Morocco	75	90	32	77
Syria	13	48	8	67
Tunisia	73	75	20	30
MED regional average	**42**	**51**	**21**	**59**

Source: World Bank, MENA Economic Developments and Prospects, 2008

2. OVERVIEW OF RECENT ECONOMIC DEVELOPMENTS IN THE EU'S EASTERN NEIGHBOURHOOD

2.1. MACROECONOMIC DEVELOPMENTS

In 2007, the combined **GDP growth** of the EU's Eastern Neighbourhood accelerated from 7.5% in 2006 to more than 8%, well above global growth (which is estimated to have fallen from 4.9% in 2006 to little more than 4% in 2007). The seven countries remained, together with the former Soviet republics of Central Asia, the second-fastest growing region in the world, after emerging Asia. Among the seven, all but one (Moldova) registered growth rates of at least 7%. Russia, which alone accounts for some 85% of the combined output of the region at market exchange rates (and about 75% at PPP exchange rates), maintained and further strengthened its growth momentum, taking advantage of further increases in energy prices (Russia is the world's second largest oil exporter and the largest gas exporter). In 2007, real GDP growth in Russia was 8.1%, up from 7.4% in 2006: nominal Russian GDP is now approaching the benchmark of EUR 1 trillion; it is comparable to the individual GDPs of Spain, Canada or Brazil.

Strong real GDP growth, appreciation of exchange rates and a population decrease (partly natural and partly economically motivated — with strong net emigration from the poorer countries of the region) have led to a very **substantial rise in GDP per capita**. Between 2004 and 2007, GDP per capita (in current EUR) increased by 65% in Moldova and by nearly 80% in Georgia and Belarus, doubled in Russia and Ukraine, more than doubled in Armenia (plus 130%) and more than tripled in Azerbaijan. GDP per capita in Russia approached EUR 7000. The steep increases in GDP per capita have led to a very substantial fall in poverty in all the countries of the region. Yet, poverty remains high — 25 to 30% of the population — in Armenia, Georgia and Moldova (Europe's poorest country).

Strong growth has also resulted in an increase in job creation and a **decline in unemployment**. The average unemployment rate[32] in the seven countries of the region declined between 2004 and 2007 from more than 7% to less than 6% of the total labour force. However, low unemployment numbers also reflect low levels of labour force participation and massive emigration (albeit with exceptions: Russia is now the second largest receiver of immigrants on the planet). The poorer countries are all facing massive emigration. At the same time, labour surveys may not take full account of the large

[32] The quality of unemployment statistics differs from one country of the region to another, which makes cross-country comparisons particularly difficult.

Graph II.2.1: **CIS and Europe -Stock market developments '07-'08**

informal labour markets and high self-employment.

In the majority of the countries of the region (including Russia) **growth has continued to be essentially driven by domestic rather than external demand**. Within domestic demand, private consumption is still the largest contributor to growth. However, investment and, to a smaller extent, government spending rather than private consumption were the most dynamic components of domestic demand in 2007 (and also in 2006). At the same time, contribution to growth of net exports was negative in most countries of the region. The situation of Russia, where growth exceeded 8% for the first time since 2000, is in this respect the most striking. The main components of domestic demand increased by more than 10% (private consumption — 13%, investments — 21%), while, despite strong external demand, the growth of exports (in volume) was much slower than that of imports. This does not mean that growing energy exports have no impact on Russia's strong growth. Indeed, the growth of domestic demand is to a large extent made possible by the increased profits of enterprises, notably those operating in the energy sector and deriving a substantial part of their profits from exports, and by the increased revenues of the State, largely originating in the same sector. Growth is also supported by rapid credit expansion, reflecting at least in part growing inflows of export revenues. The contribution of exports to growth is therefore quite substantial, but largely indirect.

The developments in Ukraine, the second largest economy in the region, show a similar pattern. Ukraine's performance is also driven by domestic demand, fuelled by vigorous income growth and a lending boom. Here too, private consumption remained the main driver of growth, but the expansion of fixed investment was faster. Investment was the most dynamic component of domestic demand in Belarus too. The same trend seems to be developing in Armenia and Georgia, where growth exceeded 13% and 12%, respectively. The strong growth performance in these two countries is also explained by increased confidence in the economy resulting from the recent acceleration of market reforms.

Exports remain the main *direct* driver of growth only in Azerbaijan, where the increase in the output of the export-oriented hydrocarbon sector — which now represents around 35% of the economy — led to a GDP growth of 25% (after an even more impressive 34.5% in 2006).

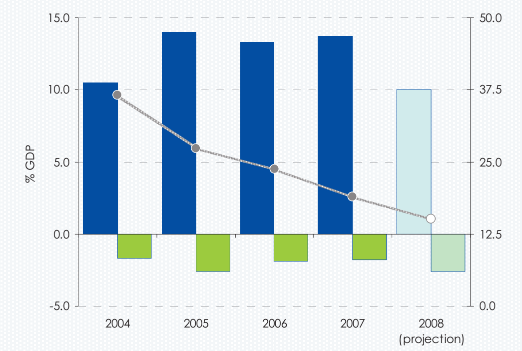
The sectors where output has grown most are construction and services. In Russia, construction, trade and financial services increased their production by 16, 12 and 11%, respectively. In Armenia, growth in the construction sector was as high as 80%. As industrial and agricultural production are growing at a much slower pace — or not growing at all, as in Moldova (both industry and agriculture) or Azerbaijan (non-energy industry) — the **composition of growth in the region is more and more dominated by the non-tradables sectors**. Clearly, this process reflects to a large part the continuing transition to a market economy. But at the same time, it is the result of continuing poor investment conditions, not attractive enough to encourage investment with longer returns, e.g. in industry.

Disappointing investment in the tradables sectors can also be explained by the low competitiveness of the countries of the region (see below), reflecting both the quality of their institutions and a strong appreciation in real exchange rates.

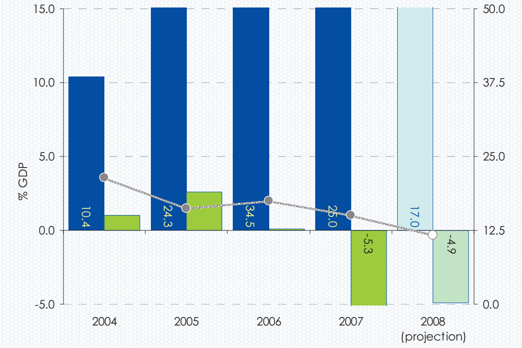
General government balances in 2007 ranged from a deficit of 4.7% (Georgia) to a surplus of 5.5% (Russia). Fiscal balances deteriorated in all the countries of the region, but the deterioration was fairly modest in the majority of countries. Only in Russia and Georgia did the deterioration — narrowing of a very comfortable surplus or widening of a moderate deficit — exceed a fraction of a percentage point of GDP.

Russia's strong, albeit diminishing, headline fiscal surplus was achieved once again on the back of high energy prices. However, the fiscal expansion ahead of the 2007-2008 electoral cycle cost Russia nearly 2 percentage points of GDP. Moreover, Russia's non-oil deficit widened in 2007 to more than 8% of GDP, from less than 7% in 2006. The non-oil fiscal deficit of Azerbaijan, the second major energy exporter in the region, increased to 47% of GDP, reflecting a rapid increase in spending programmes (+60% in

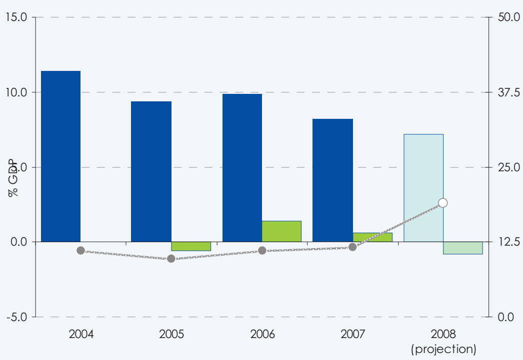
Graph II.2.2: **Armenia - GDP, fiscal balance and public debt**



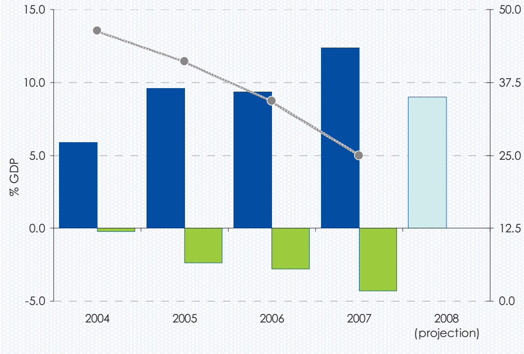
Graph II.2.5: **Azerbaijan - GDP, fiscal balance and public debt**



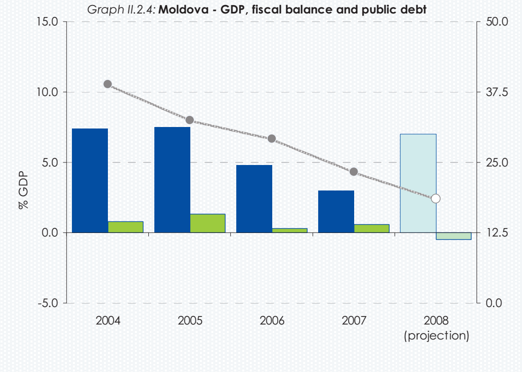
Graph II.2.3: **Belarus - GDP, fiscal balance and public debt**



Graph II.2.6: **Georgia - GDP, fiscal balance and public debt**

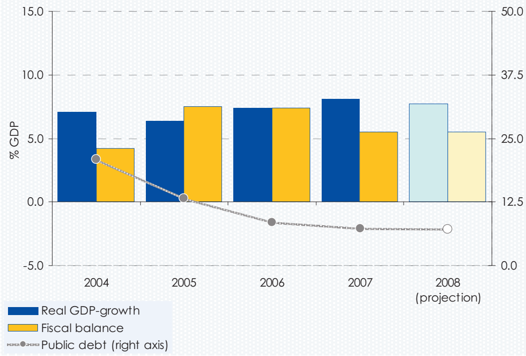


Graph II.2.4: **Moldova - GDP, fiscal balance and public debt**



Graph II.2.7: **Ukraine - GDP, public balance and fiscal debt**

Graph II.2.8: **Russia - GDP, fiscal balance and public debt**



nominal terms), but was still covered by the revenue of the oil sector. The assets of the Azerbaijan State Oil Fund, where part of the oil windfall is accumulated, rose by nearly two-thirds and exceeded 8% of GDP at the end of 2007, one percentage point more than the year before. The size of the corresponding fund in Russia, the Stabilisation Fund, was almost 13% of GDP at the end of 2007.

Fiscal policies in the other countries (with the exception of Georgia, which increased spending by 3% of GDP) remained more prudent. The government in Ukraine, for instance, despite voting additional spending twice in the course of the year, the government had no difficulties in maintaining the fiscal deficit below 2% of GDP.

The persistence of fiscal surpluses or low fiscal deficits, financed mostly by privatisation receipts (as in Georgia) or official external assistance, often in the form of grants (as in Moldova), translated into substantial **reductions in government** debt. At the end of 2007, total public debt in the countries of the region ranged from just 9.7% of GDP (Russia) to about 25-28% (Georgia and Moldova). Compared to the beginning of 2007, the average debt-to-GDP ratio had been almost halved by the end of the year. Belarus was the only country in the region where the public debt increased in 2007 (very modestly), and it is likely to increase further in 2008.

The trend of a gradual reduction in **average inflation** was reversed in 2007. It grew to 11%, from just 8.4% in 2006. A further acceleration of inflation was observed in the first months of 2008, to 13%. The price rises reflect in part global trends, responding to the rises in global energy and food prices, but also domestic factors. These domestic factors can be increases in domestic utility tariffs (as in Russia and, earlier in 2007, Moldova). But more often accelerating inflation reflects fast money growth, usually fuelled by not fully sterilised inflows of foreign exchange.

So, inflationary pressures in the energy-exporting countries are generated by monetary expansion resulting from high trade and current account surpluses. Russia's financial account was also in surplus in 2007 (for the first time), reflecting strong investment flows. Foreign exchange inflows led to the accumulation of international reserves (Russia holds the third largest reserves in the world, after China and Japan) and to appreciating exchange rates. For energy importing countries facing higher import prices, inflation primarily reflects rises in domestic utility tariffs, since increasing input costs are passed on to the final consumers. For the smaller countries of the region, inflationary pressures can also come from foreign exchange inflows connected with private transfers (e.g. remittances). In this case, they may be accompanied by an appreciation in nominal exchange rates, as in the energy-exporting countries.

The **appreciation of the exchange rates** – both real and nominal – has been a common feature in the region since at least 2002. In 2007, the exchange rates of all the currencies of the region appreciated against the USD, the only exceptions being the Ukrainian hryvnia and the Belarusian rouble, both pegged to the dollar. In early 2008, however, the Ukrainian Central Bank announced a revaluation of the hryvnia exchange rate. In addition, the Armenian dram appreciated against the euro.

The developments in 2007, in particular the persistent inflation, show that to be effective, monetary authorities need to have adequate **monetary policy** instruments. This is particularly true for interest rates, which are maintained low, and sometimes negative, in real terms, in order to create conditions for strong growth. However, the effectiveness of interest rates is limited by the availability of abundant liquidity on the inter-bank market. Furthermore, monetary policies need to be supported by appropriate fiscal policies. Thus, Russia's fiscal oil stabilisation fund has become a major instrument for the sterilisation of foreign exchange (see Box II.2.1).

Box II.2.1: **Reforms in the fiscal frameworks in the CIS: The case of Russia**

The Russian Budget Code was significantly revised in 2007 — a robust set of fiscal rules was introduced, and the old oil "StabFund" was split in two and its legal framework was changed. The same 2007 Budget Code reform introduced a Medium Term Expenditure Framework —MTEF— with three-year rolling budgets. Those changes arguably make Russia the regional leader in the Western CIS in terms of robust fiscal frameworks, as the Russian MTEF is more forceful than the one existing in Moldova and as the "StabFund" —and its successors— has more binding rules than the one in Azerbaijan.

The new fiscal rules

These new fiscal rules aim to put limits on the non-oil and gas fiscal balance and on the use of oil revenues for spending purposes. Two caps were introduced, one for the non-oil and -gas deficit (defined as expenditures minus non-oil and gas revenues) and one for the regular budget balance. The non-oil and gas deficit may not exceed 7.1% of GDP in 2008, 6.5% of GDP in 2009, 5.5% of GDP in 2010 and 4.7% GDP in 2011, remaining at this level thereafter. In order to finance this non-oil and gas deficit oil/gas revenues can be used, but only up to an amount equivalent to 6.1% of GDP in 2008, 5.5% of GDP in 2009, 4.5% of GDP in 2010 and 3.7% of GDP from 2011 onwards. The cut-off price is eliminated, and the remaining oil and gas revenues *that are not part of this transfer* to the budget are allocated to the StabFund.

The new energy funds and their framework

The traditional StabFund is now split in two parts (effective from February 2008 onwards): a *Reserve Fund* (akin to the old StabFund) and a *Future Generations (or Welfare) Fund.* As of February 2008 these two funds have distinct functions, namely (1) insurance against volatility of the oil price (its traditional function), and (2) using the oil windfalls to generate income streams to help cover structural budget deficits (for instance, in the Pension Fund), fulfilling an "intergenerational equity" function.

The Reserve Fund is *fixed* at 10% of GDP and all revenues exceeding this cap are transferred to the Welfare Fund. The tax base of the Funds has been expanded: in addition to 95% of the proceeds of the mineral extraction tax and 100% of the export customs duty on crude oil and refined oil products, now 100% of the proceeds of the mineral extraction tax and the export customs duty on gas flow into the funds as well. Also, the "switch mechanism" for the oil (and now gas) revenue flow between the budget and the Funds has been changed: the cut-off price was replaced by a nominal oil and gas transfer that is defined in the newly introduced three-year budget law described above. The rules that govern the use of the resources accumulated in the new "StabFund" effectively remain the same (i.e., restrictive and conservative), while the rules concerning the "Welfare Fund" are still being discussed.

The new fiscal rules are rather strict and clearly aim to ensure sound fiscal management, and their introduction should therefore be commended. As to the use of the oil and gas revenues, given the present state of economic development and the need to improve public services for the present generation, it is understandable that Russia wants to use part of its present oil revenues for spending (for instance, in human and physical capital accumulation, although serious questions related to the effectiveness of fiscal spending in Russia do remain). Given this, reserving the largest part of the existing StabFund for the Reserve Fund (around 80%) reveals a clear fiscally conservative bias by the Russian Government. Nevertheless, it does remain to be seen to what extent the rules will be honoured, as their phase-in path until 2011 will require both continued political will and economic growth for those rules to continue being acceptable.

In 2007, the contrast in **trade performance** between the energy exporters and importers, already striking in 2006, increased still further. Azerbaijan's trade surplus grew from 40% of the country's GDP to 51%. Russia's trade surplus widened in dollar terms, but fell as a share of GDP by over four percentage points. The trade balances of some of the other countries in the region deteriorated: the trade accounts of Ukraine and Belarus moved from moderate to more serious deficits, while the trade deficits of the three other countries remained very high, with Moldova's deficit surpassing 50% of GDP. The deterioration in the trade accounts primarily reflects continuing rises in energy prices (including the gas prices charged by Russia to its trading partners) and sustained domestic consumer demand, met increasingly by imports rather than by domestic production. This tendency may reflect a deterioration of competitiveness in certain sectors of the economy for some countries in the region.

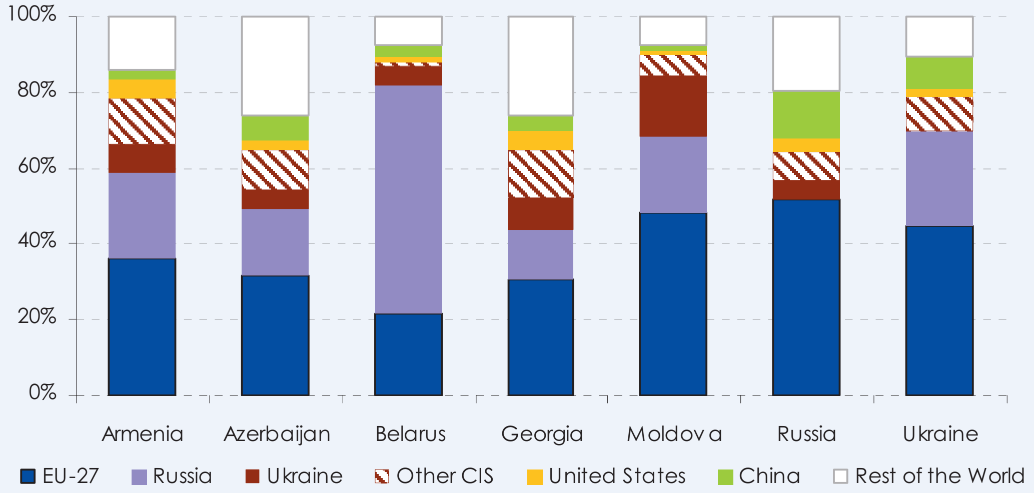
Azerbaijan, again the only country in the region to register a meaningful improvement in its trade account, was also the only one whose current **account** surplus increased as a share of GDP (from nearly 16% in 2006 to almost 25% in 2007). Russia's current account surplus decreased from 10% of GDP in 2006 to 6% in 2007, and is set to fall further in the near future, reflecting the much faster growth of imports compared to exports, although this will depend on how oil and gas prices develop. As with their trade balances, the current accounts of Ukraine and Belarus went further into deficit. The current account deficits of Armenia, Georgia and Moldova all widened as well — somewhat moderately for Armenia and Georgia, but much more substantially for Moldova. However, the rise in the current account deficits was much less severe than that of the trade deficits, reflecting the growth of private transfers, particularly remittances, which continued to be a substantial and stable source of foreign currency. In Moldova in particular, remittances — estimated at around a third of GDP in 2007 — were the major source of foreign exchange to finance the trade deficit. In Armenia, remittances were supplemented by large private capital transfers and foreign direct investment (FDI), as in Georgia.

For several years, **FDI** flows in the EU's Eastern Neighbourhood were very limited. The situation seems to be changing, although cumulative FDI still remains somewhat modest in the region, Azerbaijan being the sole exception. In 2007, FDI into Russia increased again, but still accounted for only 3.6% of GDP. Nonetheless, these FDI flows exceed those to the other major emerging economies (e.g. China). FDI to Ukraine increased from 5.4% % of GDP in 2006 to 6.6%. In both Russia and Ukraine, the corporate sector is also attracting more and more foreign capital in the form of bank credits, linked to strong domestic credit expansion. As a result, **capital inflows** in general **are picking up** and the external debt of the corporate sector in both countries is growing fast — it is now close to 30% of GDP. The increasing level of private debt stands in contrast to the decline in public debt, particularly in Russia and Ukraine.

In the other countries of the region, FDI has remained relatively modest in absolute terms, but can be very significant as a share of GDP (e.g. Georgia 16%, Moldova above 10%, Armenia above 7%). The largest relative increase was observed in **Belarus**, from 0.4% in 2006 to 3% in 2007, the result of some discretionary privatisations (mainly the selling of 50% of *BelTransGas* to *Gazprom*).

The **external indebtedness** of the smaller countries of the region has decreased substantially in the past few years. Yet, for Armenia, Georgia and (especially) Moldova the external financial situation remains fragile. Again, the largest relative worsening was seen by Belarus, and the headline figure of 5.8% in 2007 (compared to 1.6% in 2006) underestimates the degree of external public exposure, as some state-owned enterprises (SOE) and banks are also accumulating external debt to cushion the 2006-2007 energy price shocks.

Graph II.2.9: **CIS countries - Imports by partner in 2007**



Source: EC DG TRADE, IMF (Dots)

Note: CIS contains Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tadjikistan, Turkmenistan, Ukraine and Uzbekistan

2.2. TRADE LIBERALISATION AND ECONOMIC OPENING

All seven countries in the EU's Eastern Neighbourhood have, on average, further opened up their economies to international trade and continue to uphold fairly **liberal trade regimes**, with low average levels of tariff protection. The EU is now the single largest trading partner of all the countries of the region, with the exception of Belarus, which saw a renewed concentration on trade with Russia (and the CIS) after the elimination of the preferential terms of trade in Russian crude oil and natural gas. Belarus also has a (still incomplete) FTA with Russia.

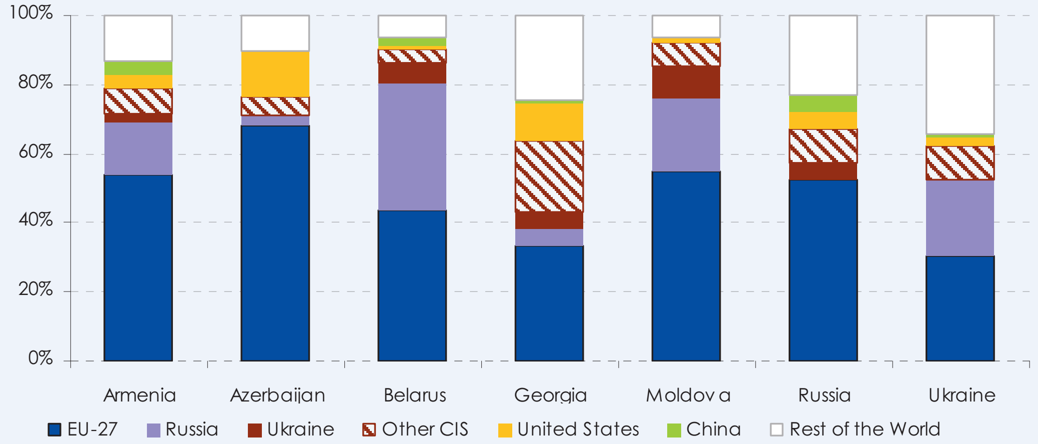
As a sign of the increased integration of those countries with the EU, their **total trade with the EU-27 increased by almost 182% in euro terms between 2000 and 2007** (or from €103 billion to over €290 billion), while the share of the Eastern ENP (European Neighbourhood Policy) countries plus Russia in total external EU-27 trade almost doubled, from 5.6% to 11% during the same period.

Yet, despite these clearly positive developments, a combination of structural and institutional factors still hinders the full development of trade in the region. This is demonstrated by the relative worsening of the '**Trading Across Borders**' element of the World Bank's '**2008 Doing Business**' indicators: the average ranking of the Eastern ENP countries plus Russia fell from 120th to 127th (in fact, the relative ranking of *all* these countries, apart from Georgia, worsened or stagnated).

Where multilateral trading relations are concerned, all Eastern ENP countries plus Russia have applied for **World Trade Organisation** (WTO) membership, but so far only Armenia, Georgia, Moldova and, since February 2008, Ukraine are members of the WTO, while the three other countries are experiencing very prolonged negotiations for accession to the WTO (almost 15 years in the cases of Russia and Belarus). On the other hand, some regional impediments to trade persist (Armenia's borders with Azerbaijan and Turkey remain closed and Russia still has restrictions on agricultural imports from Georgia, having only recently eliminated those on produce from Moldova).

The EU applies Most Favoured Nation (MFN) treatment in its trade relations with the Eastern ENP countries plus Russia. It has also granted trade preferences to all these countries under the Generalised System of Preferences (GSP). However, Belarus was excluded from the system in mid-2007, due to violations of labour rights.

Graph II.2.10: **CIS countries - Exports by partner in 2007**



Source: EC DG TRADE, IMF (Dots)

Note: CIS contains Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tadjikistan, Turkmenistan, Ukraine and Uzbekistan

Additionally, Armenia, Georgia and Moldova either benefit or are eligible to benefit from additional incentives for good governance and sustainable development under the new EU GSP. Regulation covering the period from January 2009 to December 2011 (known as 'GSP +').

Nevertheless, most of these countries have so far made only limited progress towards alignment of their national legislation and practices with the main EU trade-related *acquis*, as called for in their respective ENP Action Plans. Under these Action Plans, however, the EC has commissioned independent feasibility studies on **possible future Free Trade Agreements with Armenia and Georgia**. These studies have recently been finalised and are to be published during the summer of 2008.

In March 2008, moreover, the EC granted Moldova additional **Autonomous Trade Preferences (ATPs)** for its trade with the EU, and negotiations on establishing an extensive **EU-Ukraine Free Trade Area** were launched in February 2008 — almost immediately after Ukraine's WTO accession, aiming for a deep and comprehensive agreement on both goods and services and for significant regulatory alignment with the EU. The same is expected to happen with **Russia**, after its eventual WTO Accession: 2008 will also see the beginning of negotiations on a successor agreement to the **EU-Russia Partnership and Cooperation Agreement (PCA)**, which is expected to incorporate significant trade and economic relations components.

Regrettably, the ongoing price increases in certain agricultural commodities (see chapter 1 of the present publication) have led to the introduction of trade restrictions in the region: Moldova is considering proposals to limit wheat exports, Russia has introduced increases in its wheat export taxes (though due to be eliminated in mid-2008), while Ukraine had previously introduced export restrictions on grains and vegetable oil (which have now been lifted).

2.3. BUSINESS ENVIRONMENT AND PUBLIC INSTITUTIONS

Most countries of the Eastern Neighbourhood have long ago completed the basic market economy reforms, such as price and trade liberalisation or privatisation of the main public assets, but the establishment of open and competitive market economies and the creation of a business environment conducive to investment and growth are proving to be less smooth processes.

Yet, the overall direction seems to be the right one, and the quality of the business environment in the seven countries of the region is generally improving. This is the conclusion that can be drawn from the World Bank's 2008 Doing Business[33] report, which suggests that the CIS countries are making a **steady progress in putting in place a favourable business environment**. Indeed, with the exception of Moldova and Ukraine, all the Eastern Neighbourhood countries improved their Doing Business ranking in 2007 compared with 2006. Moreover, as in previous years, some of the Eastern Neighbourhood countries were among the top reformers in this period. Georgia in particular gained the title of top reformer for the third successive year in recognition of its ambitious reform programme since 2004. Georgia was ranked 18th best place to do business in 2007 (out of 178 countries), an improvement of 7 places from the 2006 ranking, putting it ahead of many Western European economies. Armenia's jump from 46th place to 39th also comfortably places it in the upper range of the global ranking, although reforms in 2007 were implemented at a somewhat slower pace than in previous years. However, the Doing Business indicators in Russia, Belarus and Ukraine lag considerably behind those of the two CIS frontrunners. While Russia and Belarus both made progress in 2007 and improved their relative position, Ukraine shows no tangible improvements in ease of doing business. This is a cause of concern as regards prospects for broader-based economic growth in the long term. A minor deterioration in Moldova's ranking (from 90th to 92nd) is due to the worsening situation in the labour market, despite progress in such areas as ease of starting a business and paying taxes.

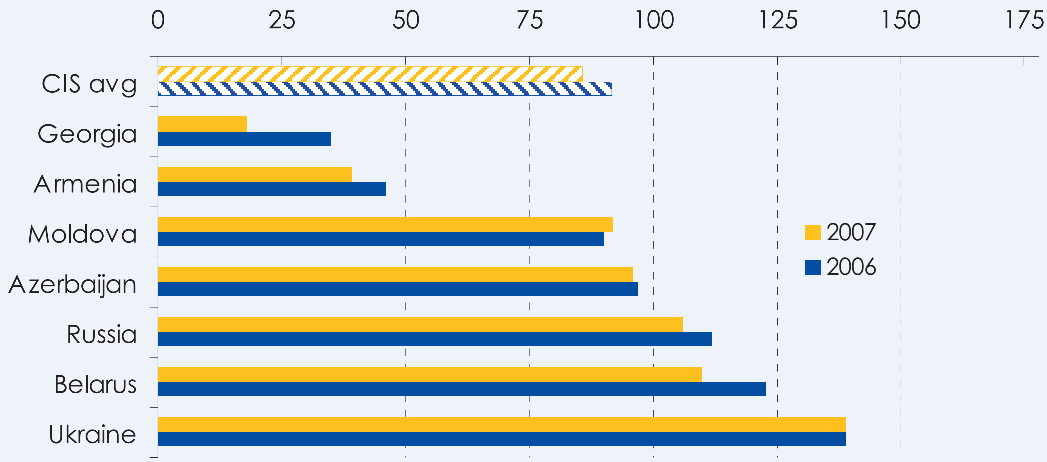
The improved conditions for starting a business and the simplification of procedures for paying taxes and getting credit were the areas where most progress was made in 2006-2007. In four countries in the region (Azerbaijan, Belarus, Georgia, Moldova) it became easier for entrepreneurs to **start a new business**. Georgia entered the top 10 by abolishing the minimum capital requirement to start a business. Moldova speeded up the registration process through administrative reforms. Although Belarus launched a one-stop shop eliminating 6 procedures and cutting 3 weeks from the start-up process, it still lags behind the other CIS countries along with Ukraine. The opening of a new private credit bureau in Russia substantially improved the assessment of access to credit, moving Russia's ranking in this area up by 72 places. Armenia took the same initiative. Significant strides were also made on more controversial measures such as **tax reform**, particularly in Moldova and Azerbaijan. Moldova made major revisions to its tax code, one of them being the complete elimination of corporate income tax. In contrast, other CIS countries still need to do much to ease the tax burden on businesses, with Ukraine and Belarus having the dubious honour of occupying the bottom two places in the world for ease of paying taxes. In fact, Ukraine had prepared a new simplified tax code (including a gradual reduction in tax rates) in 2007, but due to the political uncertainty and change of government these tax reforms have been further delayed. Complicated tax systems and excessive taxes hurt economic growth and investment, and indirectly stimulate unemployment and informal economic activity.

The methodology used in the Doing Business report has its limitations; in particular, it does not cover other areas important for business, such as transparency of government procurement, macroeconomic conditions or the underlying quality and strength of institutions. Indeed, the legislative frameworks that are steadily being put in place by the Eastern Neighbourhood countries have created the conditions for improving the business environment, but **the main challenge now is to strengthen those public institutions** with the task of implementing and upholding the market reforms. The World Economic Forum's Global Competitiveness Index (GCI[34]) provides

[33] The Doing Business report investigates and presents quantitative indicators that can be compared across 178 countries on regulations and procedures relevant for business activity, such as contract enforcement, starting and closing of business, paying taxes, dealing with licenses, and property registration, etc.

[34] The World Economic Forum's Global Competitiveness Index (GCI), introduced in 2004, measures the overall competitiveness of national economies taking into account microeconomic and macroeconomic factors. The GCI assesses different aspects of competitiveness, called the 'twelve pillars' of competitiveness. Those include: institutions, infrastructure, macroeconomy, health and education, goods, labour and financial market efficiency, development of technology, innovation, business

Graph II.2.11: **CIS countries - Doing business rankings 2006 & 2007**



The ease of doing business index ranks economies from 1 (best) to 178.
Note: Doing business 2007 rankings have been recalculated to reflect changes to the methodology and the addition of three new countries.
Source: World Bank, 2008

an assessment of some of these indicators. Based on the GCI, the Eastern Neighbourhood countries seem to be performing moderately. With the exception of Russia, ranking 58th out of 131 countries, all the other economies are in the second half of the classification, with Georgia (90th), Armenia (93rd) and Moldova (97th) ranking last in the region.

The lack of a business-friendly environment for (domestic and foreign) investors in the CIS countries remains a cause for serious concern. For example, the quality of investment protection in Russia has worsened compared to last year's GCI. Russia is now ranked 122nd in this area. The Doing Business report gives a broadly similar picture regarding the protection of **property rights**, although Georgia rated better here (33rd). The Georgian government's efforts to promote investment by offering protection to investors have led to a surge in FDI over 2006-2007. The adoption in Belarus of a new law strengthening shareholders' rights has also led to a jump of 22 places to 98th position in investor protection.

sophistication. The GCI 2007-08 covers 131 countries. Belarus is not included in the GCI.

A factor often neglected, but nonetheless quite important for the competitiveness of an economy, is the overall **quality of macroeconomic management**. Clearly, persistent double-digit inflation and increasing public deficits and debt are not conducive to a healthy business environment. Among the countries of the region, Azerbaijan (23rd), Russia (37th) and Armenia (57th) are considered to be doing best, with Ukraine (82nd), Moldova (92nd) and Georgia (93rd) lagging behind. Recent surges in world oil and food prices are creating new uncertainties as to the capacity of the emerging economies, such as the CIS countries, to maintain a stable macroeconomic framework.

In the area of **labour market** efficiency and flexibility, the Eastern Neighbourhood countries are rated relatively well, with Georgia and Russia ranked 28th and 33rd, respectively. Labour market reforms remain an important challenge and a constraint on growth in view of emerging labour shortages. Real wages remain low, reflecting at least in part low productivity, and are leading to high net emigration from some of the countries of the region (Moldova, Caucasus countries).

Another factor for long-term competitiveness, the **quality of the educational system**, varies significantly in the region, with Russia and

Table II.2.1:
CIS - Indicators competitiveness performance 2006

	Azerbaijan	Georgia	Armenia	Moldova	Ukraine	Russia	Regional Median
Institutions	**83**	**86**	**96**	**105**	**115**	**116**	**101**
- Property rights	103	117	69	107	118	122	112
- Ethical behavior of firms	62	104	111	117	128	120	114
- Burden of government regulation			77	106	104	118	105
- Favoritism in decisions of government officials	85	73	110	96	97	107	97
- Judicial independence	108	112	120	117	111	106	**112**
Global competitiveness index	**66**	**90**	**93**	**97**	**73**	**58**	**82**
Macroeconomic stability	**23**	**93**	**57**	**92**	**82**	**37**	**70**
Higher education and training	**89**	**86**	**95**	**81**	**53**	**45**	**84**
- Quality of the educational system	98	93	94	75			94
Goods market efficiency	**95**	**83**	**104**	**107**	**101**	**84**	**98**
- Prevalence of trade barriers	103	56	89	61	123	104	96
- Total tax rate (hard data)	60		52	72	101	90	72
- Business impact of rules on FDI	85	89	77	114	123	127	102
Labor market efficiency	**46**	**28**	**40**	**68**	**65**	**33**	**43**
Financial market sophistication	**91**	**84**	**110**	**101**	**85**	**109**	**96**
- Soundness of banks	113	91	90	82	119	108	100
- Ease of access to loans	91	94	123	101	71	86	93
Corruption perceptions index 2007	**150**	**79**	**99**	**111**	**118**	**143**	**118**

Note: Ranking from 1 to 131, with 1 being the highest rank. Corruption perceptions index is the main indicator from Transparency International with 1 being the best score out of 179 countries.
Source: World Economic Forum, Global Competitiveness Report 2007-2008

Ukraine ranking (in the GCI) 45th and 53rd. Russia's increased spending on the educational sector, partly in the form of the National Priority Projects[35], is likely to improve its position. Moldova (81st), Georgia (86th), Azerbaijan (89th) and Armenia (95th) all trail behind in the second half of the world rankings, although higher education and training programmes could also improve results in these countries in the near future. In Armenia, for example, social and educational spending has been increased to about one third of total public expenditure, but reform of vocational training and higher education is essential to address the needs of the business sector.

Good business regulations conducive to investment and economic growth are only one aspect of **good governance**. Empirical evidence suggests that problems with public sector efficiency, corruption, political accountability and the rule of law can undermine all the macroeconomic reforms and policy efforts that are being undertaken by governments. Interestingly, the GCI confirms the perceived weaknesses in the institutional environment and business standards. In a survey, four factors consistently cited by entrepreneurs[36] as being the main obstacles to competitiveness are corruption[37], access to finance, inefficient government bureaucracy and tax regulations. Political instability was also a cause of particular concern to local businessmen in Georgia and especially Ukraine.

Overall, the Eastern Neighbourhood countries are not performing particularly well as regards the quality of **institutions**. Azerbaijan (83rd) and Georgia (86th) have the best regional ratings, while Ukraine and Russia bring up the rear with 115th and 116th place, respectively. Lack of government efficiency and transparency, judicial independence, corporate ethics and proper protection of property rights are singled out as other causes of particular concern.

The World Bank governance indicators provide a good picture of the **quality of governance** and the **control of corruption** in the region and

[35] Russia's National Priority Projects form part of a public spending programme announced by the government in 2005 with the aim of increasing funding for four priority areas (health, education, housing and agriculture).

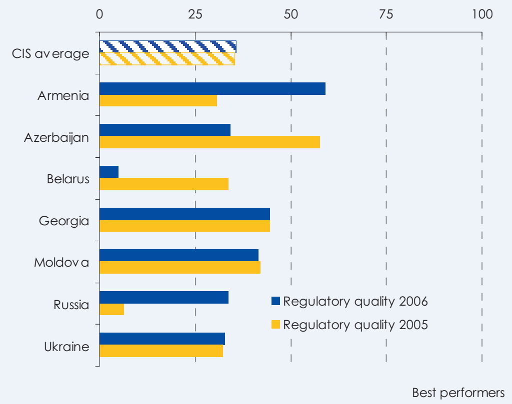
[36] For the WEF 07-08 GCI report, from a list of 14 factors, respondents were asked to select and rank the five most problematic factors for doing business in their country.

[37] It is high for all countries in the survey, but for Azerbaijan, Russia and Armenia in particular. A recent Ernst and Young survey of foreign investors in Russia added infrastructure to their list of major concerns.

confirm the GCI's conclusions. Overall, the performance of the seven countries of the region on items such as government effectiveness, rule of law, and control of corruption places them on average in the lower third (20th-30th percentile) of the ranking. There is an increasing gap between the members of the group, however. Armenia and Georgia are performing just below or slightly above the world average; Georgia in particular showed strong improvements on all indicators during the period 2003-2006. In the 45th and 35th percentile rank, respectively, Georgia and Armenia also lead the other CIS countries in controlling corruption. Azerbaijan and Belarus on the other hand are usually last in the regional rankings. Although Belarus made a small relative improvement in 2006, it is the only country that did not make progress (even showing a strong relapse) in fighting corruption over the entire period 2000-2006. Bringing up the rear, in the 15th percentile rank, Azerbaijan also still has much to do. The regulatory quality indicator shows good progress from 2000 to 2006 for all countries of the region except Belarus, which remained at a standstill in the 5th percentile at the bottom of the ranking, compared for example to the 59th percentile score for Armenia.

To summarise, the challenges that need to be tackled as a matter of priority in almost every CIS country to improve the quality of governance remain the level of corruption and insufficient rule of law, government interference in the economy, and improving the business climate. The 2007 Corruption Perceptions Index (CPI)[38] clearly shows that there is still a lot of resistance to reforming bureaucracies and improving public governance, with all CIS countries apart from Georgia being unable to improve their score and ranking compared with last year's CPI.

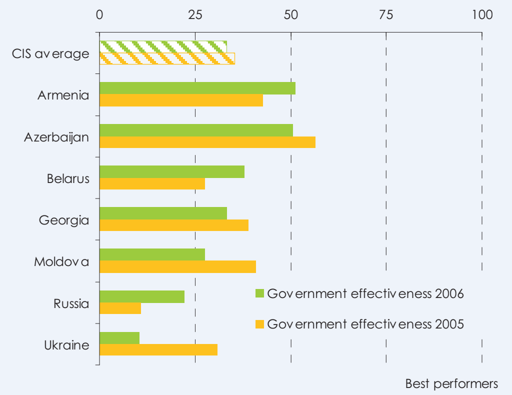
Graph II.2.12: **CIS countries - Regulatory quality 2005 - 2006**



Percentile ranking from 0 (low quality) to 100 (high quality)

Source: World Bank, Kaufmann, Kraay and Mastruzzi, 2007

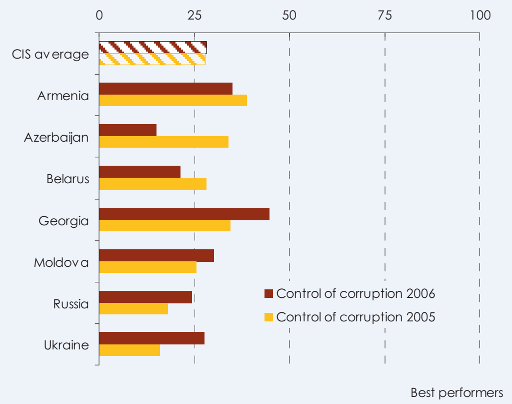
Graph II.2.13: **CIS countries - Government effectiveness 2005 - 2006**



Percentile ranking from 0 (ineffective) to 100 (very effective)

Source: World Bank, Kaufmann, Kraay and Mastruzzi, 2007

Graph II.2.14: **CIS countries - Governance indicators 2005 - 2006**



Percentile ranking from 0 (highly corrupt) to 100 (very clean)

Source: World Bank, Kaufmann, Kraay and Mastruzzi, 2007

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[38] The 2007 Corruption Perceptions Index, produced annually by Transparency International, looks at perceptions of public sector corruption in 180 countries. This composite index draws on 14 expert opinion surveys. It scores countries on a scale from zero to ten, with zero indicating high perceived levels of corruption and ten indicating low levels of perceived corruption. Relative changes in rankings are partly the result of a change in the number of included countries from 163 in 2006 to 180 countries in 2007.

Table II.2.2:
CIS countries - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)					
Armenia	10.5	14.0	13.3	13.7	10.0
Azerbaijan	10.4	24.3	34.5	25.0	17.0
Belarus	11.4	9.4	9.9	8.2	7.2
Georgia	5.9	9.6	9.4	12.4	9.0
Moldova	7.8	6.6	4.8	3.0	6.5
Russia	7.1	6.4	7.4	8.1	7.7
Ukraine	12.1	2.7	7.1	7.3	5.6
CIS Region (GDP-weighted average)	*7.8*	*6.5*	*8.0*	*8.4*	*7.7*
Nominal GDP (EUR billion)					
Armenia	2.9	3.9	5.1	6.7	
Azerbaijan	7.0	10.6	16.7	22.8	
Belarus	18.6	24.3	29.4	32.7	
Georgia	4.1	5.1	6.2	7.4	
Moldova	2.1	2.4	2.7	3.2	
Russia	475.9	614.4	788.1	942.0	
Ukraine	52.2	69.1	84.8	103.0	
CIS Region (total)	*562.8*	*729.8*	*933.0*	*1117.8*	
GDP per capita (EUR)					
Armenia	897	1223	1584	2080	
Azerbaijan	845	1270	1980	2675	
Belarus	1891	2476	3018	3368	
Georgia	956	1190	1405	1692	
Moldova	581	668	746	956	
Russia	3301	4282	5521	6628	
Ukraine	1101	1467	1815	2218	
CIS Region (simple average)	*1367*	*1797*	*2296*	*2802*	
GNI per capita, PPP current prices (USD)					
Armenia	4250	5000	5890	n.a.	
Azerbaijan	n.a.	n.a.	n.a.	n.a.	
Belarus	6990	7890	n.a.	n.a.	
Georgia	2990	3340	3690	n.a.	
Moldova					
Russia	9680	10640	11630	n.a.	
Ukraine	6370	6780	7520	n.a.	
CIS Region (simple average)	*6056*	*6730*			
Inflation (average anual % change)					
Armenia	7.0	0.6	2.9	4.4	8.9
Azerbaijan	6.7	11.6	8.4	16.7	16.2
Belarus	14.0	10.3	7.0	12.1	11.0
Georgia	5.7	8.3	9.2	9.2	9.6
Moldova	12.5	11.9	12.7	12.4	13.0
Russia	10.9	12.7	9.7	9.1	11.0
Ukraine	9.0	13.5	9.0	12.8	22.0
CIS Region (simple average)	*9.4*	*9.8*	*8.4*	*11.0*	*13.1*

Table II.2.3:
CIS countries - MEI (continued-1)

	2004	2005	2006	2007 prel.	2008 proj.
Social indicators					
Unemployment rate (%)					
Armenia	9.6	8.2	7.2	6.7	
Azerbaijan	1.4	1.4	1.3	1.0	
Belarus	1.9	1.5	1.2	1.0	
Georgia	12.6	13.8	13.9	n.a.	
Moldova	8.1	7.3	7.4	5.1	
Russia	7.6	7.7	6.9	6.1	4.0
Ukraine	9.2	7.8	7.4	6.7	
CIS Region (simple average)	*7.2*	*6.8*	*6.5*		
Fiscal sector					
General government budget balance (% GDP)					
Armenia (Central Government)	-1.7	-2.6	-1.9	-1.8	-1.8
Azerbaijan	-0.2	-0.7	0.5	-0.2	
Belarus (Central Government)	0.0	-0.6	1.4	0.6	-0.8
Georgia	-0.2	-2.4	-2.8	-4.3	
Moldova	0.8	1.6	0.3	-0.2	0.0
Russia (Central Government)	4.2	7.5	7.4	5.5	5.5
Ukraine	-4.4	-2.3	-1.3	-1.5	-2.0
CIS Region (simple average)	*-0.2*	*0.1*	*0.5*	*-0.3*	
Total gross public debt (% GDP)					
Armenia	32.4	24.3	18.7	17.6	16.5
Azerbaijan	21.4	16.2	17.5	15.0	11.7
Belarus	11.0	9.6	11.0	11.6	19.0
Georgia	46.4	41.1	34.3	25.0	
Moldova	47.2	38.0	34.0	28.0	20.0
Russia	20.9	13.2	8.5	7.3	7.1
Ukraine	24.7	17.7	14.8	12.2	11.2
CIS Region (simple average)	*29.1*	*22.9*	*19.8*	*16.7*	
Monetary sector					
Degree of monetisation (M2/GDP, %)					
Armenia	7.6	10.0	12.9	n.a.	
Azerbaijan	10.7	14.4	21.1	n.a.	
Belarus (M3/GDP)	17.7	19.7	22.1	24.8	
Georgia (M3/GDP)	13.2	14.8	19.5	23.8	
Moldova					
Russia	31.1	33.4	38.1	44.3	
Ukraine	36.6	45.5	48.2	54.0	
CIS Region (simple average)	*19.5*	*23.0*	*27.0*		
Dollarisation in bank deposits (%)					
Armenia	74.8	63.6	52.3	39.6	27.7
Azerbaijan	25.7	16.2	8.9	n.a.	
Belarus					
Georgia	74.5	71.8	69.4	65.6	
Moldova					
Russia					
Ukraine	36.5	34.2	38.0	32.1	
CIS Region (simple average)	*52.9*	*46.4*	*42.1*		

Table II.2.4:
CIS countries - MEI (continued - 2)

	2004	2005	2006	2007 prel.	2008 proj.
External sector					
Trade balance (% GDP)					
Armenia	-14.8	-13.2	-18.5	-15.5	-15.5
Azerbaijan	1.9	24.4	39.1	52.0	
Belarus	-6.5	1.0	-4.5	-9.0	-8.0
Georgia	-17.6	-18.9	-26.1	-26.2	
Moldova	-29.8	-40.6	-46.6	-52.3	-47.7
Russia	14.5	15.4	14.3	9.9	7.9
Ukraine	7.7	0.8	-2.9	-5.6	-8.8
CIS Region (simple average)	*-6.4*	*-4.4*	*-6.5*		
Current account balance (% GDP)					
Armenia	-4.5	-3.9	-1.4	-6.2	-6.7
Azerbaijan	-29.8	1.3	18.7	24.6	40.1
Belarus	-5.2	1.6	-1.8	-5.0	-6.6
Georgia	-12.2	-9.8	-15.9	-19.7	-16.6
Moldova	-1.8	-7.6	-11.5	-17.0	-16.5
Russia	9.9	11.0	9.8	5.9	4.3
Ukraine	10.6	3.1	-1.6	-4.2	-7.6
CIS Region (simple average)	*-4.7*	*-0.6*	*-0.5*	*-3.1*	*-1.4*
Foreign direct investment (net, % GDP)					
Armenia	6.1	5.1	5.3	7.2	5.8
Azerbaijan	n.a.	3.5	-6.6	-17.4	
Belarus	1.1	1.0	0.4	3.0	
Georgia	9.5	7.1	13.7	15.5	
Moldova	5.8	7.5	6.5	10.2	11.1
Russia	2.5	2.0	3.2	3.6	
Ukraine	2.7	9.0	5.4	6.6	6.0
CIS Region (simple average)	*4.6*	*5.0*	*4.0*	*4.1*	
External vulnerability					
External public debt (% GDP)					
Armenia	33.0	22.0	19.0	16.0	14.0
Azerbaijan	18.5	14.3	9.9	8.3	
Belarus	2.1	1.9	1.6	5.8	9.0
Georgia	36.2	27.1	21.9	17.5	
Moldova (public + private)	72.5	56.2	56.5	60.0	
Russia	16.4	9.3	4.6	3.4	
Ukraine	19.2	14.7	12.2	10.5	9.5
CIS Region (simple average)	*28.3*	*20.8*	*18.0*	*17.4*	
Financial sector					
Real effective exchange rate (2004=100)					
Armenia	100.0	111.8	121.9	141.6	
Azerbaijan	100.0	115.6	119.9	126.2	
Belarus	100.0	96.8	93.1	91.8	
Georgia	100.0	103.0	102.9	103.4	
Moldova	100.0	98.7	98.7	109.5	
Russia	100.0	108.8	121.2	127.0	
Ukraine	100.0	117.0	125.0	n.a.	
CIS Region (average)	*100.0*	*107.4*	*111.8*		

Table II.2.5:

CIS countries - MEI (continued - 2)

	2004	2005	2006	2007 prel.	2008 proj.
External sector					
Trade balance (% GDP)					
Armenia	-14.8	-13.2	-18.5	-15.5	-15.5
Azerbaijan	1.9	24.4	39.1	52.0	
Belarus	-6.5	1.0	-4.5	-9.0	-8.0
Georgia	-17.6	-18.9	-26.1	-26.2	
Moldova	-29.8	-40.6	-46.6	-52.3	-47.7
Russia	14.5	15.4	14.3	9.9	7.9
Ukraine	7.7	0.8	-2.9	-5.6	-8.8
CIS Region (simple average)	*-6.4*	*-4.4*	*-6.5*		
Current account balance (% GDP)					
Armenia	-4.5	-3.9	-1.4	-6.2	-6.7
Azerbaijan	-29.8	1.3	18.7	24.6	40.1
Belarus	-5.2	1.6	-1.8	-5.0	-6.6
Georgia	-12.2	-9.8	-15.9	-19.7	-16.6
Moldova	-1.8	-7.6	-11.5	-17.0	-16.5
Russia	9.9	11.0	9.8	5.9	4.3
Ukraine	10.6	3.1	-1.6	-4.2	-7.6
CIS Region (simple average)	*-4.7*	*-0.6*	*-0.5*	*-3.1*	*-1.4*
Foreign direct investment (net, % GDP)					
Armenia	6.1	5.1	5.3	7.2	5.8
Azerbaijan	n.a.	3.5	-6.6	-17.4	
Belarus	1.1	1.0	0.4	3.0	
Georgia	9.5	7.1	13.7	15.5	
Moldova	5.8	7.5	6.5	10.2	11.1
Russia	2.5	2.0	3.2	3.6	
Ukraine	2.7	9.0	5.4	6.6	6.0
CIS Region (simple average)	*4.6*	*5.0*	*4.0*	*4.1*	
External vulnerability					
External public debt (% GDP)					
Armenia	33.0	22.0	19.0	16.0	14.0
Azerbaijan	18.5	14.3	9.9	8.3	
Belarus	2.1	1.9	1.6	5.8	9.0
Georgia	36.2	27.1	21.9	17.5	
Moldova (public + private)	72.5	56.2	56.5	60.0	
Russia	16.4	9.3	4.6	3.4	
Ukraine	19.2	14.7	12.2	10.5	9.5
CIS Region (simple average)	*28.3*	*20.8*	*18.0*	*17.4*	
Financial sector					
Real effective exchange rate (2004=100)					
Armenia	100.0	111.8	121.9	141.6	
Azerbaijan	100.0	115.6	119.9	126.2	
Belarus	100.0	96.8	93.1	91.8	
Georgia	100.0	103.0	102.9	103.4	
Moldova	100.0	98.7	98.7	109.5	
Russia	100.0	108.8	121.2	127.0	
Ukraine	100.0	117.0	125.0	n.a.	
CIS Region (average)	*100.0*	*107.4*	*111.8*		

Part III

Country analysis

1. ALGERIA

- ***Real GDP growth accelerated to 4.6% in 2007, despite negative growth in the hydrocarbon sector. This growth was mainly driven by exports and business investment.***

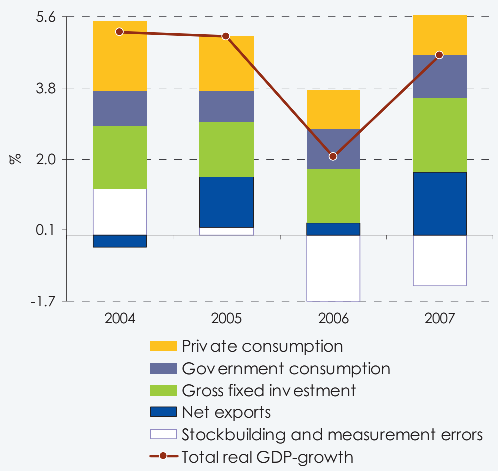
- ***In 2007 twin surpluses were sustained on the fiscal and current account balances, at double-digit levels though lower than in 2006. The non-hydrocarbon primary deficit increased worryingly to almost 38% of GDP. The process of privatisation of loss-making state companies should be accelerated to curb this steep negative trend.***

- ***WTO accession is approaching, which can help to accelerate the integration of the Maghreb region and further global integration, in line with the Association Agreement with the EU. The challenges for Algeria are to open up the service sector to private operators and foreign investments and to gradually bring local energy prices closer to global prices.***

Macroeconomic developments

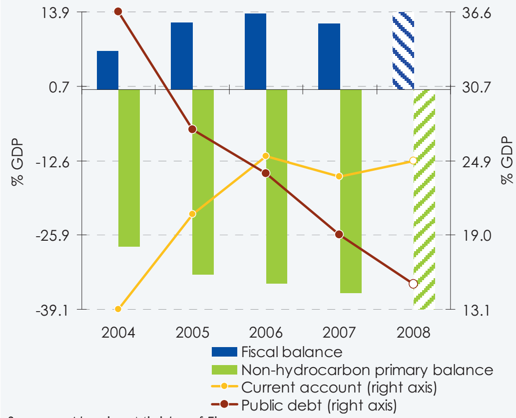
Algeria is in transition, recovering from 30 years of a command economy followed by a decade of fighting terrorism. Many market economy principles have yet to be embedded in the economic processes. The economy depends on the hydrocarbon sector; about 50% of **GDP**, nearly all exports of goods and 75% of the fiscal revenues. The key challenge during the transition remains to broaden the base for economic growth through diversification of the economy and private investment for job creation, in particular for those under the age of 30 (who make up 70% of the unemployed). Over the last few years the country has been on a steady economic growth path, apart from 2006, when it saw a slight slowdown due to maintenance works in the hydrocarbon sector. Even in 2007, when terrorist attacks multiplied all over the country, economic growth reached 4.6%. The main driving forces underlying the economic growth are the services, industry and construction sectors. 2008 will be a politically important year due to presidential elections. The expectation is that, although some reforms may be delayed, the economic growth will accelerate further to almost 5%.

Graph III.1.1: **Algeria - Contributions to real GDP-growth**



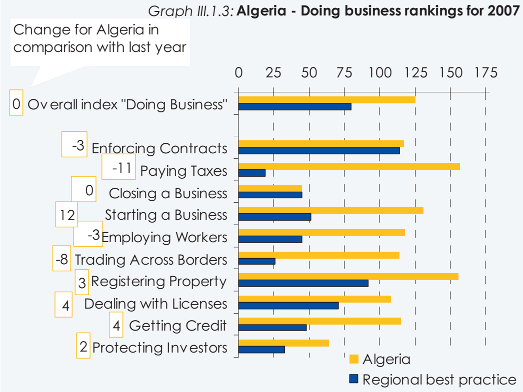
Source: EIU, Algerian national authorities and IMF

Graph III.1.2: **Algeria - Fiscal balances, public debt, current account**



Sources: Algerian Ministry of Finance.

Graph III.1.3: **Algeria - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries (Algeria, Egypt, Jordan, Lebanon, Morocco, Occupied Palestinian Territory, Syria and Tunisia).

Source: World Bank, 2008.

Although the level of **unemployment** is still high, according to the official figures it has fallen significantly from a peak of almost 30% in 2000 to around 14% in 2007. A point of concern remains that most created jobs have a temporary nature, and are therefore maybe not sustainable.

Public finances depend strongly on hydrocarbon revenues. In 2007, the primary non-hydrocarbon fiscal deficit was almost 38% of GDP, while the overall government balance reached a surplus of almost 12% of GDP. The buoyant hydrocarbon revenues financed high government spending (around 43% of GDP). Expectations are that the fiscal balance for the whole economy remains solid in 2008, with a further reduction of the debt stock. The primary balance may continue deteriorating due to further delays in reforms, such as privatisations of state banks, which will therefore act as a drain on the budget.

The Growth Consolidation Plan for 2005-09, which is basically a public investment programme, was pursued in 2007. A further **wage rise** for civil servants is planned in 2008 to retain skilled staff, in particular in the security services. These additional expenditures are one reason why the non-hydrocarbon primary deficit remained at a high level.

Algeria pushed forward with the ***Fonds de Régulation des Recettes***. The FRR is a sub-account of the government at the central bank that allows for a direct financing of the non-hydrocarbon deficit and amortisation of government debt. Budgetary receipts when the oil price is above the equivalent of USD 19 per barrel flow into the fund, as do taxes on profits realised by foreign partners. 2007 was the first year in which funds from the FRR were used.

Inflation soared in the first half of 2007 due to rising (worldwide) food prices by 6.6%. In response, the central bank of Algeria tightened monetary policy. Inflationary pressures thereafter eased and consumer price inflation reached on average 3.5% in 2007. During the first five months of 2008 inflation reached 5.5%, whereof food inflation 10.4%. Scarcity on the world food market, wage rises in the public and private sector and expansionary fiscal policy will keep putting upward pressure on prices. The high inflation will lead to a reduction of purchasing power and a price-wage spiral may unwind. The government wage increases, as well as the (probably) increasing bill for food subsidies, will push up the government expenditures.

Artificial low energy prices are still giving rise to inefficiencies, encouraging energy consumption and giving rise to smuggling to neighbouring countries. These prices should be raised, though this should be done gradually in order not to raise inflation too rapidly, and to protect vulnerable groups in the society.

The **exchange rate** regime is a managed float with no pre-announced path. It gives the central bank discretion to foreign exchange market interventions. This exchange rate policy is suitable for achieving the appropriate monetary conditions whenever necessary. The worldwide slide of the US dollar in 2007 caused the Algerian dinar to appreciate vis-à-vis the dollar, while it depreciated vis-à-vis the euro. Because Algeria´s imports of goods and services come mainly (about 60% of the total) from Europe, they have thus become more expensive.

Nonetheless, external developments remained strong and favourable in 2007 mainly due to the high hydrocarbon prices. The **current account** surplus remained high at 24% of GDP in 2007. On the downside, exports remain undiversified so that the Algeria economy could be hit hard if oil prices come down.

Gross official reserves surpassed the USD 100 billion in 2007 and are expected to reach almost USD 150 billion in 2008, presuming a solid trend in hydrocarbon exports and a strong dinar. In terms of months of imports the official reserves covered 32 months in 2007. This provides a solid buffer in case of exchange rate shocks. Repayment of the official external debt in 2007 went ahead of schedule and the debt fell to 3.5% of GDP.

Business environment

The business climate in Algeria compares poorly with the best performing country in the Arab region (graph III.1.3). According to the Doing Business indicators, the business climate deteriorated in several respects in 2007. Among others, Algeria lost its best position in the region as regards protecting investors, while registering property, dealing with licences, getting credit and starting a business have all become more difficult. On this last point, the creation of a more flexible labour market should make it easier for small and medium-sized businesses to exploit opportunities. But first and foremost, the banking system should become more market-based by further reducing state involvement in order to boost the opportunities for private businesses.

Algeria recently again announced ambitious plans aiming at improving the private sector and attracting foreign investments. Since 2005, the Algerian government has sold 350 state-owned companies, and it is planning to sell a large number of state companies in 2008. Reforms are also ongoing in the banking sector. Unfortunately, the turmoil on the international financial markets is having a negative effect on Algeria. The decision to privatise the first public bank, the *Crédit Populaire d´Algérie*, was delayed late 2007. A group of foreign banks had shown interest in acquiring a stake, but one (Citigroup) had to withdraw because of its losses related to the subprime loans crisis and the subsequent change of its main CEO. Another negative consequence of the turmoil was that liquidity shortages in the banking system led to long lines of customers at banks. More than 90% of bank assets belong to the public sector. Although credit to the private sector remains extremely low at about 25% of non-hydrocarbon GDP, domestic corporate bond markets are already large in Algeria. The Algiers Stock Exchange, which was inaugurated in July 1999, also remains thin, and a brokerage network has yet to be established. Modern knowhow is being injected by foreign shareholders. On the upside, the government has committed itself to improving insurance sector regulations. For Algeria it is now high time that financial intermediation is improved by greater competition in the banking sector, which will create a more level playing field so that the private sector can more easily access the funds needed for starting businesses.

Trade liberalisation and economic opening

Algeria has an Association Agreement with the EU since September 2005. The expectations are that this bilateral agreement will gradually benefit both economies, among others by the gradual reduction in duties on trade, an exchange of expertise and technology in energy (oil and gas, but also renewable energy). From the Algerian side, more progress is needed to attract investment and to lock in reforms. Given the pace of change in the global economy and the progress of its neighbours, Algeria needs to achieve this quickly. In line with the AA, the EU supports Algeria in its efforts to a rapid accession to the WTO. A leap forward is the recent achievement by Algeria of a reasonably solid domestic consensus in favour of WTO membership, which will enable Algeria to establish stronger trade relationships, not only globally but first and foremost with its geographical neighbours. It will also allow it to lock in domestic reforms. In particular, the areas of services and energy need specific commitments.

Public institutions and public finance management

The gradual elimination of state-owned enterprises remains one of the key reforms to be addressed. Also, while progress has recently been made in the modernisation of public finance management many reforms in this area remain to be pursued.

Social development and poverty

Despite its healthy public finances Algeria ranks poorly on human development. Life expectancy at birth is just 72 years, adult illiteracy exceeds 30% of the population, more than 25% of the population does not enrol in education, GDP per capita is relatively low and more than 5% of the population will not reach the age of 40. Government youth employment and investment plans should help relieve poverty through a careful distribution of public expenditures and, as emphasised before, structural reforms should lead to a more diversified private sector.

Table III.1.1:

Algeria - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	5.2	5.1	2.0	4.6	4.9
Real GDP non-hydrocarbon (% change)	6.2	4.7	5.6	6.0	6.5
GDP (dinar, billion)	6136	7544	8461	9110	
GDP per capita (EUR)	2115	2510	2770	2895	
GDP per capita (USD)	2624	3112	3708	3968	
GDP nominal (EUR, billion)	69	83	93	99	
GDP nominal (USD, billion)	85	102	124	135	
Inflation (average, %)	3.6	1.6	2.5	3.5	4.2
Social indicators					
Unemployment (officially registered, %)	18.7	16.0	15.2	14.1	12.9
Youth unemployment (%)	0	31	0	n.a.	
Population (million)	32.4	32.9	33.5	33.9	
Fiscal sector					
Total revenues (% GDP)	36.1	40.9	43.0	42.7	44.8
Total expenditure (% GDP)	29.2	29.0	29.4	30.9	30.8
Central govt. balance (% GDP)	6.9	11.9	13.6	11.8	13.9
Non-hydrocarbon primary balance (% GDP)	-27.9	-33.0	-34.5	-36.2	-39.1
Gross government debt (% GDP)	36.6	27.3	23.8	19.0	15.1
Monetary sector					
Credit to the economy (% change)	11.2	15.9	7.1	13.8	16.0
Money and quasi money (% change)	11.5	11.1	18.7	23.1	24.1
External sector					
Current account balance (% GDP)	13.1	20.6	25.2	23.6	24.8
Import cover of reserves (months)	21.0	26.5	29.1	32.2	36.3
Net FDI (% GDP)	0.6	1.0	1.8	1.9	
External vulnerability					
Gross external debt (% GDP)	25.6	16.7	4.9	3.5	2.5
Gross official reserves (USD, billion, e-o-p)	43.1	56.2	77.8	108.5	145.6
Financial sector					
Exchange rate (dinar per USD, end-of-period)	74.6	73.1	73.4	69.3	
Exchange rate (dinar per EUR, average)	101.8	86.6	96.9	102.0	
Real effective exchange rate (% change, e-o-p)[1]	0.6	-3.9	-0.3	-0.5	

[1] Increase (or decrease) reflects appreciation (or depreciation) of the Algerian dinar.

Sources: Algerian authorities, IMF, EUROSTAT, EC staff calculations.

2. ARMENIA

- ***During 2007 Armenia experienced high economic growth of 13.7%, driven mainly by developments in the construction and services sectors, supported by remittances from the diaspora and emigrants.***

- ***Recent political instability, insecurity and the state of emergency are expected to have a negative impact on economic growth.***

- ***The business climate is dampened by the presence of significant oligarchic and monopolistic structures, especially on the import markets.***

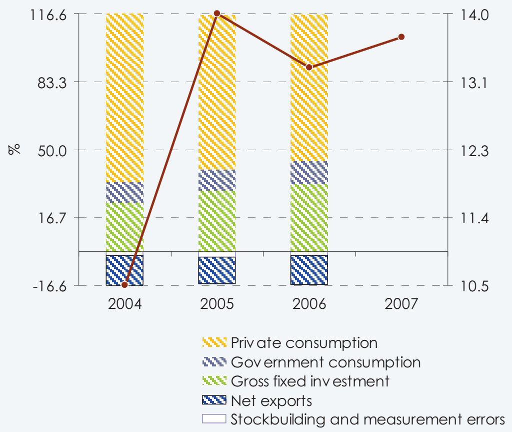
Macroeconomic developments

In 2007 Armenia continued its strong growth and expanded at a double-digit rate for the sixth consecutive year. Gross domestic product (GDP) increased by 13.7% to about EUR 6.7 billion although a certain slow-down was observed in the last few months of the year. This trend continued also in January 2008 when GDP recorded a year-on-year growth rate of 9.9%. The state of emergency which was declared in March 2008, following the political turmoil after the presidential elections could also have a negative impact on economic development. GDP is expected to slow-down further and the large remittances from Armenian diaspora might decrease significantly.

In 2007, as in earlier years economic growth was attributable primarily to the booming construction industry (79.7% year-on-year increase in January 2008) and the services sector, where output went up by approximately 20%. If construction is excluded, industry shows only modest growth of 3.2% (nevertheless better than last year's decline of 1%), dragged down by the textile, tobacco and diamond- processing sectors. The latter contracted by 34% compared with 2006.

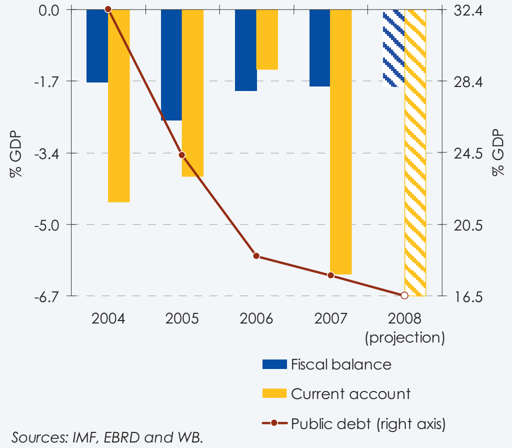
The energy sector and agriculture posted major gains. The Armenian economy also greatly benefited from the above-mentioned large remittances from the diaspora and Armenians working abroad.

Graph III.2.1: **Armenia - Economic structure of GDP**



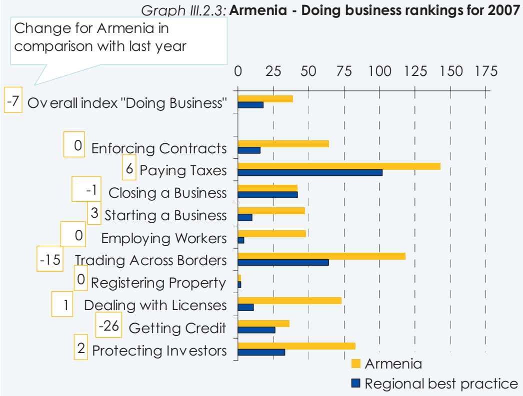
Source: EIU and IMF

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



Sources: IMF, EBRD and WB.

Graph III.2.3: **Armenia - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking CIS country among the EU Eastern ENP countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russia and Ukraine).

Source: World Bank, 2008.

Above all, these remittances have been stimulating private consumption and construction and financing Armenia's trade deficit (see below).

The growth prospects for 2008 are still unclear. Apart from the probable negative effect of the state of emergency on the economy, the conflict over the Nagorny Karabakh region remains unresolved (considering also the recent breaches of the ceasefire) and the borders with Turkey and Azerbaijan remain closed, which has a negative impact on economic development. The new UN economic sanctions against Iran might further complicate things, bearing in mind that Armenia is a land-locked country with transport routes already quite difficult for exporters. The sanctions could have a significant negative impact on Armenia's trade.

Inflation was higher than anticipated. During the last few months of 2007 it reached almost 7%, averaging 4.3% for 2007 as a whole. In January 2008 it stayed high at 6.6%.

Armenian authorities explain the recent price increases as an external shock stemming from high international food prices, which have been passed on to the Armenian market. However, the lack of fair competition and the presence of *de facto* monopolistic structures on the import markets might also explain why prices of imported products, especially of wheat and cooking oil, rose considerably in the fourth quarter of 2007 - despite the continuing strong appreciation of the national currency, the dram. The strong private consumption and increases in nominal household income (25.6% year-on-year in January 2008) also contributed to the surge in domestic prices.

For 2008 the Central Bank of Armenia announced that it was revising its inflation target from 3% to 4% (±1.5%). This move may be justified by rising international food prices but could prove counter-productive, since it runs against anchoring inflation expectations and reduces credibility, which is extremely important for the recently introduced fully fledged inflation targeting.

Strong revenue performance and under-execution of capital expenditures resulted in a budget deficit lower than planned (2.6% of GDP). Tax revenue was in line with the ambitious annual target, reflecting higher VAT and income tax collections. In this context, the government’s tax revenue increased by 35% in the period from January to November, allowing Armenian authorities to meet the high spending targets set by the State budget for 2007.

The trade deficit jumped by as much as 70% to a new record high of USD 1.8 billion in the period January November 2007, due to a surge in imports, and is expected to reach 15.5% of GDP for 2007. In January 2008 imports showed a 37.4% increase year-on-year, whereas during the same period exports increased by only 2.4%. Nevertheless, the current account shows only a modest deficit, once again due to the large-scale remittances.

Armenia’s main trading partner is the EU (38.9% of Armenia's overall external trade in 2006). In 2007 the bilateral trade recovered from past declines and total turnover showed growth of 17.4% compared with 2006 (with a 26.5% increase in Armenian imports from the EU and a 4.5% increase in Armenian exports to the EU).

Business environment

According to the *Doing Business* report by the World Bank, Armenia has further improved its business climate, although at a much slower pace than in previous years. It is ranked second in the CIS region with respect to contract enforcement, licensing and property registration. Armenia introduced changes in bankruptcy procedures increasing the range of action available to companies undergoing reorganisation.

Bureaucracy, corruption and insufficient rule of law are, however, perceived as seriously harming the business climate. Barriers to entry remain high in key sectors, such as tradable goods. Competition is impeded by monopolistic structures controlling imports of certain commodities, although the State Commission on the Protection of Economic Competition is slowly becoming more effective. The shadow economy is still thriving (it is estimated at above 30% of GDP).

Trade liberalisation and economic opening

Although Armenia has been a member of the World Trade Organisation (WTO) as from 2003 and has liberal trade regime with low tariff barriers (average tariffs are about 3%) its two closed borders with Turkey and with Azerbaijan constrain Armenian's trade.

Armenia benefits from a preferential access to the EU market under the general arrangement of the EU Generalised System of Preferences (GSP) and makes effort to qualify for special incentive arrangement for good governance and sustainable development (GSP+) under the new EU GSP Regulation in force from January 2009 to December 2011.

The ENP Action Plan for Armenia, implemented as from the end of 2006, provides for a deep gradual regulatory approximation of Armenia's legislation and practices to the main EU trade-related acquis, which should lead to a better access of its products to the EU markets. However, Armenia has so far made only a limited progress in this regulatory approximation and needs to intensify its efforts in this respect. In accordance with the ENP Action Plan, the EC has tendered an independent feasibility study on the possible future EU-Armenia Free Trade Agreement. The study has been recently finalised and is going to be published during summer.

Public institutions and public finance management

Armenia needs to tackle significant problems with tax evasion. Reforms in recent years have aimed at increasing the tax base, strengthening tax administration and closing loopholes in tax policy. As a result, VAT and profit tax revenue have increased perceptively.

There have been some recent amendments to the tax arrangements, among others to the Law on Simplified Tax. However, these amendments have come in for severe criticism. According to the critics, they have resulted in a significant reduction in the types of businesses eligible for simplified tax, which has created the preconditions for an increase in the shadow economy and militates against small and medium-size businesses.

The current simplified tax arrangements in Armenia do indeed raise serious questions about equity and efficiency and prevent long-term development of a sound tax system. A number of relatively large taxpayers are able to operate within these arrangements on the grounds that their sectors are too difficult to tax under the general system. As a result most of these taxpayers pay less than their counterparts subject to VAT and profit tax who, understandably, perceive the system as unfair.

It might be better for Armenia to impose an appropriate VAT registration threshold (as many other countries in transition have already done), which reduces administration costs, incentives for invoice fraud, etc. Based on cross-country experience, it is recommendable to introduce a truly simple presumptive tax system (based on turnover) for vendors below the threshold.

Social development and poverty

Official unemployment in Armenia has been showing a downward trend since 2003, falling from 8.1% in 2005 to about 7.6% in 2006 and further to 7.2% in mid-2007. Although actual unemployment appears to be significantly higher (especially against the background of a shrinking labour market due to net emigration) the improvements on the labour market have contributed to cutting the poverty rate in Armenia. With the assistance of the World Bank, in particular via the Poverty Reduction Support Package the government continues its efforts to fight poverty. It adopted a revised Poverty Reduction Strategy Paper for the period 2008-2021. This focuses on five specific themes[39] to fight poverty, which has contracted from almost 50% of the population in 1998 to some 30% in 2005 and further to 29% in 2007. These results can be attributed to increases in wages, social transfers and large remittances. Extreme poverty affects 6.5% of the population.

[39] These five themes are promoting sustainable economic growth through macroeconomic stability and private-sector development; improving public infrastructure; enhancing human development and improving social safety nets; implementing prudent fiscal policies and reforming the tax system and improving core public-sector functions.

Table III.2.1:

Armenia - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	10.5	14.0	13.3	13.7	10.0
GDP nominal (EUR, billion)	2.9	3.9	5.1	6.7	
GDP nominal (USD, billion)	3.6	4.9	6.4	10.3	
GDP per-capita (EUR)	897	1223	1584	2080	
GDP per-capita (USD)	1113	1523	1983	2844	
GNI per-capita (PPP current prices USD)	4250	5000	5890	n.a.	
Inflation (average)	7.0	0.6	2.9	4.4	8.9
Social indicators					
Unemployment (off. registered, average, %)	9.6	8.2	7.2	6.7	
Poverty rate (% population)	34.6	29.8	26.5	n.a.	
Income inequality (Gini, %)	n.a.	n.a.	n.a.	n.a.	
Population (million)	3.2	3.2	3.2	3.2	3.2
Fiscal sector					
Total revenues (including grants, % GDP)	15.4	15.7	15.8	18.0	17.7
Total expenditure (% GDP)	17.1	18.3	18.5	19.9	19.6
Central govt. balance (% GDP)	-1.7	-2.6	-1.9	-1.8	-1.8
Gross public debt (% GDP)	32.4	24.3	18.7	17.6	16.5
External sector					
Current account balance (% GDP)	-4.5	-3.9	-1.4	-6.2	-6.7
Trade balance (% GDP)	-14.8	-13.2	-18.5	-15.5	-15.5
Foreign direct investment (net, % GDP)	6.1	5.1	5.3	7.2	5.8
External vulnerability					
External public debt (% GDP)	33.0	22.0	19.0	16.0	14.0
Debt service ratio (% of exports of goods and services)	13.2	7.9	10.0	8.1	7.3
Gross reserves (excl. gold, USD million)	547	667	1072	1389	1610
Financial sector					
Exchange rate (DRAM per EUR, average)	662.28	570.39	521.20	467.80	
Real effective exchange rate (2000=100)	87.2	97.5	106.3	123.5	
Human development	**1985**	**1990**	**1995**	**2000**	**2005**
Human development index	n.a.	0.74	0.70	0.74	0.78

Sources: IMF, EIU, EUROSTAT, EBRD and WB.

3. AZERBAIJAN

- ***Azerbaijan continued its strong economic growth in 2007, driven primarily by the boom in the hydrocarbons sector, which increased GDP by 25%.***

- ***The main challenge facing the Azerbaijan economy is to maintain the macroeconomic balance, in light of high inflation and the first symptoms of Dutch disease.***

- ***Despite the high oil revenues, there is hardly any comprehensive and forward looking plan on the investments, which weakens economic policies of the country.***

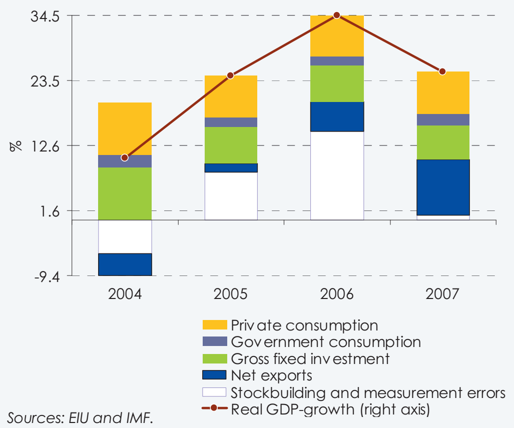
- ***Some improvements were seen in the business environment during 2007, however, further improvements in the business climate are necessary.***

Macroeconomic developments

Azerbaijan's economic growth rate fell from 34.5% in 2006 to 25% in 2007, which is nevertheless one of the highest growth rates, if not the highest in the world over the past year. The primary impetus for the booming economy came from the hydrocarbons sector, which generates over 35% of the country's GDP.

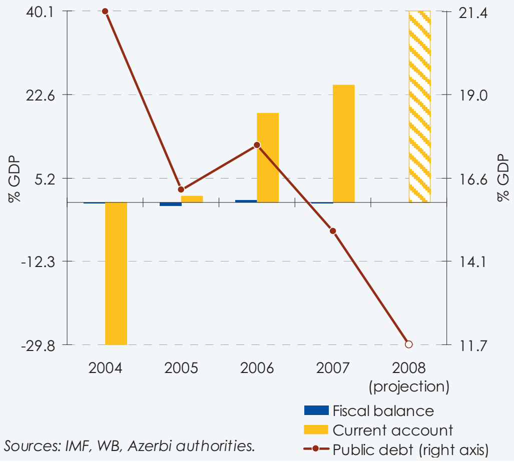
Non-oil sector grew by only 11.3% in 2007, at a lower rate than one year earlier. The growth in the non-oil sector was fuelled primarily by the non-tradable sector, of which construction and services took the lion's share. Hotel services and communication recorded the biggest increases compared with last year, with growth rates of more than 20%, driven again by developments in the hydrocarbons sector. These high growth rates were not enough to counter-balance the slowdown in the tradable sector. Instead, in 2007 tradables continued their downward trend, driven by deceleration in the chemical and textile industries. Industrial production also showed a steady decline – from 10% growth during the first half of 2006 to 4.1% in 2006 as a whole and then from 1.4% during the first half of 2007 to -1.4% by September 2007. This shrinking non-oil sector, coupled with real appreciation of the domestic currency, the manat (20% since 2005), points to loss of competitiveness and the first symptoms of Dutch disease. In particular, labour

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



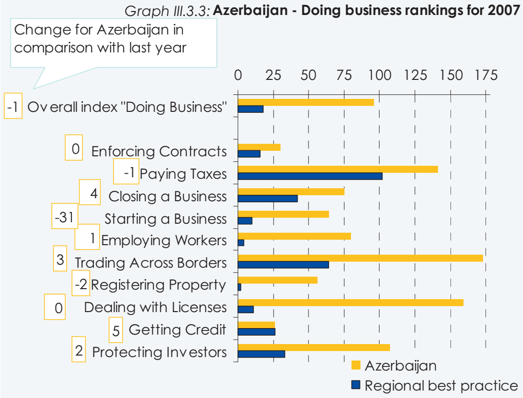
Sources: EIU and IMF.

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



Sources: IMF, WB, Azerbi authorities.

Graph III.3.3: **Azerbaijan - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking CIS country among the EU Eastern ENP countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russia and Ukraine).
Source: World Bank, 2008.

costs in the non-oil sector had increased 3.6 fold, which is a much higher than the growth rate in productivity.

In 2007 the average inflation rate stood at 16.7% and inflation even reached 19.2% in November. This core inflation rate of 16.7% marks an 11-year high and is still lower than the reported unofficial figure. The Economic Research Centre that publishes an alternative CPI, with the same methodology as the official State Statistical Committee, measured a significantly higher inflation rate of 29.8% in 2007.

National authorities point at international factors such as the general increase in food and oil prices on international markets and the one-off increase in utility prices in January 2007. The National Bank of Azerbaijan (NBA) estimates that one 1/3 of inflation is imported, that 1/3 is due to the above-mentioned increases in energy prices for households and that 1/3 could be explained by the monetary expansion stimulated by the fiscal expansion.

However, limited competition on the import markets – which are dominated by monopolistic structures – could explain the fact that prices of imported goods are significantly higher in Azerbaijan, than the prices of the same goods in neighbouring countries.

The manat depreciated against both the euro (by 2.7% in 2007) and the Russian rouble (1.2%). Moreover, the nominal effective exchange rate depreciated by 2.1% in 2006 and 4.6% in 2007.

The NBA has though only limited instruments at its disposal to combat inflation. In practice, the interest rates channel has proved ineffective. Despite high nominal interest rates, currently at 13%, the real interest rate is negative. Moreover, the financial sector seems underdeveloped, segmented and lacks competition. The interbank market is very weak. Commercial banks do not lend to each other and most of them have their own clientele. As a result increases in the cost of money by the NBA are not always passed on to the private sector. Last but not least, cash in the economy is very high. The M0 to M2 growth stood at 62% in 2007 and the ratio of cash in circulation to reserve money (manat only) is 90%, while in other transition countries this indicator averages 30%.

Like money growth, credit growth was strong. The financial sector has been expanding rapidly in Azerbaijan, recording high profits and being able to borrow internationally at low interest rates and to lend locally at much higher interest rates. In December 2007 bank and financial market institutions provided USD 4.3 billion of credit to local businesses and individuals, marking an increase of 92.8% on a yearly basis. The NBA is expected to increase its minimum reserve requirements for capital borrowed abroad. Currently, no distinction is made between capital borrowed abroad and locally and the minimum reserve ratio stands at 10%.

The announced change in the foreign exchange arrangements of the NBA - namely the move towards a managed float of an undisclosed currency basket, is a step in the right direction towards combating inflation. But decreasing the overall inflation rate is difficult for the NBA, not the least due to fiscal dominance and high monetisation. It is difficult to anchor inflationary expectations since a wage-price spiral seems to be unwinding. Pensions and salaries are *de facto* being regularly indexed.

In comparison with 2006, State budget revenue increased by 55.3% and expenses by 59.9% in 2007. Nevertheless, the State budget remained in surplus by 0.2% of GDP thanks to fiscal transfers from the oil fund. This strong increase in fiscal revenue reflects the growth in the oil sector (which provided almost 52% of all revenue) and positive spill-over effects on other sectors such as services and communications. A point of concern remains the increasing non-oil fiscal deficit, widening to 47% in 2008.

The current account surplus has been increasing massively, from 1.3% of GDP in 2005 to 16.7% in 2006, and is expected to reach 26% in 2007, as a result of the rise in oil exports and high global oil prices. At the same time, the non-oil exports slowed down and changed in composition. The foreign debt stabilized – at around USD 2 billion (9.9% of GDP).

The EU was Azerbaijan's main trading partner both for imports (32%) and for exports (59%).

Oil products and chemicals made up 82.5% of Azerbaijan's exports, while the main non-oil export commodities were food products. According to 2006 data – EU's share in AZ's imports is 30.9% and in AZ's exports 57.2%.

The official unemployment rate decreased from 1.5% in 2006 to 1.0% in 2007, but actual unemployment is much higher. Since no unemployment benefits exist, there is no incentive to officially register as unemployed. Nonetheless, the positive trends on the labour market are acknowledged. The government managed to keep its promise and created some 600 000 new jobs over the period 2003-2008.

Business environment

In 2007 the government finalised the long-expected sales of 50% of the smaller of the two State-owned banks, the *Kapital Bank*. This is commendable, but, on the negative side, the tender may have lacked some transparency. The privatisation of the second and larger State owed bank – the International Bank of Azerbaijan, which holds 48% of the banking system's assets - is currently at standstill.

Further challenges to the Azerbaijani economy remain the decrease of the level of corruption, the disentangling of monopolistic structures and improvements in the business climate. On the latter, the non-oil sector is crucial to achieve diversification of the economy. A number of legislative measures have been introduced, such as the new legislation to facilitate entrepreneurship - the one stop shop system for registration of businesses.

It was launched on 1 January 2008 and, according to the national authorities, the number of newly registered companies during the first two months of 2008 equalled the number of newly registered businesses during the whole of 2007. However, it is still not known whether all of them will be involved in economic activities, or if the registrations are driven primarily by considerations of a personal nature, e.g. tax advantages.

Trade liberalisation and economic opening

Azerbaijan applied for WTO membership in 1997 and its accession negotiations are ongoing. However, the government should pursue them significantly more vigorously. Some progress has been made in the bilateral part of negotiations on market access for goods and services. They have been concluded with Turkey, Georgia and Moldova and are continuing with the EU, the US, Japan, Canada and South Korea.

Azerbaijan benefits from the preferential access to the EU market as it is a beneficiary of the EU's Generalised System of Preferences (GSP), but does not make sufficient use of the opportunities offered by this scheme. The ENP Action Plan for Azerbaijan, implemented as from the end of 2006, provides for a deep gradual regulatory approximation of Azerbaijan's legislation and practices to the main EU trade-related acquis, which should lead to a better access of its products to the EU markets. However, Azerbaijan has so far made only a limited progress in this regulatory approximation and needs to intensify its efforts in this respect.

Public institutions and public finance management

For the EC support for democratic development and good governance is a key priority in its 2007-2010 NIP for Azerbaijan and support for this will be available from the ENPI. The ambitious long-term goal is to "develop a modern state geared towards meeting the needs of citizens and capable of managing future oil and gas wealth in an accountable, transparent and efficient manner". Azerbaijan is participating in the Extractive Industries Transparency Initiative.

Social development and poverty

A new 10-year programme for the three-year State Programme on Poverty Reduction and Economic Development is expected for the period 2006-2015. The principal objective is to improve the material welfare of citizens, to halve poverty by 2015 and to provide social protection. Poverty is going down, driven in particular by high GDP-growth (boom in the hydrocarbons sector). The population living below the national poverty line (defined as the value of a minimum

Table III.3.1:
Azerbaijan - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	10.4	24.3	34.5	25.0	17.0
GDP nominal (EUR, billion)	7.0	10.6	16.7	22.8	
GDP nominal (USD, billion)	8.7	13.2	19.8	29.3	38.6
GDP per capita (EUR)	845	1270	1980	2675	
GDP per capita (USD)	1040	1574	2336	3479	5153
GNI per capita, PPP current prices (USD)	n.a.	n.a.	n.a.	n.a.	
Inflation (period average)	6.7	11.6	8.4	16.7	16.2
Social indicators					
Unemployment rate (officially registered only)	1.4	1.4	1.3	1.0	
Poverty rate (% population)	28.5	24.0	21.0	n.a.	
Inequality (Gini index consumption/ income)	2.1	2.3	n.a.	n.a.	
Fiscal sector					
Total revenue (% GDP)	17.4	17.3	21.9	23.8	
Total expenditure (% GDP)	17.6	18.0	21.4	24.0	
Budget balance (% GDP)	-0.2	-0.7	0.5	-0.2	
Gross public debt (% GDP)	21.4	16.2	17.5	15.0	11.7
Monetary sector					
Domestic credit to private sector (% GDP)	9.3	9.5	12.4		
Broad money (M2) (% change)	n.a.	25	53	79	
Degree of monetisation (M2/GDP, %)	10.7	14.4	21.1	n.a.	
Dollarisation in bank deposits (%)	25.7	16.2	8.9	n.a.	
External sector					
Current account balance (% GDP)	-29.8	1.3	18.7	24.6	40.1
Trade balance (% GDP)	1.9	24.4	39.1	52.0	
Foreign direct investment (net, % GDP)	n.a.	3.5	-6.6	-17.4	
Import cover of reserves (months)	2.0	2.1	3.7	4.1	7.5
External vulnerability					
Total external debt (% GDP)	18.5	14.3	9.9	8.3	
Of which: public external debt (% GDP)	18.3	12.5	9.9	9.0	7.5
Debt service ratio1	6.0	3.2	2.3	1.8	1.0
Gross reserves (excl. gold, USD billion)	1.1	1.2	2.5	3.5	7.9
Reserves/M2	4.7	6.2	n.a.	n.a.	
Financial sector					
Short-term interest rate	9.18	8.52	10.58	11.56	
Lending rate	15.72	17.03	17.86	19.18	
Exchange rate (local currency per EUR, average)[2]	1.22	1.18	1.12	1.17	1.22
Exchange rate (local currency per USD, average)[2]	0.98	0.94	0.89	0.86	0.84
Real effective exchange rate (2000=100)	74.2	85.8	89.0	95.1	
Real effective exchange rate (% change)	-3.5	15.6	3.7	5.2	

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

[2] Recalculated for the new manat=5000 old manat

Sources: IMF, WB, EUROSTAT, Azerbi authorities

consumption basket worth EUR 29 in 2004), was reduced to 21% in 2006 from 40% in 2004. Rural poverty is caused by the lack of access to basic services and poor physical infrastructure, while urban poverty is related to employment opportunities and wages.

4. BELARUS

- ***2007 was yet another year of strong growth – 8.2% – as Belarus withstood the double energy "price shock" (increases in gas prices and oil duties) at the end of 2006 much better than expected.***

- ***This limited adjustment to the price shock was made possible by an increase in external debt (partly supported by the awarding of sovereign ratings to the country) and more privatisation (largely to Russian companies, including Gazprom).***

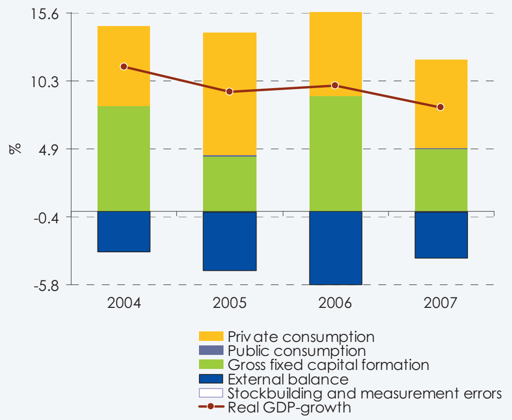
- ***However, several fundamental weaknesses of Belarus (the limited reform of the economy, the still overwhelming influence of the State and the over-dependence on Russia) have not yet been addressed.***

Macroeconomic developments

GDP growth in 2007 decelerated from the very high 9.9% of 2007, but still remained robust on 8.2%. Industrial production also decelerated, but again grew faster than GDP, with 8.5%, down from 11.4% in 2006. This relative deceleration of industrial output growth is largely related to the fuel-linked industries (refining and chemicals), which generated almost half of the industrial growth in 2006 (while machinery grew by 10% in 2006, the fuel industry grew by 23%: the figures for 2007 were 13.4% and -0.5%, respectively) and which bore the brunt of the 2006-2007 energy price shock.[40]

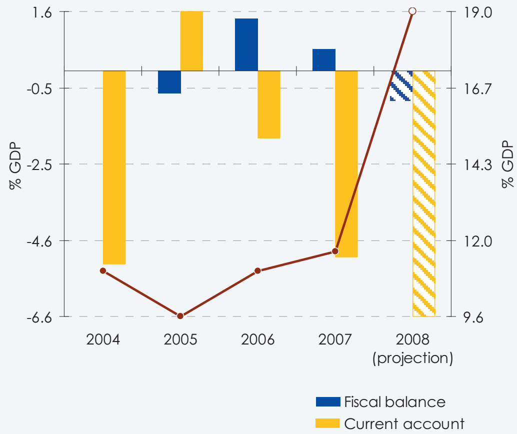
Growth in agriculture also decelerated, from 6.1% to 4.1%. On the demand side, investment was again the most dynamic component of GDP, increasing by 14.7%, but this was nevertheless a sharp deceleration from the (admittedly unsustainable) hefty 31.4% growth in 2006: investment, mainly public, now stands at an impressive 26.3% of GDP. Unemployment fell further, to 1% from 1.2% in 2006. Real average salaries rose by 9.5% in 2007, likely again surpassing productivity growth (which stood at 7.7% for January-November 2007). This, combined with the energy price shock (which was partly passed on to industry and household

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



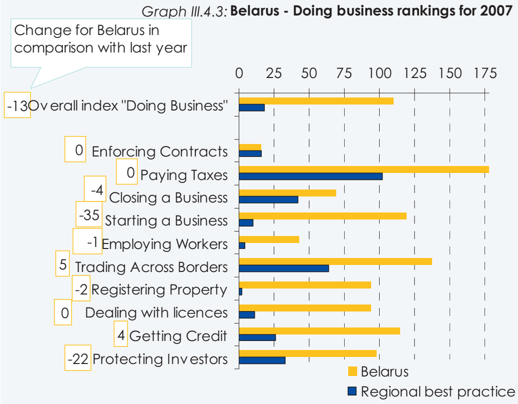
Source: Ministry of Statistics and Analysis.

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



Source: Ministry of Statistics and Analysis.

Graph III.4.3: **Belarus - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking CIS country among the EU Eastern ENP countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russia and Ukraine).

Source: World Bank, 2008.

[40] See DG ECFIN, 2007.

energy prices), plus the worldwide rekindling of inflation, resulted in an almost doubling of the CPI inflation rate (from 6.6% to 12.1%).

This undeniably robust growth is still largely due to the "special relations" between Belarus and Russia, which still apply (even in the energy field). Russia and Belarus have a joint free trade area, which gives Belarus tax-free access to the huge and fast-growing Russian market. Even after the price increases of 2007 (and the additional smaller price increases to USD 119 per 1000 m^3 during the 1st quarter of 2008 and to USD 128 for the 2nd quarter), Belarus – a country almost completely dependent on imports for its energy needs – still pays a price for gas far below the EU and CIS rates. Contrary to its behaviour in other former Soviet republics, Russia has been relatively tolerant towards Belarus, allowing it to accumulate arrears in payments for energy imports during the first half of 2007 and providing a EUR 1 billion loan at the end of the year on preferential terms (while keeping the door open for more loans in 2008).

The budgetary data available indicate a surplus of 0.6% of GDP in 2007, down from an unusual 1.3% surplus in 2006.[41] Fiscal revenue as a share of GDP not only remains high, but actually increased, compared with 2006, to 50%, because the fiscal revenue improved following the imposition of Russian-level export duties on oil sub-products. Revenue was also bolstered by a selective sale of State companies, including the partial sale of *BelTransGaz* to *Gazprom*. On the other hand, tax schemes have been designed for the oil industry (for instance, the government gives fiscal rebates worth 90% of the Russian oil export duty), the energy price rises have only partly been passed on to industry and households and the government's own gas and oil bills have increased, which has also raised expenditures.

The National Bank of the Republic of Belarus (NBRB) increased its refinancing rate from 10% to 11% in January 2007 to defend the exchange rate, as the energy price shock and the potential for an attack on the currency led to a run on its reserves (historically already very low, at 0.6 months of imports). An increase in reserves from EUR 1.1 billion to EUR 2.9 billion, or from 3.7% to 9.3% of GDP (worth 1.8 months of imports), enabled it to cut the refinancing rate back to the 2006 level in four successive steps between July and October 2007 (given the inflation, the rate is now negative in real terms).

Belarus abandoned its dual exchange rate targeting the Russian rouble and the USD and switched to a single USD peg in 2008, aiming to reduce appreciation pressures. The NBRB now targets the USD within a +/- 2.5% band.

The trade balance worsened again very considerably in 2007, as the twin energy price shocks hit the economy: the deficit virtually doubled from 4.5% of GDP to around 9%. This was due to a significant decline in the trade surplus with non-CIS countries (essentially due to a large fall in exports of processed oil products) combined with a parallel increase in the trade deficit with CIS countries (largely caused by the growth in the trade deficit with Russia, due to the partial removal of preferential energy trade terms). So far this external gap has been bridged by a combination of increased FDI inflows and greater foreign debt, but this strategy is only sustainable in the short term.

FDI into the Belarusian economy jumped from 0.4% of GDP in 2006 to almost 3% in 2007, due to a few large discretionary privatisations. The most important by far was the sale of 50% of BelTransGaz to Gazprom for EUR 1.7 billion, to be paid in instalments over the next four years (EUR 425 million per year). BelTransGaz is the owner and operator of the remainder of the gas transit network in Belarus (beyond the Yamal-Europe pipeline, which Gazprom already owned). Its sale was instrumental in enabling Belarus to negotiate the so far limited gas price increases with Russia. Other "privatisations" included the sale to Russia's Vneshtorgbank of 50% plus one share of Slavneftebank and of an equal controlling stake in Belvneshekonombank to another Russian bank, Vneshekonombank. The Motovelo bicycle and motorcycle factory was wholly sold to the Austrian company ATEC Holding GmbH. Also, a 51% stake in one of the country's mobile phone companies, MDC, was

[41] The Belarusian government in fact generated "precautionary savings" in 2006, in expectation of an energy price shock. This included establishment of a "National Development Fund".

acquired by a Cyprus-based company which already owned the remainder of its capital and which promptly sold 70% of the company to an Austrian group, Telekom Austria (an Austrian group also owns the largest private bank in the country). Several deals selling small banks to foreign partners were also announced in early 2008, and, in addition, plans for the selling of up to 15% of the capital of Belarusbank (the largest bank in the country) to a foreign partner, to be followed by an IPO, have been aired.

External debt is still relatively low, but is growing fast. S&P and Moody's awarded sovereign ratings to Belarus for the first time in August 2007, giving the Belarusian government the possibility of access to international markets. As a first step towards this, a bond placement of about EUR 270 million on the Russian stock market is being planned.

Also in August 2007 Belarus obtained a EUR 340 million loan from the government of Venezuela. In addition, in December 2007 the Chinese government agreed on a EUR 340 million credit to Belarus, and the Russian government agreed to provide Belarus with a EUR 1 billion loan, under preferential conditions (the maturity of the loan is 15 years with a five-year grace period, at an interest rate set at LIBOR plus 0.75%). The total foreign debt of Belarus totalled over 28% of GDP by the end of 2007, up from 18% in 2006 (a 54% increase in share terms).

Business environment

Belarus still suffers from comprehensive government interference in the economy, ranging from direct ownership of most large enterprises to a "golden share" rule, which enables the government to interfere with already privatised enterprises (with the exception of banks), and to administrative allocation of credit, "recommended" interest rate ceilings, wage growth targets and price controls.

On the other hand, limited and gradual liberalisation seems to be being planned. In December 2007, Belarusian authorities prepared several legislative acts aimed at improving the business climate in the country. They envisage simplifying the company registration system and streamlining the tax framework. The government programme for development of the stock market also provided for gradual abolition of the "golden share", first with respect to particular companies, then to whole industries (as has happened already with the banking sector) and, finally, for the rest of the economy (which happened in March 2008). In January 2008, a strategy for development of the domestic equity market was adopted and the NBRB said that it intends to abolish caps on loan interest rates. This was followed in March and April by a reduction of equity taxes, by the relaxation of rules on foreign investment and by the further liberalisation of the domestic equity market.

The World Bank *"Doing Business 2007"* survey ranks Belarus in 110th place, far below the CIS average of 96th and above only Tajikistan, Ukraine and Uzbekistan in this group.

Trade liberalisation and economic opening

Belarus's external trade relations still centre on Russia, which accounted for 37% of its exports (January-November 2007) and 60% of its imports. The end of the subsidised trade in refined oil products actually led to a reconcentration of exports towards Russia and the CIS, although part of this may be due to the further acceleration in economic growth observed in this region.

Belarus applied for WTO membership in 1993, but its accession process (like Russia's) is still ongoing. The EU granted GSP preferences to the country in the mid-1990s, but those were withdrawn in June 2007, after an investigation into infringements of the freedom of association. The effect of removal of the GSP was likely to be limited, as it simply reinstated standard tariffs, under the most favoured nation regime.

Social development and poverty

Belarus has one of the lowest official unemployment rates in Europe, at a mere 1%. The government's social policy is geared to maintaining a broad social safety net. As an additional sign of that, the share of households with an income below the (nationally defined) poverty level fell from 10.1% in the 3rd quarter of 2006 to 7.5% in the 3rd quarter of 2007.

Table III.4.1:

Belarus - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	11.4	9.4	9.9	8.2	7.2
GDP nominal (EUR, billion)	19	24	29	33	
GDP nominal (USD, billion)	23	30	37	45	50
GDP per-capita (EUR)	1891	2476	3018	3368	
GDP per-capita (USD)	2338	2986	3808	4619	5192
GNI per-capita (PPP, current prices, USD)	6990	7890	n.a.	n.a.	
Inflation CPI (%, end of period)	14.0	10.3	7.0	12.1	11.0
Social indicators					
Unemployment (%)	1.9	1.5	1.2	1.0	
Life expectancy (years)	69				
Under 5 mortality rate (%)	9.1				
Literacy (total, %)	99.7				
Population (million)	9.8	9.8	9.7	9.7	9.6
Fiscal sector					
Total revenue (% GDP)	44.2	48.3	48.2	50.0	48.7
Total expenditure (% GDP)	44.1	48.9	46.9	49.4	49.5
Central government balance (% GDP)	0.0	-0.6	1.4	0.6	-0.8
Gross domestic public debt (% GDP)	5.7	5.8	6.5	6.3	
Gross public debt (% GDP)	11.0	9.6	11.0	11.6	19.0
Monetary sector					
Private sector credit (% change)	61.2	48.7	52.4	52.4	
Private sector credit (% total credit)	67.6	74.6	74.9	93.0	
Broad money (M3, %)	44.1	42.0	39.3	35.9	
Degree of monetisation (M3/GDP, %)	17.7	19.7	22.1	24.8	
External sector					
Current account balance (% GDP)	-5.2	1.6	-1.8	-5.0	-6.6
Trade balance (% GDP)	-6.5	1.0	-4.5	-9.0	-8.0
FDI (net, % GDP)	1.1	1.0	0.4	3.0	
Import cover (months)	0.5	0.9	0.7	1.8	1.9
External vulnerability					
External public debt (% GDP)	2.1	1.9	1.6	5.8	9.0
Debt service/exports (%)	2.0				
Gross reserves (excluding gold, USD, million)	770	1297	1383	4200	3283
Reserves/M3 (%)	5.3	4.5	16.3	44.5	
Financial sector					
Short-term interest rate (%)	16.9	11.4	12.9	10.4	
Exchange rate (rouble per EUR, end of period)	2956	2550	2812	3167	
Exchange rate (rouble per USD, end of period)	2170	2152	2140	2150	2257
Real effective exchange rate (2000=100)	78.8	76.3	73.4	72.3	

Sources: Belarus Ministry of Statistics and Analysis, NBRB, UNDP, WDI, IMF, BNP Paribas, EC staff calculations.

5. EGYPT

- ***Economic growth accelerated from 6.8% in fiscal year 2006 to a record 7.1% in 2007 underpinned by investment, especially FDI, and private consumption.***

- ***The strong economic growth and the sale of (semi-)state-owned enterprises led to a narrowing of the general public deficit in fiscal year 2007. On the downside, unemployment remains close to 10% and high food prices have caused headline inflation to surge to double digit levels.***

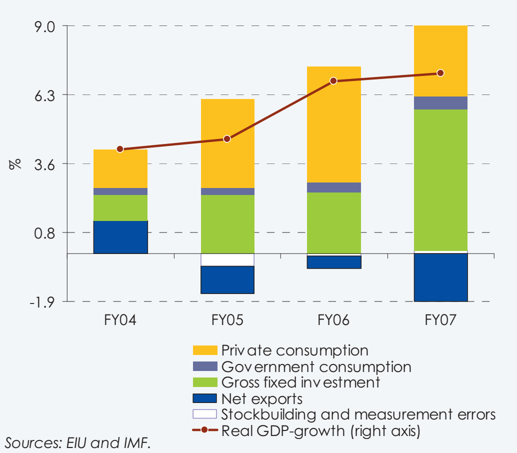
- ***The current economic conditions offer an opportunity to continue the structural reforms, along the lines of the EU-Egypt ENP Action Plan. Key priorities remain the further reduction of the government debt but, first and foremost,the achievement of price stability.***

Macroeconomic developments

Economic growth accelerated in FY07 (fiscal year running from July 2006 until June 2007) to a record high 7.1% from 6.8% in FY06 fuelled by investment, especially FDI, and exports of goods and services. Final consumption contributed 70% to GDP, investment 22% and exports of goods and services 34%. Imports of goods and services were 38% of GDP (graph III.5.1). Government consumption was again high, at 12% of GDP. FDI and tourism have been expanding rapidly.

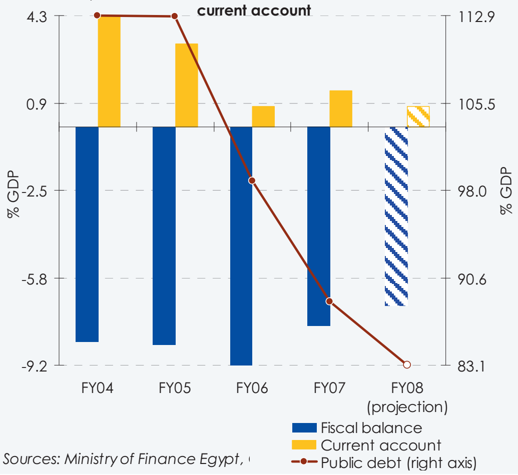
The relatively high **fiscal deficit** and the high **government debt** burden remain major concerns. Nonetheless, the government deficit narrowed to 6.9% of GDP in FY07 thanks to the high economic growth and one-off revenues such as the sale of the fourth largest state bank, *Bank of Alexandria*, which was sold to a foreign buyer (1.3% of GDP). Subsidies account for 25% of all expenditures, while wages and interest payments account for 50%. These high recurrent expenditures leave limited room for discretionary expenditure. In addition to the high deficit, the debt stock is still more than 80% of GDP, leaving the economy vulnerable to macro-economic shocks and hampering the effectiveness of monetary policy that aims at price stability.

Graph III.5.1: **Egypt - Contributions to real GDP-growth**



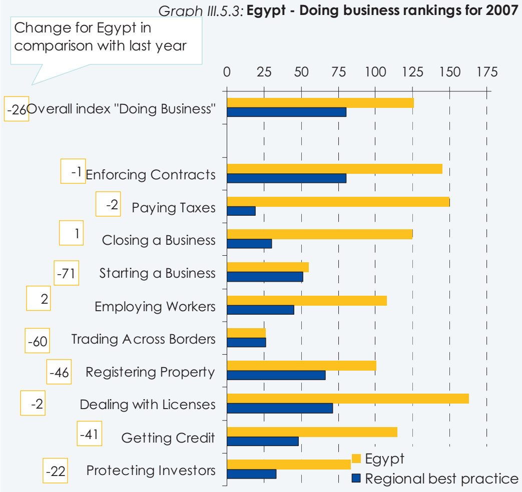
Sources: EIU and IMF.

Graph III.5.2: **Egypt - Fiscal balance, public debt and current account**



Sources: Ministry of Finance Egypt,

Graph III.5.3: **Egypt - Doing business rankings for 2007**



The Egyptian government is pursuing a plan to remove all fuel **subsidies** for the industrial sector by 2010. But recently, it approved an amendment to the FY07 budget that would increase fuel subsidies to around EGP 50 billion because of the soaring crude prices. Spikes in energy and also food prices caused inflation in FY07 to jump to double digit levels and remains high in FY08. In reaction to the high inflation, the central bank tightened monetary policy in the first months of 2008 to avoid second round effects.

The surge in **prices** of food, notably wheat, on world markets poses new challenges for Egypt's policy makers. The share of food prices in the average Egyptian consumer price basket is substantial, at 50%. The fact that food consumes a disproportionally higher share for the many poor people than for the rich and the fact that Egypt relies on imported wheat triggered the adoption of a plan to stimulate the domestic wheat production. Local wheat prices are planned to be gradually brought to global prices, with the first step the setting of minimum prices. This food price policy change is highly welcome, as it should bring new domestic employment opportunities, reduce food supply side inefficiencies and eventually lead to the abolishment of food subsidies.

The **pension and health insurance systems** are being overhauled. The National Investment Bank and Social Insurance Funds are being restructured with the result that the government no longer borrows from these institutions. This will lead to a more accurate calculation of the government debt. Further achievements are the restructuring of short-term debt financing (1 year) into longer term financing (up to 8 years soon) and the successful issuance of EGP-denominated bonds on the international markets. Continuing fiscal reform is indispensable for keeping government finances sustainable in the long run, in the light of the still high public debt and demographic developments. The government should adhere to its commitment to reduce the deficit by at least 1% of GDP in each of the next five years, starting from FY07.

Unemployment has remained persistently high despite the acceleration in GDP growth since 2004. Still, close to 10% of the labour force is unemployed. The relatively high population growth seems to be one reason for the persistent unemployment. Also, a surge in wages may have hampered the creation of jobs. A considerable number of jobs will have to be created in order to absorb the continuing high annual inflow into the labour force and the pool of existing unemployed.

Since 2003 Egypt was pursuing a managed float **exchange rate regime** until July 2007, which was *de facto* close to a free float. Since July 2007 the Egyptian pound has floated fully freely, giving rise to much more volatility. Egypt's strong economic growth with high inflows of FDI and high portfolio inflows have made the Egyptian pound stronger, mainly against the sliding dollar. Related to this is the rise of the leading CASE-index at the Cairo-Alexandria stock exchange, up by 50% during the calendar year 2007, apart from a shallow dip of about 10% in August at the start of the international turmoil. Large portfolio investments were also made by foreign investors, triggered by the turmoil on capital markets abroad, by the high returns on capital in Egypt and by the appreciating Egyptian pound. The steadily increasing international official reserves form a solid buffer against any threats to the stability of the domestic currency in the future.

The Central Bank of Egypt still aims to introduce **inflation targeting** as the monetary policy regime. In addition to the fiscal dominance, the measurement of the price index and the monetising of the government deficit remain crucial issues.

Egypt imports more goods than it exports, but the **balance of payments** remains positive due to the large inflow of revenues from tourism, private transfers, remittances from workers abroad, FDI and Suez Canal revenues. Although Egypt is not characterised as an energy resource-rich country, about 50% of its exports consist of oil and gas. The trade deficit has widened (to 12% of GDP in FY07) as a consequence of the rising standard of living and associated higher demand for foreign goods. In FY07 the trade deficit was again compensated by the prospering tourist sector, remittances, and large inflows of remittances and foreign investment -direct as well as portfolio. The US, Europe and neighbouring Arab countries invested a total amount of FDI in FY07 of more than EUR 7.5 billion, representing a rise of 80% in comparison with FY06. These funds are nowadays distributed more evenly, as the sectors outside the oil and gas sector receive 70%. Egypt should ensure that these types of investment will lead to durable job creation.

Business environment

Egypt was the top reformer in the world in 2007 (graph III.5.3). It has achieved impressive reforms, notably in the areas of starting a business or trade across borders (see the changes in its ranking since last year in graph III.5.3). It is now catching up with its ENP-neighbours.

Egypt is also making rapid progress in privatisation, enterprise restructuring and the private business sector. The inefficient state-dominated banking system has in the past made financial intermediation in Egypt relatively weak. Reform of the financial sector by restructuring the banking sector and tackling the major problem of non-performing loans are ongoing. A significant number of non-performing loans have been rescheduled.

After the privatisation of the *Bank of Alexandria* in FY07, the second largest state bank, *Banque de Caire*, has been tendered for privatisation. Expectations are that the restructuring and reform in the banking sector will take some more years before completion.

The number of SMEs with access to formal credit remains small - yet. SMEs have the majority share in employment. The trickle down effects of the reforms can further be increased, in particular, by paying more attention to SMEs' needs and by improving the education system. At the same time, more and better financing opportunities will lead to more job creation and this will be conducive to economic growth.

Trade liberalisation and economic opening

In March 2007 an EU-Egypt Action Plan was adopted in the framework of the ENP. Building upon and complementing the already existing close ties through the 1995 Barcelona process and the 2004 EU-Egypt Association Agreement, this provides a framework for deepening economic and trade relations via further reduction of trade barriers, increased access to each others´ markets and approximation of technical legislation on industrial goods. The AP broadly outlines the plans to stimulate economic development and reform in Egypt, notably by moving to a market economy.

Public institutions and public finance management

Reform in public finance management is making rapid progress. The Ministry of Finance made a single treasury account operational and circular debts among the central government, the National Investment Bank and the Social Insurance Funds are being settled, enabling cash and debt management to be streamlined. Transparency in public finance in general has been augmented by the publication of a detailed budget one year ahead, and by publication of comparisons of Egypt with peer country groups on the website of the Ministry of Finance (on foreign debt, foreign debt service and the budget balance). There remains room for improvement concerning transparency on the size and management of the debt stock.

Social development and poverty

Poverty is widespread in Egypt. Life expectancy at birth is low at 71, adult illiteracy above the age of 15 is high at around 30%, and almost 25% of the population get no formal education. Youth unemployment is high, even among males. At the same time poverty among senior citizens is growing, which is a serious problem because the number of people in this age group is expected to overtake the number of young people for the first time in Egypt’s history by the year 2050.

By refocusing the government intervention on the population most in need, this policy will help reduce further the government debt, creating room for discretionary government spending.

Table III.5.1:

Egypt - Main economic indicators

	FY04	FY05	FY06	FY07 prel.	FY08 proj.
Real sector					
Real GDP growth (domestic currency, % change)	4.1	4.5	6.8	7.1	7.3
GDP (Egyptian pounds, billion)	485	539	618	731	
GDP nominal (EUR, billion)	63	75	85	91	
GDP (USD, billion)	78	93	108	127	
GDP per-capita (EUR)	914	1068	1196	1228	
GDP per-capita (USD)	1135	1324	1514	1716	
Inflation (consumer price, average)	10.3	11.4	4.2	11.0	11.6
Social indicators					
Unemployment (off. registered, average, %)	10.7	10.5	11.5	9.5	8.5
Life expectancy at birth (years)			70.2	70.7	71.6
Adult literacy (% ages 15 and older)	55.6	n.a.	71.4	n.a.	
Domestic population	71.6	72.9	74.2	76.0	78.7
Income inequality (Gini, %)	35.2	n.a.	n.a	34.4	
Human development index	0.532	0.575	0.613	0.659	0.708
Fiscal sector					
General government revenues (% GDP)	25.6	24.8	28.6	27.8	26.0
General government expenditures (% GDP)	31.7	31.8	36.3	32.9	32.2
General government balance (% GDP)	-8.3	-8.4	-9.2	-7.7	-6.9
General government primary balance (% GDP)	-2.6	-3.3	-2.4	-1.7	-1.7
Gross public debt (% GDP)	112.9	112.8	98.8	88.5	83.1
Monetary sector					
Broad money M2 (% change)	13.2	13.6	13.5	18.3	16.8
Dollar/Euro/other currency-isation (% of broad money)	28.4	24.4	24.3	23.2	
Credit to private sector (%)	4.5	3.6	8.6	12.3	12.8
External sector					
Current account balance (% GDP)	4.3	3.2	0.8	1.4	0.8
Trade balance (% GDP)	-9.9	-11.5	-11.2	-12.4	-13.0
FDI (net, % GDP)	3.2	4.3	5.6	8.2	5.5
Remittances (% GDP)	3.8	4.9	5.0	4.9	4.9
Import cover of reserves (months)	5.7	5.8	5.9	6.1	6.6
External vulnerability					
External public debt (% GDP)	37.9	32.2	28.8	24.2	20.2
Gross reserves (USD, billion)	14.8	19.3	22.9	28.3	34.1*
Financial sector					
Official discount rate (end-of-period, %)	10.00	10.00	9.75	9.75	.
Lending rate (average, on less than one year loans, %)	13.40	13.39	12.71	12.64	.
Exchange rate (LE per EUR, average)	7.73	7.18	7.24	7.53	.
Exchange rate (LE per USD, mid FY)	6.16	6.00	5.75	5.72	.
Real effective exchange rate (%, + is apprec.)	-21.6	4.2	8.1	4.4	.
Stock market (CASE-index, % change FY)	86	235	-1	63	.

*End-May 2008.

Sources: Central Bank of Egypt, CAPMAS, Ministry of Finance of Egypt, IMF, EUROSTAT, EIU, EC staff calculations.

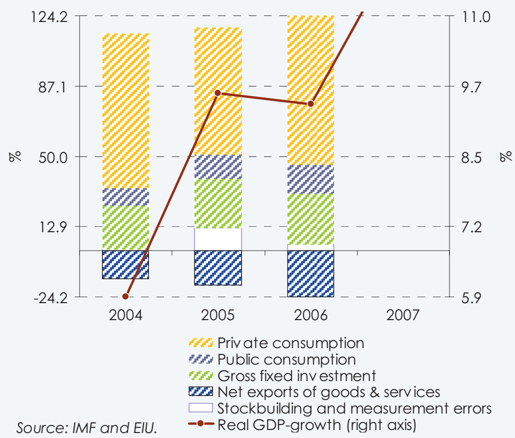
6. GEORGIA

- ***The pace of government initiatives has speeded up to accompany the electoral cycle (Presidential elections in January 2008 and Parliamentary elections in May) and more emphasis is being put on social spending following the public protests in November 2007. Governance and public accountability require close attention by the authorities, as Georgia is seeking to position itself as an attractive international business location.***

- ***Inflationary pressures have emerged in Georgia, but global trends in food and energy prices are only part of the explanation. In 2007 strong capital inflows and money growth led to the first signs of overheating. Support from a prudent fiscal policy is called for as the National Bank of Georgia is taking measures to tighten its monetary policy stance.***

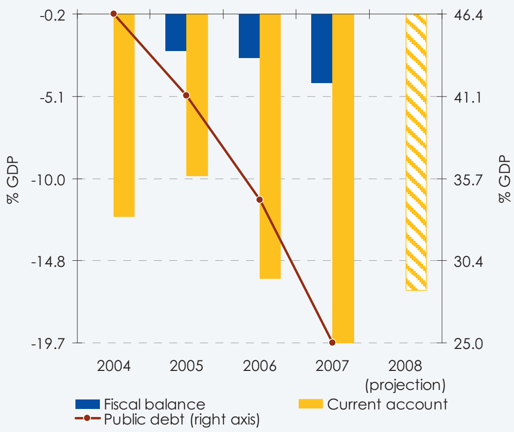
- ***Under the ENP, the focus is on removing non-tariff barriers in the bilateral EU-Georgia trade. Georgia's institutions in trade- related areas need to be strengthened (e.g. certification, conformity assessment, customs, etc.) so that closer economic ties with the EU can develop.***

Graph III.6.1: **Georgia - Economic structure of GDP**



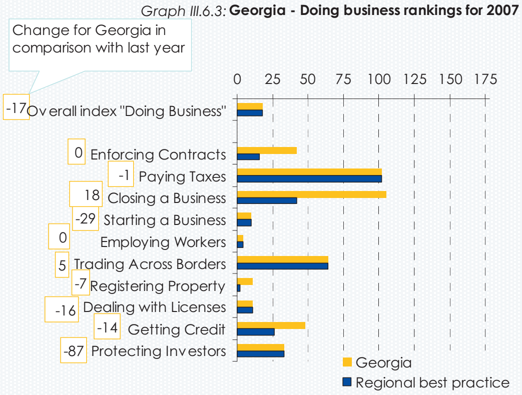
Source: IMF and EIU.

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



Sources: IMF, WB, Georgian authorities, EC staff calculations.

Graph III.6.3: **Georgia - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking CIS country among the EU Eastern ENP countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russia and Ukraine).

Source: World Bank, 2008.

Macroeconomic developments

Georgia's strong economic performance continued in 2007, unabated by Russia's economic embargo and higher energy import prices. After a spurt in privatisation (equivalent to about 5% of GDP in both 2006 and 2007), foreign capital inflows are now being attracted to greenfield investments in real estate, banking and manufacturing. Construction and financial intermediation have been driving economic growth, which exceeded expectations in 2007 at 12.4% after 9.4% in 2006. Mining and trade were other sectors showing rapid growth. Infrastructure investment for both transport and electricity generation has boosted growth prospects across the economy.

The central bank legislation was amended in early 2008 to make price stability the main objective of the National Bank of Georgia (NBG). It is to be pursued by means of a monetary policy of inflation targeting.

Although the acceleration of consumer price inflation in the second half of 2007 (11% in December year-on-year) was partly down to international commodity price trends, the rapid growth in monetary aggregates became an overriding concern in the booming economy. Accordingly, the NBG considerably tightened its monetary stance. Its operational mandate will also be strengthened under the new law, provided its independence is respected.

Bank assets grew from 30.7% of GDP to 43.5% by the end of 2007. As rapid credit expansion continues to drive economic growth, systemic development of the financial sector is of the utmost importance for macroeconomic stability too. The gradual monetisation of the economy is nevertheless a positive sign of enhanced confidence on the part of businesses and the public.

Demand for imports increased in line with growing incomes and brisk investment activity, widening the trade deficit to 26% of GDP. The import bill also increased as natural gas imports from Russia and Azerbaijan became more expensive. Export revenue growth, although held back by the Russian embargo on Georgian exports, was supported by high world market prices for metals. Relations with Russia remain strained, notwithstanding the re-establishment of direct flights and other transport links between the two countries. Foreign capital inflows (mostly foreign direct investment) financed the current account to the tune of nearly 20%. Workers' remittances transferred via banks increased by 83% compared with 2006 (64% originating from Russia). Net FDI is estimated at about 15% of GDP in 2007. For the first time the international reserves of the National Bank of Georgia surpassed the equivalent of three months of imports. The private sector (mainly the leading banks) has gained access to international capital markets over the last few years, and the economy's total external debt is growing as a result, and was estimated at nearly 50% of GDP in 2007. Georgia's sovereign credit rating was maintained by Standard&Poor's at B+ with a positive outlook and by Fitch at BB- with a stable outlook.

Public spending was increased over the year by several supplementary budgets as tax revenue continued to perform strongly as a result of robust nominal GDP growth and a stronger tax administration. The tax revenue to GDP ratio is estimated at 25% which is a marked step up from the average of 20% in the period 2004-2006. Priority was given to defence spending which surged to 6.7% of GDP. The public protests in November 2007 prompted the government to revise its spending priorities for 2008, allocating more resources to pensions, salaries and social and employment programmes. Nevertheless, defence spending is projected to account for nearly 20% of total public expenditure in 2008.

Following the loose fiscal policy stance in 2007 (resulting in a deficit of 4.7% of GDP financed by privatisation proceeds), a new fiscal rule was established to ensure that balanced budgets are the norm in future. Any budget surplus would be saved in special funds for future development projects. In April 2008 the government tapped the international capital markets for the first time with a USD 500 million Eurobond. This funding is intended for large-scale investment projects by State-owned enterprises in the energy sector.

Business environment

In the World Bank's *Doing Business 2008* survey, Georgia further improved its relative position. It is now ranked in 18th place out of 178 countries in terms of ease of doing business (up from 37th the year before). New liberal legislative frameworks put in place on taxation and customs, inspections, permits, certification and standardisation have improved the business environment, and the main challenge now is to strengthen the public institutions which have the task of implementing them. Another major priority for reform is the independence and accountability of the judiciary and law enforcement, which have come under the spotlight for instance in the context of property rights violations. Other positive developments include legislative changes in 2007 to shorten the maximum time for bankruptcy proceedings to five months. Corporate governance has been tightened up to provide better protection for minority shareholders too.

The surge in foreign direct investment in 2006 and 2007 started with the privatisation of the remaining large State-owned enterprises (including telecommunications and energy sector operators). Since then however, FDI has been attracted to a broader spectrum of industry and services (including tourism), where the government's active efforts to promote investment are beginning to bear fruit. Although the overall tax burden on businesses is already fairly light (corporate income tax has been reduced to 15%), the government has launched free industrial zones that will offer special tax and regulatory arrangements. Off-shore investors are being attracted to the financial sector by the new legislation on international financial centres.

Trade liberalisation and economic opening

Georgia has been a WTO member since 2000 and conducts a liberal trade policy. Import tariffs on goods were abolished in 2006 apart from on some agricultural goods and construction materials. In 2007 Georgia finalised negotiations with Turkey on a free trade agreement which has yet to be implemented. Under the EU Generalised System of Preferences (GSP), Georgia qualifies for the special incentive arrangement for good governance and sustainable development (GSP+). Since these enhanced preferences are conditional upon good effective implementation of internationally agreed core standards on human and labour rights, environmental protection and good governance, their continuation in 2009-2011 will be subject to effective implementation of all 27 ILO and other relevant international conventions by Georgia according to the EU Regulation on the GSP. Negotiations are in progress with the EU on a bilateral agreement on protection of geographical indications for agricultural products. While sufficient certification mechanisms are in place for wine and nuts to be exported to the EU, Georgia's is failing to live up to its export potential for other agricultural goods because of the lack of capacity to implement the regulatory legislation. The same bottlenecks also apply to conformity assessment, technical regulations and standards for industrial goods to be exported to the EU. On the other hand, for imports to Georgia, technical regulations of OECD countries are fully recognised by Georgia. The European Commission is carrying out a feasibility study exploring the possibility of establishing a free trade area between Georgia and the EU, including deep regulatory approximation with the EU as an ultimate aim.

Public institutions and public finance management

Since the Georgian government is committed to limiting the role of the State in every respect, efforts are focusing mostly on improving service delivery by involving the private sector. For instance, the government is implementing an ambitious health sector reform in cooperation with private-sector operators. In three years, 100 new privately managed hospitals will be in operation. Given that the government departments and agencies have been in flux and subject to frequent management changes, the civil service reform has not yet taken root. In the process, some areas, such as the statistics department, have become seriously under-resourced.

In public finance management, the reform process has advanced in parallel on both budget planning/preparation and treasury management and has now reached a stage where the control and oversight functions also need to be addressed in order to have a balanced, modern public finance management system. New legislation to reform the Chamber of Control as the supreme audit institution stalled in the Parliament, however, in the midst of the electoral cycle.

Social development and poverty

The impressive economic growth record has not yet improved the aggregate employment situation markedly as large shifts of labour from the public sector to the private sector have been underway. Unemployment has been fairly stable at about 14%. If job creation is to be sustainable, the skills and training sought by employers need to be better addressed in the reform of vocational and higher education.

The relatively large share of agriculture (55% of total employment) remains a prominent feature of the Georgian economy. The small plot sizes and low productivity are straining agriculture's contribution to poverty reduction. Extreme poverty (10.7% in 2006) and the overall poverty rate (31%) are declining as a result of government measures such as targeted poverty

Table III.6.1:

Georgia - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	5.9	9.6	9.4	12.4	9.0
GDP nominal (EUR, billion)	4	5	6	7	
GDP nominal (USD, billion)	5	6	8	10	14
GDP per capita (EUR)	956	1190	1405	1692	
GDP per capita (USD)	1188	1484	1764	2355	3119
GNI per capita, PPP current prices (USD)	2990	3340	3690	n.a.	n.a.
Inflation (period average)	5.7	8.3	9.2	9.2	9.6
Social indicators					
Population (million)	4.3	4.3	4.4	4.4	4.3
Unemployment rate (ILO definition)	12.6	13.8	13.9	n.a.	n.a.
Poverty rate (% population)	27.2	32.9	31.0	n.a.	n.a.
Inequality (Gini index consumption/ income)	40.4	n.a.	n.a.	n.a.	n.a.
Fiscal sector					
Total revenue (incl. grants) (% GDP)	22.0	23.4	24.8	28.2	
Total expenditure (% GDP)	18.9	24.9	29.2	32.5	
General government balance (% GDP, cash basis)	-0.2	-2.4	-2.8	-4.3	n.a.
Gross public debt (% GDP)	46.4	41.1	34.3	25	n.a.
Monetary sector					
Domestic credit to private sector (% GDP)	9.8	14.8	20	28	n.a.
Broad money (M3) (% change)	42.4	26.5	39.7	49.7	n.a.
Degree of monetisation (M3/GDP, %)	13.2	14.8	19.5	23.8	n.a.
Dollarisation in bank deposits (%)	74.5	71.8	69.4	65.6	n.a.
External sector					
Current account balance (% GDP)	-12.2	-9.8	-15.9	-19.7	-16.6
Trade balance (% GDP)	-17.6	-18.9	-26.1	-26.2	n.a.
Foreign direct investment (net, % GDP)	9.5	7.1	13.7	15.5	n.a.
Import cover of reserves (months)	1.8	1.6	2.2	3.2	n.a.
External vulnerability					
External public debt (% GDP)	36.2	27.1	21.9	17.5	n.a.
Debt service ratio1	12.0	7.4	7.2	5.7	n.a.
Gross reserves (excl. gold, USD million)	386.7	478.6	930.8	1361.1	n.a.
Reserves/M3	2.1	2.2	1.7	1.9	n.a.
Financial sector					
Money market rate	11.9	7.7	9.5	7.4	n.a.
Lending rate	31.2	21.6	18.8	20.4	n.a.
Exchange rate (lari per EUR, average)	2.2	2.3	2.2	2.3	n.a.
Exchange rate (lari per USD, average)	1.9	1.8	1.8	1.7	n.a.
Real effective exchange rate (% change)	12.8	3	-0.1	0.5	n.a.

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

Sources: IMF, WB, Georgian authorities and EC staff projections

benefits and higher pensions. The impact of higher gas tariffs is being mitigated by voucher schemes and lifeline tariffs, but the higher living costs (especially for food and energy) are putting pressure on most households. Social and education spending has been increased to about one third of total public expenditure.

7. ISRAEL

- ***Real GDP growth accelerated to 5.3% in 2007, although this was tempered by negative developments in terms of trade. The main drivers were investments, exports and private consumption.***

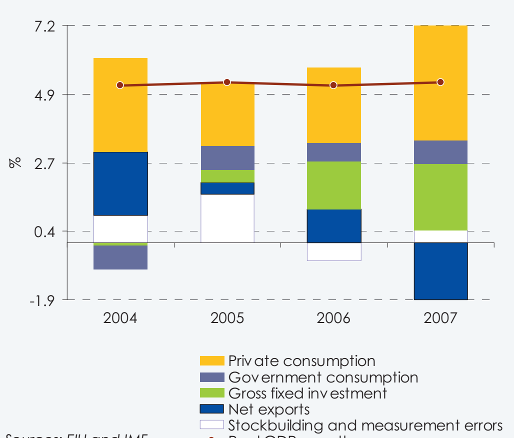
- ***The fiscal position improved significantly during 2007 owing to higher than projected revenues allocated to debt reduction and to tight expenditures control. The debt/GDP ratio remains a constraint, despite the fact that its decline to 80.6% signalled the upgrade of Israel's credit ratings.***

- ***Employment benefited substantially from growth and the unemployment rate was reduced to 7.3% in 2007. However, poverty and inequality continue to be a major challenge, with 1.68 million people below the poverty line among them over 800.000 children.***

Macroeconomic developments

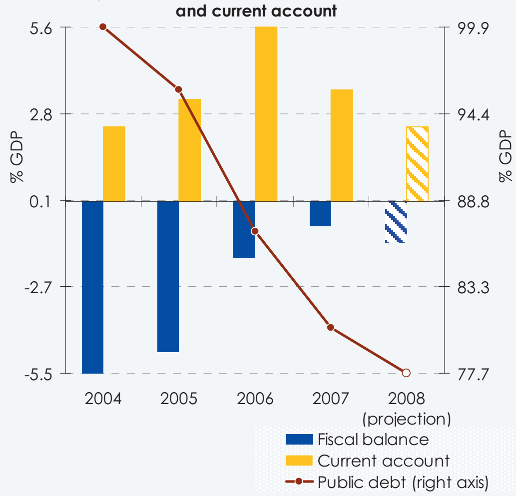
Israel's economy continued to benefit from high growth in 2007 notwithstanding political uncertainties and hostilities in the Northern border during the summer of 2006. Sound macroeconomic policies, improved security, buoyant external demand and benign financial conditions allowed the economy to expand by more than 5% for the fourth consecutive year, reaching 5.3% in 2007. The main drivers for growth were investments, exports and private consumption, which rose by 18.3%, 8.6% and 5.3% respectively. The business sector expanded more than the economy as a whole. All manufacturing industries recorded increases, most markedly among the high-tech and medium-high-tech sectors, resulting from increased investment and higher rates of capital utilisation. The recovery in the construction and tourist industries was noteworthy after a long period of modest increases. As external demand from the US and the EU becomes less supportive GDP growth for 2008 is expected to slow a little to 3.2% but to remain healthy and broad based. The impressive momentum of Israel's economy was acknowledged by Standard and Poor's, which upgraded Israel's risk rating in November, and earlier in 2007 (May) by the

Graph III.7.1: **Israel - Contributions to real GDP-growth**



Sources: EIU and IMF.

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



Sources: IMF, Ministry of Finance Israel.

Graph III.7.3: **Israel - Doing business rankings for 2007**

The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking country among the Mediterranean and CIS ENP countries and Russia.

Source: World Bank, 2008.

OECD, which invited Israel to begin membership negotiations.

Despite strong growth, the appreciation of Israel's currency (NIS) prompted deflation during the first semester of 2007, resulting in interest rates cuts to 3.5% in June 2007. Slowdowns in productivity, wage increases, falling unemployment, and increases in food prices all fuelled inflation, which on average reached 0.5% in 2007. The Central Bank of Israel responded by increasing interest rates to 4.25% in January 2008. Consumer prices are affected mostly by the domestic component, which is rising, while the external component is declining owing to the appreciation of the shekel against the US dollar. As global prices rise, the narrowing of the current account surplus and the accompanying capacity constraints are expected to fuel inflationary pressures to over 2% in 2008.

Thanks to tight expenditure control and to a sharp increase in revenues, Israel achieved remarkable improvement in its fiscal position during 2007. Growth in tax receipts was derived from business activity expansion, increases in wages, the growth in consumption, and from higher earnings in the capital markets. Expenditure was below the level prescribed by the budget offsetting war-related expenditures however, compressing welfare spending and resulting in rising poverty and inequality. As a result, the central government deficit was close to balance in 2007 while the general government deficit was roughly 0.8% of GDP in 2007. Public debt was significantly reduced to 80.6% of GDP in 2007, reflecting the government's decision to allocate revenue over-performance and privatisation proceeds to debt reduction. Nevertheless, public debt still remains high, constraining policy options in sustaining welfare payments necessary for reducing poverty and inequality.

The trade deficit widened mainly because of the rapid increase in imports 13% (excluding diamonds and fuels), attributable to increases in private consumption and investment but also to the decline in the relative price of imports. Exports rose by 8.5% (excluding diamonds). If the real exchange rate appreciation of shekel continues, it is expected to create pressures for reductions in exports. However, the sensitivity of the exports of goods and services to the real exchange rate is lower than that of the imports mainly because a large proportion of export products is not supported by the local market. The current account surplus reached 3.6% of GDP in 2007 compared with a surplus of 5.6% of GDP in 2006, which was an exceptionally high level. The current account surplus in 2007 was the result of the surplus in the services account (boosted by an increase of 11.5% in high-technology exports and of 26.7% in medium-high technology services), and of the narrowed deficit of the financial account. The income account recorded a small surplus partly explained by increases in the financial assets of the economy abroad.

The financial sector is reaping the fruits of the reforms that have been implemented in the previous years. The sector is strong and more diversified even though, capital and solvency ratios remain at lower levels than in many advanced economies. The declining trend in classic intermediation activity continued in 2007 with the introduction of new financial instruments including sale and repurchase agreements. Further significant measures are planned, including increasing the mobility of savings between different financial products and providers, the extension of (plain vanilla) securitisation, and the introduction of money market funds. Recent developments, that have improved the competitiveness of the financial sector can however increase overall risk. Regulators are attempting to improve the financial strength of banks and insurance companies by introducing several new measures. The Bank of Israel has asked the banks to increase capital ratios further in advance of the implementation of Basel II, while insurance companies were asked to restrict the payment of dividends to no more than 50% of income pending the finalisation of the new solvency requirements.

Business environment

Overall, Israel has a good ranking in terms of ease of doing business. In the relative World Bank survey it holds the 29 place among 178 countries, by far the best performance in the region and consistent with the investment flow in the country. Nevertheless, certain areas such obtaining licenses, enforcing contracts and registering property require significant improvement to contribute to a more attractive business environment.

Trade liberalisation and economic opening

Israel has a high income economy with a good degree of openness, as the high level of trade and capital inflows indicate. The share of total exports reached 44% of GDP in 2007 while the share of total imports was 46% of GDP. Foreign direct investments reached USD 9.5 billion in 2007 while Israelis' investments abroad reached about USD 13.7 billion in 2007. Israel is in second place (after the US) in terms of the number of companies listed for trading on the Nasdaq; it also holds a high ranking for venture capital investments. In 2007 about 168 venture capital investments took place in Israel totalling about USD 1.3 billion. The authorities are continuing with their reform agenda to boost competitiveness and efficiency in the markets. In 2007, the government reduced its holding in the Pi-Glilot gas depot and completed the privatization process of the Israel Oil Refineries with the sale of the second oil refinery in Haifa. Further structural changes in the energy sector also include the government's intention to split the monopolistic Electric Corporation into several separated companies (transmission, generation and distribution) in order to improve efficiency and induce price reduction. Additional planned privatizations, which are currently in the stage of evaluation and assessment, include the Postal Authority, the Israeli Military Industries (IMI), the Israel Aircraft Industry (IAI) and the seaport in Eilat.

Public institutions and public finance management

Budget expenditures for 2007 were in compliance with the multi-year ceiling on increases (a real rate of 1.7% annually) however, given the good growth potential and complaints about low welfare spending this fiscal rule is considered unsustainable. Authorities are considering embarking on a revised fiscal rule on the objective of reducing public debt to 60% by 2015. Under this context, priority should be given to the expenditure side as present tax rates are in line with those of OECD. Also, better and more transparent long term fiscal planning would help the authorities to build up flexibility to long-run changes and better communicate the vulnerability of the economy to the public debt ratio.

Social development and poverty

Employment has benefited substantially from growth and the unemployment rate was reduced to 7.3% in 2007 compared with 7.7% on 2006, even though this was partially assisted by an increase in part-time employment. The rise in demand for labour had a positive impact on women and on poorly-educated people. However, unemployment among the Arab population is estimated to be around 20%.

Despite the growth of Israel's economy and the improvement in the standard of living, the number of poor people and poor families in the first half of 2007 has risen slightly (24.7% of the population compared with 24.5% in the second half of 2006, and 20.5% of families compared with 20%). Around 420,000 families in Israel (1.68 million people - among them over 800.000 children) are considered to be below the poverty line. Poverty rates remain high most particularly among those sections of the population not involved with the booming business sector like the Arab population (51%). This raises questions about the ability of social benefits and direct taxes in reducing the poverty gap. The government, in this regard, adopted (April 2007) the "Social-Economic Agenda for 2008-10", which sets explicit targets for poverty and the labour market participation rate. The two targets are gradually increasing the participation rate for ages 25-64 by 2.6% to the OECD average (71.7%) and increasing the income of the lowest socio-economical quintile by 10% higher than the growth of GDP per capita until 2010. To achieve these targets, the government intends to introduce in the course of 2008 an Earned Credit Income Tax (EITC), which subsidizes low wage working families, to expand vocational training, to subsidize day-care centers (to encourage mothers to join the labour market), to strengthen enforcement of labour laws and to reduce the number of illegal foreign workers.

Table III.7.1:
Israel - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	5.2	5.3	5.2	5.3	3.2
GDP nominal (EUR, billion)	99	104	112	118	122
GDP nominal (USD millions)	124	131	142	157	168
GDP per capita (EUR)	14475	15050	15868	16621	17080
GDP per capita (USD)	18801	19620	20793	22518	23464
Inflation (period average)	-0.4	1.3	2.1	0.5	2.7
Social indicators					
Unemployment	10.4	9.0	7.7	7.3	7.4
Poverty rate (% of households)	n.a.	n.a.	20.0	20.5	
Population, annual growth rate (%)	1.5	1.5	1.5	1.5	1.5
Human development index	n.a.	0.932	n.a.	n.a.	
Life expectancy at birth, annual (years)	n.a.	80.3	n.a.	n.a.	
Adult literacy rate (% aged 15 and older)	n.a.	97.1	n.a.	n.a.	
Gini index (%)	n.a.	39.2	n.a.	n.a.	
Population (millions)	6.5	6.6	6.8	6.9	7.1
Fiscal sector					
Central govt. Revenues (% GDP)	35.0	35.3	35.2	36.1	35.8
Defense expenditure (% GDP)	9.2	8.9	9.2	7.9	7.9
Central govt. balance (1) (% GDP)	-3.6	-1.9	-1.0	0.0	-0.4
General govt. balance (2) (% GDP)	-5.5	-4.8	-1.8	-0.8	-1.3
Total public debt	99.9	95.9	86.8	80.6	77.7
Monetary sector					
Domestic credit to private sector (change %)	3.9	7.1	4.3	7.7	
Broad money (3) (M3, % change)	4.6	7.9	7.4	16.2	
Narrow money (M1, % change)	18.0	17.5	13.7	18.1	
External sector					
Current account balance (% GDP)	2.4	3.3	5.6	3.6	2.4
Trade balance (% GDP)	-2.3	-2.9	-2.3	-4.0	-5.5
Foreign direct investment (net, % GDP)	1.6	3.6	10.1	4.4	3.0
Foreign reserves (billions USD)	27.2	28.3	29.4	28.4	31.1
External vulnerability					
Gross reserves (excl. gold, USD billions)	26.5	27.2	29.1	28.4	
External debt (% GDP)	60.7	56.7	58.5	53.3	50.3
Financial sector					
BOI (4) policy rate (average, %)	4.2	3.7	5.1	3.9	
Exchange rate (local currency per EUR, average)	5.6	5.6	5.6	5.6	
NEER (5) (period average)	-3.3	-0.8	0.4	0.1	
REER (5) (period average)	-6.0	-2.1	0.0	-0.7	
Terms of trade (6)	92.3	89.2	87.5	85.0	

(1) National definition . Cash basis
(2) International definition, accrual basis
(3) Data for 2007 as of August
(4) Data for 2008 as of January
(5) Data for 2007 as of October
(6) Export prices/Import prices, excliding ships, aiplanes and diamonds

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

8. JORDAN

- ***Jordan's GDP growth rate slowed to 6.0% in 2007. Core inflation remained low but pressures are increasing on the back of fuel and food prices.***

- ***Twin deficits increased. Contrary to previous years, no progress was made to reduce the large budget deficit and address its dependency on external grants. The current account deficit also widened.***

- ***The authorities eventually took the step of fully removing fuel subsidies. The move was endorsed by the 2008 budget, which foresaw a broad range of compensatory measures targeting large segments of the population.***

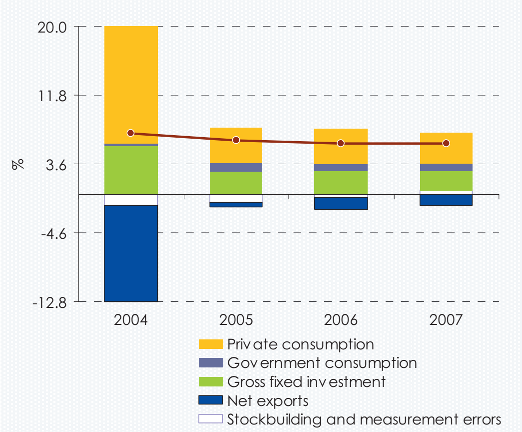
- ***External shocks and the situation in the region remained the main sources of vulnerability. In the absence of significant fiscal consolidation and structural reforms, the economic situation is likely to deteriorate in the short to medium term.***

Macroeconomic developments

Jordan's GDP growth rate reached 6.0% in 2007 slowing from 6.4% in 2006. Economic performance was underpinned by private consumption and construction. Private consumption and investment continued to take advantage of high liquidity in the region. Unemployment growth remains an issue although the unemployment rate improved slightly in the second half of the year. The economic outlook for 2008 is generally favourable, buoyed by investment financed by petro-dollars and public capital expenditures higher than in 2007. However, external shocks and the situation in the region will remain the main sources of vulnerability and tighter macroeconomic policy will be needed to mitigate the risks.

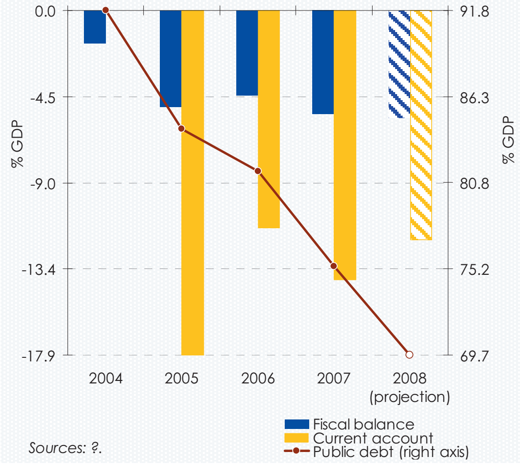
With a fixed exchange rate and an open capital account, fiscal policy remains the main channel of adjustment to maintain macroeconomic stability. In contrast to previous years, however, no progress was made to reduce the large budget deficit and address its dependency on external grants. On the contrary, the budget deficit increased significantly to 5.4% of GDP including

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



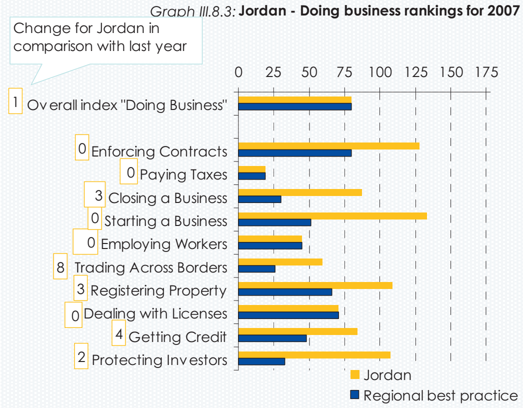
Sources: EIU and IMF.

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



Sources: ?.

Graph III.8.3: **Jordan - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries (Algeria, Egypt, Jordan, Lebanon, Morocco, Occupied Palestinian Territory, Syria and Tunisia).

Source: World Bank, 2008.

grants (2006: 4.4%). Increase in (i) military expenditure and defence budget, (ii) fuel and food subsidies, (iii) wages, pensions and bonuses transfers to public sector and (iv) debt service were the main drivers of the government's expansionary budget in 2007, the first time that a Jordanian government departed from the contractionary fiscal policy that has been central to Jordan's economic reform.

The 2008 budget eventually confirmed the full removal of fuel subsidies but still plans a further increase of the deficit (including grants) to 5.6% of GDP (9.1% excluding grants) and a projected increase of grants by an impressive 27% compared to 2007. Expenditures would increase on account of a vast programme of compensatory measures ("a social safety net") intended to counterbalance the expected increase in the cost of living following the liberalisation of fuel prices.

Debt-to-GDP ratio continued to fall in 2007. Debt reduction continued in March 2008 as a result of the government’s recent debt payback deal under which the government paid back around USD 2.1 billion. The Public Debt Law, which has been effective so far in securing past adjustment, is currently being revised in parliament, and would reduce the current limit on the debt-to-GDP ratio from 80%, to a ceiling of 60%.

Monetary policy continues to aim at maintaining the exchange rate peg and keeping interest rates in line with US rates. The Central Bank’s policy appears increasingly restrictive with a view to controlling inflation in a situation of an expansionary fiscal policy. The monetary authorities allowed for a widening of interest rates differentials between the US dollar and the Jordanian dinar. Despite fuel and food price increases, as well as excess liquidity which boosts domestic credit growth, consumption and imports, inflation was contained in 2007 but inflationary pressures are expected to intensify in 2008 on the back of high fuel prices, and fiscal expansionary policy (wage hikes).

The current account deficit widened to 14% in 2007 from 11% in 2006 on the back of a soaring trade deficit, which increased by 23.5% compared with 2006. The increase in deficit was mainly due to the rise in the cost of importing food and fuel products. Iraq and India remain the largest recipients for Jordanian exports, while Europe was the main source for the country’s imports.

Remittances reached a record high of nearly 20% of GDP. The financing of the current account deficit continues to rely largely on (long-term) capital inflows. FDI inflows continued in 2007.

Business environment

Progress on structural reforms, such as the privatisation programme and measures to improve the investment climate, slowed down in 2007. Following the successful launch of the privatisation of the Royal Jordanian and three electricity companies, the Privatisation Commission is preparing a regulatory framework for public-private partnerships to attract private capitals for public investment projects. Jordan continued to improve its business environment. It enhanced operations in its one-stop shop at the Company Registry, which has decreased the time and number of procedures needed for a business start up. Despite progress in reforms, however, Jordan declined in the overall World Bank's "Doing Business 2008" ranking. Therefore, more efforts should be made to deal with the lack of strategy and continuity in the policies for investment promotion and facilitation, export and enterprise developments.

The implementation of Basel II standards is underway. The year 2007 saw the enactment of the anti-money laundering (AML) law and the establishment of an AML unit in the Central Bank, new corporate governance regulations for banks, implementation of an electronic check-clearing system and publication of the Financial Stability Report. The planned enactment of the credit bureau legislation supported by the EC will boost the further development of the financial sector.

Trade liberalisation and economic opening

Jordan has developed a new and comprehensive trade strategy to provide guidance for various FTA negotiations, and its multilateral and bilateral trade relations. An active participant in the regional discussions on the Euro-

Mediterranean free trade area, Jordan has been very reluctant to launch bilateral negotiations with the EU on the liberalisation of trade in services making them conditional on the results of a benchmarking study. The National Competitiveness Report also provides an evaluation of the potential of the services sector. Jordan is an active supporter of the Agadir free-trade agreement, signed together with Morocco, Tunisia and Egypt, which entered into force in July 2006. It also hosts the Agadir Technical Unit which was established in Amman in April 2007. Private-sector-led consultations have started on sub-regional cooperation. Jordan concluded a new gas deal with Egypt in September. Jordan has been also active with finding new economic and trade partners outside of the Euro-Med framework. It prepared for the negotiations of a new series of free-trade agreements with Canada, Turkey and Pakistan, and signed three cooperation agreements with China.

Public institutions and public finance management

The new initiative Kuluna al Urdun (*We are all Jordanian*) completes the National Agenda and sets priorities under the political pillar within a 10 year framework. In 2007, the following measures were enacted: municipalities´ law (incl. quota for women), political party law, anti-corruption law, disclosure of public officials' assets, anti-money laundering, new press and publication law. Jordan holds the second place among the EU southern neighbours, after Israel, in the Transparency International 2007 Corruption Perception Index. It ratified the United Nations Convention against Corruption (UNCAC) and emerged as a leader in efforts to promote the implementation of UNCAC being the only Arab country volunteering for an UNCAC pilot review.

The implementation of the financial management reform continued in 2007. Focusing on budgetary procedures, the authorities continued to make progress in preparing the ground for the introduction of a medium-term expenditure framework. Steps were taken to improve the medium-term fiscal framework, including setting a partial ceiling of expenditures for each ministry according to priorities and national objectives, to effectively implement the Single Treasury Account, to improve budget classification, and to prepare for results-oriented budgeting. The authorities made no progress in 2007 with the tax reform, which is central to the Government's macroeconomic policy, to improve efficiency and transparency and to increase tax revenue collection. The draft legislation to simplify personal and corporate income tax and to streamline the fiscal incentives framework for businesses has been withdrawn from the parliament following the requested amendments.

Social development and poverty

The main development in this area consists of the broad compensatory measures adopted by the authorities to alleviate the negative impact of the liberalisation of fuel prices and support the population in coping with the increasing costs of living. In addition to these, the Social Security Law has been amended to include a provision introducing unemployment insurance to cover jobless subscribers for at least three months. The law will be debated by the parliament in 2008. Additionally, in July 2007, Jordan launched a code of conduct for child labour with guidelines for employers in order to abide by ILO conventions. The code of conduct has no legal power, however. The result of the new Employment and Unemployment Survey, which was carried out by the Department of Statistics during November 2007, shows that the unemployment rate has reached 13 % (10.1 % for males against 26.0 % for females). The rate in the age groups 15-19 and 20-24 years was 34.1 % and 25.3 % respectively.

Table III.8.1:

Jordan - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	8.6	7.2	6.4	6.0	6.0
GDP (Jordanian dinar, billion)	8	9	10	11	11
GDP (EUR, billion)	9	10	11	12	13
GDP (USD, billion)	11	13	14	16	17
GDP per-capita (EUR)	1718	1873	2035	2105	2152
GDP per-capita (USD)	2131	2317	2533	2767	2971
Inflation (consumer price, year average)	3.4	3.5	6.3	5.4	9.0
Social indicators					
Unemployment (off. registered, average, %)	12.5	14.8	13.9	13.1	
Life expectancy at birth (years)	72.0	---	---	---	
Adult literacy (% ages 15 and older)	90.0	---	---	---	
Domestic population growth (%)	2.3	2.3	2.3	2.3	2.3
Income inequality (Gini, %)	38.8	--	--	--	
Human development index	--	0.754	--	--	
Fiscal sector					
General government revenues, excl. grants (% GDP)	25.7	28.2	31.2	33.9	
General government expenditures (% GDP)	38.3	38.3	38.4	42.4	
General government balance, incl. grants (% GDP)	-1.7	-5.0	-4.4	-5.4	-5.6
General government balance, excl. grants (% GDP)	-12.7	-10.0	-7.4	-8.5	-9.1
Net public debt (% GDP)	91.8	84.2	81.5	75.4	69.7
Monetary sector					
Broad money (% change)	11.7	17.0	14.1	10.0	
Degree of monetisation (M2/GDP, %)	131.4	130.8	137.2	--	
External sector					
Current account balance, incl. official transfers (% GDP)	0.0	-17.9	-11.3	-14.0	-11.9
Trade balance (% GDP)	-30.0	-42.0	-37.6	-35.0	-34.5
FDI (net, % GDP)	5.7	12.0	21.9	10.6	8.5
Remittances (% GDP)	18.0	17.0	17.8	19.1	
Import cover of reserves (months)	5.1	4.7	5.6	5.0	
External vulnerability					
External public debt (% GDP)	66.1	56.6	51.9	47.0	41.0
Gross reserves (USD, billion)	4.8	4.7	6.2	7.0	6.5
Financial sector					
Exchange rate (JOD per EUR, period average)	0.88	0.88	0.89	0.97	1.03
Exchange rate (JOD per USD, period average)	0.71	0.71	0.71	0.71	0.71
Real effective exchange rate (% change, + is apprec.)	-3.9	-0.3	2.6	--	

Sources: Ministry of Finance Jordan, IMF, World Bank, EIU, EC staff calculations.

9. LEBANON

- ***With a GDP growth rate of 4.0% in 2007 and robust financial conditions, the economy showed once again a strong resilience to political instability. Macro-economic stability was maintained. External assistance helped to achieve a primary surplus of 1.8% of GDP.***

- ***2007 was a difficult transition year, in which the government had to strike a careful balance between reconstruction needs, an acute social situation, security expenditures and fiscal consolidation.***

- ***All targets and monitorable actions defined in the IMF Emergency Post-Conflict Arrangements were met.***

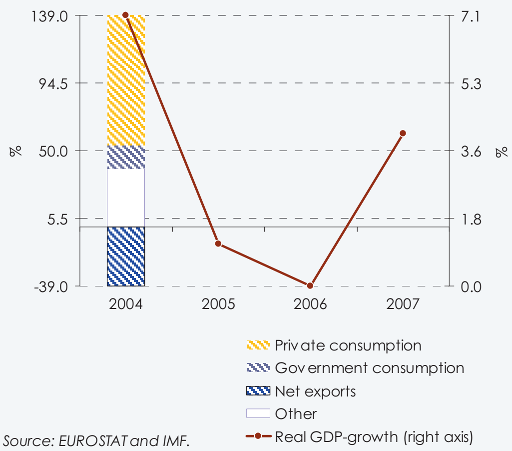
- ***The authorities pursued the programme of structural reforms focused on privatisation, improvements in the business climate and the opening of markets. However, the difficult political context and the paralysis of legislative activity limited progress.***

Macroeconomic developments

In 2007, the economy has slowly recovered from the 2006 conflict with Israel in a context of continuous political stalemate and recurrent outbreaks of violence. Once again, it showed resilience to pressures, which was reflected in growth figures and financial conditions. Real GDP growth of 4% was well above the rates initially expected. The negative impact of oil price increases and uncertain political environment was broadly compensated for by boosted regional demand and high financial aid from the region. Despite the difficult political situation, the regular administration of the country was ensured.

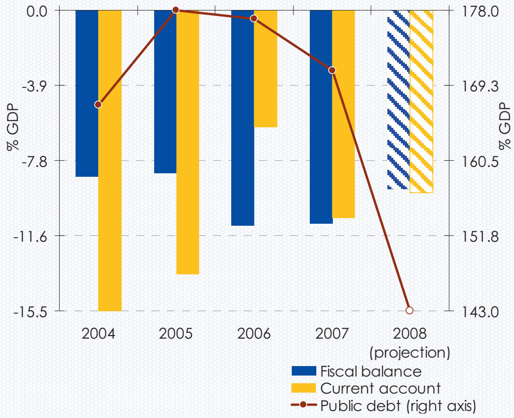
Fiscal outcomes in 2007 were better than expected at the beginning of the year. The budget deficit reached 11% of GDP, comparable with 2006.[42] It exceeded initial targets on the back of

Graph III.9.1: **Lebanon - Economic structure of GDP**



Source: EUROSTAT and IMF.

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



Sources: Ministry of Finance Lebanon, IMF, WB, EC Staff calculations.

Graph III.9.3: **Lebanon - Doing business rankings for 2007**

The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries (Algeria, Egypt, Jordan, Lebanon, Morocco, Occupied Palestinian Territory, Syria and Tunisia).

Source: World Bank, 2008.

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[42] The 2007 budget was approved by the Council of Ministers mid-2007.

stronger-than-projected revenue collection. Lower-than-foreseen foreign financed capital expenditure (partly on account of delays in donors' disbursements) contributed to fiscal over-performance. External grants and loans helped to achieve a primary surplus of 1.8% of GDP (0.4% without foreign assistance). Public debt-to-GDP ratio decreased to 171% by the end of 2007 from 177% in 2006.[43]

The deficit is expected to further decrease in 2008, although risks of unforeseen expenditure, such as security measures and transfers to Electricité du Liban (EdL) on account of higher oil prices[44], remain. The 2008 Budget approved by the government foresees an increase in the VAT rate to 12% from 10% and of taxes on interest income from 5% to 7%, in line with the Paris III programme of reforms. Privatisation should reduce public debt by about 30 percentage points of GDP.

The authorities succeeded in maintaining macro-economic stability. Despite pressures on reserves, the loss of confidence and outflows of deposits, confidence was restored fairly quickly. Money demand has remained robust. Interest rates remained unchanged. Bank deposits, which represent almost 300% of GDP (out of which 77% in foreign currency), increased by 10.5%. Profits in the banking sector rose by 10%. Gross reserves, excluding gold, remained stable. In early 2008, Saudi Arabia once again deposited USD 1 billion at Banque du Liban (BdL) to bolster monetary and financial stability.[45] The value of Lebanon's gold reserves surged thanks to the price increase in international markets.[46] In 2007, inflation declined despite the depreciation of the US dollar, to which the Lebanese pound is pegged.

Reflecting reconstruction needs, the current account deficit is estimated to increase to 10.7% of GDP (2006: 6%) on account of a higher trade deficit. The current account deficit is largely financed by official inflows and sustained foreign direct investment.

Business environment

Lebanon pursued its programme of structural reforms focused on privatisation, improvements in the business climate and opening of markets. However, the difficult political context and the paralysis of legislative activity limited progress in many fields. The government took steps to prepare the ground for reforming the energy and social sector with the aim of limiting open-ended transfers from the budget while protecting capital and social expenditure. Addressing power sector losses will contribute to fiscal sustainability. In the telecommunications sector measures were taken to prepare for the corporatisation of *Liban Telecom* and for the privatisation of the two mobile operators. The valuation of the mobile networks, the timing of the auction, the impact of the privatisation on public finances[47] and the role of parliament remain uncertain. A Telecommunication Regulatory Authority was also created to ensure competition. Progress has been, however, slower than expected. At the end of October, the government approved a draft law on competition that aims to increase competition by fighting monopolistic and non-competitive arrangements. The Law foresees the creation of a Competition Council as the official reference for all related issues.

Despite some progress in reforms, Lebanon regressed in the overall 2007 World Bank “Doing business rankings” (see Graph III.9.3). The authorities still need to improve investor protection laws and the system to enforce commercial contracts. A Business Registration Simplification project that aims to reduce the

43 The decline resulted from the transfer of unrealised gold valuation gains from the BdL to the government. Ministry of Finance (2007), Debt and debt markets, A Quarterly Bulletin of the Ministry of Finance, No.3, Q. IV.

44 In 2007, EdL suffered a loss of USD 1.2 billion. The full impact of higher oil prices will be felt only in 2008 since the fuel supplies from abroad for power utlities (about 90% of power plants use fuel oil) are financed through letters of credit, the stock of which gradually increased in 2007.

45 The deposit will carry an interest rate equivalent to the prevailing Libor rate.

46 Gold reserves are estimated at more than 9 million ounces.

47 Budgetary revenue from the mobile operators reached USD 1.1 billion (4.5% of GDP) in 2007.

time and cost of registering new companies is under preparation.[48]

The financial sector proved resilient to shocks despite its large public debt and significant external vulnerabilities. Its strength is attributed to three factors: (i) perceived implicit guarantee from donors; (ii) Lebanon's track record of having never defaulted on external debt or deposits and (iii) unique market structure for Lebanese debt that is dominated by local banks and dedicated investors and depositors.[49]

Trade liberalisation and economic opening

Despite initial announcements, Lebanon did not succeed in achieving WTO membership in 2007. Progress in negotiations has been halted by the paralysis of legislative activity. In the meantime, the efforts of the authorities have focused on ensuring energy supplies to the country under favourable conditions, which resulted in a renewed electricity agreement with Syria and an agreement with Egypt on natural gas imports. Some protectionist actions have also been taken such as imposing a 60% tariff on Egyptian ceramics in contradiction with the Arab Free Trade Agreement.

Public institutions and public finance management

Lebanon’s position in various governance rankings deteriorated compared with 2006. Within the southern ENP region it lagged behind in the Transparency International Corruption perception Index in 2007, performing just slightly better than Egypt, Libya and Syria and at the same level as Algeria. Lebanon regressed as well in the rankings on the six World Bank governance indicators. On average, only Syria and West Bank and Gaza were behind it among the group of Southern Mediterranean neighbours. On the other hand, the Ministry of Finance was among the winners of the United Nations Public Service Awards (UNPSA) for 2007 for the category "Taxpayer Service".

Regarding public finance management, reform efforts focused on budget formulation and execution as well as medium-term planning and prioritisation of expenditures across ministries and public agencies. Measures aiming at improving cash management and implementing a single treasury account are a key part of the Medium-Term Public Financial Management Reform Action Plan. A global income tax law was adopted by the Council of Ministers in November 2007 but still requires parliamentary approval.

Social development and poverty

Living conditions of the Lebanese have deteriorated in 2007, with purchasing power dropping by more than 10%. According to a recent study, the poverty ratio in Lebanon represents around 28.5% of the population (approximately 1 million Lebanese) with 8% of the population (300 000 individuals) living in extreme poverty.[50] The distribution of poverty across regions is very uneven, with Beirut, which attracts investment and where job creation takes place, but also the South Bekaa being the richest and Mount Lebanon and the North lagging behind. Regulations on the labour markets are also a source of inequalities especially for immigrant workers and Palestinian refugees. Of all host countries, Lebanon has the highest percentage of Palestinians living in abject poverty and registered with the UN Relief Works Agency (UNRWA) as "special hardship cases". Even though the Labour Ministry partially eased the restrictions barring Palestinian residents from working in certain semi-skilled professions , they remain excluded from the Lebanese labour market and unemployment rates in the country's 12 refugee camps remain as high as 60%.[51]

48 The Ministry of Finance announced that on adoption it will cancel most of the required registration fees, as such fees account for only 1% of public revenue.

49 Schimmelpfennig, A. and E. H. Gardner (2008), Lebanon – Weathering the Perfect Storm, IMF Working Paper 08/17, January.

50 Laithy, Heba, Khalid Abu-Ismail, Kamal Hamdan (2008), *Povert, growth and income distribution in Lebanon*, Country study n°13, Internationl Poverty Center supported by the UNDP, January.

51 Ohrstrom, Lysandra (2007), Lightened labour restrictions have yet to help Palestinians find work. And insiders warn that changes could be repealed on a whim. The Daily Star, June 06.

Table III.9.1:
Lebanon - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	7.1	1.1	0.0	4.0	4.0
GDP (Lebanese pounds, trillion)	32	33	34	36	
GDP (EUR, billion)	17	17	18	18	
GDP per-capita (EUR)	4924	4916	5147	4906	
Inflation (consumer price, average)	1.7	-0.7	5.6	4.1	12.4
Social indicators					
Unemployment (off. registered, average, %)	n.a.	n.a.	n.a.	n.a.	
Life expectancy at birth (years)	71.0	71.5	n.a.	n.a.	
Adult literacy (% ages 15 and older)	86.6	n.a.	n.a.	n.a.	
Resident population (million) [1]	3.8	n.a.	n.a.	n.a.	
Income inequality (Gini coeff. for nominal consumption, %)	37	n.a.	n.a.	n.a.	
Human development index	n.a.	0.772	n.a.	n.a.	
Fiscal sector					
General government revenues, incl. grants (% GDP)	23.1	22.8	24.7	24.8	25.9
General government expenditures (% GDP)	31.8	31.2	35.8	35.8	35.1
General government balance, incl. grants (% GDP)	-8.6	-8.4	-11.1	-11.0	-9.2
General government primary balance, incl. grants (% GDP)	3.5	2.1	1.7	1.8	2.6
Gross public debt (% GDP)	167	178	177	171	143
Monetary sector					
Broad money (% change) [2]	12.3	3.5	6.4	11.2	
Degree of monetisation (M5/GDP, %)	266	275	277	n.a.	
External sector					
Current account balance, incl. official transfers (% GDP)	-15.5	-13.6	-6.0	-10.7	-9.4
Merchandise trade balance (% GDP)	-30.1	-28.4	-25.3	-29.5	-28.2
FDI (net, % GDP)	10.9	12.2	12.0	10.8	24.7
Remittances (% GDP)	5.6	4.9	5.2	n.a.	
Import cover of reserves (months)	7.7	7.2	7.2	6.6	7.2
External vulnerability					
External public debt (% GDP)	89	89	90	87	73
Gross reserves (EUR, billion)	7.7	7.7	9.0	8.4	12.3
Financial sector					
Three-month T-bill yield	5.2	5.2	5.2	5.2	
Two-year T-bill yield	7.9	8.5	8.7	8.7	
Exchange rate (L£ per EUR, period average)	1872	1875	1892	2064	
Exchange rate (L£ per USD, period average)	1508	1508	1508	1508	
Real effective exchange rate (% change, + is apprec.)	-6.9	-4.1	2.1	-4.0	
Stock market index	637	1309	1184	1454	

[1] Resident population, except those living in Palestinian refugee camps
[2] Defined as currency in circulation plus resident and non-resident deposits.
Sources: Ministry of Finance Lebanon, IMF, World Bank and EC staff calculations.

10. LIBYA

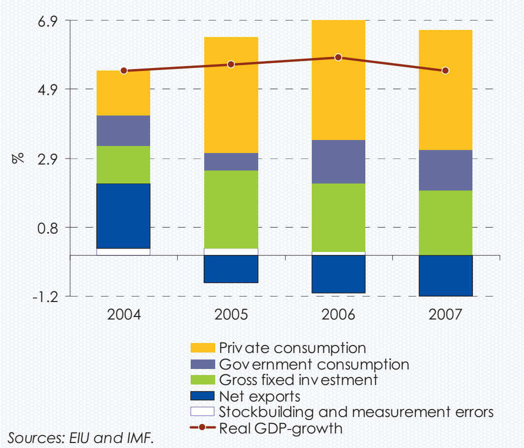
- ***Libya is emerging after two decades of international isolation and is attracting foreign interest mainly in the energy sector.***

- ***Rising oil output and high oil prices have underpinned economic growth and allowed the government to launch large infrastructure investment projects.***

- ***Reforms for opening up the economy and develop the private sector have been launched but seem to advance at slow pace.***

- ***Libya has established a consolidated sovereign wealth fund controlling USD 40 billion. It intents to invest mainly abroad assisted by international asset managers.***

Graph III.10.1: **Libya - Contributions to real GDP-growth**

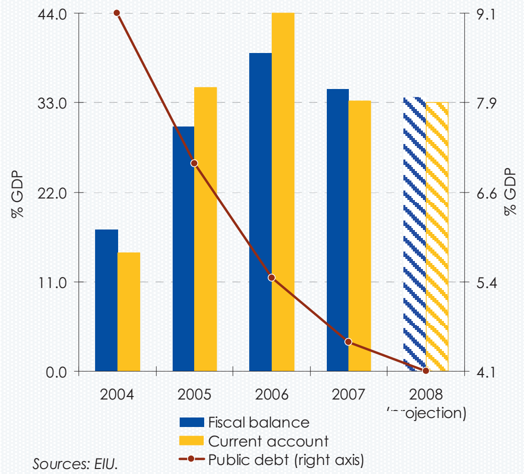


Sources: EIU and IMF.

Macroeconomic developments

Surging oil prices coupled with strong government consumption helped Libya to keep real growth at a healthy level in 2007. However, the economy remains one of the least diversified in the region and will continue to depend on its oil and gas sector, which accounts to around 70% of GDP. Therefore, the promotion of growth in the non-hydrocarbon sectors and the facilitation of private sector development throughout the economy will be the main challenge for Libya. At the same time, Libya aims to upgrade its dilapidated infrastructure after years of sanctions and to increase oil production, which is currently at 1.7 million barrels per day, down from 3.3 million of barrels per day in the 1970's.

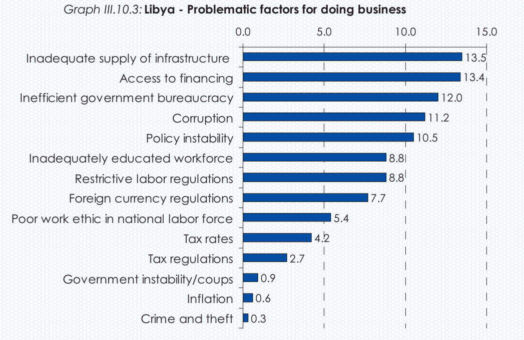
Graph III.10.2: **Libya - Fiscal balance, public debt and current account**



Sources: EIU.

Revenues from the oil sector and public spending will continue to underpin future economic growth despite the recent opening of the banking sector and the increased numbers of tourists. Growth for 2008 is expected to slow down marginally to 5.2% although this depends on the extent of rationalisation in the size of the public sector.

Graph III.10.3: **Libya - Problematic factors for doing business**



Source: World Economic Forum 2007

Inflation picked up to 5.9% in 2007 as the government relaxed its control over the domestic market and eased electricity and fuel subsidies.

The increase in international non-oil commodity prices, housing and food prices also had a significant impact on inflation as Libya imports

75% of its consumption in food. Moreover, the rapid acceleration of money supply growth (31% in 2007) following years of economic stagnation contributed to inflationary pressures. Although the relative stability of the Libyan dinar is expected to minimise imported inflation, consumer prices are projected to increase by 6.3% in 2008 owing to persistently high housing and food prices. Improvements in the capacity and technical expertise of the Central Bank of Libya are necessary in order to enhance monetary policy. The Libyan dinar is pegged to the IMF's special drawing rights (SDR) and is tightly controlled. The country's slow economic opening and its huge foreign reserves (USD 83.1 billion in December 2007) are expected to deter any pressures on the exchange rate and might lead to a marginal appreciation.

Government expenditure rose by 34% in 2007 pushed up by sharp increases in the public wage bill but also by a 42% rise in capital expenditure particularly in infrastructure following years of sanctions. Revenues also grew by over 15% owing to higher oil output and prices but less than expenditures. As a result, the fiscal surplus narrowed to 34.7% of GDP down from 39.1% in 2006. The non-oil budget deficit also widened significantly in 2007 underscoring the significant imbalance in the Libyan economy and its over-dependence on oil income.

In 2007, Libya announced the establishment of the Libyan Investment Authority (LIA), a consolidated sovereign wealth fund to manage the country's existing state funds. The LIA controls around USD 40 billion intending to invest on a commercial basis almost exclusively abroad. In 2007, USD 8 billion were to be invested in participations in industry, commerce, agriculture, tourism and real state, USD 3 billion in real estate and USD 8 billion in global stock markets. Future plans involve private equity participations. With the current oil production and oil prices close to USD 90 per barrel, the LIA may receive around USD 19 billion each year from oil revenues.

The trade surplus narrowed to 44.1% of GDP in 2007 as demand for inputs for capital investment projects and growing domestic appetite for consumer goods increased imports by 9%. This trend is expected to continue in 2008 although it will be partially offset by increases in oil production output. The services and income balances continued to run on deficits. As a result, the current account remained in a surplus of 33.2% of GDP in 2007 while it is expected to narrow further to 33% of GDP in 2008.

Considerable improvement has been made in restructuring the financial sector and strengthening its supervision. Measures taken by the authorities aim to improve off-site surveillance techniques, to upgrade the methodology of setting capital requirements, to modernize the national payments system and to upgrade the credit culture in the banking system. Improvement was also notable in the financial soundness indicators of banks, while the adoption of international accounting standards will support the efforts of banks and supervisors to monitor developments and take early corrective action while the banking sector is developing. The recent privatisation of Bank Sahara and Wehda Bank was also an important step which will enhance knowledge transfer and competition in the banking sector.

Business environment

As a result of the improvement in Libya's relations with the US and the EU, large investment projects have been announced in various sectors (hydrocarbon, aviation, banking, infrastructure, tourism) exceeding USD 35 billion in total value. Nevertheless, the general business environment is facing problems arising from the lack of transparency, the corruption, the absence of an agreed-upon plan, and the lack of coordination between government institutions. In the area of private sector development, key priorities include the simplification of the approval process for entry into competitive sectors, lifting remaining restrictions on foreign participation in services like finance, and clarifying laws related to renting and owning property. Related areas of possible intervention include reforming the labour code to add operational flexibility while ensuring sound working conditions, replacing the progressive corporate tax rate with a low flat rate which is competitive with other countries, and pursuing reforms in customs administration to reduce excessive delays.

Trade liberalisation and economic opening

Despite recent steps in privatisation, Libyan economy is still highly controlled by the state. Import bans and restrictions, import fees, non-transparent and discretionary regulation, state trade and customs corruption are serious obstacles for trade and increase the cost of trade. However, trade freedom is expected to improve as Libya's international relations have been restored, the private sector is developing, and the country applied for WTO membership in 2004. Economic opening is still low and mostly limited to the oil sector. Nevertheless there are signs of improvement under the pressure of the developing private sector particularly in the financial sector. Fourteen foreign banks had established operation offices by mid 2007. Also, both residents and non-residents may hold foreign currency accounts although with prior approval. The presence of foreign businesses in domestic projects, is expected to increase in the non-oil sector (banking, aviation, construction, telecommunication). However, the process of privatising public enterprises needs to be simplified and accelerated.

Public institutions and public finance management

Some steps have been made in improving public financial management including the consolidation of the budget presentation. Moreover, the intended move to a functional classification of the budget starting in 2008 will increase transparency. Oil revenue will continue to make up the bulk of fiscal revenue. However, the implementation of reforms in customs administration and the establishment of a large tax office are expected to contribute to a significant rise in tax in 2008. The rise in government spending is expected to continue as Libya has announced a public works programme of USD 120 billion to upgrade its infrastructure over the next five years. Government has announced a public sector reform program which would involve the reduction of about 400.000 public sector employees. The government intents to mitigate the effects of this policy by encouraging those workers who will be laid off to set up private businesses and by offering them state loans and grants.

Social development and poverty

Unemployment rates are high in Libya (25% according to unofficial estimates). Libya's workforce is dominated by the public sector which employed one million civil servants in 2007, around 50% of the total labour force. Government's decision to cut back 400.000 jobs in the public sector is expected to increase the unemployment rate although many of the former civil servants are expected to be employed in foreign companies or open their own businesses. The scarcity of scientific and technically-skilled staff remains a core human resource issue while the employment problem is compounded by the high rate of population growth, which is higher than the rate of job creation. New employment regulations are intended to provide work opportunities for Libyan nationals, reducing both state payrolls and the country's dependence on foreign workers - mainly from central Africa. In addition, foreign companies are required by law to train Libyan nationals for more skilled jobs and to provide all local employees with the same benefits as foreign workers. Nevertheless, a rapid improvement in the development of human resources is necessary to improve productivity, increase diversification, and guarantee competitiveness as the economy gradually moves towards market-economy standards.

Many direct and indirect subsidies and free services have helped raise the economic status of low-income families, a policy which has prevented extreme poverty. Consequently, while certain social groups (i.e., top civil servants, military officers, and politicians) enjoy much higher living standards than average citizens, Libya is not a highly polarized society divided between extremes of wealth and poverty. Moreover, Libya has the highest ranking in the UN Human Development Index among African countries.

Table III.10.1:
Libya - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (% change)	5.4	5.6	5.8	5.4	5.2
GDP (EUR, billion)	25.1	33.7	39.9	43.0	48.6
GDP (USD, billion)	31.7	42.8	50.4	58.9	68.6
GDP per capita (EUR)	4333	5706	6614	7166	7838
GDP per capita (USD)	5480	7230	8350	9570	10930
GDP (Libyan Dinars, billion)	41.4	56.0	66.2	74.1	83.6
Inflation (average)	-2.2	2.0	3.5	5.9	6.3
Social indicators					
Unemployment (off. registered, average, %)	n.a.	n.a.	n.a.	17.0	
Life expectancy at birth (years)	73.8	73.4	n.a.	n.a.	
Adult literacy (% ages 15 and older)	n.a.	84.2	n.a.	n.a.	
Population, annual growth rate %	1.9	1.9	1.9	1.9	1.9
Human development index	0.798	0.818	n.a.	n.a.	
Population (in millions)	5.7	5.8	5.9	6.0	6.2
Fiscal sector					
General government revenues (% GDP)	58.5	68.6	72.2	74.0	76.1
of which: Oil - revenues	50.6	63.7	66.8	66.7	69.7
General government expenditures (% GDP)	41.2	38.6	33.1	39.3	42.4
General government balance, excl. grants (% GDP)	17.4	30.0	39.1	34.7	33.7
General government non - oil balance (% GDP)	-33.3	-33.7	-27.7	-32.0	-36.0
General government debt (% GDP)	9.1	7.0	5.4	4.5	4.1
Monetary sector					
Broad money (M2, % change)	9.2	29.2	20.2	31.0	24.6
Credit to the economy (% change)	-0.7	4.5	6.2	4.6	5.5
Credit to the private sector economy (% change)	1.1	0.8	1.6	0.7	1.4
External sector					
Current account balance (% GDP)	14.5	34.9	44.0	33.2	33.0
Trade balance (% GDP)	27.3	41.2	48.1	44.1	42.7
FDI (net, % GDP)	1.1	2.4	4.1	3.7	3.6
External vulnerability					
Total external debt (% GDP)	12.9	9.8	8.7	8.1	8.0
Gross reserves (USD, billion)	25.6	39.3	59.2	83.1	115.4
Financial sector					
Lending rate (average, %)	6.1	6.1	6.3	6.0	6.5
Exchange rate (LD per USD, mid FY)	1.30	1.31	1.31	1.26	1.22
Exchange rate (LD per EUR, mid FY)	1.62	1.63	1.65	1.72	1.77
Real effective exchange rate (%, + is apprec.)	-8.99	-7.75	-0.33	-0.98	2.00

Sources: IMF, EIU, EUROSTAT, EC staff calculations.

11. MOLDOVA

- ***Moldova's GDP continued growing in 2007 despite a severe drought, but at a slower pace than in the previous years; Moldova's resilient economic performance is supported by capital inflows, mainly remittances and FDI, which more than financed the huge trade deficit.***

- ***Capital inflows, together with the effects of the drought on food prices, are generating persistent inflationary pressures. The National Bank is taking measures to tighten monetary policy, supported also by a supportive fiscal stance.***

- ***The structural reform agenda is set in the National Development Strategy adopted in 2007. There is much to be done to improve the business environment and the public and private governance.***

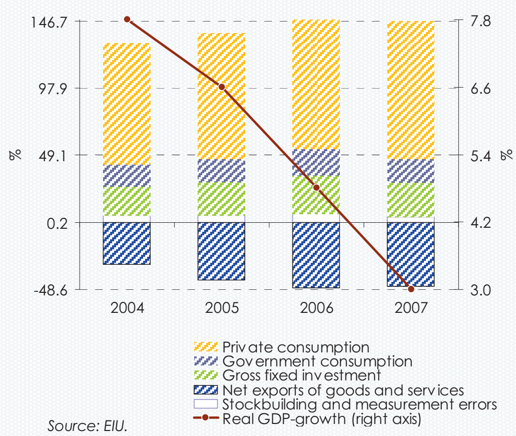
Macroeconomic developments

Moldova's economic performance in 2007 was surprisingly strong in view of the external shocks the country faced. Despite a severe drought that hit Moldova in summer and reduced agricultural output by nearly a quarter (by 23.1%, according to preliminary figures), the country's GDP still increased, albeit by a modest 3%.

As in the past, growth is exclusively due to the services sectors, especially construction and trade. Industrial production is reported to have contracted by 2.7%, after a drop of nearly 5% in 2006; this primarily reflects the poor conditions in which the food industry has continued to operate (drought and the persistent effects of the Russian ban on wine exports introduced in 2006, which are being overcome only gradually). Yet, there are indications that new small-scale industries are developing and creating jobs (e.g. the textile sector). Growth is mainly driven by domestic demand; however, unlike in previous years, growth in investments, both residential and industrial, is much stronger than growth in household consumption – more than 20% against 4% (in 2007).

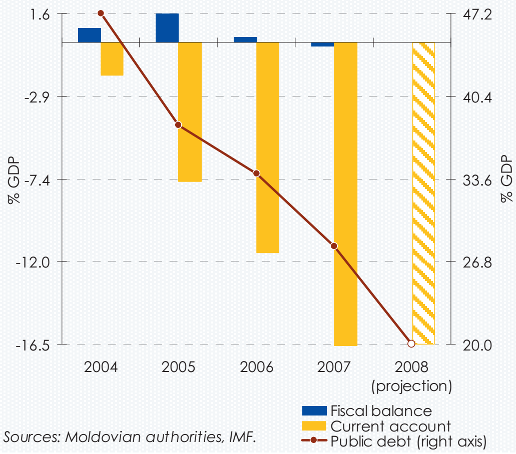
The slowdown in the output of agriculture and industry and the strong domestic demand led to

Graph III.11.1: **Moldova - Economic structure of GDP**



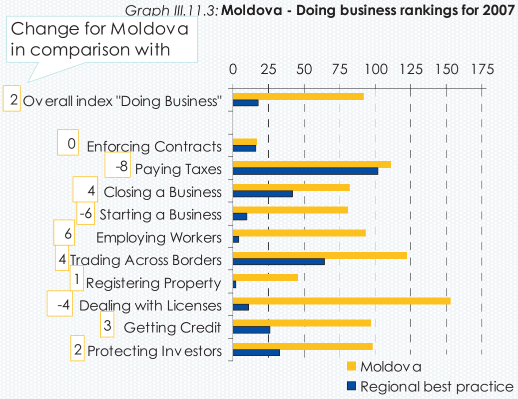
Source: EIU.

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



Sources: Moldovian authorities, IMF.

Graph III.11.3: **Moldova - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178.
The regional best practice refers to the best ranking CIS country among the EU Eastern ENP countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russia and Ukraine).

Source: World Bank, 2008.

a widening of the trade deficit from USD 1.6 billion to 2.3 billion, or more than 50% of GDP.Once again, the trade deficit was only partly compensated by remittances from Moldova's workers abroad (estimated to about one third of GDP). As a result, for the third year running, the current account deficit increased – to 17% of GDP in 2007. However, capital inflows, in the form of FDI (which almost doubled, reaching 10% of GDP) or credits (foreign debt of the non-government sector rose in 2007 to 50% of GDP from 40% three years earlier) were well in excess of this amount. Large capital inflows have also translated into an accumulation of international reserves of the National Bank of Moldova (NBM), close to the target of three months of projected 2008 imports set in the PRGF programme.

Massive capital inflows, not fully sterilised by the National Bank, translate into strong money growth, which inevitably generates inflationary pressures. Twelve-month inflation in 2007 remained well above the 10% target of the NBM, at more than 13%; it accelerated further to over 16% by the end of April 2008. Accelerating inflation, together with the appreciation of the Moldovan leu, is leading to a loss of competitiveness of Moldova's economy. The leu's real effective exchange rate appreciated in 2007 by more than 10%. The NBM has gradually stepped up its disinflation policy, combining sterilisation operations and higher interest rates and reserve requirements.

Moldova's key macroeconomic policy challenge, namely controlling inflation, is constrained by weak monetary policy transmission mechanisms and huge development needs (Moldova remains the poorest country in Europe). Yet, in the near future, its likely fiscal policy is to continue supporting the disinflation efforts of the National Bank. The 2007 budget deficit was lower than planned – 0.2% of GDP – primarily reflecting stronger revenue performance, while the government succeeded in keeping spending increases below the rises in revenue. Restrictive fiscal policy has also allowed public debt to be further reduced, to 28% of GDP (down from 34% in the previous year and over 47% in 2004). The bulk of this debt is owed to external creditors/

Business environment

In 2007, Moldova made progress in several areas of business environment reform. In February, an independent competition authority, the National Agency of Protection of Competition, was set up. New legislation on registration of enterprises and on the legal regime of joint-stock companies was passed and enacted. Also, the government decided to revitalize the privatisation process that had been stalled for several years. This is one of the objectives of the new law on management of state property adopted in May 2007.

In April 2007, the parliament approved several amendments to taxation legislation, proposed by the government on the initiative of the President. These amendments included, in particular, the introduction of a 0% corporate income tax on undistributed income from 2008, to replace all other investment incentives. Amendments relating to the possibility of extending the capital legalisation up to December 2008 and a fiscal amnesty for tax liabilities from before January 2007 were also approved. While these measures have caused some concern in terms of their impact on public finances and the State's capacity to implement its development strategy, they are seen as being favourable to business.

Yet, despite progress, there are still barriers to the establishment of businesses, in particular due to the onerous and sometimes arbitrary administrative requirements and controls imposed on investors. Not surprisingly, the business environment in Moldova is still seen as unattractive. Indeed, Moldova's ranking in the World Bank's Doing Business survey remained essentially unchanged in 2007 (it even deteriorated slightly from 90th place in the 2007 Doing Business Report to 92nd place in the 2008 Report).

Trade liberalisation and economic opening

Moldova's trade regime remains generally open, but the authorities have still not dismantled all the administrative restriction on trade. So, with the world prices for wheat increasing, proposals to limit or ban wheat exports were floated. Also, a new, cumbersome system of approving meat and dairy imports was introduced in 2007 (only to be removed shortly afterwards). In principle, no new restrictions are expected to be introduced.

Moldova's economy, like many small economies, is very open: total foreign trade turnover far exceeds GDP. Not surprisingly, the objective of developing exports, together with the diversification of export destinations, is extremely high on the authorities' agenda. Improving access of Moldova's exports to the EU markets and taking advantage of the preferential trade arrangements offered by the latter are at the centre of this strategy.

In 2007, given the improvement in Moldova's system of controls and certification of origin of goods, the European Commission concluded that Moldova had met the requirements for receiving additional Autonomous Trade Preferences (ATPs) from the EU. ATPs eventually entered into force in March 2008. From 2006 onwards, Moldova benefited from trade preferences under the so-called "GSP Plus" regime, although this did not include some important agricultural products. Moldova was also party to the Central European Free Trade Agreement (CEFTA).

Public institutions and public finance management

Moldova's authorities have repeatedly stressed their commitment to strengthening public institutions and public finance management. Improved governance is seen both as a goal and as a means to achieve the objectives of the government's strategy for improving the competitiveness of the economy and raising the living standards. In 2007, the government developed and adopted (in December) a new policy document, the National Development Strategy (NDS), building on and replacing the Economic Growth and Poverty Reduction Strategy Paper which dated back to 2004. The aim of the NDS is to become the reference tool for defining short- and medium-term policy priorities. It will be accompanied by National Developments Plans, drawn up for three-year periods, consistent with the budget planning within the three-year Medium-Term Expenditure Frameworks (MTEF). Better articulation between the policy goals and budget planning is one of the improvements in Moldova's governance that are expected to flow from the implementation of the new national development strategy.

The other policy area where some progress was seen in 2007 was public finance management. Moldova implemented several measures under the 2006-2010 Strategy for the Development of the Tax Service, such as the setting up of a Division for combating tax fraud and the strengthening of the Large Taxpayers Division. Also, further progress was made in the area of public procurement, in particular with the entry into force of the new law in October 2007 and the adoption of related regulations. Sound implementation of the law, along the lines of a specific Action Plan, now requires the strengthening of the administrative and training capacities of the Public Procurement Agency as well as awareness-raising activities directed at the contracting authorities and stakeholders. One of the objectives of the Action Plan is to prepare Moldova's accession to the WTO Agreement on Government Procurement. Progress can be noted in the fields of internal and external audit, and financial control and accounting, following the entry into force in January 2008 of new laws that help to bring legislation more closely into line with EU standards.

Social development and poverty

With a GDP per capita of less than 1000 euros (in 2007), Moldova remains Europe's poorest country. According to the latest available estimates, about 30% of Moldova's population live in absolute poverty (i.e. have a daily consumption of less than USD 4.3 in PPP terms), and 4.5% live in extreme poverty (daily consumption of less than USD 2.3 in PPP terms). The Gini coefficient measuring consumption inequality was 0.315.[52]

Understandably, social spending remains a major component of the public expenditure: about two

[52] These data are not consistent with the data for previous years which were based on measures of income rather than consumption. While the incidence of absolute poverty in 2005, when measured by income, was comparable in size, the incidence of extreme poverty was much higher – around 15% of the population. The Gini coefficient, calculated on income distribution, was around 0.38.

Table III.11.1:
Moldova - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	7.8	6.6	4.8	3.0	6.5
GDP nominal (EUR, billion)	2	2	3	3	4
GDP (USD, billion)	3	3	3	4	6
GDP per-capita (EUR)	581	668	746	956	1040
GDP per-capita (USD)	721	831	936	1300	1650
Inflation (average)	12.5	11.9	12.7	12.4	13.0
Social indicators					
Unemployment (ILO definition, %)	8.1	7.3	7.4	5.1	
Rate of activity	49.7	49.0	46.3	44.8	
Poverty rate (% of population)	26.5	29.1	n.a.	n.a.	
Fiscal sector					
Total revenues (% GDP)	35.4	38.6	39.9	41.8	39.1
Total expenditures (% GDP)	34.6	37.0	39.6	42.0	39.1
General government balance (% GDP)	0.8	1.6	0.3	-0.2	0.0
Gross public debt (% GDP)	47.2	38.0	34.0	28.0	20.0
Monetary sector					
Domestic credit to the private sector (% GDP)	23.1	26.5	30.8	39.1	41.1
Broad money (M2, % change)	44.7	36.7	12.2	47.3	26.8
Degree of monetisation (M2/GDP, %)	25.4	29.5	27.9	34.5	37.1
Dollarisation in bank deposits (%)	44.7	41.8	49.1	43.3	
External sector					
Current account balance (% GDP)	-1.8	-7.6	-11.5	-17.0	-16.5
Trade balance (% GDP)	-29.8	-40.6	-46.6	-52.3	-47.7
FDI (net, % GDP)	5.8	7.5	6.5	10.2	11.1
Remittances (% GDP)	25.4	29.1	32.8	32.3	30.4
External vulnerability					
External public and private debt (% GDP)	72.5	56.2	56.5	60.0	
International reserves (USD, million)	470	597	775	1334	
Financial sector					
Real effective exchange rate (%, + is apprec.)	12.8	-1.3	0.0	10.8	
Exchange rate (Moldovan leu per EUR, average)	15.31	15.67	16.47	16.50	
Exchange rate (Moldovan leu per USD, average)	12.33	12.60	13.13	12.14	

Sources: Moldovan authorities, IMF, EBRD, WB, NBM, EC staff calculations

thirds of Moldova's State budget is spent on health, education and social assistance. The single largest social spending programme, the so-called nominal (or nominative) compensations, covering part of the utility costs of the population, accounts for nearly 40% of social spending. In 2007, the government prepared a reform of the nominal compensations scheme, based on population categories, which consisted in the phasing out of this scheme to be replaced by a new one based on means tested income levels. The reform, supported by the EU (through its budget support operations) and other international donors, is to be implemented in autumn 2008. Together with the pension reform launched in 1998, it is one of the government's major tasks in the area of social policy.

12. MOROCCO

- ***Economic growth remains vulnerable to agriculture output. Delinking them would require a serious restructuring of the agricultural sector, which still absorbs around 50% of the active population. Considerable growth variations (2007: 2.2%; 2006: 8.0%) point to the need for further structural reforms leading to higher growth of the non-agricultural sector and step change in the dynamics of the productivity growth in the agricultural sector.***

- ***The excellent performance of total revenues in 2007 helped to further contain the budget deficit (2007: 0.2%; 2006: 2.0% of GDP). However, the expected growth in government spending in infrastructure, education and security, together with the heavy toll that oil and food subsidies are taking on the budget, will cancel out the benefits of the current fiscal reform efforts in 2008. This points to the need to start reforming less efficient categories of spending, such as subsidies.***

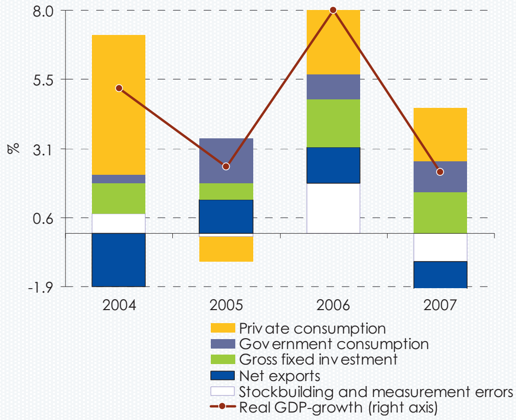
- ***Unemployment (9.9%) and poverty (14%) remain at unacceptably high levels. Achieving the targets announced by the new government –6% real GDP growth, 250000 new jobs and 150000 new housing units a year for the next five years – remains a serious challenge if structural reforms are not accelerated.***

Macroeconomic developments

After a record harvest and strong economic growth in 2006 (8.0%), severe drought and a contraction in agricultural output in 2007 have resulted in **lower estimates of economic growth** (2.2% end-2007). The economy still remains vulnerable to shocks in agricultural output, although steady growth in non-agricultural GDP (5.5% end-2007 up from 5.2% in 2006) and its ongoing diversification (chemicals, metals and textiles, telecoms, construction, finance) is helping to increase the Moroccan economy's resilience to shocks.

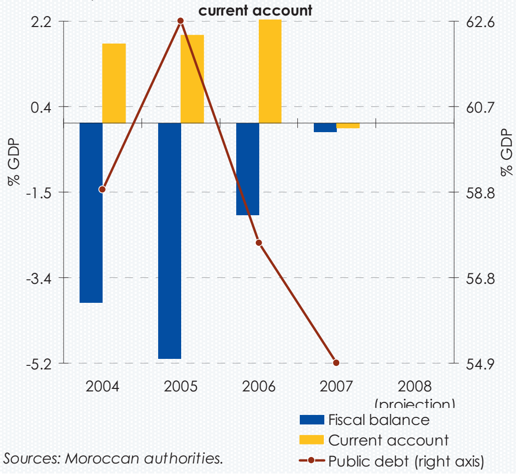
The labour market has also benefited from the good performance of non-agricultural sectors

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



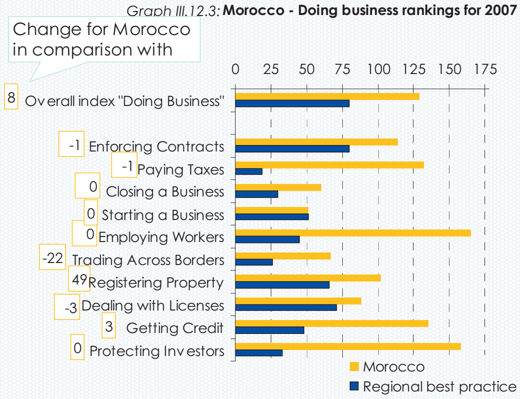
Sources: EIU and Moroccan authorities.

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



Sources: Moroccan authorities.

Graph III.12.3: **Morocco - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries (Algeria, Egypt, Jordan, Lebanon, Morocco, Occupied Palestinian Territory, Syria and Tunisia).

Source: World Bank, 2008.

mainly tourism, infrastructure and lodging) with services being responsible for 50% of employment generation. Unemployment is expected to remain under 10% at end-2007.

Domestic demand has driven GDP growth: private consumption has been fuelled by urban wage growth, rapid credit expansion and the positive evolution of the labour market, while public consumption has strongly accelerated following the a strong 8% increase in recurrent expenditures end-July 2007. Strong investment owes much too big infrastructure projects (mainly tourism and energy industry) and the expansion of the housing market.

The external environment remains shaped by a **substantial trade deficit** standing at 21.0% of GDP (2006: 17.0%), with imports growing by 22% and exports by just 7% in 2007. Morocco's disappointing trade performance is linked to scarce product and market diversification, a low productivity of the labour force, a loss of competitiveness in international markets, and the failure to enforce some trade agreements. Large increases in tourism revenues (+13.2%) and remittances (+15.1%) have been insufficient to offset the trade deficit resulting in a **slightly negative current account balance** standing at 0.1% of GDP in 2007 (2006: +2.6%). However, rising GDP is expected to consolidate the steady fall in the external debt-to-GDP ratio to 22% of GDP at the end of 2007. In addition, Morocco has been successful in attracting increasing volumes of foreign direct investment (+28% end-2007 amounting to 5.5% of GDP). The challenge for the government is to attract foreign capital to sectors other than the tourism and automobile industries.

The overall fiscal deficit is estimated to have significantly contracted in 2007 to 0.2% of GDP (excluding privatization receipts), which confirms the government's commitment to fiscal consolidation. Recent tax cuts and other tax-related policy measures aimed at enlarging the tax base have raised fiscal revenues,[53] which has helped to consolidate the upward trend in total revenues (+15.3% in 2007).[54] Additionally, the freeze on net hiring in the civil service, and the redeployment of civil servants to priority sectors has reduced the public wage bill by around 10% of GDP (2005: 11.88%). However, a substantial increase in food and petroleum subsidies (+32.7%) – owing to escalating global oil and food prices[55]— has highlighted the urgent need to rationalise the current subsidy scheme. The government has taken a step in the right direction by recently starting to reflect on how to increase the efficiency of subsidies with the goal of curbing their costs. One priority should be returning to a mechanism indexing retail domestic prices of petroleum products to international oil prices as well as improving the targeting mechanisms.

Subsidies have, however, helped keep inflationary pressures down, with average inflation of 2.0% end-2007. **Moderate price increases** also reflect the strength of the MDH which has had a moderating impact on imported inflation. Money market interest rates have been static owing to abundant liquidity in the economy and a strong growth of money supply. The current exchange rate regime which pegs the MDH to a euro-dominated basket of currencies has resulted in deteriorating terms of trade owing to the MDH appreciation in line with the EUR-USD exchange rate. Exporters' pressures for a more competitive exchange rate have so far been contained by Bank Al-Maghrib, which opposes devaluation mainly on grounds of raising debt costs. The authorities have decided to **gradually liberalise the external capital account**, which would mean abandoning the current peg, moving towards a more flexible exchange rate regime and inflation targeting. A more flexible exchange rate would help fight inflationary pressures, preserve a role for monetary policy under full convertibility, and avoid implicit exchange-rate guarantees.

53 The new government recently approved a corporate tax cut by 6 %-points, committed to eliminate the many VAT exonerations, extending VAT to all economic activities.

54 During 2007, fiscal revenues increased by 19%, notably corporate tax revenues (+25.8%), income revenues (+13.7%) and VAT (+27.4%) fuelled by the introduction of a simplified and more transparent tax system.

55 Food and petroleum subsidies almost doubled end-2007 in comparison with the amount budgeted (MDH 8.3 bn).

Business environment

Morocco was the best-performing country on reform in the MED region in 2006, but its performance slowed down in 2007, particularly when compared to that of other countries in the region. According to the WB's 2008 Doing Business report, Morocco stands in 129th position worldwide in terms of ease of doing business (Graph III.12.3); this slippage can be explained by its lack of progress regarding ease of employing workers, protecting investors and paying taxes. During 2007 progress was only visible in two of the ten areas analysed by the report: trading and the time needed to obtain new licences. At the regional level, Morocco ranks in 13th place in a list of 17 MENA countries; it comes last for the second year in a row for employing workers and scores poorly in protecting investors and paying taxes. It does best in ease of starting a business, closing a business, and dealing with licences.

Those findings reveal that Morocco needs to intensify its efforts to eliminate the remaining obstacles to investment if it wants to continue to attract foreign investment for which there is an increasing competition among neighbouring countries. Future reforms should focus on introducing flexibility in the labour market, improving investor protection and simplifying the fiscal system, even if they prove costly in the short term.

Trade liberalisation and economic opening

Morocco continues to make progress in the area of trade liberalisation. The gradual elimination of tariffs foreseen in the AA with the EU is proceeding satisfactorily, according to schedule and should be completed by 2012. However, the benefits deriving from the conclusion of free-trade agreements have not yet materialised: Morocco's product and market diversification remains weak and its export competitiveness does not seem to have improved as a result of market opening in spite of the signature of four regional and six bilateral agreements.[56] Redressing this situation requires a combined action on several fronts: eliminating the confusion created by overlapping preferential trade agreements and facilitating their effective application, strengthening the promotion of products abroad, and renewing the commitment to facilitate the development of new firms.

Public institutions and PFM

Morocco made some effort to improve governance during 2007. It ratified the UN Convention against corruption on 5 May 2007 and, also in 2007, approved a law on money laundering and a new decree on public procurement. This helped Morocco improve its ranking in an index measuring corruption perception published by Transparency International (2007: 72nd; 2006: 79th). However, corruption is still widespread in public services (health, police, justice, and government contracts) and has been identified by firms as the main obstacle to investment and economic development.

The modernisation of PFM is proceeding at a good pace. Fiscal discipline and the efficient allocation of resources have improved following the establishment of a tri-annual medium-term fiscal framework. Progress has been made towards the inclusion of the regional dimension in the General Budget although this is not yet a reality. In addition, control of public expenditures is being made possible by granting greater responsibility to authorising officers in line ministries: seven pilot ministries have been selected to implement this reform once their budget management and accounting capacity has been strengthened.

Social development and poverty

Social problems in Morocco are widespread. Poverty affects 4.3 mn people (that is, 14% of the population according to the 2004 census) and varies widely geographically.[57] Differences between rural and urban poverty remain significant (urban poverty: 6%; rural poverty: 23%). Morocco ranks 126th (out of 177 countries) in the UN 2007/08 HDI, between Namibia and Equatorial Guinea, and last among

56 Morocco's trade deficit greatly increased in the last six years. The trade deficit with the EU, e.g., reached MDH 27.7 bn at the end of 2006 (2000: MDH 12 bn).

57 A recent poverty rate estimates (government) is 11%.

Table III.12.1:
Morocco - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	5.2	2.4	8.0	2.2	6.1
Non-agriculture real GDP growth (% change)	4.6	4.8	5.2	5.0	5.2
GDP nominal, (EUR billion)	46	47	52	54	
GDP nominal, (USD billion)	56	59	65	73	80
GDP per capita (EUR)	1518	1572	1708	1735	
GDP per capita (USD)	1890	1956	2149	2368	2569
Inflation CPI (period average, % change)	1.5	1.0	3.3	2.0	3.6
Fiscal sector					
Unemployment rate (%)	11.1	11.3	9.6	9.8	
Total revenues, including grants (% GDP)	22.8	24.4	25.7	24.6	24.2
Grants (% GDP)	0.3	0.5	0.4	0.4	0.3
Total expenditures, incl. grants, excl.Fond Hassan II (% GDP)	27.0	29.9	27.6	26.9	26.5
Government balance including grants[1] (% GDP)	-3.9	-5.1	-2.0	-0.2	
Total government debt (% GDP)	58.8	62.6	57.6	54.9	
Monetary sector					
Credit to the private sector (% change)	7.2	13.1	17.0	12.8	
Base money (% change)	12.1	9.2	16.3	12.4	
Broad money (M3, masse monetaire, yoy, % change)	7.7	14.0	17.2	19.3	
Degree of monetisation (M3/GDP, % change)	83	91	96		
External sector					
Exports of goods (% GDP)	17.6	18.1	17.6	17.5	17.1
Imports of goods (% GDP)	29.1	31.8	32.8	32.0	31.6
Trade balance (% GDP)	-14.0	-16.3	-17.0	-21.0	
Current account balance, including official transfers (% GDP)	1.7	1.9	2.6	-0.1	
FDI flows (USD billion)	1.1	2.9	3.4	3.9	
FDI flows (% GDP)	1.5	2.6	4.5	5.5	
Gross reserves (USD billion)	16.3	16.1	20.0	23.6	26.1
Gross reserves (months of imports)	8.5	7.4	7.8	8.4	8.4
External vulnerability					
Total external debt (% GDP)	27.3	25.4	23.3	22.0	20.1
Debt service ratio[2] (%)	13.6	10.8	8.4	9.1	8.0
Gross reserves (exl. gold, USD billion)	16.3	16.1	20.0	23.6	26.1
Gross reserves (months of imports)	8.5	7.4	7.8	8.4	8.4
Financial sector					
Short-term interest rate (money market rate, average)	3.25	3.25	3.25	3.25	
Exchange rate (per EUR, average)	10.01	11.01	10.94	11.32	
Exchange rate (MAD/USD, average)	8.87	8.87	8.80	7.69	8.61
Real effective exchange rate (1992=100)	120	120	121	130	

[1] Excluding privatization revenues [2] Excluding Hassan II Fund, and including balance on special treasury accounts

Sources: Haut Commissariat au Plan, IMF, Ministry of Finance, EIU, EU staff calculations.

the ENP countries, which highlights its relative human underdevelopment compared to countries with similar income per capita. Although the government spends over a quarter of the budget on education and enrolment and literacy rates are rising (58% in 2004), adult illiteracy still affects almost 50% of the population aged 15 years or older. Life expectancy at birth rose to 70 years in 2004; however, after making steady progress for many years, health indicators have deteriorated: only half of the rural population have access to proper healthcare, fewer than 1/5th have access to sanitation and safe water. Morocco has one doctor per 1800 people (compared to one per 1200 in Tunisia and one per 450 in Jordan and Egypt). Government strategies to reduce rural poverty include raising agricultural productivity, improving access to finance, enhancing rural infrastructure, raising the minimum wage and boosting education provision.

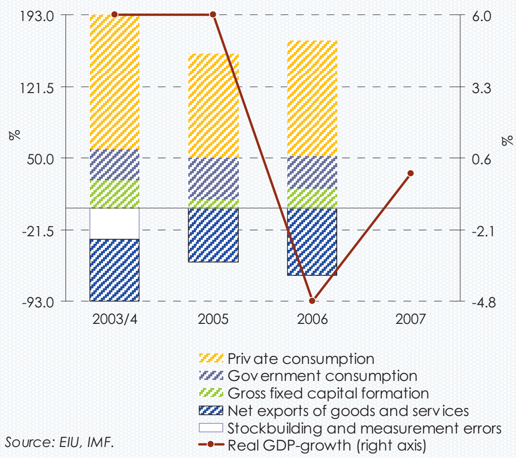
13. OCCUPIED PALESTINIAN TERRITORY

- ***Continued growth of settlements, closures and the cut-off by Israel of transfers of Palestinian tax revenues to the PA resulted in real GDP contracting by 4.8% in 2006. Growth estimates for the end of 2007 point to stagnation, a more favourable forecast than expected in early 2007 owing to economic recovery in the West Bank in the second half of 2007.***

- ***The liquidity crisis that followed the creation of a Hamas government in March 2006 continued during 2007, resulting in an estimated recurrent fiscal deficit projected at 26.7% of GDP by the end of 2007. The Palestinian Reform and Development Plan (PRDP) will focus on gradually reducing the recurrent expenditure and the budget deficit over the period 2008-10.***

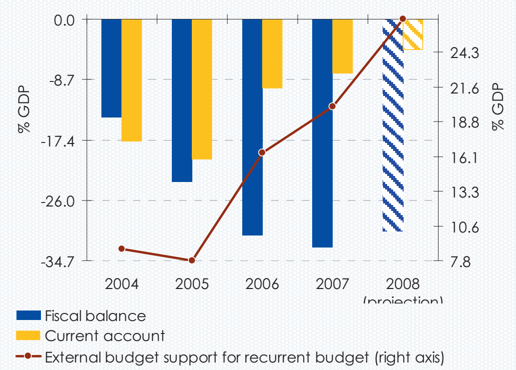
- ***Even if the PRDP's targets for external assistance are entirely financed and Palestinian commitments fulfilled, GDP will continue to contract over the coming years unless the Government of Israel removes movement and access restrictions hampering the movement of goods and people.***

Graph III.13.1: **OPT - Economic structure of GDP**



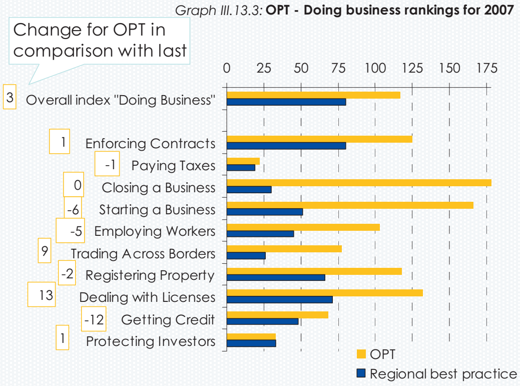
Source: EIU, IMF.

Graph III.13.2: **OPT - Fiscal balance, current account, budget support**



Sources: National authorities, IMF.

Graph III.13.3: **OPT - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries (Algeria, Egypt, Jordan, Lebanon, Morocco, Occupied Palestinian Territory, Syria and Tunisia).

Source: World Bank, 2008.

Macro-economic developments

Economic growth in the occupied Palestinian territory (oPt) was reversed following the international response to the victory of Hamas in Parliamentary elections in early 2006. Continued growth of settlements, closures and the suspension by Israel of the transfer of Palestinian tax revenues to the PA resulted in real GDP contracting by 4.8% in 2006. Recent forecasts point to stagnation (zero growth) end-2007 owing to further deterioration in Gaza and some economic recovery in the West Bank in the second half of 2007. Rapid population growth in a context marked by private sector contraction is expected to bring the **official unemployment rate** to over 21% (end-2007). [58]

[58] Official unemployment data excludes workers who have turned to unpaid family labour or seasonal agriculture to make up for lost jobs, and disheartened workers who have left the labour market. With the inclusion of both categories, unemployment figures for the end of September 2007 might be as high as 29.1% (2006: 39% in Gaza and 28% in the West Bank).

During the last few years, **the composition of the Palestinian economy** has changed. GDP has been increasingly driven by government and private consumption (supported by remittances and foreign aid) while public investment has nearly ceased, government funds having been used to pay salaries and recurrent costs. Private investment is estimated to have shrunk by 15% between 2005 and 2006 and there is no evidence of recovery in 2007.

The fiscal situation of the PA in 2007 remains dramatic. The overall public deficit approaches 33% of GDP end-2007, fuelled by a large wage bill standing at 25% of GDP. A battery of fiscal measures introduced by the PA in mid-2007 is helping to rein in expenditure and improve fiscal transparency. Measures include a wage bill containment plan, based on a moratorium on public salary increases over the next three years and a net freeze on civil servants recruitment; a plan to reduce net lending,[59] currently standing at over 10.6% of GDP; and a tax administration reform aimed at improving the collection of tax and customs revenues. Furthermore, the economic development agenda proposed by the PA in its 2008-10 “Palestinian Reform and Development Plan” (PRDP) includes bold plans for fiscal reform that should help reduce the recurrent fiscal deficit from 24.4% to 18% of GDP over the period 2008-2010, and the overall fiscal deficit to 29% of GDP in 2010.

The price of all basic commodities increased in the oPt during 2007. Estimations of the overall CPI inflation rate by the Palestinian Central Bureau of Statistics (PCBS) point to an increase of 2.7% end-2007. **Palestinian trade volumes** remain small.[60] Costly and unpredictable border crossings, undiversified markets and products, security concerns and a trade-hostile political situation have all hampered Palestinian trade flows. In June 2007, trade was further hampered by the *de facto* split of the oPt into two politically divided entities. In 2006 (latest available figures), declared Palestinian exports to the EU amounted to €13 million and total trade with the EU stood at €52 million. Agricultural products (e.g. cut flowers, grapes, strawberries) accounted for over 50% of EU imports from the oPt followed by imports of textiles and clothing (23%). Total trade flow estimates for 2007 show decreasing exports (11.6% of GDP in 2007 down from 12.1% in 2006) and increasing imports (79.7% of GDP in 2007 up from 79.1% in 2006), resulting in a trade deficit of over 50% of GDP. The estimated **current account deficit** (excluding official transfers) is expected to worsen to 33.8% of GDP end-2007 (2006: 32.5%).

Business environment

Persistent labour and goods movement restrictions imposed by Israel and the increasing separation, both physical and political, between the West Bank and Gaza have resulted in a deterioration of the business environment for the private sector in 2007. The almost complete isolation of Gaza, and in particular the Israeli decision to prevent the import of almost all raw materials, has paralysed most industrial activities in the Strip due to the risks and uncertainties linked to the closing of crossings and the multiplication of transaction costs.

The oPt ranks 117th out of 178 countries for ease of doing business in the World Bank’s 2008 Doing Business index, which highlights the persistence of many barriers to conducting business. Mounting difficulties in dealing with licences and trading across borders have contributed to a slight lowering of the oPt’s ranking compared to last year (2007: 112th position). Currently, the oPt ranks worst in terms of closing a business (178th position) and is one of the most difficult places in which to start a business (166th position). In contrast, at the regional level, the oPt has improved its ranking to 10th position out of 17 MENA countries for ease of doing business (2007: 13th position); it ranks 3rd in protecting investors (33rd position

[59] Net lending refers to the PA's financial support to municipalities and other public entities, chiefly to cover utility expenses. These outlays are recorded as "net lending" because they are notionally eventually payable by these entities and therefore accumulate as assets on the PA's balance sheet.

[60] Reported trade figures for the OPT are just rough estimates. Palestinian traders often use Israeli channels to export their products; these products, although of Palestinian origin, leave with an Israeli certificate of origin. In addition, Palestinian inputs used by Israeli firms, notably in the textile sector, go unreported since the final product will be exported under an Israeli certificate of origin.

worldwide) behind only Israel and Kuwait, 4th in getting credit and 6th in paying taxes.[61]

The Palestinian banking system is small and relatively underdeveloped. Ongoing reforms in the banking sector include the completion of a credit registry which will be accessible to banks and credit institutions; and a new electronic network that will soon link all banks operating in Palestine with the Palestine Monetary Authority (PMA), thus enhancing the security, timeliness and accuracy of reports and data exchange. These reforms have boosted confidence in the banking system despite the difficult political and economic environment.

The PMA monitors banking operations and conformity to prudential practices. The Banking Law provides guidelines for both internal and external auditing of banks, as well as bank's data obligations to the PMA, and sets out the guidelines for on- and off-site inspections, as well as penalties, liquidations and mergers. The PMA has introduced a new organisational structure and is implementing its Strategic Transformation Plan. These reforms cover the areas of legislation (including money laundering), bank regulation, management information systems and training. Most elements of the Strategic Transformation Plan have been implemented and the PMA continues to reform and to build its internal capacity with a view to becoming the central bank in a future Palestinian state.

Trade liberalisation and economic opening

During 2007, there has been no relaxation of the policy of closure imposed by the Government of Israel (GoI) for security reasons, and restrictions on the Gaza Strip have been greatly increased. Comprehensive restrictions on the movement of people and goods within the West Bank, highly constricted movement of goods across the border with Israel, and a near total separation of economic and social interaction between the territories of Gaza and the West Bank have resulted in increased costs, unpredictable domestic and international trade flows and shrinking available markets.[62] The commitments included in the 2005 Agreement on Movement and Access (AMA) have not been implemented. Palestinian economic recovery will not take place unless the efficient movement of goods and people is effectively implemented.

The Paris Protocol, annexed to the Oslo Accords and the main instrument guiding commercial relations between the GoI and the oPt, establishes that goods should circulate freely among them. However, both parties are contemplating alternative instruments, whereby Palestinians would be able to secure access to markets and to establish efficient trade borders. The PA has so far concluded Free Trade Agreements (FTA) with the EU, the EFTA countries, Canada, the US, and Turkey. Israel contests some of these agreements, although they seem to be in line with the provisions of the Paris Protocol. It also contests the EC-PLO Interim Association Agreement (IAA) governing political and economic relations between the EU and the oPt, which is also problematic for Palestinian trade.[63]

Public institutions and public finance management

Palestinian public institutions have suffered greatly from the political disarray prevailing in 2007. Public sector strikes seriously hampered the work of ministries. The implementation of civil service and public administration reform stalled under Hamas rule and the National Unity Government, and the substantial progress made

61 In 2007, the oPt reduced the VAT rate from 16% to 14.5% and the corporate income tax rate from 16% to 15%, causing the total tax rate to decrease by 1.4%.

62 West Bank and Gaza Investment climate assessment: Unlocking the Potential of the Private Sector. World Bank. Report no. 39109 published on 29 March, 2007.

63 Indeed, products that are destined for the Palestinian Territories and that carry a certificate of origin seeking preferential treatment under the EC-PLO IAA are customarily rejected by Israeli customs. This results in the exporter refraining from preferential treatment and paying Most Favoured Nation duties changing the paperwork so as to reflect the EC-Israel FTA. As customs and fiscal revenues are allocated on the principle of final destination, the PA will lose out on their customs or VAT revenue.

in fiscal reforms to some extent reversed, greatly affecting the integrity of the Treasury system.[64]

The creation of a new government on 14 June ensured a return to the *status quo ex ante*. PA ministries are functioning again, with monthly salaries paid in full every month. The PA has also managed to partly redress the public finance management (PFM) system, including rebuilding the Single Treasury Account (STA) and reversing 20,000 staff additions, bringing about an immediate reduction of about 8% of the wage bill. The West Bank-Gaza split presented additional challenges as a number of PFM functions, such as budget preparation and audit mechanisms, had been largely undertaken by Ministry of Finance staff in Gaza. The PA has, however, addressed this through the development of an alternative system for government accounting and the establishment of a budget department presence in the West Bank. The recently adopted Palestinian Reform and Development Plan will further contribute to improving the PA's accounting system and to better matching of planning and budgeting activities.

Social development and poverty

Human development in the oPt continued to be negatively affected in 2007 by a highly unstable political situation and the socio-economic crisis associated with it. The poverty rate has dramatically increased during the last two years. In Gaza, the poverty rate based on actual consumption reached 51% and deep poverty[65] increased to nearly 35% in 2006, despite large inflows of aid. Expected stagnation end-2007 combined with the current strict closure policy in Gaza would result in a substantial increase in the poverty rate. The poverty rate in the West Bank stood at 24% in 2006.

Income-based estimates show that poverty is unevenly distributed in the oPt: 69% of households are below the poverty line in Gaza, compared with 48% in the West Bank (November 2007).[66] Differences between rural and urban poverty remain negligible. However, from March 2006 to May 2007 poverty and deep poverty both progressed much faster in urban areas (from 44% to 60% and from 17% to 27% respectively), linked to an unstable domestic political context. Indeed, many public employees only returned to work after the national unity government was formed. Further increases in urban poverty rates might occur in 2008, resulting from the proposed wage bill containment policy and associated lay-offs in the public sector, unless the movement and access restrictions imposed by Israel are reduced with a view to creating conditions conducive to private sector growth.

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64 *Two Years After London: Restarting Palestinian Economic Recovery*. Economic Monitoring Report to the Ad Hoc Liaison Committee. The World Bank, 24 September 2007.

65 The Palestinian Central Bureau of Statistics (PCBS) defines a deep poverty line that reflects a budget for food, clothing and housing. For a six-member household the deep poverty line in 2006 was NIS 1,837.

66 Poverty estimates based on income need to be carefully considered because they are generally less accurate than poverty measures based on household expenditures and consumption. Stated poverty figures are constructed according to the household income. A household is below the poverty line when income is under NIS 2,000 per month. *Palestinian Poverty Monitor*. http://www.neareastconsulting.com/surveys/poverty/p211/out_ct_region_poverty.php

Table III.13.1:

OPT - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	6.0	6.0	-4.8	0.0	3.0
Real GDP (USD billion)	4.7	4.9	4.5	5.1	6.1
Nominal GDP (EUR, billion)	3.5				
Nominal GDP (USD billion)	4.1	4.5	4.5	5.1	6.1
Nominal GDP per capita (EUR)	1024				
Nominal GDP per capita (USD)	1372	1190	1166	1258	1467
Inflation CPI (% average)	3.0	3.6	3.8	2.7	8.8
Social indicators					
Unemployment rate (ILO definition)	26.8	23.5	23.6	21.5	22.0
Poverty (%)		44	58		
HDI Rank (n=177)		106			
HDI index (2005) [1] most recent		0.731			
Population (millions)				3.7	
Fiscal sector (in % of GDP)2					
Revenue	23.4	27.5	25.4	23.6	24.4
Total expenditure	37.5	44.5	50.2	50.3	46.8
Public sector wage bill	21.3	22.4	26.3	25.4	24.4
Non-wage expenditure	n.a.	14.5	16.5	14.4	15.9
Net lending	n.a.	7.7	7.4	10.6	6.6
Recurrent balance- before external support	n.a.	-17.0	-24.9	-26.7	-22.4
Donor financed development expenditure	n.a.	6.0	6.2	6.1	8.1
Overall fiscal balance- before external support	-14.1	-23.4	-31.1	-32.8	-30.4
External budget support (for recurrent budget)	8.7	7.8	16.3	20.0	26.9
External budget support (USD million)	353	349	741	1012	1635.0
External sector[3 B55](% GDP)					
Exports of goods and nonfactor services	n.a.	13.1	11.8	13.2	13.5
Imports of goods and nonfactor services	n.a.	80.3	78.5	79.4	81.0
Net factor income	n.a.	11.8	11.4	9.8	9.0
Net transfers	n.a.	n.a.	45.0	47.1	53.4
Official transfers	n.a.	14.2	22.5	26.2	35.0
Current account balance (% of GDP) including official transfers	-17.5	-20.1	-9.9	-7.7	-4.4
Current account balance (% of GDP) excluding official transfers		-34.3	-32.5	-33.8	-39.4
Financial sector					
Israeli Shekel (per EUR, eop)	5.34	5.72	5.59	n.a	n.a
Israeli Shekel (per USD, eop)	4.3	4.6	4.5	4.1	n.a.
Jordanian Dinar (per EUR, eop)	0.88	0.88	0.89	n.a	n.a
Jordanian Dinar (per USD, eop)	0.71	0.71	0.71	n.a	n.a

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

2 On a commitment basis

3 Trade data needs to be treated with caution and has been taken from several sources.

Sources: IMF

14. RUSSIA

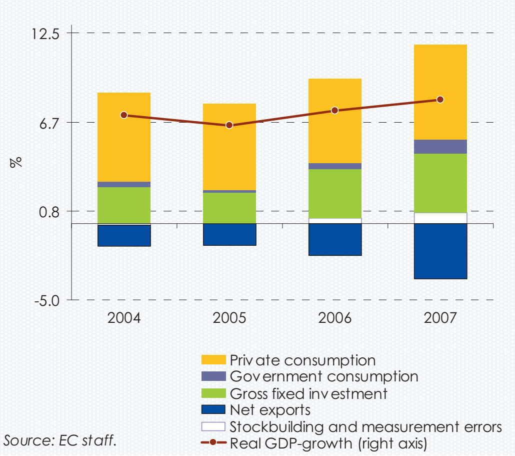
- ***Economic growth in Russia remains very strong: the Russian State Statistical Committee (Goskomstat) estimate for growth in 2007 is 8.1%, while the 2006 figure was raised to 7.4%, from 6.7%. This would put Russia's GDP in 2007 at over EUR 900 billion.***

- ***2007 was the ninth successive year of strong growth: the average rate over the period 1999-2007 is a robust 7%.***

- ***The current account surplus has fallen, but this has been more than counter-balanced by a financial account surplus.***

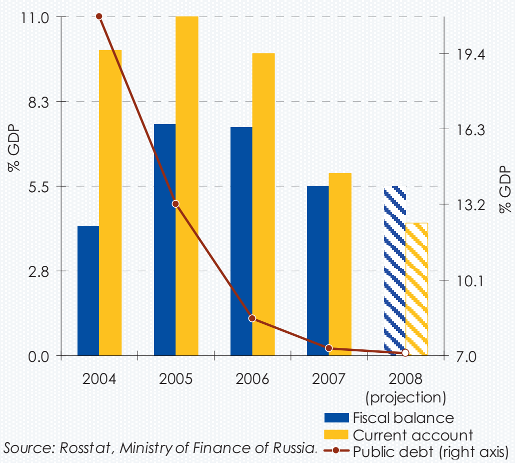
- ***Inflation has returned to low double digits, on the back of worldwide food price increases, growing fiscal expenditure, monetary expansion fuelled by capital inflows and faster GDP growth.***

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



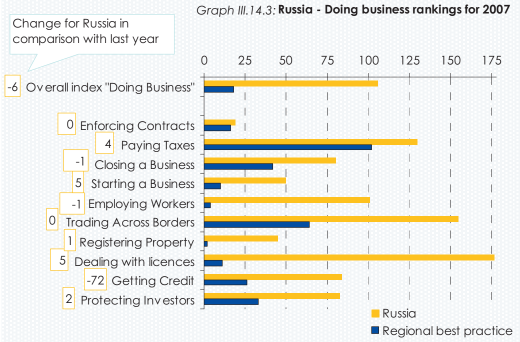
Source: EC staff.

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



Source: Rosstat, Ministry of Finance of Russia.

Graph III.14.3: **Russia - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking CIS country among the EU Eastern ENP countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russia and Ukraine).

Source: World Bank, 2008.

Macroeconomic developments

2007 was the ninth successive year of strong growth for Russia. After a growth rate of 7.4% in 2006 (revised upwards from 6.7%,[67] and itself an increase over the 6.4% recorded in 2005), GDP growth rose to 8.1% in 2007. That means that the average growth over the period 1999-2007 was 7% per year, the rate necessary to double GDP in ten years, as promised by outgoing President Vladimir Putin.

The key factors behind this **higher-than-expected growth** (almost half a percentage point above DG ECFIN's autumn forecast) are a continued acceleration of investment spending (which grew by almost 21% in 2007), supported by the very significant increase in net capital inflows observed since full capital account liberalisation in mid-2006 and by a rebound in oil prices, after the softening observed in late 2006/early 2007. An additional factor is the increase in fiscal spending, linked to the electoral cycle.

[67] The main driver of this upward revision was investment, which is now estimated to have grown by almost 18% in 2006, up from 13% previously.

Compounding the increasing importance of domestic demand in determining growth dynamics in Russia, household consumption expanded by 13.1% in 2007 (up from 11.3% in 2006).

Industrial production grew by 6.3% in 2007, the same figure as 2006.[68] *Manufacturing* growth stood at 9.5% in 2007, above the revised strong 2006 growth rate of 8.3%. Mining and quarrying (still the most important sector in the Russian economy, as it includes oil and gas), on the other hand, decelerated further, to 1.9% (from 2.5% in 2006). The highest growth rates in 2007 were in construction (16.4%), which reflects the very significant and largely State-supported investment in infrastructure, wholesale and retail trade (12%) and financial intermediation (11.4%). Year-on-year growth in industrial production stood at 9.2% in April 2008 -mining remained stagnant, and investment growth reached 20.8%. GDP growth was estimated at 8.3% year on year at April 2008.

The Central Bank of Russia's (CBR) estimate of *net* **capital inflows** for 2007 is close to EUR 59 billion, far above the figure for 2006. This was largely fuelled by borrowing by Russian companies, especially banks, to finance their participation in large initial public offers (IPOs) held during the first half of 2007 (notably for the two largest State-owned banks, Sberbank and VTB) and also to finance acquisition of the remaining assets of Yukos, sold in auctions to settle alleged tax claims. The strength of the inflows was forecast to abate during the second half of 2007, even before the market turbulence of August 2007. Nevertheless, this increase was one of the factors behind the strong expansion in domestic investment mentioned above. Beyond the direct State investment in infrastructure, the investment activities of State-controlled companies (Gazprom, Rosneft and RAO-UES) seem to be another significant driver of this development. FDI into Russia also increased between 2006 and 2007, from almost EUR 23 billion to EUR 32 billion, with net FDI estimated to have totalled EUR 4.6 billion in 2007. On the other hand, estimates for the first quarter of 2008 seem to point to a significant capital outflow during that period, of almost EUR 14.5 billion, driven by repayments of foreign loans taken out by the non-financial sector (nevertheless, 2008 estimates up to May seem to show a net inflow of around EUR 13 billion).

In order to contain the **financial instability** triggered by the collapse of the sub-prime mortgage market in the USA, the CBR took various measures in August 2007. Mirroring the action by other central banks worldwide, it provided very significant injections of liquidity in the form of repo operations. The CBR also sold around EUR 3.7 billion on the domestic markets to deal with a lack of liquidity in foreign currency. Those resources were taken from its huge hard currency reserves (the third largest on the planet, at over EUR 335 billion at the end of April 2008), as investors repatriated an estimated EUR 5.2 billion in short-term capital from Russia during August. This outflow had already been reversed by October 2007.

The **price of the Urals blend** (the benchmark for the heavy sulphur oil sold by Russia) fell to USD 50 in January 2007, but by mid May 2008 it was close to USD 120. The effects of this brief softening of export value were therefore limited to the early part of 2007. At the end of 2007, the CBR estimated that total exports had grown by almost 18% (in nominal USD terms) compared with 2006.

2007-2008 witnessed a long **electoral cycle** for Russia, as elections to the Duma (the elected lower house of the Russian Parliament) were held in December 2007, followed by presidential elections in early March 2008. The Duma elections resulted in the governing party, "United Russia", winning almost 70% of the seats, which would enable it to approve changes to the Russian Constitution (although any such changes would also have to be endorsed by the upper house, the Federation Council, and by the numerous regional assemblies). The presidential elections were also won by the "United Russia" candidate, Dmytri Medvedev, with slightly more than 70% of the votes. Medvedev appointed former President Putin as his Prime Minister.

68 After the revision of GDP growth figures for 2006 issued by Rosstat in early 2008, Rosstat also published in April 2008 significantly revised figures for industrial and manufacturing growth for the years 2005-2007. They show a significant increase in manufacturing growth, largely driven by the capital goods industry.

Reflecting this political cycle, **fiscal expenditure** in the 2007 Federal Budget increased by around 2% of GDP compared with 2006. As a consequence, the budget surplus fell from 7.4% to an estimated 5.5% of GDP (Russia has had budget surpluses since 2000).

Russian CPI **inflation** finally fell below two digits in 2006, to 9.7% (this was also the first year in which the CBR met its own inflation target). In 2007 inflation increased again to above the 10% mark, climbing to 11.9% (end-of-year figures) on the back of worldwide food price increases (estimated to have added over 2% to Russian CPI in 2007), growing fiscal expenditure, continued monetary expansion fuelled by capital inflows, policy measures to offset potential liquidity shortages and faster GDP growth. The May 2008 CPI was even higher, at 15.1% yoy.

In response to these developments, the CBR increased its refinancing rate by 0.25% (to 10.25%) in early February 2008, while overnight repo rates and rates for several other operations were also raised by 0.25% (it did the same again in late April, by the same amount). The CBR also increased its obligatory reserve requirements three times between January and May. This is a sign that the CBR wishes to use monetary means to counteract inflationary pressures, instead of relying on the traditional exchange rate channel.

After Russia secured a **current account surplus** of almost 10% of GDP and a goods trade balance of over 14% of GDP in 2006, the CBR estimates that both fell in 2007, largely due to an increase in imports: the current account surplus fell to around 6% of GDP and the trade surplus to around 10%. On the other hand, the fall in the current account surplus was more than counter-balanced by developments in the financial account, where the surplus is estimated at almost 7% in 2007. In addition, during the first quarter of 2008 the rise in oil prices generated a record trade surplus of almost EUR 29 billion, which compensated for the net capital outflow described above.

Business environment

Taking the World Bank survey of business regulations and their enforcement, entitled *"Doing Business 2008"* (which is based on 2007 data), as a benchmark, Russia ranked 106th out of 178 countries (this is a relative deterioration compared with its 2006 ranking of 96th out of 175 countries, although the changes in the index methodology and in the sample of countries make inter-year comparisons difficult). Russia is close to the average ranking of the CIS countries (this average is significantly influenced by one country, Georgia, which is now classified as one of the 20 easiest places in the world to do business) and above countries like Ukraine. The areas in which Russia performs worst compared with the CIS average are "dealing with licences", "employing workers" (where it stands at roughly the EU average) and "trading across borders" (export and import costs are comparatively high in Russia, which is partly related to the sheer size of the country). On the other hand, it ranks *above* the EU on items like "enforcing contracts" (19th), "registering property" (45th) and "starting a business" (50th).

The World Economic Forum's *"Global Competitiveness Report 2007"*, a similar global benchmarking index, ranks Russia 58th out of 131 countries – the highest rank of all CIS countries covered and ahead of three EU Member States. Russia's main weaknesses here are in "institutions" (it comes close to the bottom in the "usual suspect" categories like protection of minority shareholders and property rights) and in "goods market efficiency" (where it ranks much lower on some items relating to FDI).

Trade liberalisation and economic opening

Russia has still not achieved its goal of WTO membership – a process initiated in 1993 – as bilateral issues still remain with Georgia, Saudi Arabia and the United Arab Emirates. In addition, Ukraine's entry into the WTO in June 2008 may add further hurdles to this process.

Upon Russia's accession to the WTO, the EU is expected to launch talks on a deep Free Trade Area between the EU and Russia. 2008 is also expected to see the start of EU-Russia talks concerning the successor to the Partnership and Cooperation Agreement, the legal cornerstone of EU-Russia relations. In addition, in May 2007 Russia was accepted to initiate talks with a view to eventual OECD membership.

In a governmental reorganisation after the inauguration of the new Russian Government in May 2008 that mostly stressed continuity, the responsibility for foreign trade policy was removed from the Ministry of Economic Development and Trade (MEDT, now MED) and given to the Ministry of Industry (MoI, now MoIT).

Public institutions and public finance management

2007 witnessed many changes in the Russian fiscal framework. In February 2008, the Oil Stabilisation Fund (StabFund), arguably the cornerstone of Russia's macro-stabilisation, was divided into a fiscal stabilisation and an investment component. The new StabFund will perform the same functions as the old StabFund (i.e. shelter fiscal policy from swings in oil prices) and will be *set* at 10% of GDP (currently worth EUR 82 billion), while the investment component (or "Welfare Fund", currently worth around EUR 20 billion) is *expected* to have some functions akin to a sovereign wealth fund. The revenue formula for the StabFund (previously based on a "strike price" of USD 27 per barrel of crude oil) was eliminated and its revenue sources were expanded to include natural gas taxes.

A medium-term expenditure framework was also formally introduced by the same April 2007 reforms. This rolling three-year budgetary framework includes separate oil and non-oil budgetary systems (to be phased in up to 2011). Transfers from the oil to the non-oil budget will be capped (eventually at 3.7% of GDP by 2011), while a binding limit will be introduced for the non-oil budget deficit (set at 4.7% of GDP by 2011), which leaves a maximum margin for an overall total deficit of 1% of GDP.

Social development and poverty

Unemployment has continued to fall in Russia, from 6.9% at the end of 2006 (ILO method) to 6.1% by the end of 2007. Big metropolitan areas (Moscow and St Petersburg) are actually suffering from labour shortages in some sectors. Correspondingly, real disposable income grew by 10.4% in 2007.

Also, following the CIS-wide trend of strong reductions in poverty and in income inequality, the poverty rate in Russia fell from 36% in the aftermath of the 1998 financial crisis to 17% in 2004, with almost 20 million Russians being lifted out of poverty in the space of a few years. The share of households whose income was less than USD 2 a day (a World Bank benchmark) had fallen to around 4% in 2004. There has been a small reduction in inequality, with the Gini index falling from its post-1998 high of 0.37 to 0.34 in 2002, although it is not clear if this downward trend has continued since then. A retrenchment in social expenditure is also being reversed. This is being done partly in the form of the National Priority Projects for health, education, housing and agriculture, which added almost 1% of GDP to expenditure in those areas during 2007.

On the other hand, Russia's *official* population continues to age and shrink,[69] although life expectancy seems to have started to increase again, reaching 65.3 years in 2005 (up by one year from 1995, but still below the 67 years of 1992), as has fertility. Mortality rates are still very high in Russia, particularly among working-age men. The rate of population increase in Russia is the world's second lowest: -0.6%, just above Ukraine's -0.8%. The UN forecasts a population decline in Russia during the period 2004–50 of 22% (from 144 million to 112 million).

In order to compensate for this decline in full, an annual inflow of around 1 million working-age migrants would be necessary. As there is no visa system between the CIS countries, immigration flows have indeed been quite substantial, especially in the last few years. More specifically, some estimates calculate that there may be up to *14 million – legal and illegal – foreign workers* in the country (or around 10% of the entire Russian population). According to census data, up until 2002 most of the decline in the Russian population (5%) was offset by a net migration of 3.8%. Given the very large volume of unregistered migrants, migration may even have fully compensated for the fall in population.

[69] Russia's official resident population fell to 142.2 million in 2007, from 147 million in 1989.

Table III.14.1:
Russia - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	7.1	6.4	7.4	8.1	7.7
GDP nominal (EUR, billion)	476	614	788	942	n.a.
GDP nominal (USD, billion)	592	764	979	1300	1665
GDP per-capita (EUR)	3301	4282	5521	6628	
GDP per-capita (USD)	4116	5322	6856	9142	11725
GNI per-capita (PPP, current prices, USD)	9680	10640	11630	n.a.	n.a.
Inflation CPI (average, %)	10.9	12.7	9.7	9.1	11.0
Social indicators					
Unemployment (%)	7.6	7.7	6.9	6.1	4.0
Life expectancy (years)	65.3	65.3			
Under 5 mortality rate (per 1000)	21	18			
Literacy (total, %)	99				
Population (million)	144.2	143.5	142.8	142.2	
Fiscal sector					
Total revenue (% GDP)	20.6	23.7	23.2	24.3	26.5
Total expenditure (% GDP)	15.7	16.2	15.8	18.7	21.0
Central government balance (% GDP)	4.2	7.5	7.4	5.5	5.5
Gross public debt (% GDP)	21	13	9	7	7
General govt non-oil balance (% GDP)	-4.3	-5.9	-6.9		
Monetary sector					
Private sector credit (% change)	48.2	35.2	48.3	50.9	
Private sector credit (% total credit)	94.6	124.6	144.0	151.5	
Broad money (% M2)	35.8	38.5	48.8	39.8	
Degree of monetisation (M2/GDP, %)	31	33	38	44	
External sector					
Current account balance (% GDP)	9.9	11.0	9.8	5.9	4.3
Trade balance (% GDP)	14.5	15.4	14.3	9.9	7.9
FDI (% GDP)	2.5	2.0	3.2	3.6	
Import cover (months)	16	18	17	20	
External vulnerability					
External public debt (% GDP)	16.4	9.3	4.6	3.4	
Debt service/exports (%)	10.0	7.4	7.9		
Gross reserves (excl. gold, USD, billion)	125	182	296	466	
Reserves/M2 (%)	2	2	1	1	
Financial sector					
Short-term interest rate (average, %)	3.3	2.7	3.4	6.3	
Exchange rate (rouble per EUR, end of period)	37.8	33.9	34.7	35.8	
Exchange rate (rouble per USD, end of period)	27.7	28.8	26.3	24.6	
Real effective exchange rate (2000=100)	137	149	166	174	

Sources: Rosstat, Ministry of Finance of Russia, MEDT, CBR, WDI, IMF, Renaissance Capital, Bank of Moscow, Troika Dialog, DB Research and EC staff calculations.

15. SYRIA

- ***Real GDP increased by 6.0% in 2007 despite the adverse weather conditions which affected corps. Domestic consumption, non-oil exports, higher private investment and tourist inflows drove growth offsetting the decline in oil production.***

- ***The authorities took a significant step to the gradual elimination of subsidies by almost tripling the price of oil in May 2008. However, this will be partially be offset by the 25% increase in government salaries and pensions.***

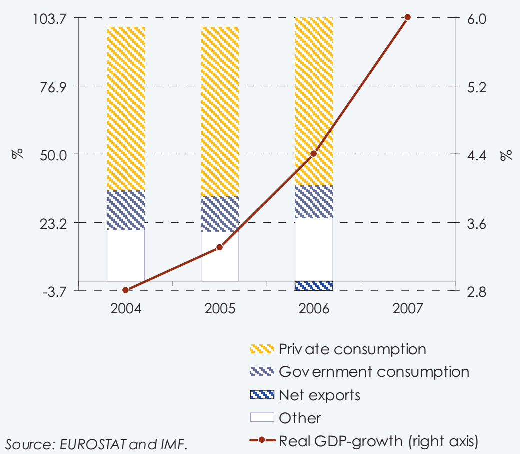
- ***Tax reforms, trade and financial liberalisation contributed to the improvement of the investment climate. However, state's participation in the economic activity is still high and the business environment remains largely constrained.***

Macroeconomic developments

Despite the drought and the continuous decline in oil production, the Syrian economy proved resilient in 2007 growing by 6.0%. The main factors underpinning growth were strong aggregate demand from Iraqi's refugees, construction and housing projects, good export performance, private investments and an increase in the inflow of tourists. The economic impact from the instability in the region and the US sanctions was not significant although it is a deterrent for investors particularly outside Golf countries and Turkey. The falling oil output, the reduced agricultural production and the large increase in energy and food prices are expected to slow growth to 4.5% in 2008. However, these negative trends will be partially offset by the expansion in the services sector and the continuous efforts of Syria to diversify the economy and gain better access to regional markets.

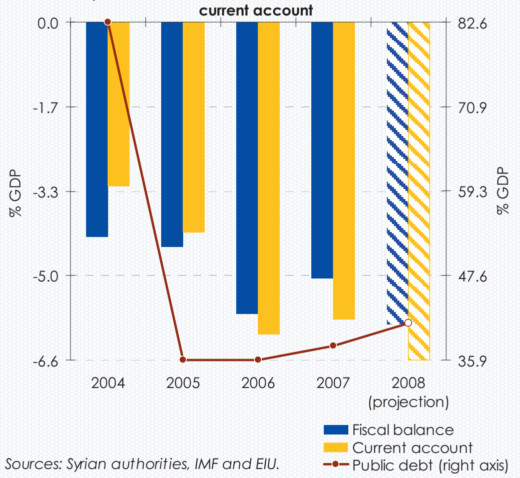
The official unemployment rate was around 9% in 2007 although unofficially the rate is estimated to be around 15%. Unemployment is particularly high among young people. According to estimates about 60% of Syrians are aged under 25 and some 61% of them are unemployed.

Graph III.15.1: **Syria - Economic structure of GDP**



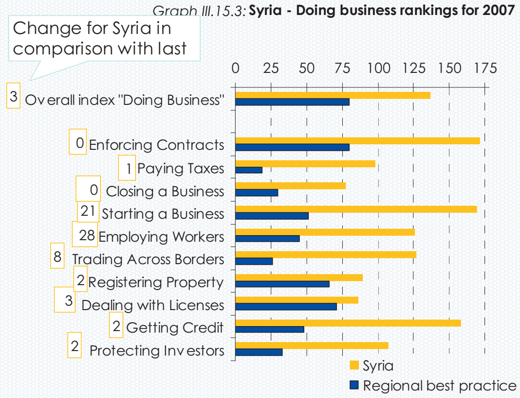
Source: EUROSTAT and IMF.

Graph III.15.2: **Syria - Fiscal balance, public debt and current account**



Sources: Syrian authorities, IMF and EIU.

Graph III.15.3: **Syria - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries (Algeria, Egypt, Jordan, Lebanon, Morocco, Occupied Palestinian Territory, Syria and Tunisia).

Source: World Bank, 2008.

Although official full-year figures report the inflation rate to 5.5%, an annual average of 12.2% is closer to the real price increase based on unofficial estimates. The bulk of the annual price growth seemed to have occurred in the last quarter owing to the surge in global food and oil prices. Average inflation for 2008, is estimated to reach 16.8% due to significant reductions in fuel subsidies and to an increase by 25% in government salaries and pensions that have been decided in May 2008.

Since June 2007, Syria has abandoned the dollar peg in favour of the SDR. In the three months leading up to the formal announcement of the new peg, the local currency appreciated by about 3% against the dollar and depreciated about 1.5% against the euro. Even though some laws concerning foreign currency transactions were relaxed, the currency will not be allowed to float freely, with the government to prioritise stability.

In 2007 the overall budget deficit is estimated to have reduced to 5% of GDP from 5.7% in 2006, notwithstanding an expected further decline in oil revenues of about 0.7% of GDP. This reflects improvements in tax administration, further rationalization of capital spending and an increase in the price of benzene by 20% in September 2007 (followed by another one in January 2008).

In May 2008, the authorities took a significant step to eliminate the fuel subsidies by increasing the oil price to USD 0.54 per litre (from USD 0.15) and the price of petrol to USD 0.87 per litre. Although, the savings in the budget are estimated to reach USD 4.4 billion, they will be partially offset by the increase by 25% in the salaries of public sector employees and pensioners which will cost around USD 1.2 billion. Also, the government's decision to increase the subsidies paid to the farmers is expected to make the fiscal situation more expansive. The introduction of VAT that was postponed for 2009, and the further rationalization of subsidies will be vital for the sustainability of the fiscal situation in Syria.

Free-trade agreements, such as the Greater Arab Free Trade Area (GAFTA), and an agreement signed with Turkey slashed tariffs increasing regional trade and helping exports to offset the decline in the value of oil exports. Economic sanctions on Iraq and the subsequent war that decimated Iraqi industry have opened up this market as an important destination for Syrian products, mainly food products. However, poor harvests in the last two years exposed the unreliability of agriculture and demonstrated the need to increase export diversification. This can result in more resilient growth, in more experienced labour market, in higher purchasing power, and even in stronger currency (following its de-pegging from the USD) and in a lower inflation rate.

The banking system is showing signs of progress towards financial liberalisation. Regulation has been passed covering conventional banking, Islamic banking, insurance and micro-credit institutions. Restrictions have also been eased on the interest rates banks can offer. In 2007, the banking system consisted of seven conventional private banks, two Islamic banks and six state-owned banks. Private sector banks developed rapidly in terms of deposits, which are increasing by USD 1.5 billion per year on average despite the low geographical expansion (one branch of a private bank for every 500,000 people). Nevertheless, state owned banks still dominate the banking sector, holding about 86% of lending and 75% of deposits. Preparations for the opening of stock-exchange market in Damascus have advanced and are expected to have a vitalising impact to the economy.

Business Environment

Reforms in the tax and regulatory framework, trade and financial liberalisation and flexibility in the exchange rate system facilitated the flow of foreign direct investments which amounted to USD 787 million or about 2.1% of GDP in 2007. A new investment law was passed in 2007 as well as a presidential decree which regulates the transformation of companies and the revaluation of their assets. Moreover, at the start of 2008 the cabinet issued a decree allowing foreign investors, to register according to the various investment laws, to obtain external loans in foreign currency for their projects and to receive those services through the local bank that they have designated to manage their hard currency account. Despite theses steps, Syria's poor ranking in the doing business indicator (137 among 178 countries) indicates that the reform agenda remains substantial for the improvement of business climate in Syria particularly for non-Arabic investments.

Trade liberalisation and economic opening

Syria's efforts to open up the economy continued during 2007. Since the beginning of the year, the Free Trade Zone agreement with Turkey was implemented and economic ties with Iran have been strengthen. Tariff levels and import restrictions have been diminished leading to maximum levels of import duties of 50% from 200%, in recent past. However, the Syrian authorities are facing the challenge of more efficient controls in third countries' products which pass the borders with false certifications of origin leading to significant loss of customs. The government continued to give more room to both to local and to foreign business in the private sector. Two new private banks were opened and three insurance companies started operations. Syria’s first two Islamic banks opened, while three Islamic insurance companies almost finished preparations. New fields which had been previously monopolised by the public sector were also opened such as privately owned taxi companies and private currency exchange companies following the disengagement of the currency from USD. Despite the significant progress made in 2007, the economy remains closely related to the public sector and the foreign non-Arabic economic presence is still limited.

Public Institutions and Public Finance Management

Syria is facing pressing challenges for reforms in the public sector, as reduced oil production, the high burden of subsidies and the low efficiency of public administration, can threaten fiscal sustainability. New legislation was introduced allowing family businesses to be transformed into joint stock companies and thus to be taxed based on their market value. This is expected to give a push to public revenues and bring more companies into the formal economy. A law has passed aiming to reform state enterprises (although the loss-making state enterprises will continue to receive budget support for the next three years). Better-performing companies could be listed on the stock market allowing limited shareholding of private investors. Moreover, the introduction of treasury bills is expected to bring improvements in public debt management and in banking operations. Also, the start of operations of a large taxpayers unit in Damascus will improve revenues collection and is expected to expand in other areas of the country. Despite the significant reduction in fuel subsidies the price of oil is still subsidised to 50% burdening the budget by USD 5 billion or around 12.5% of GDP in 2008. Also, the introduction of VAT has been postponed for 2009.

Social development and poverty

Slight, progress has been made in poverty rates which are estimated below 13% reduced from 14.4% in 2004, owing to the positive impact of the gradual liberalisation of the Syrian economy, resulting in new opportunities for private entrepreneurs and new jobs. However, by setting poverty threshold to USD 2 per day poverty rates are estimated around to 30%. The presence of Iraqi's refugees mainly in urban areas has significantly increased prices putting pressure to low income households. Syria ranks in the 31 place among 108 developing countries according to the Human Poverty Index of the UN. Poverty is strongly correlated with the literacy rate of 80.8% and even a moderate improvement in education can reduce the ranks of the poor. Syria is on track to achieving the goal of halving the number of people unable to cover their basic food and non-food needs by 2015. Yet regional discrepancies exist and the incidence of poverty is close to three times higher in rural areas compared to urban ones. Close to 60% of the country’s poor live in the so-called ‘poverty triangle’ between Aleppo, Raqqa and Hassakeh in the north-east of the country and poverty in this region has increased. Likewise, growing income disparities raise new questions of equality as Syria moves to embrace a social market economy. Poverty rates will be adversely affected in case the elimination of subsidies is not well-targeted as subsidies play a key role for low-income citizens especially in rural areas.

Table III.15.1:
Syria - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (% change)	2.8	3.3	4.4	6.0	4.5
Real non-oil GDP growth (% change)	5.0	6.0	6.5	5.8	5.8
GDP nominal (EUR, billion)	19.9	22.5	26.2	27.7	28.9
GDP nominal (USD billion)	25.0	28.6	34.9	36.9	38.8
GDP per capita (EUR)	1091	1222	1382	1427	1459
GDP per capita (USD)	1392	1560	1844	1928	1984
Inflation (period average)	4.4	7.2	10.0	12.2	16.8
Social indicators					
Unemployment (officially registered)	7.5	8.0	8.5	9.0	n.a.
Life expectancy at birth (years)	n.a	73.6	n.a	n.a	n.a
Adult literacy (% ages 15 and older)	n.a	80.8	n.a	n.a	n.a
Population annual growth rate %	2.2	2.2	2.2	2.2	2.2
Poverty (HPI %)	n.a	13.6	n.a	n.a	n.a
Human development index	n.a	0.724	n.a	n.a	n.a
Population (million)	17.9	18.3	18.9	19.4	19.8
Fiscal sector					
Total revenues (% GDP)	27.2	24.0	21.9	22.0	22.3
Oil-related revenues	11.2	7.1	4.5	3.8	3.0
Non-oil revenues	16.0	16.9	17.4	18.2	19.3
Total expenditure (% GDP)	31.4	28.4	27.6	27.0	28.1
Current expenditures	19.0	18.1	18.7	18.4	19.5
Development expenditures	12.4	10.3	8.9	8.6	8.6
Central govt. Balance (% GDP)	-4.2	-4.4	-5.7	-5.0	-5.9
Non-oil budget balance	-15.4	-11.6	-10.2	-8.9	-8.9
Gross public debt (% GDP)	82.6	35.9	35.9	37.8	41.0
Monetary sector					
Credit to private sector (% change)	35.0	45.9	18.4	19.2	23.9
Broad money (M2) (% change)	13.5	12.0	14.6	15.5	14.1
Degree of monetisation (M2/GDP, %)	78.2	73.7	66.4	69.7	n.a.
External sector					
Current account balance (% GDP)	-3.2	-4.1	-6.1	-5.8	-6.6
Balance of goods and services (% GDP)	-12.0	-9.5	-8.8	-8.0	-8.0
Non-oil export of goods and services (% GDP)	25.4	26.8	24.0	27.5	27.2
Non-oil import of goods and services (% GDP)	-37.4	-36.2	-34.8	-35.5	-35.0
Oil balance (% GDP)	5.2	2.0	0.4	-0.1	-1.0
Foreign direct investment (% GDP)	1.1	1.7	1.7	2.1	3.9
Import cover of reserves (months)	20.0	16.4	13.4	12.1	11.4
External vulnerability					
External public debt (% GDP)	73.2	23.3	19.4	17.2	17.8
Debt service to exports ratio	5.9	4.7	5.4	7.3	7.5
Gross reserves (excl. gold, USD billion)	5.3	6.1	6.7	6.4	n.a.
Financial sector					
Lending rate	7.5	8.0	8.0	8.0	n.a.
Weighted avg. of nominal exch. rate (per USD, avg.)	50.5	52.2	51.0	52.1	n.a.
Real effective exchange rate (1990=100))	58.8	59.8	66.0	67.9	n.a.
Real effective exchange rate (in %)	-0.2	1.7	10.3	3.0	n.a.

Sources: Syrian authorities, IMF and EIU.

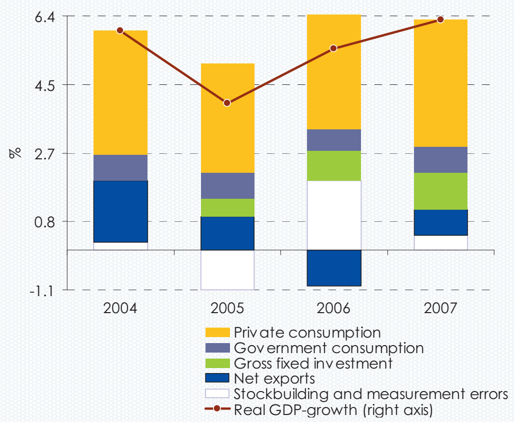
16. TUNISIA

- ***The Tunisian economy grew buoyantly in 2007 on the back of an expansion of agricultural output, strong growth in industry and a boom in exports***

- ***The revival of textile exports continued despite competition from Asia. FDI in services sector increased sharply.***

- ***Liberalisation of the economy needs to accelerate to counter the high unemployment rate of 14%, especially among university graduates.***

Graph III.16.1: **Tunisia - Contributions to real GDP-growth**

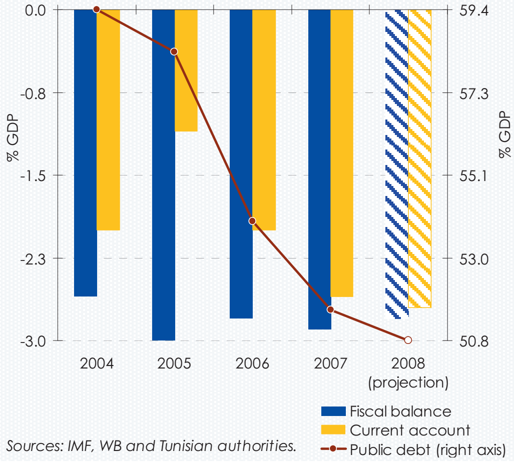


Sources: EIU and Tunisian authorities.

Macroeconomic developments

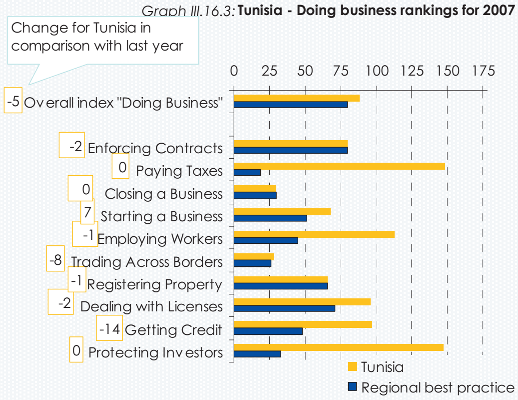
Despite the surging prices of oil and other important commodities, the economic performance of Tunisia has been one of the best in the region, sustaining relatively strong growth rates while maintaining macroeconomic stability. Real GDP-growth picked up to 6.3% in 2007, driven by growth in non-textile manufacturing, in the energy sector, and in transportation and telecommunication services, which increased by 20%. The growth rate is expected to remain high, presaged by substantial increases in imports of capital goods and commodities in 2007. Tunisia's strong economic performance has been recognised by international organisations such the Davos Forum, which ranked Tunisia as the most competitive country in the region, and by the Japanese agency R&I which raised Tunisia's sovereign rating from BBB+ to A- in 2007. Despite surges in the prices of oil and basic commodities, average inflation declined from 4.6% in 2006 to 3.1% in 2007. Inflationary pressures re-emerged in the second semester of 2007, with year-on-year inflation to reaching 4.9% in June 2008. Even though imported inflationary pressures continued in 2008, the central bank's cautious policy on raising its required reserve ratio is expected to help limit the acceleration in inflation. In 2007, the dinar recorded an average depreciation of 4.5% with respect to the euro and an appreciation of 4% with respect to the USD, following the appreciation of the euro against major currencies.

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



Sources: IMF, WB and Tunisian authorities.

Graph III.16.3: **Tunisia - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking Arab country among the Mediterranean ENP countries (Algeria, Egypt, Jordan, Lebanon, Morocco, Occupied Palestinian Territory, Syria and Tunisia).
Source: World Bank, 2008.

In real effective terms, the dinar recorded a slight depreciation of about 3%, which primarily reflects deterioration in the terms of trade, the persistent yet sustainable current account deficit, and tariff reductions resulting from trade liberalisation.

Fiscal discipline was maintained in 2007 despite the surge in oil and commodities prices. Record prices for commodities prompted the authorities to raise the subsidies for the *Caisse Générale de Compensation* (CGC) by 0.6% of GDP, bringing the total to 1.3% of GDP. However, two increases in domestic oil prices in May and October 2007 helped to keep the fiscal deficit to 2.9% of GDP, below 3.1% of GDP as planned in the budget forecast. Higher revenues from oil companies, non-tax receipts, and customs duties—on account of the substantial increase in imports—also helped to offset the additional expenditures. Although high, the level of public debt decreased to 51.6% of GDP in 2007 notably thanks to early repayments from privatisation proceeds. The continuation of the cautious fiscal policy, the continued removal of subsidies and further fiscal consolidation will all be necessary to counter budget pressures arising from demographic changes and declining revenues resulting from privatisation and trade liberalisation.

Although Tunisia has faced structural deficits in its trade account for several years, exports are a key growth engine, representing about 42% of GDP and demonstrating Tunisia's capacity of diversifying its exports and transforming the production base with the use of technology. The trade deficit remained broadly unchanged in 2007, partly because of oil imports and the need to import equipment and input to fuel the growth of the economy. The current account recorded a deficit of nearly USD 1 billion (around 2.6% of GDP) partly due to the deterioration in the terms of trade. However, it is expected to be financed by the FDI flow which amounted to USD 1.1 billion in 2007. International reserves increased by USD 1 billion in 2007 to reach USD 7.8 billion, representing 4.6 months of imports of goods and services.

Favourable economic environment and vigilant supervision has helped banks to increase their profitability and strengthen their financial position. Some institutions such as Amen Bank and BIAT used this opportunity to recapitalise. The quality of banking services, which was instituted as a legal obligation, has improved and the authorities are committed to bring it to international standards. Furthermore, Tunisian banks are preparing for the transition to Basel II by 2010, while authorities aim to reduce the non-performing loans ratio from 19% currently to 15% by 2009. The requirement that banks transfer their end-of-day foreign exchange balances to the Central Bank of Tunisia has been abolished and banks are now authorised to manage 20% of residents' foreign exchange holdings not subject to surrender requirements, thereby promoting the interbank exchange market. Privatisations continued though at a smaller pace with the sale of a stake in a small bank called *Banque Tuniso-Koweitenne* mainly interesting for its banking licence. However, more international partners are needed in the banking sector able to reduce the credit burden of the Tunisian banks and improve the quality of their services. Efforts to increase competitiveness and consolidation of the relatively fragmented banking sector should continue since it is expected to take an active role in providing finance for private projects and intermediary services to the increasing number of tourists (6.7 million visited Tunisia in 2007 yielding revenues of about USD 2.5 billion). The stock market index benefitted from the economic growth. The TUNINDEX increased by 12.1% in 2007.

Business environment

Tunisia has demonstrated overall good performance in improving its business environment. Significant progress was made in reducing corporate taxes from 35% to 30%, in lowering the minimum loan requirement at its public registry and in reducing the time required for electronic filing of properties in the registry. Total investments in 2007 amounted to USD 1.38 billion. While traditional sectors like oil and gas, manufacturing, food processing and textiles continued to attract foreign investment, investments in services began to accelerate. FDI in the services sector amounted to USD 115 million in the first eight months of 2007 up from USD 15.2 million in 2006, as foreign firms set up increasing numbers of call centres benefiting from the relatively well-developed information technology infrastructure. The Tunisian authorities have successfully focused on enhancing the country's innovation capacity by attracting high technology businesses in an effort to gain benefit from Tunisia's sound educational system. Nevertheless, low efficiency in financial and labour markets, gaps in infrastructure and the need for further improvements in the public sector may slow down necessary investments in the medium term.

Trade liberalisation and economic opening

Trade liberalisation in Tunisia has advanced in recent years. Total exports and imports of goods accounted for 98% of GDP in 2007, while the import cover ratio is at 90% and FDI is on an increasing trend. On January 2008, Tunisia lifted import tariffs on its manufacturing industry as part of its free trade zone with the EU and it is negotiating further liberalisation of its services and agriculture. A gradual liberalisation of the services sector which has a significant potential, could point the way towards a fully-opened economy following the successful example of the telecommunication sector. Liberalisation and competition in the services sector could lead to significant benefits for consumers and for employment, particularly in the IT sector, as services account for some 25% of total exports. Furthermore, more diversified and modern backbone services notably in the field of logistics are an important factor for the Tunisian companies´ competitiveness. However, it is clear that some reforms and adjustments may be necessary in the medium term.

Public Institutions and Public Finance Management

Despite surging oil and commodities prices fiscal discipline was maintained in 2007 and the budget deficit was along the lines of the budget forecast that is below 3.1% of GDP. The authorities are focusing on the implementation of the 11th five-year plan (2007-2011) to achieve further fiscal consolidation. Provided that deficits remain in target, reduction of public debt could be achieved even without the use of privatisation proceeds since the yearly growth forecast is above 5% and some 55% of the public debt consists of relatively low-interest foreign currency-denominated borrowing.

Subsidy costs are starting to become a significant burden for Tunisia as oil prices remain high, (a USD 1.0 rise in imported oil prices adds 35 million dinars - about USD 29 million to the annual energy subsidy) even though they are partially offset by increased excise tax revenues on petroleum products. To narrow the energy budget Tunisia increased domestic petrol prices by 4% in October 2007, following another increase in May. Nevertheless, alternative measures less costly than the subsidies should be considered for low-income households. Reforms in the health insurance system and increases in pension contributions during 2007 restored the financial position of the social security system over the medium term. A more cautious fiscal policy, targeting to deficits below 3% and supporting the restrictive monetary policy will help to contain mounting inflationary pressures. Moreover, comprehensive fiscal reforms within a forward-looking fiscal framework would enhance fiscal flexibility against future challenges like ageing.

Social development and poverty

Despite its healthy overall macroeconomic performance Tunisia still faces relatively high unemployment of 14% in 2007, especially among university graduates. To boost growth and employment Tunisia should move faster in implementing structural reforms, especially in the financial and services sector, in strengthening macroeconomic policies and in improving further the investment climate, all of which should help it to become a knowledge-based, high value-added economy. Consecutive years of economic growth helped Tunisia to reduce the poverty rate to 3.8% in 2007 from 4.2% in 2004 according to the Ministry of Development. Under the new Tunisian standards, around 376000 people are considered as poor. However, this figure results from a poverty threshold set in 400 dinars per year which is considered to be very low. Tunisia ranked 45th among 108 developing countries according to the UN Human Poverty Index in 2004, with a poverty rate of 17.9%.

Table III.16.1:

Tunisia - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	6.0	4.0	5.5	6.3	5.7
GDP nominal (EUR, billion)	22.7	23.4	24.7	25.6	27.0
GDP nominal (USD, billon)	29.3	27.6	31.8	36.6	39.2
GDP per capita (EUR)	2287	2329	2459	2504	2601
GDP per capita (USD)	2955	2751	3123	3548	3752
Inflation (period average)	3.6	2.0	4.6	3.1	5.1
Social indicators					
Unemployment (officially registered)	13.9	14.2	14.3	14.1	14.0
Human poverty index (HPI-1, %)	17.9	17.9	n.a.	n.a.	
Population growth rate (%)	1.0	1.0	1.0	1.0	1.0
Adult literacy rate (%)	74.3	74.3	n.a.	n.a.	
Life expectancy at birth (years)	73.5	73.5	n.a.	n.a.	
Human development index	0.760	0.766	n.a.	n.a.	
Population (mn)	9.9	10.0	10.2	10.3	10.4
Fiscal sector					
Total revenues (% GDP)	23.8	23.6	23.8	24.0	23.5
Total expenditure (% GDP)	26.6	26.9	26.6	27.0	26.5
Central govt. Balance, incl. grants (% GDP)	-2.6	-3.0	-2.8	-2.9	-2.8
Gross public debt (% GDP)	59.4	58.3	53.9	51.6	50.8
Monetary sector					
Credit to private sector	5.3	6.3	6.7	7.9	
Broad money (M3) (% change)	10.3	11.0	11.4	9.9	
Degree of monetisation (M2/GDP, %)	61.3	64.0	63.7	n.a.	
Dollarisation in bank deposits (%)	755	939	976	n.a.	
External sector					
Current account balance (% GDP)	-2.0	-1.1	-2.0	-2.6	-2.7
Trade balance (% GDP)	-8.6	-6.8	-8.2	-8.2	-8.5
Foreign direct investment (net, % GDP)	2.1	2.6	10.4	3.0	3.4
Import cover of reserves (months)	3.0	3.7	5.1	5.0	5.0
Terms of trade (deterioration -)	-4.5	-2.3	-3.6	-5.0	
External vulnerability					
External public debt (% GDP)	66.5	65.4	58.3	55.6	52.9
Debt service ratio(1)	16.4	14.8	18.8	13.3	9.3
Gross reserves (excl. gold, USD bn)	4.0	4.4	6.8	7.8	8.7
Financial sector					
Short term intrest rate	5.0	5.0	5.3	5.2	
Exchange rate (local currency per EUR, average)	1.55	1.61	1.67	1.75	
Exchange rate (local currency per USD, average)	1.24	1.30	1.32	1.27	
Real effective exchange rate (annual average, %)	-3.4	-4.5	-0.8	-2.9	

(1) Percent of exports of GNFS

Sources: IMF, EIU, UN, Tunisian authorities

17. UKRAINE

- ***Rapid credit expansion fuelled economic growth in 2007. Inflationary pressures stemming from international commodity prices were exacerbated by a boom in domestic demand, including lax public spending. Despite the turmoil on international financial markets, foreign capital inflows were brisk.***

- ***WTO accession in 2008, a landmark in Ukraine's integration in the world economy, is to be followed by a free trade area with the EU (to be part of the New Enhanced Agreement between the EU and Ukraine) aiming at Ukraine's far-reaching regulatory approximation with the EU in key sectors.***

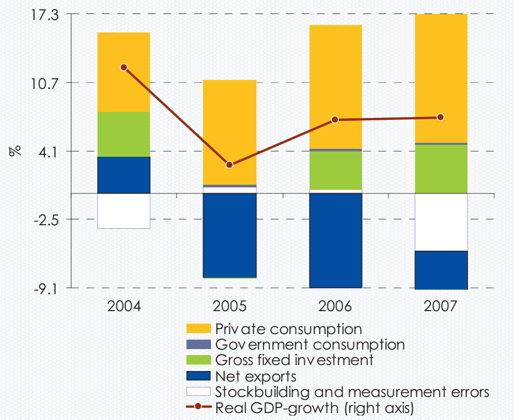
- ***The political situation has not been conducive to structural reforms and the core legislation in the areas of company law, public procurement and taxation has yet to meet the standards of a major emerging economy.***

Macroeconomic developments

Real GDP growth was maintained at a robust level of 7.3% from 2006 to 2007. This strong performance has brought Ukraine's real GDP level back to close to 70% of the level achieved in 1989, before the transition shocks were felt. In 2007 economic growth continued to be driven by strong domestic demand, fuelled by vigorous income growth and a lending boom. Investment performed strongly with real gross fixed capital accumulation of 21.8%. Households' real final consumption grew at 15.2% in the period January-September 2007.

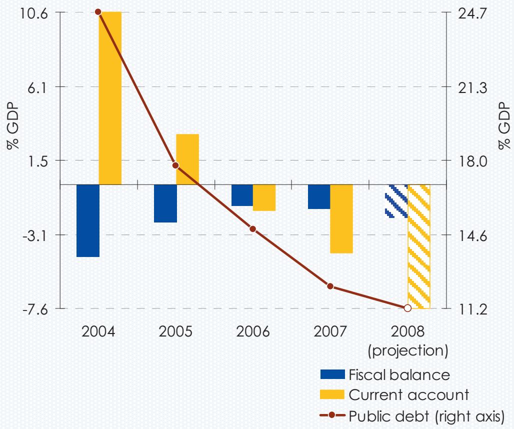
The negative balance in net exports deepened as economic restructuring and foreign direct investment boosted imports of capital goods while demand for imports of consumer goods also grew rapidly. Trade and industry were the leading contributors to GDP growth. Data on industrial production show 10.2% growth against 6.2% in 2006, with metal production, machine-building and food production in the lead.

Graph III.17.1: **Ukraine - Contributions to real GDP-growth**



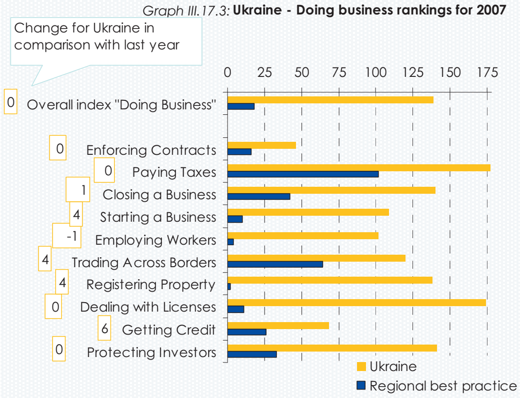
Sources: EIU and EC staff calculations.

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



Sources: Ministry of Finance and Central Bank Ukraine.

Graph III.17.3: **Ukraine - Doing business rankings for 2007**



The ease of doing business index ranks economies from 1 (best) to 178. The regional best practice refers to the best ranking CIS country among the EU Eastern ENP countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russia and Ukraine).

Source: World Bank, 2008.

Given the strong external market conditions and the high export prices of steel in particular, Ukraine's steel and chemical sectors have so far adjusted fairly smoothly to the increase in energy prices since 2006.

A further price rise for imported natural gas came into force in 2008 (from USD 130 to USD 179.5 per 1000 cubic metres), requiring additional adjustments and investment in energy-saving technologies. The rapid pace of gas price increases is set to continue in 2009 as producers in Central Asia are expected to raise their gas export prices which are still well below the levels on world markets.

Nevertheless, Ukraine's terms of trade have remained positive as export prices for steel have continued to surge. The merchandise trade balance and the current account are projected to deteriorate in 2008, however, largely due to persistently strong demand for imports. Last year, the current account deficit was 4.2% of GDP. The inflow of foreign capital comfortably financed the current account deficit. Therefore, to counter appreciation pressures on the hryvnia, the National Bank of Ukraine intervened on the foreign exchange markets to maintain the *de facto* peg of the hryvnia to the US dollar.

The 12-month consumer price inflation accelerated from 10.6% in May 2007 to 16.6% in December. By April 2008, annual inflation had already reached 30.2%, largely owing to food price inflation and also because of services. In particular, tariffs for utilities have been brought closer to cost-recovery levels. Food price inflation rose to 25% over 2007 and 47.2% year-on-year by April 2008. The share of food products in the CPI consumption basket (55%) is high in comparison with other countries at the same level of GDP per capita. The National Bank of Ukraine (NBU) has raised the discount rate from 8% to 12%, but further tightening is expected. Coordination and communication of anti-inflationary measures between the NBU and the government is the main economic policy challenge under the present circumstances. In the medium term, the NBU's strategy is geared towards adopting an inflation-targeting monetary policy framework and more flexibility on the exchange rate. Meanwhile, the government has resorted to administrative price controls, including a ceiling on mark-ups for goods deemed socially important.

Ukraine's stock market was the strongest performer in Europe (and the second in the world after China) gaining 135% in 2007. The potential for IPOs is still untapped on the Ukrainian market. IPOs would also have the welcome effect of bringing greater transparency to the corporate sector, currently dominated by large oligarchic industrial groups. Another aspect of Ukraine's status as an emerging economy is the rapid credit expansion. Bank assets grew by 76% due to a rapid increase in lending. Outstanding credit increased by 80% with credit to households growing by 97.5% in 2007. The inflow of foreign capital to the banking sector is likely to subside somewhat in 2008, given the uncertainty on the international financial markets, but overall the prospects for foreign direct investment are still good.

As a result of stronger than expected economic growth, the government allocated its additional revenue to expenditure programmes in two supplementary budgets and had no difficulty in keeping the fiscal deficit below 2% of GDP in 2007. Public and guaranteed debt has stabilised at a low level, below 15% of GDP, which has boosted Ukraine's creditworthiness. The prudent policy stance on indebtedness has not been consolidated by equal improvements in the quality of public finances. The new government that came into power in December following the early parliamentary elections in September 2007 has launched new spending such as faster compensation for people who lost savings in the Soviet-era Sberbank.

Business environment

Based on the results of international surveys, no tangible improvement was achieved on the ease of doing business in 2007, which raises concern about the prospects for broader-based economic growth in the longer term. The World Bank ranked Ukraine's business environment 139th out of 178 countries (which means no change in its relative position from 2006 to 2007). Ukraine is lagging considerably behind its regional peers, in particular in areas such as paying taxes, dealing with licences and protecting investors. Equally, indicators on corruption showed no improvement. Marred by prolonged disputes over the sale of some large State-owned companies in the telecommunications sector and industry, privatisation deals fell behind the target in 2007 (only 23% of the budgeted privatisation proceeds of 10.6 billion hryvnias materialised).

A new Tax Code was prepared in 2007 to replace some 200 regulations on taxation and with a view to broadening the tax base to allow gradual reductions in tax rates. Amid the political uncertainty and the early parliamentary elections that led to a change in government, the tax reform has been further delayed. The envisaged tax system and administration would still remain over-cumbersome. Due to a dysfunctional legislative process, adoption of a law on joint stock companies was also stalled. Cases where investors' rights have been violated, for instance by "raidering" (illegal takeovers of corporate assets), have become widespread as the corporate law and the judicial system are not effectively protecting investors against corruptive practices. The administrative systems such as company registrars are also prone to manipulation. The government's plan for modernisation of capital markets (November 2007) addresses some of the pressing reforms needed but still requires further elaboration.

Trade liberalisation and economic opening

In February 2008 the General Council of the WTO approved the terms of Ukraine's accession which were ratified by Ukraine's Parliament in April. Ukraine's average tariff bindings are 10.66% for agricultural products and 4.95% for industrial goods. The highest tariffs may be applied to items such as sugar (50%) and sunflower seed oil (30%). Ukraine has agreed not to subsidise agricultural exports and trade-distorting domestic support to farmers is capped under the accession terms. In the case of services, Ukraine has taken on specific commitments on giving access to foreign service providers on a non-discriminatory basis in a broad range of sectors, including financial services, communication, transport, construction and engineering. Ukraine's other commitments include elimination of export bans on non-ferrous scrap metal and reductions of its export duties. Ukraine's WTO accession has immediate repercussions on its trade with the EU as the EU import quota for Ukrainian steel was abolished upon accession.

Most importantly, negotiations on establishing an EU-Ukraine free trade area were launched in February 2008, aiming at a deep and comprehensive agreement in terms of both coverage of goods and services and the extent of Ukraine's regulatory approximation with the EU. Ukraine's export restrictions on grain and vegetable oil have not been helpful for addressing global challenges on food markets. With a more liberal and coherent policy Ukraine would have vast potential to benefit from growing global demand.

Public institutions and public finance management

The central government functions are in disarray as the constitutional arrangements for the executive arm of the government have not yet been laid down in any consistent manner. A shift from a presidential system to a parliamentary system was agreed in the political compromise following the "orange revolution" of 2004, but the main tenets of its implementation are still contested given the intense rivalry between the main political forces. Effectively there have been parallel policy-making mechanisms in the various state institutions which have hindered coherent policies, also marred by vested interests. The findings of the OECD's Governance Assessment therefore remain valid. Increased politicisation of Ukraine's public administration is another cause for concern.

The pace of social spending (including pension outlays), a rationalisation of subsidies and a reduction in the tax burden are the main fiscal policy challenges yet to be addressed coherently within a medium-term fiscal framework. The urgent need to overhaul the public procurement legislation is now acknowledged. Following the recent repeal of the Public Procurement Law, a new draft law is expected to address the serious shortcomings in the transparency and efficiency of the system.

Social development and poverty

Unemployment declined from 7.4% (2006) to 6.7% (2007). In a strongly growing economy,

Table III.17.1:
Ukraine - Main economic indicators

	2004	2005	2006	2007 prel.	2008 proj.
Real sector					
Real GDP growth (domestic currency, % change)	12.1	2.7	7.1	7.3	5.6
GDP nominal (EUR, billion)	52.2	69.1	84.8	103.0	
GDP nominal (USD, billion)	64.9	86.1	106.5	140.5	182.9
GDP per capita (EUR)	1101	1467	1815	2218	
GDP per capita (USD)	1372	1835	2282	3046	3995
GNI per capita (PPP current prices, US$)	6370	6780	7520	n.a.	
Inflation (period average)	9.0	13.5	9.0	12.8	22.0
Social indicators					
Unemployment (ILO definition)	9.2	7.8	7.4	6.7	
Population (million)	47.1	46.7	46.5	46.1	45.8
Poverty rate (% of population)	14	8	n.a.	n.a.	
Inequality (Gini index consumption/ income)	27.5	27.6	n.a.	n.a.	
Fiscal sector					
Total revenue (% GDP)	37.1	41.8	43.7	42.3	42.7
Total expenditure (% GDP)	41.5	44.1	45.1	43.8	44.6
General government balance (% GDP)	-4.4	-2.3	-1.3	-1.5	-2.0
Gross public debt (% GDP)	24.7	17.7	14.8	12.2	11.2
Monetary sector					
Domestic credit to private sector (% GDP)	25.2	32.2	44.9	59.1	
Broad money (M2) (% change)	32.6	53.9	34.3	50.8	
Degree of monetisation (M2/GDP, %)	36.6	45.5	48.2	54.0	
Dollarisation in bank deposits (%)	36.50	34.20	38.00	32.1	
External sector					
Current account balance (% GDP)	10.6	3.1	-1.6	-4.2	-7.6
Trade balance (% GDP)	7.7	0.8	-2.9	-5.6	-8.8
Foreign direct investment (net, % GDP)	2.7	9.0	5.4	6.6	6.0
Import cover of reserves (months)	3.1	5.1	5.0	5.3	
External vulnerability					
Total external debt (% GDP)	47.3	45.3	50.4	60.2	55.0
Of which: public external debt (% GDP)	19.2	14.7	12.2	10.5	9.5
Debt service ratio1	11.0	13.0	n.a.	n.a.	
Gross reserves (excl. gold, USD billion)	9.5	19.0	21.8	32.5	
Reserves/M2	2.4	2.0	2.3	2.4	
Financial sector					
NBU discount rate	9.00	9.50	8.50	8.00	
Lending rate	17.4	16.2	15.2	14.0	
Exchange rate (hryvnia per EUR, average)	6.62	6.40	6.32	6.92	
Exchange rate (hryvnia per USD, average)	5.3	5.1	5.1	5.1	
Real effective exchange rate, % change	2.7	17.0	8.0	n.a.	

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

Sources: IMF,WB, Ukrainian authorities and EC staff projections

shortages of qualified labour are starting to appear. The informal economy is still estimated as fairly large because high payroll taxes create no incentive to declare business activities. Ukraine's population is aging rapidly and the country faces challenges in development of its pension systems. The total population is continuing to decline at a rate of 0.6% per year. Ukraine recorded a sharp reduction in poverty from 2001 to 2005 as a result of real wage growth at an average annual rate of about 20% accompanied by significant increases in pensions and other social transfers. Taking an absolute poverty line as a measure, the poverty rate was cut from 32% in 2001 to 8% in 2005. Since then poverty incidence has come under upward pressure as food prices and utility tariffs have increased.

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