

# EUROPEAN ECONOMY

Occasional Papers 48 | June 2009



## The Impact of the Global Crisis on Neighbouring Countries of the EU

Directorate-General for Economic and Financial Affairs

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KC-AH-09-048-EN-C  
ISSN 1725-3195  
ISBN 978-92-79-11262-1  
doi: 10.2765/44237

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European Commission

Directorate-General for Economic and Financial Affairs

# IMPACT OF THE GLOBAL CRISIS ON NEIGHBOURING COUNTRIES OF THE EU

## ABBREVIATIONS

AA	Association Agreement
AP	Action Plan
CDS	Credit Default Swaps
Commission	European Commission
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EMBI	Emerging Markets Bond Index
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)
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GNI	Gross National Income
HDI	Human Development Index
IIP	International Investment Position
ILO	International Labour Organisation
LNG	Liquefied Natural Gas
IMF	International Monetary Fund
JOD	Jordanian dinar
MAD	Moroccan dirham
MED	Mediterranean Countries
MEI	Main economic indicators
MENA	Middle East and North Africa region
MTEF	Medium Term Expenditure Framework
NDF	National Development Fund
NEER	Nominal Effective Exchange Rate
NIP	National Indicative Programme
NIS	New Independent States
NPLs	Non-Performing Loans
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
UAE	United Arab Emirates
UN	United Nations
UNDP	United Nations Development Program
USD	US dollar
VAT	Value Added Tax
WB	World Bank
WDI	World Development Indicators
WTO	World Trade Organisation

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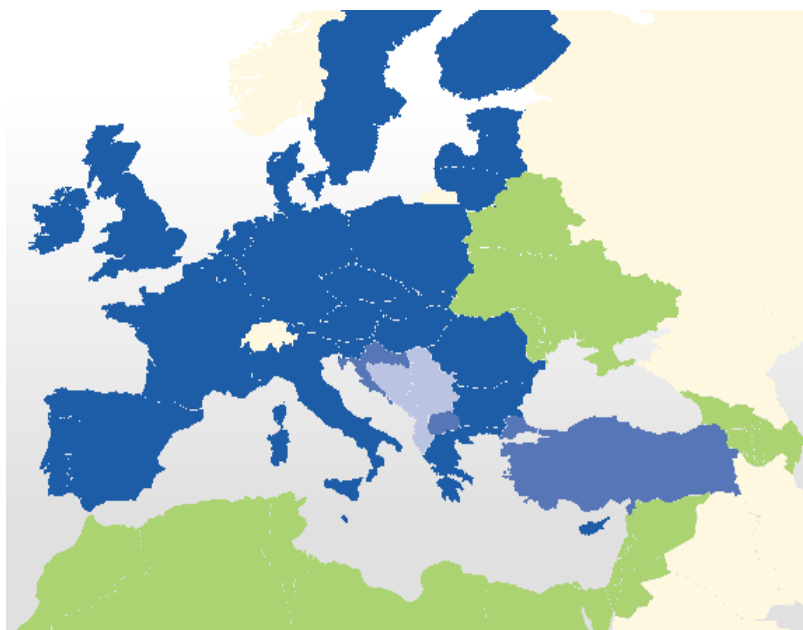
## FOREWORD

The global financial crisis that originated in the financial sector of developed economies and then hurt the real sector of those countries has now gradually spread to emerging and developing countries via several transmission channels with negative spillovers. Although it was initially the core of the financial sector that was the eye of the hurricane, in the case of a great many emerging and developing economies it has been the fall in global world trade rather than a shock to their domestic financial sector that has pushed them into downturn. The sharp drop in world trade at the end of 2008 has led to a fall in their exports, which has directly slowed down their economic growth. The macroeconomic policy responses to this negative external shock have depended, among other things, on whether the financial sector or the real economy has been affected first. Timing has also proved crucial to the effectiveness of the policy response. While some emerging and developing countries have reacted rapidly to the new situation, easing monetary and fiscal policies in order to stimulate their domestic economies, others have been more cautious. The emerging, and in particular the developing economies, display a number of characteristics which make them particularly vulnerable to the difficult economic circumstances: a risk of fiscal unsustainability, relatively weak private sectors, high unemployment rates and weak automatic stabilisers, a shallow financial sector which hampered the rise of economic activity and thus welfare levels in the past, and a lack of buffers. It will be as difficult for them as for the developed economies to mitigate or even reverse the impact of the global crisis on their economies, and though they have a similar set of policy instruments at their disposal the challenges will be quite different.

This Occasional Paper reviews recent developments in the countries neighbouring the EU, in particular in the financial and monetary sector and in public finances. It contains three main parts. The *first* part analyses the financial cross-border exposure of the EU's neighbours and reflects on the vulnerabilities of and risks to their economies in view of the financial crisis and global economic slowdown. It uses a broad range of financial indicators for this comparison and also describes recently announced and/or implemented policies and other crisis response options. The *second* part is divided into two regional sections, dealing with the EU's southern and eastern neighbours respectively. Both sections look at the main areas of reform, such as macroeconomic developments, trade liberalisation and economic opening, business environment, governance, social development and poverty. They also compare the monetary, fiscal and financial measures taken by countries within each region in more depth. The *third* part contains country chapters, each of which gives an overview of the economy of one country. In addition to fiscal, financial and monetary issues, these chapters also contain country-specific information on labour market developments and social indicators.

The main focus of this publication is on countries that are part of the European Neighbourhood Policy (ENP) framework. The ENP encompasses the EU's immediate neighbours by land or sea, along the southern rim of the Mediterranean – Algeria, Egypt, Israel, Jordan, Lebanon, Libya, occupied Palestinian territory, Morocco, Syria and Tunisia – and the countries to the east of the EU which form the Commonwealth of Independent States – Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. Other countries analysed are Russia and the Gulf Cooperation Council (GCC) countries – Saudi Arabia, the United Arab Emirates, Bahrain, Kuwait, Oman and Qatar. Relations between the EU and Russia are governed by a strategic partnership and those with the GCC countries by a cooperation agreement.

The wider group of Mediterranean countries that take part in the restyled 'Barcelona Process: Union for the Mediterranean' but are not formally part of the ENP are occasionally included in the analysis, as are a number of other countries (such as EFTA-member Iceland and Kazakhstan). This broader scope is used to review the performance of the EU's neighbours against peers.



This Occasional Paper was written, under the guidance of Loukas Stemitsiotis, by Ronald Albers (thematic chapter, Georgia, Lebanon, Tunisia), Stylianos Dendrinis (Armenia, Israel, Jordan, Libya, Syria), Inmaculada Montero Luque (overview of the Mediterranean countries, Morocco, occupied Palestinian territory), Olha Nychai (Azerbaijan, co-authorship on sections of the overview of the Mediterranean countries), Andreas Papadopoulos (Moldova), Marga Peeters (thematic chapter, Algeria, Egypt, GCC, Moldova, editorial) and Lúcio Vinhas de Souza (overview of the CIS, Belarus, Russia, Ukraine). Editorial assistance was provided by Anja Nielsen.

The authors are grateful for the comments of Mr Antonio de Lecea, Johan Baras, Peter Grasmann, Martin Hallet, Peter Lohmus, Paul van den Noord and Christophe Pavret de la Rochefordière.

Thanks go to Sophie Bland, Roslyn Bottoni, Graham Dalton and Chris Maxwell for copy-editing, and to Dominique Marchalant for production and distribution. The authors are also grateful for the comments of Bettina Kotzinger (DG RELEX), Marie Corman (DG ENTR), Raul De Luzenberger, Uffe Holst Jensen (EU Delegation Armenia), Janis Aizsalnieks (EU Delegation Belarus), Christophe Besse, Chiara Francini, Gerhard Krause, Ghada Mostafa, Felipe de la Mota, Rodrigo Romero Van Cutsem (EU Delegation Egypt), Thomas Boyer (ECTAO Jerusalem), Eyal Inbar (EU Delegation Israel), Patrick McClay (EU Delegation in Jordan), Michael Miller and Charles Abdallah (EU Delegation Lebanon), Fabrice Ferrandes (EU Delegation Morocco), Hervé Busschaert (EU Delegation Palestine), Simao Bojsen-Moller, Ahmad Shihadeh (EU Delegation Syria), Fabian Seiderer (EU Delegation Tunisia/Libya), Timo Hammaren, Alexandr Kravchuk, Marina Rorina, Barbara Stacher, Ulrich Weins (EU Delegation Russia), Luigi Narbone (EU Delegation Saudi Arabia/GCC), and Oksana Popruga (EU Delegation Ukraine).

Brussels, May, 22<sup>nd</sup> 2009.

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# Part I

Thematic issues

# 1. THE IMPACT OF THE GLOBAL CRISIS ON THE EU NEIGHBOURS: VULNERABILITIES AND POLICY REFLECTIONS

## **SUMMARY**

*The crisis is having a profound impact on all regions in the world, including the EU's neighbours. However, the extent and timing of the effects differ depending on structural characteristics and policy responses. As regards transmission channels, eastern neighbours have felt the impact of the crisis more directly than Mediterranean neighbours, reflecting the higher dependence on foreign inflows (and for some on commodity exports which suddenly became much lower priced), stronger financial linkages, and the openness of financial accounts. The direct impact on Mediterranean neighbours appears to have been more muted, reflecting their more closed structure, relatively conservative financing pattern and also due to the rebalancing of Gulf region investment that helped cushion the shock. EU neighbour countries both in the south and the east are at risk of facing a prolonged adjustment process as the feedbacks to the real economy and to public finances weigh in. In addressing the crisis, policy makers in the region face significant challenges in order to ensure economic stability and sustainable development. Whereas the crisis has dented near term prospects, it should not be allowed to derail the structural reforms that are much needed to secure sustainable welfare gains in future.*

## **1.1. INTRODUCTION**

The global financial crisis which initially emerged in 2007 and which worsened dramatically in the autumn of 2008 has triggered a global recession unprecedented since the Second World War. Although the initial effects of the crisis were mostly felt in the financial systems of advanced economies, emerging and developing economies were affected as heavily or even more so as financial stress compounded in the second half of 2008. The dramatic decline in world trade, falling remittances, rising financing costs, heightened uncertainty, reversals in credit and capital flows and ongoing adjustments in asset prices and exchange rates all

affect emerging economies. Both advanced and emerging economies are weathering a very deep and largely synchronous downturn, underlining the interdependence of the global economy. The current crisis is also exceptional in that in both advanced and emerging economies, debt, banking, equity and foreign exchange markets are all affected simultaneously.

The main emphasis of this chapter is on the impact on financial markets, asset prices, exchange rates, banking systems and external positions in EU neighbouring countries. Issues of financial market development and financial stability are crucial to account for the way the crisis affects the economies to discern risks and vulnerability and to identify policy options to address the situation.

The next section describes the main transmission channels of the crisis, whereas section 1.3 assesses empirical evidence of financial exposures and other financial indicators on a range of aspects of the EU's neighbouring region. Section 1.4 gives an overview of policy reactions and addresses some policy issues that arise at this juncture, touching upon protectionism versus free trade, and privatisation versus nationalisation. The final section summarises and concludes.

## **1.2. TRANSMISSION CHANNELS**

In recent years, emerging markets have benefited from a general strategy of low risk aversion and increased integration and interdependence in the global economy, coupled with booming trade and foreign investment and enhanced financial integration (albeit unevenly spread across regions). EU neighbouring countries, both in the southern Mediterranean and to the east, were no exception. In the past few years, all benefited from robust growth, partly triggered by inflows of capital. However, in 2007 and the first half of 2008 soaring food and commodity prices led to substantial terms-of-trade losses for commodity importing countries, which include most neighbouring countries. By contrast, export

revenues for energy exporters soared (of the EU's neighbouring countries this mainly concerned Algeria, Azerbaijan, Libya and Russia). In these countries the proceeds of export revenues fuelled a boom in demand. In addition, recycling petrodollars from the Gulf region added to the external stimulus experienced by several southern Mediterranean countries. With the benefit of hindsight, the dramatic increase in commodity prices and the substantial global imbalances that had built up were symptoms of unsustainable development that led to the sharp and synchronised downturn in the global economy in the second half of 2008, triggered by the crisis in the financial markets.

The impact on emerging economies is differentiated according to economic fundamentals, the structure of the affected economies and their linkages with other economies<sup>(1)</sup>, and the kind of policy responses. Transmission channels are further shaped by various feedback loops. They operate simultaneously, determined by factors such as expectations, liquidity needs, and adjustment of external imbalances, flight-to-quality, and portfolio rebalancing. The substantial progress of globalisation, trade integration and dependence on external financing and foreign investment and remittance flows also meant that the world economy had no good shield against the synchronized downturn which occurred in the recent extraordinary circumstances. Naturally, countries with strong initial conditions are better placed to accommodate the global shock without excessive disruption. Also, strong and coherent policy responses should be able to mitigate the negative consequences. But even in the best of cases, the current downturn will put unusually high pressure on several of the EU neighbour countries in terms of their adjustment as the crisis exposed previously existing vulnerabilities. While some of the feed-through occurred with a lag, the adjustment process can be expected to take several stages, and on the whole to be protracted by historical standards.

---

<sup>(1)</sup> For instance, the pattern of transmission among many eastern neighbours with strong links with Russia is to a large extent shaped by developments there.

Most vulnerable to the direct negative impact of the crisis originating in financial markets were emerging economies with a high external exposure depending on leveraged finance, with strong trade linkages and with few restrictions on capital movements. There are several reasons for this. First, the global re-pricing of risk was felt more acutely in markets where risk premia had been compressed more strongly. Second, higher financing costs and capital needs in the financial sector typically led to a more pronounced process of deleveraging and adjustment in cross-border capital flows from which countries with capital restrictions were more insulated. Third, countries with a high dependence on trade, especially on commodities, were particularly hard hit by the slump in commodity prices and/or by the sharp decrease in trade.

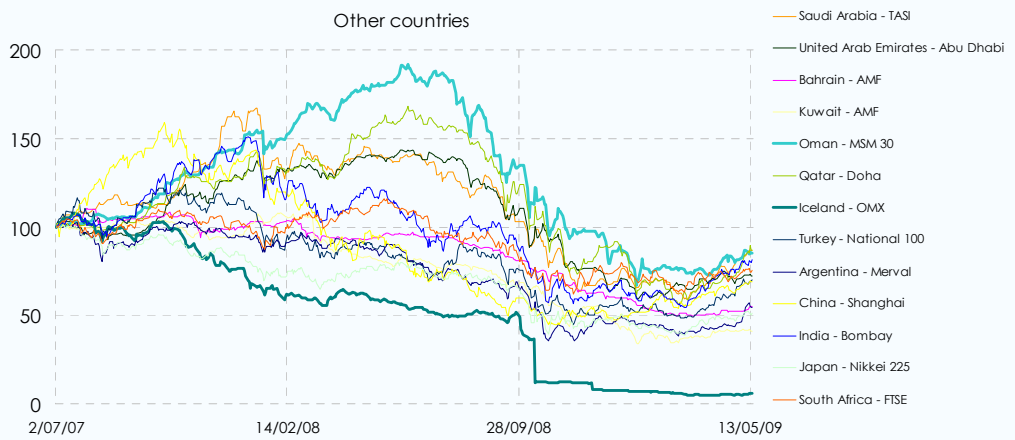
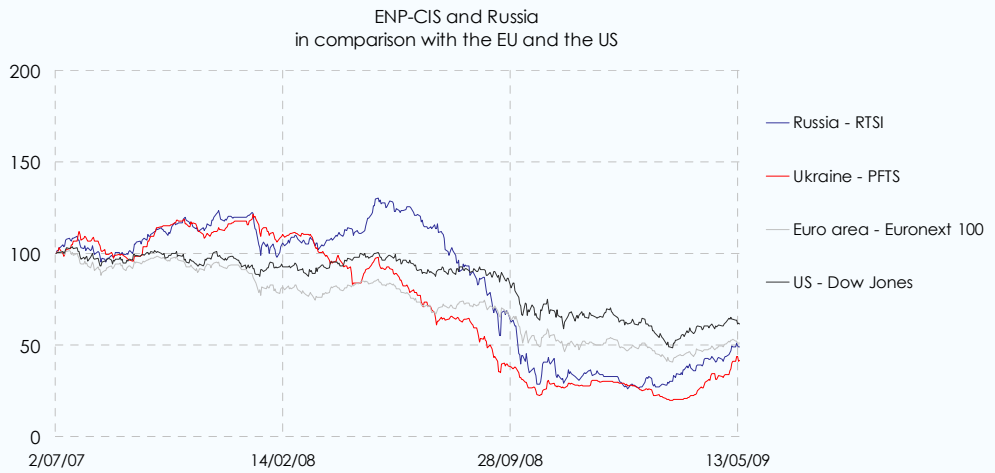
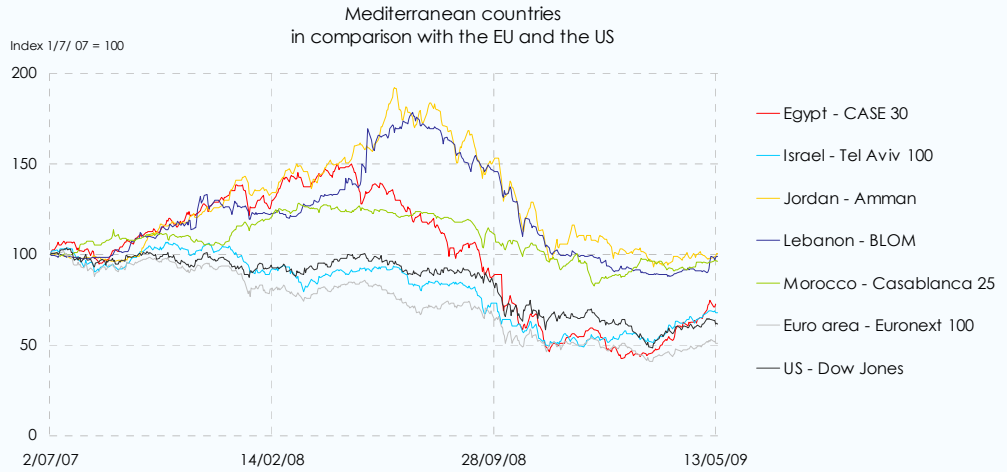
That said, relative isolation has not come for free. Countries which were less integrated globally and were more shielded from the first impact in past years have suffered the costs of a lack of integration in international markets through foregone investment opportunities and growth. They are affected by the secondary effects of the crisis, with structural weaknesses in their economies reducing the options to limit the negative impact.

As regards tracking the impact of the crisis, the analysis focuses on three main **channels of transmission**:

First, on the real side, there is the **trade channel**, which acts powerfully and with a relatively short lag operating through the negative impact of weakening world demand on exports.

Second, **lower commodity prices** not only reduce export revenues of many emerging and developing economies which rely heavily on commodity exports, but, when compounded by underlying vulnerabilities, have also exacerbated the downward correction in stock markets and exchange rates and affected expectations more generally. Here again, the impact varies considerably depending on whether the countries are either resource-rich economies that are net exporters of commodities, or net importers in that they depend on the relative dependence on commodity imports.

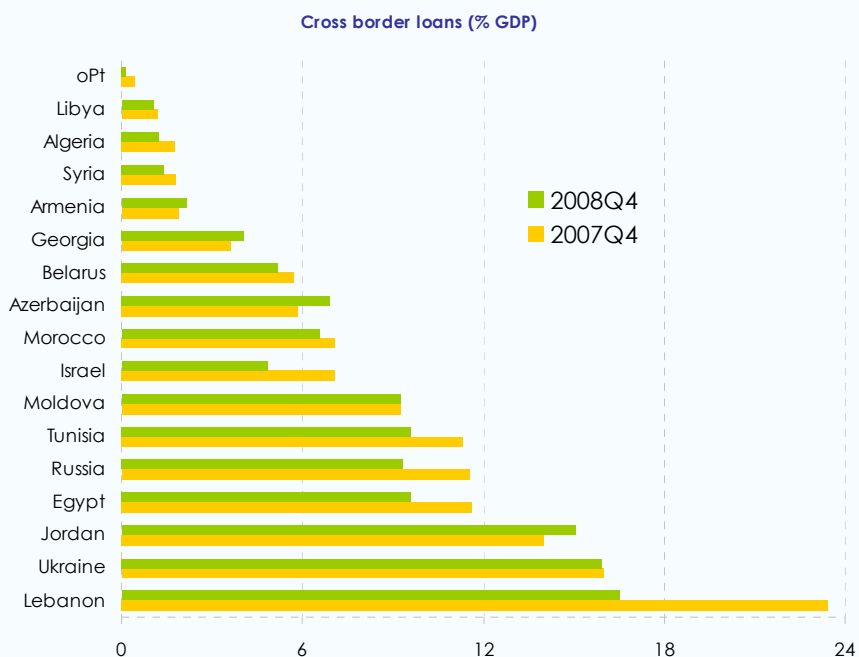
**Box I.1.1: Stock market developments**



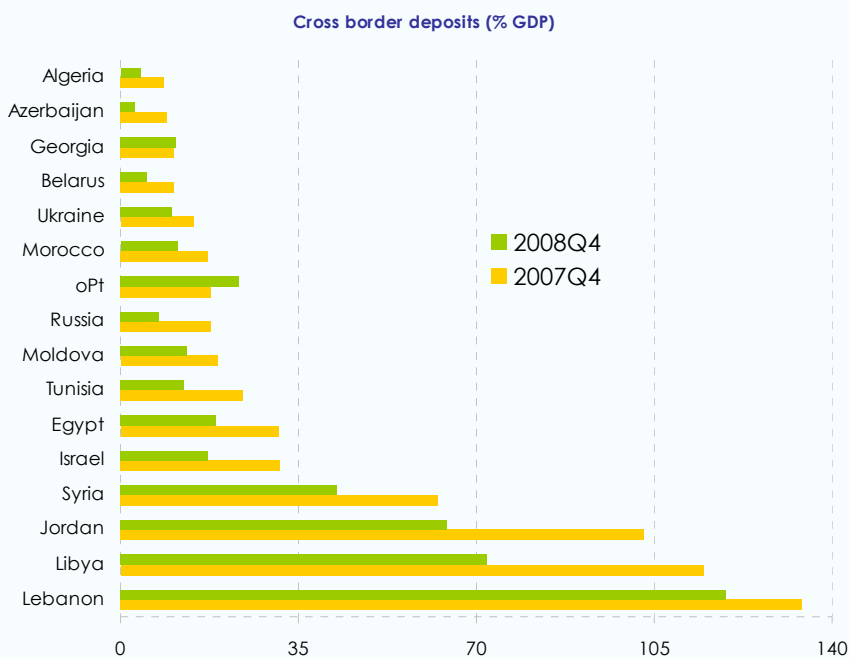
Source: ECOWIN Reuters / Bloomberg.



Box I.1.2: External loans and deposits



Note: Loans to all sectors of the respective countries as reported by BIS banks.  
Source: BIS and IMF.



Note: Deposits from all sectors of the respective countries held with BIS banks.  
Source: BIS and IMF.

Third, **financial transmission channels** have been at work. There are multiple complex channels operating here, and attention in terms of concrete indicators is focused on **equity prices, interest rate spreads** and thus financing conditions and **exchange rates**.

The impact on **capital flows**, as well as on the **financial sector** is more difficult to gauge directly. Changes in cross-border financial exposures partly depend on the pattern of deleveraging and unwinding that has taken place, a process which is also far from finished. Similarly, the structure and institutional set-up of the domestic banking system shape the effect on the real economy. There are severe difficulties in fathoming these transmission channels, especially in the often relatively underdeveloped financial systems of several neighbour countries. Some measures to gauge financial transmissions are presented below, in particular on external debt and the exposure to financial institutions and markets in advanced economies.

Finally, **feed-back loops to the real economy** will occur with a lag, via the effect on credit, balance sheets and financial wealth, public finances, profits, and employment. But they become visible with a longer lag.

As regards the scope for **policy reactions**, initial fiscal positions, monetary and exchange rate frameworks and the level of reserves are important determinants. But across EU neighbour countries, the type and intensity of policy reactions have varied considerably, also in function of the available room for manoeuvre (see section 1.4 on policy issues).

### 1.3. TRACKING THE IMPACT OF THE CRISIS

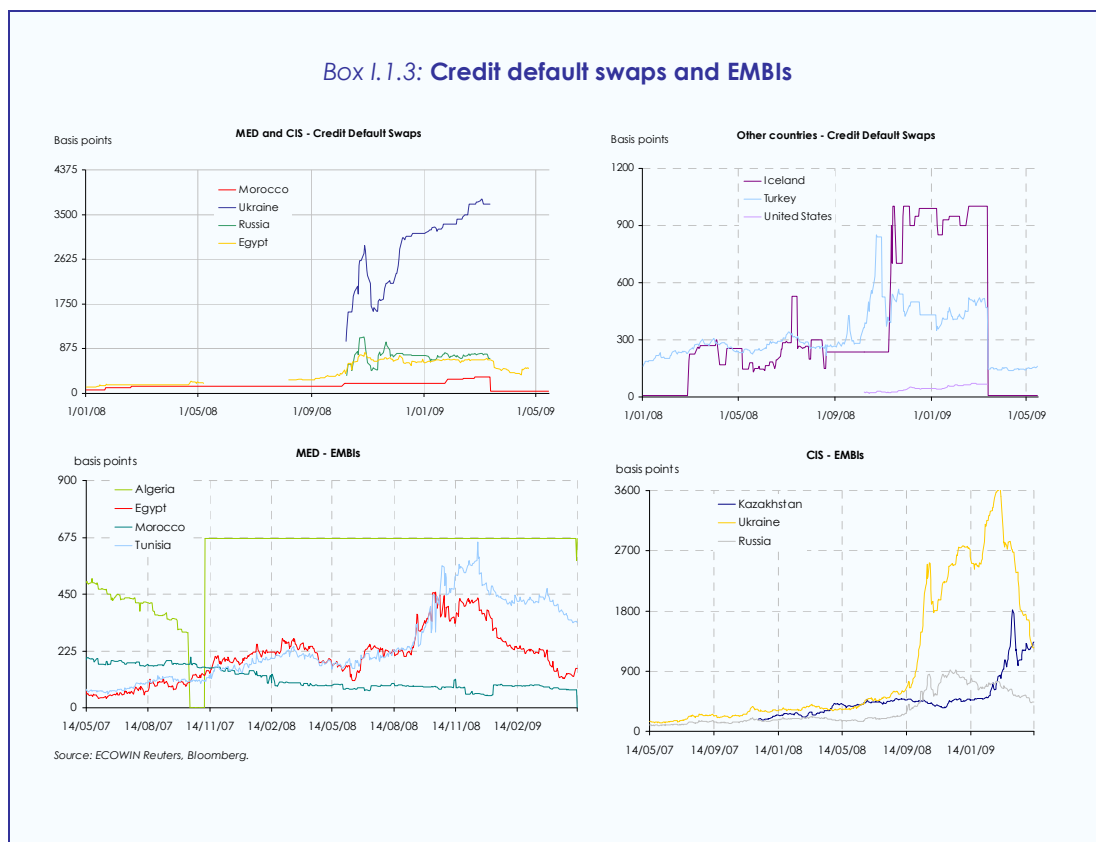
This section attempts a stock taking of the impact of the crisis on EU neighbour economies through a set of available indicators on the real and financial spheres.

The spectacular **fall in global trade** since late 2008 is comparable only to the 1930s. The trade channel has arguably been the most powerful immediate link through which the downturn in advanced economies dragged down economic growth and growth prospects in neighbour

countries, even those with a relatively small external exposure and strong initial positions. Countries heavily dependent on exports to the EU and the US, which are facing a sharp contraction in activity, are particularly affected. Moldova, Morocco, Tunisia and Ukraine are cases in point. **Tourism** is also negatively affected, which would accentuate the slowdown in countries with a large tourism sector, notably in the Mediterranean. In view of the expected downturn in exports, the slowdown in domestic demand (most pronounced for countries where external funding had been an important driver of growth), **current account** positions are forecast to continue the **adjustment** already evident towards the end of 2008. The fall in capital inflows and slowdown in domestic demand are expected to trigger a further adjustment in the current account of neighbour countries with external deficits. For the oil-producing surplus countries, a marked decrease in the current account surplus is projected, with some moving to deficits.

With respect to **financial transmission channels, share prices** have fallen markedly across the EU neighbours since the start of the crisis (box I.1.1). In the initial stages of financial turmoil (from the summer of 2007 onwards), share prices still increased in many neighbour countries, in particular in those exporting petroleum and natural gas. However, as the crisis intensified in the autumn of 2008, share prices started to slide in most Mediterranean, CIS and Gulf countries, against the backdrop of re-pricing of risk, sharp decreases in international capital flows, and rapid decreases in commodity prices. The recent stabilisation or modest increase in share prices only very partly offset these heavy falls. Relatively low market capitalisations limited wealth effects on the real economy in most eastern neighbour countries. For Russia, this would be due to a high degree of concentration of share ownership and a relatively large share of foreign holdings. A similar reasoning applies to Mediterranean countries, even though some of them have fairly developed stock exchanges (notably Egypt, Jordan and Morocco) with a stock market capitalisation of around 100% of GDP before the crisis. But it is likely that also in those countries any negative impact on the real economy via wealth effects is mitigated by the low diffusion of share

Box I.1.3: Credit default swaps and EMBIs



ownership among the domestic population. Especially in the Mediterranean, soaring share prices were partly a symptom of a lack of financial investment and diversification outlets in the wake of vigorous economic expansion and foreign inflows that were partly related to oil revenues on the back of the commodity price boom. Nevertheless, the fall in share prices registered among neighbour economies in several cases are as sharp as in advanced economies. They may be evidence of a broad-based worsening in sentiment.

**Adjustments to exchange rates** are another main transmission channel. In several neighbouring countries, this has put the authorities to the test as regards their commitment to prevailing exchange rate arrangements, in some cases putting a drag on reserves. It is revealing that no amount of foreign reserves has proven sufficient to insulate a country from the effects of the crisis. On the whole, exchange rate pressures in the EU's eastern neighbours have been more intense than in its southern neighbours. This is unsurprising in

view of their greater dependence on foreign funding, greater openness of financial accounts and hence greater sensitivity to changes in investor sentiment. As a result, significant exchange rate adjustments occurred. Some countries (Armenia, Belarus, Georgia) were forced to realign or adjust de facto pegs to the dollar in response to pressure on the currency. Ukraine suffered intense depreciation pressure at the height of the financial turmoil, resulting in significant devaluation. In Russia, foreign currency reserves were partly used to accommodate a gradual but quite marked depreciation of the exchange rate. To the extent that the monetary authorities increased policy interest rates to stabilise the exchange rate, monetary conditions tightened. By contrast, the external anchors of exchange rates in Mediterranean neighbours have so far been more resilient. Several southern Mediterranean countries peg their currencies to the US dollar whereas others, notably Morocco and Tunisia, closely shadow the euro. To date, southern EU neighbours have been broadly successful in maintaining stable exchange rates, albeit in some

cases at the expense of using reserves. Countries with currency pegs benefited from significant monetary easing (and to some degree from liquidity provision) by the monetary authorities conducting monetary policy for the anchor currency. For highly dollarised economies, such as Lebanon, the currency pegs serve an additional purpose in stabilising balance sheets and debt service.

On the whole, the exchange rate adjustments that did occur provided an easing of monetary conditions. However, they have been accompanied by substantial wealth redistribution and balance sheet adjustments, and in some cases added to vulnerabilities in the banking sector in the wake of external stabilisation, for instance as the weight of foreign-currency-denominated liabilities increased in terms of domestic currency.

Rising risk aversion has meant an **increase in financing costs**, downgrading of ratings, and a sharp **increase in perceived default risk**. EMBI spreads and credit default swap (CDS) spreads provide measures to gauge the impact of changes in risk premia (box I.1.3).<sup>(2)</sup> Rising interest rate spreads according to these measures (which occurred also for private sector interest rates) provide evidence of a substantial increase in the costs of foreign financing, both for governments and corporations. Interest rate spreads, which had fallen to historically low levels in the years before the crisis on the back of high risk appetite, peaked around the time global financial turmoil in the autumn of 2008. These figures testify to the turnaround in investors' risk assessment of emerging markets, with the cost of foreign borrowing increasing sharply as external liquidity evaporated.

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<sup>(2)</sup> EMBI spreads measure standardised yield differences on foreign bond issues and are available only for a selected number of emerging economies. CDS are credit derivative contracts, whereby the buyer pays the seller in return for a pay-off if the underlying instrument on which the CDS is written defaults. In this sense, a CDS is equivalent to an insurance premium on defaulting of a credit (although the 'credit events' specified in contracts can be more varied, e.g. delayed payment or restructuring). While they offer a less than perfect measure, CDS spreads can be interpreted as signalling changes in country risk as perceived by investors. Similarly, EMBI spreads offer an indication of the costs of external financing.

Eastern neighbour countries suffered stronger increases in interest rate spreads than Mediterranean ones, even though the latter also felt the negative consequences of tightening external liquidity conditions. Interest rate spreads for eastern neighbours decreased less during the episodes in early 2009 where liquidity conditions and sentiment in financial markets somewhat improved, reflecting relative risk aversion on the part of investors.

The crisis has impacted particularly strongly on countries with high external financing and roll-over needs, be they public or private. The degree of **foreign indebtedness** and the **external exposure of the banking sector** are thus important determinants of how conditions in the global markets feed through to the domestic economies of the neighbour countries. Table I.1.1 gives an overview of some financial indicators that can shed light on vulnerabilities from the external side and from the financial sector. Such measures could for instance give an indication of the costs of refinancing debt at higher interest rate spreads and of the responsiveness to deleveraging by internationally active financial institutions. A few neighbour countries exhibit a relatively high ratio of external debt to GDP of around 60% or more (Moldova, Tunisia, Ukraine and in particular Lebanon). Statistics on cross-border exposures by BIS reporting banks (which cover the overwhelming share of internationally operating banks) shed some light on the external exposure of banking sectors in the neighbour countries to advanced economies. On the whole, among both Mediterranean and eastern neighbours the relative size of foreign claims on the domestic banking sector is not particularly high by international standards, with only Jordan and Ukraine reaching a level as high as 15% of GDP.

As regards the extent to which the financial sector was affected by the crisis, Eastern neighbour countries (with some exceptions, in particular Russia) have largely privatised banking sectors which are relatively sensitive to developments in global financial markets. Also, the higher loan-to-deposit ratios than, for instance, in Mediterranean countries indicate a greater sensitivity to rising financing costs (table I.1.1). This poses some issues of financial stability even if most of the acute banking

problems in the region have been with domestically owned banks. The situation differs much from country to country. In Russia, the authorities actively supported the financial sector through liquidity support and recapitalisations. In Armenia, Georgia, and Ukraine banking sectors remain vulnerable, despite stabilisation efforts.

More closed banking sectors in the southern Mediterranean implied lower external exposure and greater resilience to the first-order impact of the crisis, even though in some countries (in particular Egypt) privatisations and the opening up to foreign capital have led to a substantial increase in foreign involvement in the financial sector since 2005. Institutional characteristics further helped determine the impact. The lower degree of external linkages, the orientation towards more traditional forms of finance, the support provided by a high degree of state ownership and hence of implicit or explicit government guarantees and the more conservative loan-to-deposit ratios all helped soften the direct impact. Strong prudential restraint and portfolio rebalancing has even left Lebanon with well-capitalised banks that are highly liquid (barring a sudden surge in demand for government paper).

However, Mediterranean banking sectors may face more difficulties in subsequent rounds of the transmission of the crisis as the real economy is being affected, and as the financial sector is exposed to adverse trends in equity and real estate markets and to tighter liquidity conditions. Structural weaknesses in the banking system as, for instance, evidenced by high non-performing loan ratios, weaknesses in administrative organisation and risk management, and severe difficulties for small and medium-sized enterprises to obtain credit add to the vulnerabilities. Hence, financial sectors in Mediterranean countries remain vulnerable to indirect or second-round effects of prolonged financial stress and deleveraging of balance sheets in mature economies as it impacts on liquidity and financing costs. This in turn may well pose a drag on credit and economic activity.

Differential **changes in risk appetite** among investors also partly determined how the crisis impacted on the financial sector and on exchange rates (box 1.1.3). For a part, this is because in times of crisis existing financial vulnerabilities (which were clearly present in many eastern neighbour countries) matter a lot in determining the perception and response of international investors. With increased uncertainty, a heightened risk perception of common risks among market participants tends to increase correlations in financial market among countries that are seen to be belonging to a certain vulnerable region, despite widely differing fundamentals. In such an environment, with a steep risk-price curve, conditions are in place for strong capital flows and current account reversals and aggressive re-pricing of risk with ensuing pressures on exchange rates, with a great likelihood of overshooting. Exposed financial sectors in eastern neighbour countries certainly were much affected by the broader negative sentiment towards a broad class of financial assets originating in 'emerging Europe'. Mediterranean countries were not exposed to a similar degree of risk aversion, even though in several cases the debt and banking exposures to the rest of the world are not lower than among eastern neighbours. Although capital controls and the often substantial involvement of the state (despite some privatisations and involvement of foreign banks in recent years) in the mainly domestically oriented banking sectors played a role in partly insulating them from the short-term direct impact of the crisis, this has been costly in terms of medium-term access to international finance and ultimately economic growth. Moreover, being outside the main areas of turmoil and being perceived as relatively safer countries, Mediterranean neighbours appear to have been relatively more resilient to risk aversion among investors. Although foreign investment is set to decrease markedly and several large investment projects have been delayed, the rebalancing of foreign portfolios by Gulf countries may partly cushion the effect on the region. Lebanon is a case in point, as the banking sector has attracted a lot of liquidity in the wake of the crisis, probably due to portfolio shifts and search for yield in view of the relatively high interest rates offered.

Table I.1.1:

**Exposures and other financial indicators**

as % of GDP in 2008 unless indicated on the line below

	Algeria	Egypt	Israel	Mediterranean ENP-countries						Syria	Tunisia
				Jordan	Lebanon	Libya	Morocco	oPt			
1 Net international investment positions		-6.4 2007	-9.3 2007	-128.5 2007				-38.2 2007			-106.3 2007
2 Cross border bank liabilities bank loans (08Q4)**	1.2	9.6	4.8	15.0	16.5	1.1	6.6	0.1	1.4	9.6	
3 Cross border bank assets		10.8	15.2								
4 Cross border bank exposures		-18.7	2.3								
5 Net FDI	0.6	7.5	1.4	11.8	4.7	3.6	2.7		3.8	4.6	
6 Net cross border portfolio investments		0.8	3.5								
7 Net remittances	0.6	5.3	1.5	14.7	12.0 2007		6.9		1.5		
8 Tourism income	0.6	6.6	1.8				7.3				
9 Exports of goods	75.8	32.8	40.4	38.7	11.5	88.4	19.5		23.2	48.6	
10 Imports of goods	37.9	38.8	42.4	74.8	37.3	37.1	35.3		26.3	58.7	
11 Trade balance	37.9	-6.0	-2.0	-36.1	-25.7	51.2	-15.8		-3.1	-10.1	
12 Current account balance	22.0	0.5	0.8	-23.9	-11.4	48.3	-4.8	2.4	-4.1	-4.4	
13 External debt (eop) of which private debt	3.0	20.1 7.2	42.8 15.8	25.8	190.8 151.7	8.9	21.1		10.5	66.6	
14 FOREX (eop, excl. gold)	92.3	19.8	21.4	42.8	44.3	135.2	28.2		12.1	22.5	
15 Deposits in domestic currency	48.9	61.6	122								
16 Loans (as % deposits)	52.1	53.1	86.9				117.6				
17 Non-performing loans	5.0 2007	7.9	1.5				11.3				
18 Stock market capitalization (08M12)	0.0	45.5	73.6				0.0		0.0		
19 Sovereign credit rating*		BBB-/BB+	AA-/A	BBB/BB	B-/B-		BBB/BB+			A-/BBB	

**MED and CIS - Exposures and other financial indicators (% GDP)**



(Continued on the next page)

Table (continued)

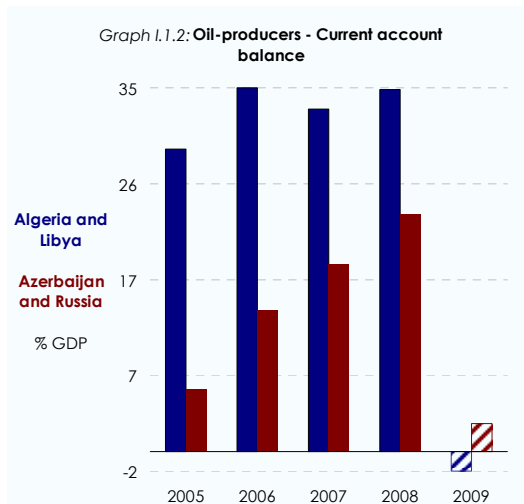
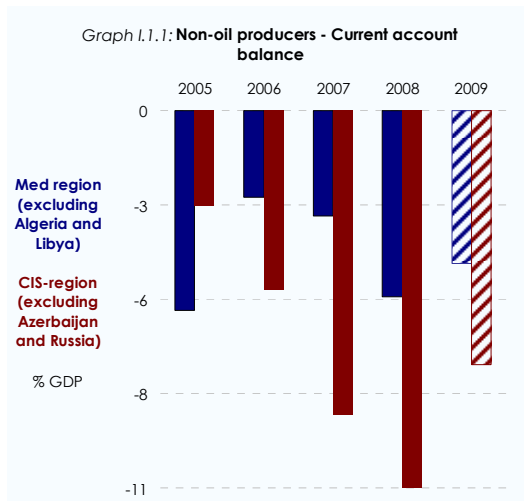
	CIS ENP-countries and Russia							
	Armenia	Azerbaijan	Belarus	Georgia	Moldova	Russia	Ukraine	Kazakhstan
1 Net international investment positions	-22.7	2.0	-17.6	-69.9	-61.8	-9.8	-21.9	-41.5
	2007	2007	2007	2007	2007	2007	2007	2007
2 Cross border bank liabilities		5.4						
bank loans (08Q4)**	2.2	6.9	5.2	4.1	9.2	9.4	15.9	12.2
3 Cross border bank assets		3.1						
4 Cross border bank exposures		-2.3						
5 Net FDI	5.8	-4.1	3.6	9.5	11.2	3.5	3.6	
6 Net cross border portfolio investments	0.1	-9.4	0.0		-0.1			
7 Net remittances	13.7				31.2			
8 Tourism income		0.6						
		2007						
9 Exports of goods	9.4	74.4	54.8	28.1	27.2	28.1	37.6	
10 Imports of goods	31.5	18.4	64.9	57.9	80.5	17.4	47.0	
11 Trade balance	-22.1	56.0	-10.1	-29.8	-53.3	10.7	-9.4	
12 Current account balance	-12.6	35.5	-8.2	-22.6	-16.7	6.3	-6.1	
13 External debt (eop)	15.3	19.2	24.6	35.6	68.2	28.9	58.0	80.4
of which private debt		11.7		20.7			46.9	
14 FOREX (eop, excl. gold)	11.8	14.0	4.8	10.9	27.7	25.4	17.3	
15 Deposits in domestic currency		2.6			16.1			
16 Loans (as % deposits)		164.7		189.9	138.8			
17 Non-performing loans		0.4		3.7	9.5			
18 Stock market capitalization (08M12)	0	0	0	0	0			
19 Sovereign credit rating*		BB+/BB+	BB-/B+	B/B		BBB+/BBB	B-/CCC+	BBB/BBB-
	Average	Average	Other regions and countries					
	<b>MED</b>	<b>CIS</b>	<b>GCC</b>			<b>EU27</b>	<b>G20</b>	<b>Iceland</b>
1 Net international investment positions	-57.7	-28.8						-125.5
2 Cross border bank liabilities	21.2	5.4						
bank loans (08Q4)**	6.6	7.5		68.6		135.9	11.6	130.2
3 Cross border bank assets	13.0	3.1						
4 Cross border bank exposures	-8.2	-2.3						
5 Net FDI	4.5	4.7						4.4
6 Net cross border portfolio investments	2.2	-2.3						11.6
7 Net remittances	6.1	22.5						
8 Tourism income	4.1	0.6						
9 Exports of goods	42.1	37.1		69.3				34.8
10 Imports of goods	43.2	45.4		38.1				35.4
11 Trade balance	-1.1	-8.3		31.2				0.1
12 Current account balance	2.5	-3.5		19.5				-11.1
13 External debt (eop)	43.3	39.1		50.3				670.2
of which private debt	58.2	26.4						
14 FOREX (eop, excl. gold)	46.5	16.0		14.1				15.1
15 Deposits in domestic currency	77.5	9.4						99.9
16 Loans (as % deposits)	77.4	164.4		94.3				173.8
17 Non-performing loans	6.4	4.5						
18 Stock market capitalization (08M12)	23.8							
19 Sovereign credit rating*			AA-/AA-					BBB+/BBB-

Sources: Central banks and Ministries of Finance, BIS, IMF, Commission.

Notes: \* Standard and Poor's, on local currency/foreign currency \*\* BIS-reporting banks.

"Other G20" contains Argentina, Australia, Brazil, Canada, China, India, Indonesia, Japan, Mexico, South Africa, South Korea, Turkey and US.

More information on this table is available upon request.



The strong upsurge in **capital flows** to emerging markets (often mirrored by widening current account deficits on the part of the receivers), which occurred in the wake of high risk appetite, reversed sharply as the crisis started to unfold (graphs I.1.1 and I.1.2). The re-pricing of risk and adjustment of portfolios led to a very sharp contraction in gross capital flows in the second half of 2008. This development likely continued into 2009. EU neighbour countries benefited from strong capital inflows, in particular of **foreign direct investment**, in recent years. But investors drastically reduced their exposure to emerging economies as the global crisis intensified, a pattern visible across regions and financial instruments. Neighbour countries, in particular those with substantial external exposure, started feeling the effect of the fall in foreign direct investment, portfolio and bank

finance inflows towards the end of 2008, with an ongoing adjustment expected in 2009. According to the latest estimates of the International Institute of Finance, capital flows to emerging markets would remain at a low level in 2009 across all regions of the world.

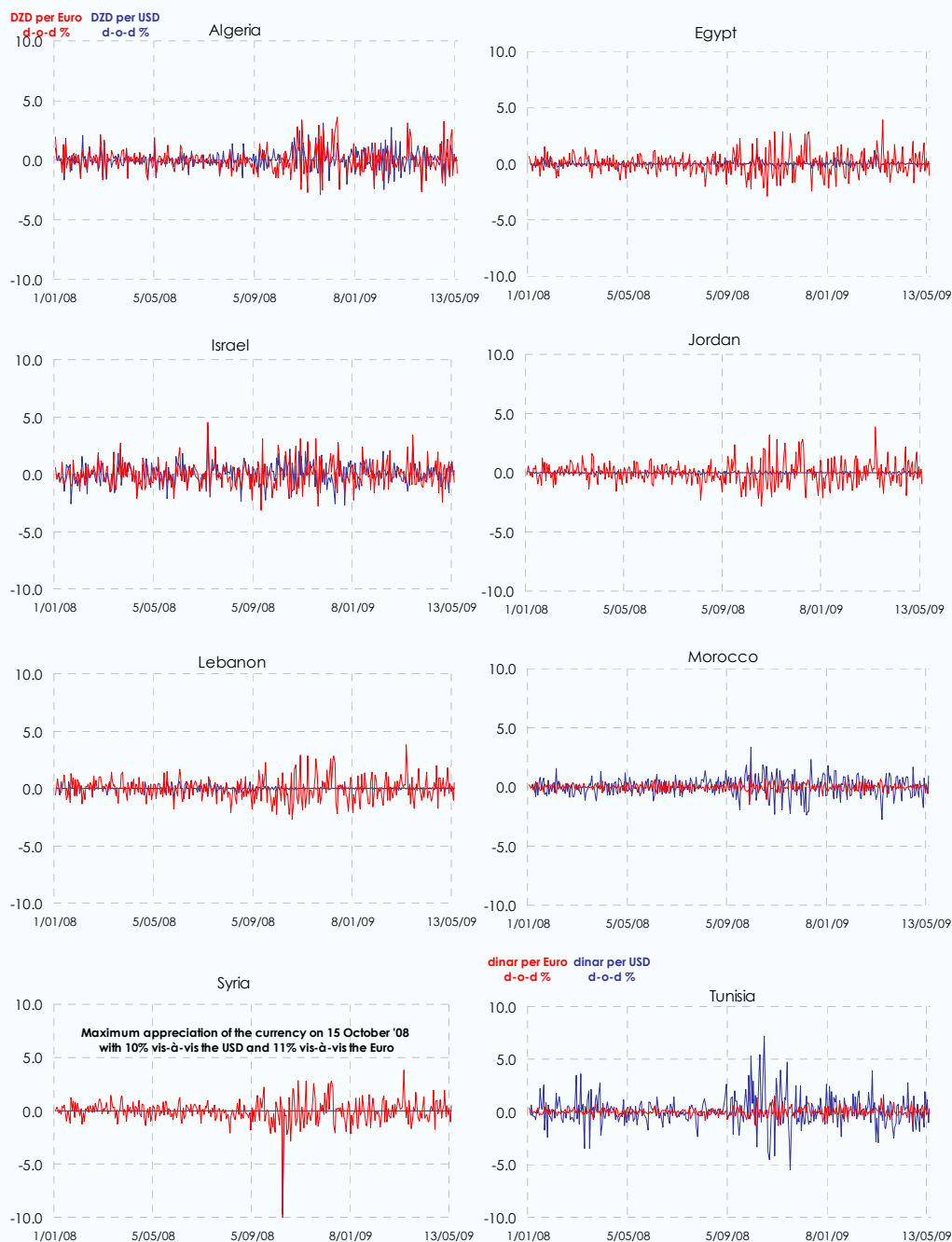
For countries with a high **public debt**, increased debt servicing and rating downgrades pose a clear challenge to fiscal policy. In addition, the fiscal burden of shoring up the capital and guaranteeing the assets of financial institutions is burdening public finances. This triggered external funding needs, which in several cases led ENP countries in the eastern neighbourhood to turn to international financial institutions for assistance.

While the **challenges** among the eastern neighbours are formidable and clearly visible, Mediterranean neighbour countries also do face substantial challenges. Structural rigidities, adjustments in remittances, and a large public sector with notable inefficiencies will weigh on the adjustment in the Mediterranean, especially since it is likely that the full brunt of the crisis will only be felt in 2009 as the collapse in trade, remittances and foreign investment is expected – with a lag – to lead to a marked slowdown in growth. In any event, both eastern and Mediterranean neighbours are likely to suffer notably from the delayed fiscal shock to revenue that would result from slowing growth.

As regards the severity of the crisis and the **policy responses**, cross-country experiences differ markedly in function of initial conditions, available policy cushions, and the differentiated policy actions taken (for a detailed overview of policy measures see the regional overviews and country chapters for in parts II and III of this paper). In view of the deepness and synchronicity of the global crisis, its fall-out can be conjectured to last for an extended time period, with several rounds of feedback and adjustment, and it is still early in the process to judge on the final outcome for any of the affected economies. A turn for the positive depends on the recovery of the world economy.



Box I.1.4: MED – Exchange rate volatility



In the Med region exchange rate volatility increased in the course of 2008, in particular in Algeria, Egypt, Syria and Tunisia.

Source: ECOWIN Reuters.

### Box 1.1.5: CIS and Iceland – Exchange rate volatility



In the CIS region exchange rate volatility strongly increased in the course of 2008, in particular in Russia and Ukraine. The currencies of Armenia, Belarus, Georgia, Ukraine and Russia markedly depreciated (as follows from the big upward movements).

Source: ECOWIN Reuters.

#### 1.4. POLICY ISSUES

The current crisis sheds new light on a number of policy issues. EU neighbour countries face huge challenges, as do other countries, not only in responding to the crisis, but also in putting their economies back on a sustainable growth trajectory. Across the globe, the crisis has sparked bold and multifaceted policy responses. In December 2008, the EU took action to prevent a financial meltdown and agreed to put in place a European Economic Recovery Plan to support the economy and create the conditions for recovery. Coordinated European action to recapitalise and guarantee banks across the EU helped stabilise the banking industry and helped restore liquidity. The EU is now moving forward in developing proposals to establish a strengthened European financial supervision system. The collective policy actions will ensure a level playing field and compliance with state aid rules, upholding the benefits of the Single Market, while limiting the impact on public finances and ensuring fiscal sustainability. Since its adoption, the Recovery Plan has been broadly implemented with the size of the fiscal support (including automatic stabilisers) amounting to more than € 400 billion or 3.3% of EU GDP, while monetary policy has been eased considerably.

In view of the large cross-country variation in economic and financial structures among EU neighbour countries, policy responses have been diverse, in function of initial conditions and of the varying degree to which urgent stabilisation was needed. In several EU neighbour countries, risks may materialise as the real economy adjusts to the crisis (with a marked impact also on public finances) and in function of adverse developments in the wider region. Strong vigilance to protect financial stability is therefore needed. The cushion provided by stimulus packages and by donor-funded loans will give some relief. But they come at a cost, to the extent that the accumulated debt has to be serviced.

On the whole, there was a need for more far-reaching and encompassing policy actions in several eastern neighbour countries in order to stabilise the economies. In several instances, the EU and international financial institutions were involved in supportive actions to counter the

sharp reductions in private foreign inflows. For the most affected countries among eastern neighbours this implied monetary easing and liquidity injections as financial sectors came under strain. In several instances, the concomitant pressures on the exchange rates finally led to depreciations or devaluations. By contrast, packages were more modest in several Mediterranean countries with a more inward orientation. Formal and informal exchange rate pegs in the Mediterranean were on the whole upheld. In some countries, considerable fiscal stimulus was put in place, whereas in others a high debt ratio limited the scope for fiscal action. Due to the low loan-to-deposit ratios, the less sophisticated nature of the banking sector (which implied a limited exposure to the worst affected global asset markets) and higher government control, banking sectors in the Mediterranean neighbour countries so far have been less in need of financial sector support. But Mediterranean neighbour countries risk a backlash on government finances going forward as the slowdown takes hold on the real economy. Also, the financial sector is exposed to the falls in asset prices and the lack of liquidity in global financial markets.

Clearly, in the near term stabilisation measures to address the immediate impact of the crisis are the first priority for policy makers. In this regard, policy makers in the EU neighbour region, as elsewhere, face various **trade-offs and dilemmas** in designing concrete measures. For instance, successful external stabilisation may come at the expense of a high fiscal burden, while it will take time to restore foreign capital inflows that would only start again if investors regained confidence in the economy. International support may in such instances help ensure the financing. Countries with a high government debt face a clear limitation in the degree of fiscal easing that they can pursue, and need to take account of the fiscal burden of extending guarantee schemes to help restore confidence in the financial sectors. The fiscal challenge will be aggravated by the decrease in fiscal revenue that is likely to be a delayed effect from the economic slowdown triggered by the crisis. Fiscal measures should be designed with a view to maintaining long-term fiscal sustainability, for instance through robust fiscal rules with a long-term focus. One option is to

curtail distortive public expenditures, e.g. by reducing and/or better targeting food and oil subsidies in countries where these account for a substantial share of public expenditure. With commodity prices having receded from their earlier peaks, but likely to reverse as the global economy recovers, there is a window of opportunity for such reforms. Also, the tax base should be broad enough to support attaining fiscal targets. Monetary and exchange rate arrangements and policies should be consistent with other measures. The extraordinary circumstances have induced some countries to move in the direction of more exchange rate flexibility. However, for countries with a high degree of dollarisation and external debt denominated in foreign currency, the impact of a nominal exchange rate adjustment has to be weighed against the effect of balance sheet adjustments. In the area of financial stability, measures need to be taken to strengthen banking systems and enhance prudential regulation. Securing sustainably low and well-anchored inflation and inflation expectations remains a major challenge for monetary policy, in particular when the economy recovers, to the extent that it would involve unwinding stabilisation measures that were necessary but bear the seeds of inflationary pressures in the future.

A focus on near-term stabilisation and recovery efforts should not stand in the way of continuous reflections on the implications for policy design and longer term targets, which is linked to, but distinct from, the immediate crisis response. There is a risk that a pre-occupation with the direct response to the crisis may delay or jeopardise implementation of a long-term reform agenda that needs to be addressed, implying long-term opportunity costs. In this regard, key issues include those of privatisation versus nationalisation, of protectionism versus trade and market liberalisation (see the boxes on this topic for a more detailed discussion), of fiscal sustainability, and of managing inflation.

As regards financial integration, recent developments have led some to question the usefulness of further financial development and globalisation. To be sure, the current crisis has indeed exposed unacceptable risks in the current functioning and governance of financial markets.

In a globalised world, the unprecedented degree of integration and interdependence has also meant that growing financial linkages increase the transmission of shocks. Against this background, the bold measures being taken to restore stability in the global financial system must be matched by reform to remedy known weaknesses, to strengthen supervision, and identify and prevent the emergence of new vulnerabilities in the future. It is clear that these issues need to be addressed in a coordinated fashion, with a need to enhance sound regulation and supervision, strengthen international supervisory cooperation, reform the governance of the international financial institutions, and enhance multilateral surveillance and thus improve protection against devastating external financial disruptions. Yet there is still a strong case for expecting high benefits from enhanced global financial integration. In any event, countries should not wait to take the measures needed to improve supervision and enhance the functioning of their financial sectors, reducing systemic risk.

In sum, structural reform challenges continue to remain a key issue for EU neighbour countries, and it is important not to lose this out of sight. Of course, recent developments will shed a different light on the optimal structure and pace of measures. But in order to realise the catch-up potential, neighbour countries should continue improving fundamentals and institutional arrangements in order to boost potential growth, increase the efficiency of the public sector, ensure fiscal sustainability, promote entrepreneurship, and reduce poverty. The status quo can be no answer to the development challenge that EU neighbour countries face in the longer run. Looking through the immediate challenge of weathering the current crisis, the fundamental choice is not between reform and growth; it is how to reform to grow optimally. Authorities should be open to the strategies of change that can help bring prosperity.

## 1.5. SUMMARY AND CONCLUSIONS

The crisis is having a profound impact on all regions in the world, including on EU neighbours. No region managed to escape the largest and most synchronous post-World War II

#### Box 1.1.6: The risks of protectionism

The current global financial and economic crisis incubates a number of risks that may have long-lasting negative effects, one of which is protectionism. The spectre of protectionism has reared in several countries, be they advanced, emerging or developing economies.

Policies to achieve protectionist goals, such as imposing tariffs or quotas on imported goods, or putting administrative barriers or anti-dumping legislation on imports, aim to 'protect' domestic businesses and employment. Other protectionist policies that are easier to mask, such as subsidies to local businesses or exports or exchange rate manipulation, serve a similar purpose.

Although these measures clearly benefit some operators, the gains of free trade outweigh macroeconomic losses, especially taking into account the longer-term growth and trade

boosting effects. By and large, and despite wide fluctuations in activity, countries with the highest degree of welfare tend to be those with a high degree of trade openness and global financial integration.

Protectionism will have negative effects on the world economy as a whole and is costly for governments. Lost fiscal revenue in the form of administrative barriers or higher subsidies will drain government budgets.

The current crisis can only be resolved by minimising lasting damage through global policy coordination stimulating economic growth and enhancing the functioning and stability of the global financial system. Protectionism is not a strategy for success.

downturn. However, the relative strength and timing of transmission channels differs markedly, as a function of prior characteristics of

the affected economies, of policy responses, and of the room for manoeuvre available in view of initial conditions.

Broadly speaking, eastern neighbours and Russia have felt the impact of risk aversion and deleveraging more directly and more suddenly than southern neighbours, for instance through sharp adjustments in exchange rates and in confidence, reflecting the higher dependence on foreign inflows (and for some on commodity exports which suddenly became much lower priced), stronger financial linkages, and the openness of financial accounts. The rapid worsening of the economic situation triggered intensive policy responses, in several cases aided by international financial institutions. By contrast, the financial systems of Mediterranean neighbours appear to have been more resilient to the initial shock, in function of their more closed

structure, relatively conservative financing pattern and also due to the rebalancing of Gulf region investment that helped cushion the impact. However, Mediterranean neighbour countries are by no means immune to the downturn and are at risk of facing a prolonged adjustment process as the feedbacks to the real economy weigh in. A rebound in economic activity may be held back by piecemeal policy actions (with a strong domestic orientation and on the whole more limited involvement of the international community) and by some of the very rigidities that mitigated the initial impact of the crisis.

Policy makers face significant challenges in order to ensure economic stability and development in the EU neighbour countries. Naturally, initial policy responses focused on stabilisation, safeguarding financial stability, and mitigating the adverse impact of the initial phases of the crisis. Important policy challenges lie ahead in addressing the adjustments needed in the medium term. As the current crisis is a global

one and occurred in an age of unprecedented interdependence, no recovery can be complete and sustainable until the players in the world economy are once again growing and trading together. This entails that protectionist measures do not provide a viable solution but also that coordination is needed in order to improve the functioning of the global trade and financial systems so as to maximise the benefits of globalisation. The response to the crisis should also not imply losing sight of a longer term reform agenda in order to achieve structural improvements.

The need to respond to the crisis and lessons learnt will imply that policies will be different from those in the past and need to be adequate to respond to the specific challenges. There will be considerable cross-country variation in policy measures and strategies. As the economic and financial structure of countries and their institutional arrangements differ notably, policy levers will have to be used in function of specific circumstances. In some cases, starting conditions imply restricted room for manoeuvre for policies. For instance, the effectiveness of fiscal stimulus is impaired by high initial public debt. And external stabilisation efforts will be unsuccessful in the presence of incompatible exchange rate arrangements. Hence, fiscal policy has to be kept on a sustainable footing whilst monetary and exchange rate policies need to be consistent with fundamentals. Inefficiencies and structural deficiencies in the functioning of the public and the financial sector and of markets need to be addressed in order to be able to benefit from economic recovery and to boost potential growth. Enhanced financial integration will be beneficial, but only with adequate oversight consistent with international best practice.

These processes define a challenging reform agenda for the EU neighbour countries in the years ahead. The severe crisis has changed near term prospects, but should not be allowed to derail the prospects of sustainable welfare gains in future.

### Box I.1.7: Privatisations versus nationalisations

While a great many emerging and developing countries implemented reforms in the public sector by privatising state banks during the last decade, some developed economies recently (partly) nationalised financial institutions.

Until the start of the turmoil in the global financial markets in July 2007, ENP countries had actively privatised state companies, with several implications. First, there were windfalls in fiscal revenue from the proceeds of sales. These one-off proceeds diminished government debt significantly. Second, the privatized companies became healthier and better able to compete with private-sector peers. This stimulated private-sector development, with fair competition, profitable business management and new job creation. Last but not least, the recurrent costs of government remunerations to these companies disappeared.

In the CIS region, privatisation took place at a larger scale and more quickly than in Mediterranean countries.

Meanwhile, the financial crisis forced the governments in the most financially integrated economies (the US, UK and other EU countries) to inject capital in host institutions to reduce systemic risk.

In this emergency situation, governments took stakes in, or temporarily fully nationalised, some financial institutions. Although these are **temporary** measures, there are major differences between state companies in the ENP countries and the recently (partly) nationalised companies in advanced economies concerning **governance** and **operational costs**, not least remuneration.

Nationalised companies in the latter category are steered by an independent board, with a high degree of transparency. The accountability of the board in the eyes of the government and the public has increased. These companies aim to maximise profits. Each board of a (partly) nationalised company pays its employees from current revenue, in sharp contrast with the high burden of 10% of GDP that Mediterranean governments pay each year.

Clearly, privatisation in ENP countries should not be designed merely to reap the benefits of easily achievable targets like efficiency gains or debt stock reduction. The aim should be to boost technology transfer, increase fair competition and help upgrade institutional infrastructure.

Table 1:  
Average budgetary government expenditures by economic type  
Compensation of employees  
(as % of domestic nominal GDP)

Algeria	8.4
Egypt	6.4
Israel	6.8
Jordan	18.3
Lebanon	8.4
Morocco	12.2
Tunisia	10.9
Med countries (average)	10.2
ENP-CIS and Russia	2.7
Non-ENP CIS	4.6
East EU Member States	4.0
Candidate and potential candidate countries	7.8

Source: Government Finance Statistics from the IMF and own calculations.





# Part II

Regional issues

# 1. OVERVIEW OF RECENT ECONOMIC DEVELOPMENTS IN MEDITERRANEAN COUNTRIES

## 1.1. SUMMARY

2008 was a difficult year for the implementation of the European Neighbourhood Policy (ENP) in the Mediterranean shore. Two events had a direct impact on economic developments in the region. First, the extreme variability of food and oil prices created enormous tensions on budgets and spurred a wave of inflationary pressure across the region. Second, towards the last quarter of 2008 Mediterranean ENP economies (MED countries in short) started to feel the impact of the global financial and economic crisis and rushed to come up with economic support packages for the sectors affected. On top of these two major economic shocks, the year was also marked by the violent conflict that followed Israel's military operation of Gaza in December 2008/January 2009, which polluted diplomatic relations and froze negotiations on a range of economic reforms. On a more positive note, the gradual deepening of the ENP was strengthened in 2008 by the development a new initiative: the Union for the Mediterranean was launched in July, sparking new hopes in the region and attracting a great deal of international attention to this area of the world.<sup>3</sup>

In general, policy-makers underestimated the depth and extent of the current financial crisis. MED countries were no exception to the rule. In some developed economies policy actions came rather late and were not entirely adequate for handling the scale and the nature of the crisis. In the Mediterranean region, policymakers were

confident about the resilience of their economies to the international crisis on the belief that insulation from international financial markets would spare their economies. Having been busy containing inflation, MED economies were caught by surprise when the crisis started to hit them in late 2008.

Despite the difficult overall environment, MED countries made significant progress in the implementation of the ENP Action Plans during 2008. Major economic reform efforts were recorded, although their future speed, sequence and depth are likely to be affected by the impacts of the worldwide financial and economic crisis. Some countries advanced in trade negotiations, tax and customs reform and competition policy, and kept introducing reforms conducive to improving the business environment. However, as the crisis spread to the real economy, the economic outlook of these economies is likely to change radically in 2009.

This chapter provides an overview on recent economic developments in MED countries. It describes main reform efforts, including recent economic measures MED countries have undertaken to fight against the impact of the crisis, and discusses economic projections for 2009 at the light of recent economic developments in international markets.

## 1.2. MACROECONOMIC DEVELOPMENTS

**Real GDP growth:** For a third year in a row, **the average growth rate in the MED region hovered around 5%**, a good performance when compared with spreading recession among developed economies. In 2008, most countries in the region grew at rates above 4%, with more than half of them outpacing 5%. The low exposure of their financial markets to financial turbulences and their low integration in the international economy helped them to cushion the impacts of the shock for the most part of 2008.<sup>4</sup> Growth rates, although positive, were

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<sup>3</sup> The July 2008 Paris Summit launched the *Union for the Mediterranean* (UfM) with the objectives of providing a new political impetus to the EU's critical relationship with its Mediterranean partners, providing greater co-ownership and making this relationship more concrete and visible through regional and sub-regional projects, building on the achievements of the Barcelona Process. The first set of projects to be developed under this initiative include the de-pollution of the Mediterranean Sea, the establishment of maritime and land highways, civil protection initiatives to combat natural and man-made disasters, a Mediterranean solar energy plan, the inauguration of the Euro-Mediterranean University in Slovenia, and the Mediterranean Business Development Initiative focusing on micro, small and medium-sized enterprises.

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<sup>4</sup> Israel has always been an exception within the MED region in that its financial and banking system proved relatively

however inferior to those in 2007 particularly in Tunisia, Lebanon and Israel. Economic growth in oil-exporting countries was largely driven by hydrocarbon revenues and the boost to private sector investment financed by FDI inflows from neighbouring Arab countries. Oil-importing countries also registered impressive growth rates reflecting growth in non traditional sectors, abundance of liquidity and strong domestic demand.

The economic outlook of these economies might however radically weaken as the financial crisis spreads to the real economy. **In 2009, the regional average growth is expected to halve to 2.4%.** Basically all the main drivers of economic growth in the region are showing the first signs of weakness: oil revenues are quickly contracting in oil-exporting countries, FDIs from the Gulf countries are falling, and the European demand has taken a serious hit with several EU countries already in recession. Most MED countries would need to rely more upon domestic demand to be able to sustain growth in 2009. In the case of Syria and Jordan, a positive stimulus might derive from fast-rising import demand from neighbouring Iraq, which is undergoing a rapid reconstruction.

All countries in the region expect lower growth in 2009, although the reasons are variable. Oil exporters are getting hit quickly; plummeting oil prices have already reduced government revenues drastically, held back ambitious infrastructure plans, and reduced drastically growth projections; trade surpluses are being and will be further reduced, limiting the future ability of these governments to cope with social challenges and unemployment. Oil importers (Tunisia, Jordan, and Morocco) have welcomed cheaper oil; trade deficits are narrowing and pressure on budgets will be eased since governments will have to employ fewer resources to finance oil subsidies; however, trade

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robust despite its high integration with the global economy, free capital mobility and the extensive international trade and financial flows. Notwithstanding some stress in the lending rates and the equity and corporate markets, the functioning of the financial system was not severely impaired. This is the result of the prudent banking practices, the increased transparency and the longstanding implicit government guarantees that anchored confidence.

dependence on economies already in recession will also bring about a contraction in growth projections.

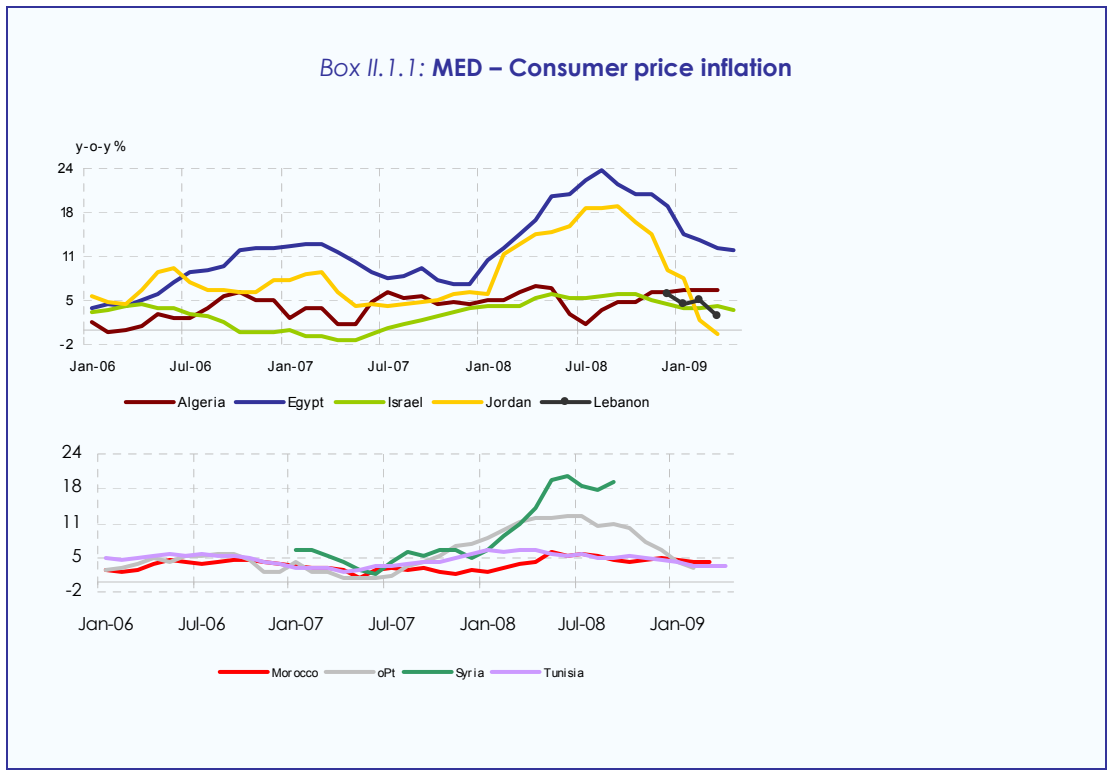
**Falling average unemployment rates:** The region has the highest, albeit decreasing, levels of labour force growth (3.4% per year: 2000-2005, 3.0% per year: 2005-2010) than any other region in the world, except sub-Saharan Africa. Labour force growth is expected to remain high, increasing the pressure for job creation.<sup>5</sup>

Consistently high average growth rates have been translated into falling average unemployment rates (2004: 13.8%, 2008: 11.9%<sup>6</sup>), narrowing the gap with other developing regions. Unemployment rates have contracted in almost every country during 2008 (over one point contraction in Algeria and Israel), excluding Syria where unemployment has raised to 9% in spite of the positive economic growth at 5.2%. Egypt has gone under 9% for the first time in 2008, but the remaining MED countries (excluding Israel) still have unemployment rates equal or above 9%. The employment gains made during 2008 might however be at risk by the gloomy regional average growth projections for 2009 combined with economic recession in some European countries which traditionally absorb a large part of MED countries' migration.

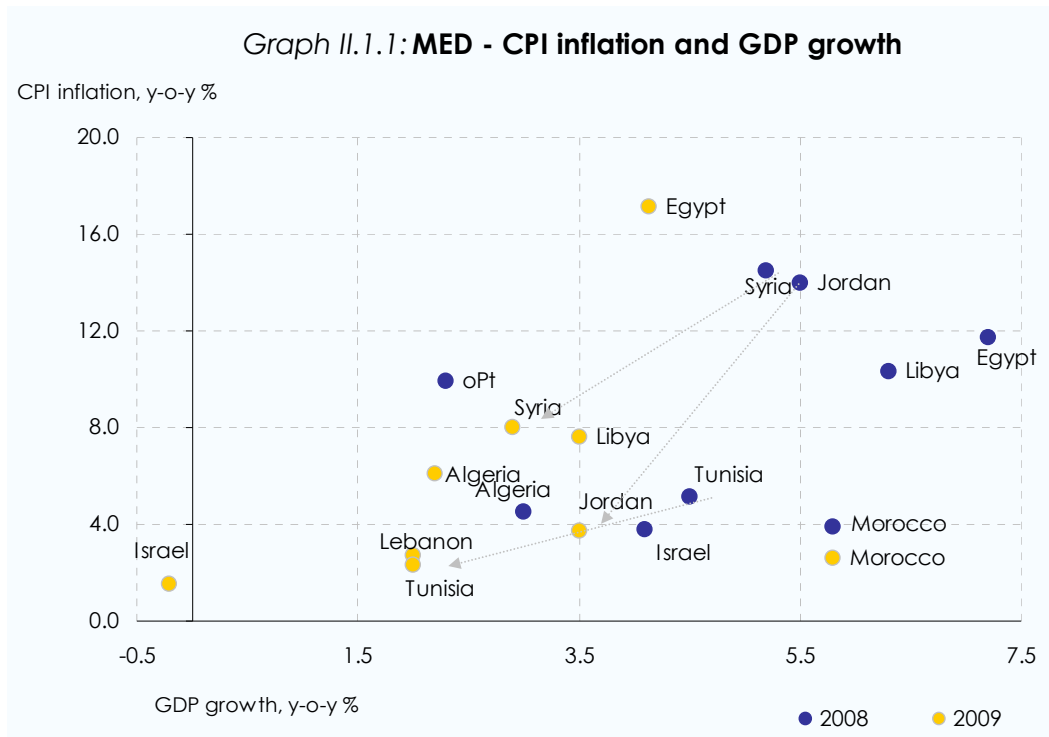
**Inflation and monetary policy:** The MED region has suffered from inflationary pressures fuelled by a combination of strong domestic demand, monetary expansion –partly due to growing liquidity resulting from high oil prices in the first half of 2008 and capital inflows— extraordinary high oil and food prices, and rising housing costs (Box II.1.1). **Average inflation more than doubled y-o-y and reached 8.8% end-2008 up from 4.3% in 2007,** and this happened despite a wide use of oil and food subsidies across MED countries. Inflation rates multiplied by six in Israel, tripled in Jordan, Lebanon, the occupied Palestinian territory (oPt), and Syria, and doubled in Morocco.

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<sup>6</sup> These figures exclude Libya, for which unemployment rates are only available for 2007.



In Egypt, inflation reached 18.3% end-2008 despite the fall in commodity prices during the second half of 2008.



The **exchange rate regimes** among MED countries vary from fixed pegs to the USD (Jordan, Lebanon, Syria), to euro-dominated baskets (Morocco, Tunisia), to managed floats (Algeria, Egypt) and free floats (Israel) (see Boxes I.I.4 and II.1.3)<sup>7</sup>. Some countries have been importing inflation for the first half of 2008 due to high commodity prices and overheating demand and accommodative monetary conditions. Inflationary pressures have been mitigated across the region in the second half of 2008 following the steep fall in world commodity prices, in the wake of the weakening demand world wide due to the economic deceleration.

The recent relaxation on inflation pressures has made it possible for some countries to resort to monetary policy easing to stimulate the economy. Key intervention rates were lowered towards the end of the year in Egypt, Jordan, Israel, Morocco, and Tunisia, a movement that was well received among the business community. Recent financial support measures have been described in other Chapters (Chapter I and the country chapters) and include the guarantee of deposits in domestic banks (Algeria, Egypt, Israel and Jordan), loan guarantees and capital injections.

As for the longer run monetary policy two clear trends are emerging in the region: First, a number of central banks have adopted or are planning to adopt inflation targeting frameworks. Israel has already introduced it and Egypt, Morocco and Tunisia are planning to do so. However, the movement to an inflation targeting might be technically and economically demanding, particularly as the high instability in international financial markets might delay the

declared intentions. Second, the MED region seems to be slowly moving towards more exchange rate flexibility.

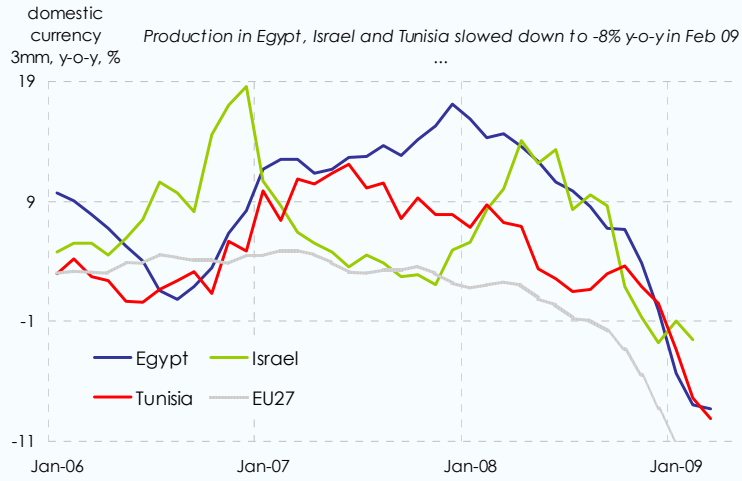
For instance, the Central Bank of Egypt allowed since 2007 more exchange rate flexibility (although the exchange rate regime is still classified as a USD peg), and has let the Egyptian pound appreciate against the USD dollar in order to curb rising inflationary pressure. In Syria, the government switched in 2007 the exchange rate peg from the USD to the SDR. While the Syrian pound appreciated somewhat against the US dollar in July/August 2007, the parity appears to be fixed again since then.

**Budgetary position:** Overall, the region has seen the general government budget deficit widening slightly to 0.5% of GDP up from a close-to-balance position of 0.3% in 2007. Excluding both Libya (+33.2%) and the oPt (-23.3%) from calculations, we obtain a regional average at -1.9%, moderately increasing from 2007 (-1.3%).

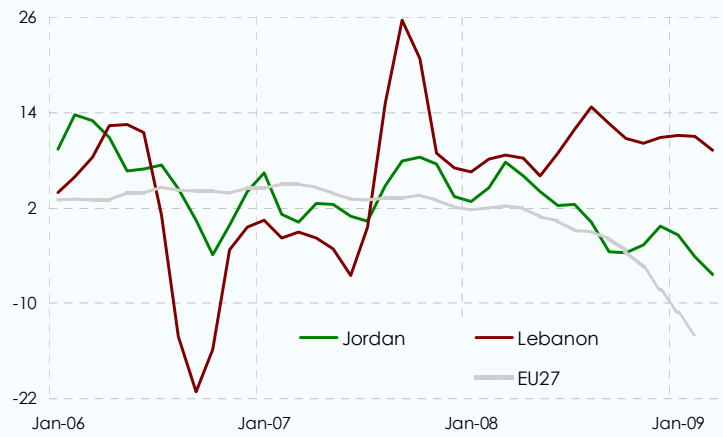
Most countries in the region experienced a weakening in their budgetary positions. In oil-exporting countries fiscal positions remain solid (+9% in Algeria and +33.2% in Libya), owing to buoyant oil export revenues; oil revenues have been used to increase government spending, including rises on civil servant wages, fund ongoing infrastructure, facilitate the expansion of credit to the private sector (+14.7% in Jordan, +10% in Israel), and reduce public debt (15.1% of GDP in Algeria down from 36.6% in 2004; and 4.3% of GDP in Libya down from 9.1% in 2004). Among oil-importing countries, budget balances improved marginally mainly as a result of better fiscal revenue performances. This was the case in Morocco, which registered a small surplus (0.1% in 2008), and in Tunisia, which managed to reduce its budget deficit thanks to mounting efficiency in tax and customs administration. However, the deficit remained unaltered in Egypt at 7.5% of GDP in FY08 (a mild performance given that the economy grew in 2008 at 7.2%) and widely increased in Israel (2.8%) as a result of the rapid slowdown in the economy and legislative changes that reduced the collection of direct taxes.

<sup>7</sup> During 2008, the USD was highly volatile: in the first half of 2008, when investors believed that the financial problems were confined to the US, the dollar depreciation accelerated (USD/€ 1.6). Since then, the dollar has appreciated significantly vis-à-vis major currencies and moved to USD/€ 1.25 in the last quarter of 2008. The currencies of the MED economies fared well against the euro. In 2008, the currencies of Jordan, Egypt and Lebanon appreciated by 10% to 13%, the Moroccan dirham by 3% and the Algerian dinar by 5%. Only Tunisia saw a depreciation of the dinar, by 4%. This stands in stark contrast with the vertiginous fall of local currencies against the Euro in Eastern European economies (-29% in Ukraine, -20% in Russia).

**Box II.1.2: MED – Short term indicators of industrial production**

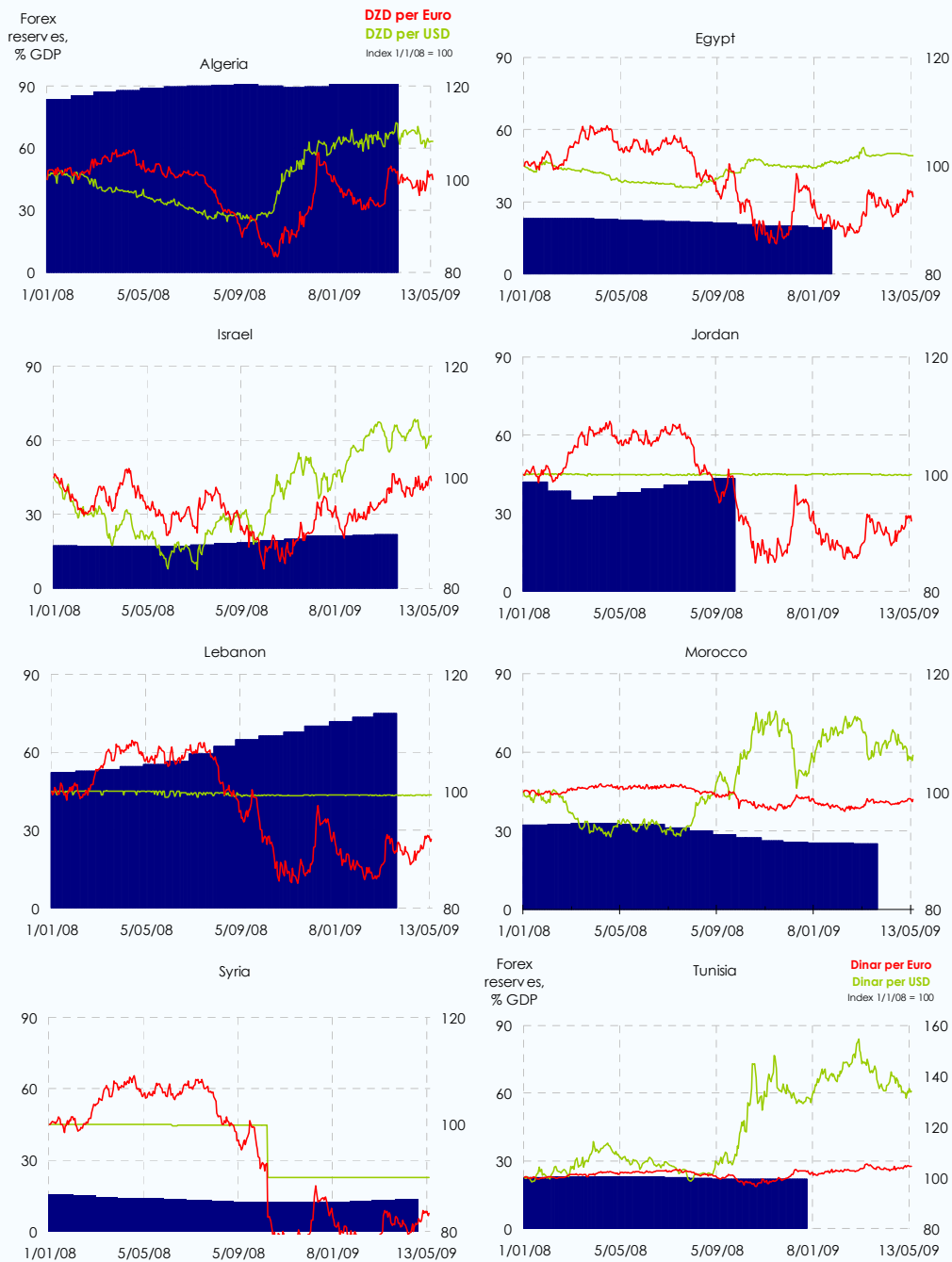


*...while Jordan and Lebanon show less of a slowdown.*



Source: National sources, ECOWIN.

Box II.1.3: MED – Foreign exchange reserves and exchange rates



Source: ECOWIN Reuters, IMF, Commission.

Subsidies continued to substantially impact on public finances in 2008 in some MED countries, with direct food and oil subsidies accounting for an estimated 4% of GDP in Tunisia, 5% in Morocco, and 9% in Egypt.

In 2009, budget balances are expected to deteriorate in all MED countries, resulting in a drop in the average budget deficit to 9.2% down from 0.5% (Graph II.1.2). Oil exporters (Algeria and Libya) are expected to register budget deficits for the first time in a long period (6.4% and 13.1%, respectively), while for the rest of the countries the current budget deficits are likely to deepen in variable intensity (from slight changes in Egypt to more pronounced deteriorations such in the case of Morocco, Jordan and Syria). Gloomy forecast budget deficits are the result of declining oil prices combined with the first fiscal responses of some MED economies to the crisis.

The analysis provided in Table II.1.1 shows that MED countries have responded to the first impacts of the global crisis by putting in place a battery of fiscal stimulus packages geared toward job-creating infrastructure investment (Egypt, Jordan, Morocco), supporting domestic SMEs and employment (Tunisia) and reactivating the sectors affected by the crisis. Although the timeliness of these measures can hardly be contested, there are risks that fiscal expansions

might have negative repercussions in the medium run from a further widening of fiscal deficits.

Lower oil prices have made it possible for MED countries to embark on fiscal expansions, although these have been variable in size: Egypt (1.5% of GDP), Morocco and Jordan (1%) and Israel (0.7%). Some MED countries are better prepared than others to stave off the crisis. In Morocco, years of fiscal reforms efforts have contributed to create the necessary fiscal space to respond to external shocks without incurring in huge public deficits. In contrast, the announced fiscal expansion will further widen the fiscal deficits in some countries (Jordan), therefore increasing budget pressures and the weight of the public debt.

It is difficult to judge whether recent economic policy measures are commensurate with the scale of the problem. Most MED countries have announced that fiscal measures will be temporary in nature but have let the window open for extensions. In the short-run, the scope for counter-cyclical fiscal policy will be determined by several factors such as MED countries' appetite for external financing through international borrowing, the expected volume of privatization revenues, and their current levels of debt. In the current context of scarce liquidity in international markets, borrowing may be an

Table II.1.1:

**Mediterranean countries - Overview of recent fiscal, monetary and financial support**

	Algeria	Egypt	Israel	Jordan	Lebanon	Libya	Morocco	oPt	Syria	Tunisia
<b>Fiscal support</b>										
Fiscal stimulus (% of GDP) ***		1.5	0.7	1.0			1.0			
Nature of stimulus										
* Infrastructure		1.05	√	√					√	
* Export		0.45					√			
* Tax cuts							√			
<b>Monetary support</b>										
Monetary easing (basis points, decrease from peak)		250	375	324			(-) 25**			75
Quantitative easing										
<b>Financial support</b>										
Deposit guarantees		√	√	√						
Liquidity provision			√		√		√			√
Loan guarantees		√					√			√
Capital injection		√					√			
Asset purchase			√							
Exchange rate regime switches										
Drop in reserve requirements				√	√		√***		√	√
Legend: *** Announced, † Effective, √ yes										

Source: Ministries of Finance and Central Banks of the ENP-countries.



expensive option, and privatization revenues will drop as foreign investors behave conservatively and delay buying decisions. Naturally, the main oil exporters will have a bigger margin of manoeuvre to enhance the scope of the fiscal response, but they should closely monitor the speed at which foreign reserves might get depleted, particularly given the extent of decline in foreign demand.

In the long-run, MED economies would need to reduce the dependence on a few commodity exports by diversifying the productive fabric. This would require massive public investments in infrastructure, education, health and renewable energy sources (solar and wind). The fact that most MED countries are sticking to announced public investment programs should be welcomed.

Improved fiscal balances helped **reduce the burden of public debt** in all MED countries in 2008. The regional gross public debt average stands at 57.5% of GDP, steadily declining since 2004 (80%). Country analysis reveals that debt-to-GDP ratios have been reduced across the region. Oil exporters have used oil revenues to repay the debt and oil importers have managed to reduce the debt burden by lowering their public deficits. However, the countries showing high levels of debt (Egypt, Israel, Jordan and Lebanon) will face mounting difficulties to keep reducing the debt stock. Indeed, the privatization revenues that helped to keep public deficits on check are expected to contract at the light of the break on privatization processes brought about by the current international credit crunch.

**Current account:** Excluding Libya from regional averages, the region continues to display a negative average current account balance (-2.3% in 2008 down from -0.1% in 2007). The high volatility of oil and commodity prices has greatly affected trade balances, resulting in a substantial deterioration of the current account balances in all MED countries in 2008 (excepting Libya).<sup>8</sup> Country analysis reveals that

in Algeria it has marginally contracted to 22.4% of GDP in 2008 (and is expected to shrink to just 4% of GDP in 2009) while in Libya it has improved 5 percentage points to reach 48.3% in 2008 (similarly to Algeria, the current account will dramatically contract to -7.9% in 2009). In oil-importing countries, the combination of growing imports (fuelled by high oil prices and strong domestic demand) and declining exports (as the external demand from main trade partners –the EU and the USA- started to contract) explains the substantial weakening of current account balances, particularly in Jordan, Lebanon and Morocco (-24%, -11% and -5%, respectively), indicating how sensitive these countries are to oil price movements and how dependent they are on a narrow number of trade partners (Box II.1.4).

MED countries have traditionally financed large trade deficits by using tourism and remittances revenues.<sup>9</sup> In 2008, total gross remittances inflows for Egypt, Lebanon, Jordan, Tunisia and Morocco reached USD27 billion, three times as much as in 2000. However, the slowdown in European economic growth is already weakening both sources of revenue: the potential earnings of emigrants and their ability to remit wages to their home countries, and the tourism sector, a vital job creator and economic driver in Egypt, Tunisia and Morocco which greatly rely in European demand.<sup>10</sup> In Morocco, tourism revenues and remittances have declined in 2008 by 3.5% and 2.4% respectively. That was also the case in Lebanon, with remittances markedly decreasing as labour demand in the

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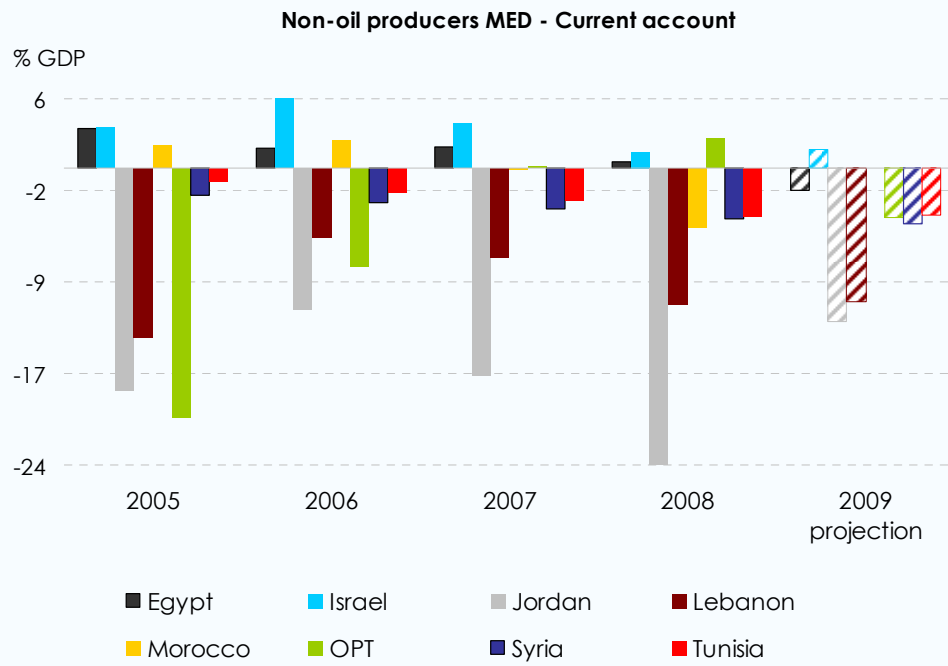
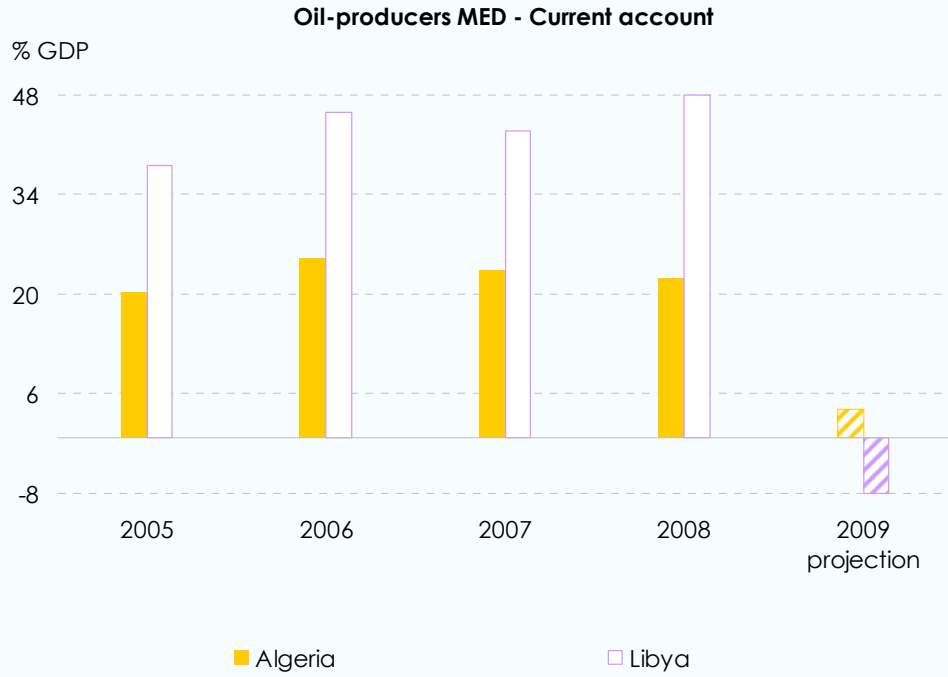
Algeria and Libya in the wave of rising oil prices and are projected to remain at high levels in spite of the recent oil price correction and a declining oil demand from developed countries. In Syria, the oil trade surplus is projected to contract to 1% of GDP in 2010 (down from 9% in 2004), while for Tunisia and Egypt the trade balance keeps improving year after year, turning these countries into net oil exporters. Review of recent economic and financial developments in Mediterranean countries. Frankfurt, 24-25 June 2008. European Central Bank.

<sup>8</sup> The importance of oil prices cannot be underestimated since oil is becoming an economic asset in a growing number of economies in the region (in Egypt and Tunisia oil represents 20% and 15% of total export revenues in 2008, respectively). Oil trade surpluses have improved in

<sup>9</sup> The Med region has received the largest amount of worker's remittances relative to its GDP in the world during 1996-2006

<sup>10</sup> Jordan is an exception. Tourism revenues are holding up (+6% in 2008 accounting for 8% of GDP).

Box II.1.4: MED – Oil and non-oil producers – Current account



Sources: See country chapters.

Gulf region contracted. In Jordan, remittances have decreased by 6% during the last quarter of 2008 although they have increased y-o-y. These negative developments are likely to continue and will result in nearly doubling the regional average current account deficit to over 3.5% in 2009.

### 1.3. TRADE LIBERALISATION AND ECONOMIC OPENING

Trade flows have been among the first variables to be affected by the crisis. World trade volume grew by 4.4% in 2008 at nearly half of the average annual growth of 8.6% over the period 2004-2007. Provisional data for 2009 points to a strong decline in world import volumes (-10%), a situation that can be aggravated as recession spreads among advanced economies.

While the global contracting demand would affect all categories of MED countries alike, the costs of falling trade are getting unevenly distributed across the MED region. As export revenues decline among the MED economies' main trade partners (EU and the US), their imports (including the ones from MEDs) will follow suit, therefore affecting the growth prospects of the countries that are more EU trade dependent, such as Morocco, Tunisia, Libya and Algeria. In countries with a more diversified set of trade partners, the trade impact will not be as radical since import demand from emerging economies is still holding. Oil economies will also suffer from the dramatic fall in oil and primary commodity prices that intervened during the second half of 2008, with export revenues expected to drop up to 19% in 2009 (Box II.1.5).

Since trade is a crucial engine of growth in the MED region, countries have been reacting to declining trade flows. In Syria, the authorities have recently adopted a series of measures aimed at protecting the Syrian industry.<sup>11</sup> In Egypt, the temporary export bans on rice and cement have been extended or re-established in 2009.

Although these are rather isolated movements, their ability to spark a protectionist wave across the region cannot be underestimated. If other countries follow, the overall trend **towards trade liberalization** that has been observed during the last years could be compromised.

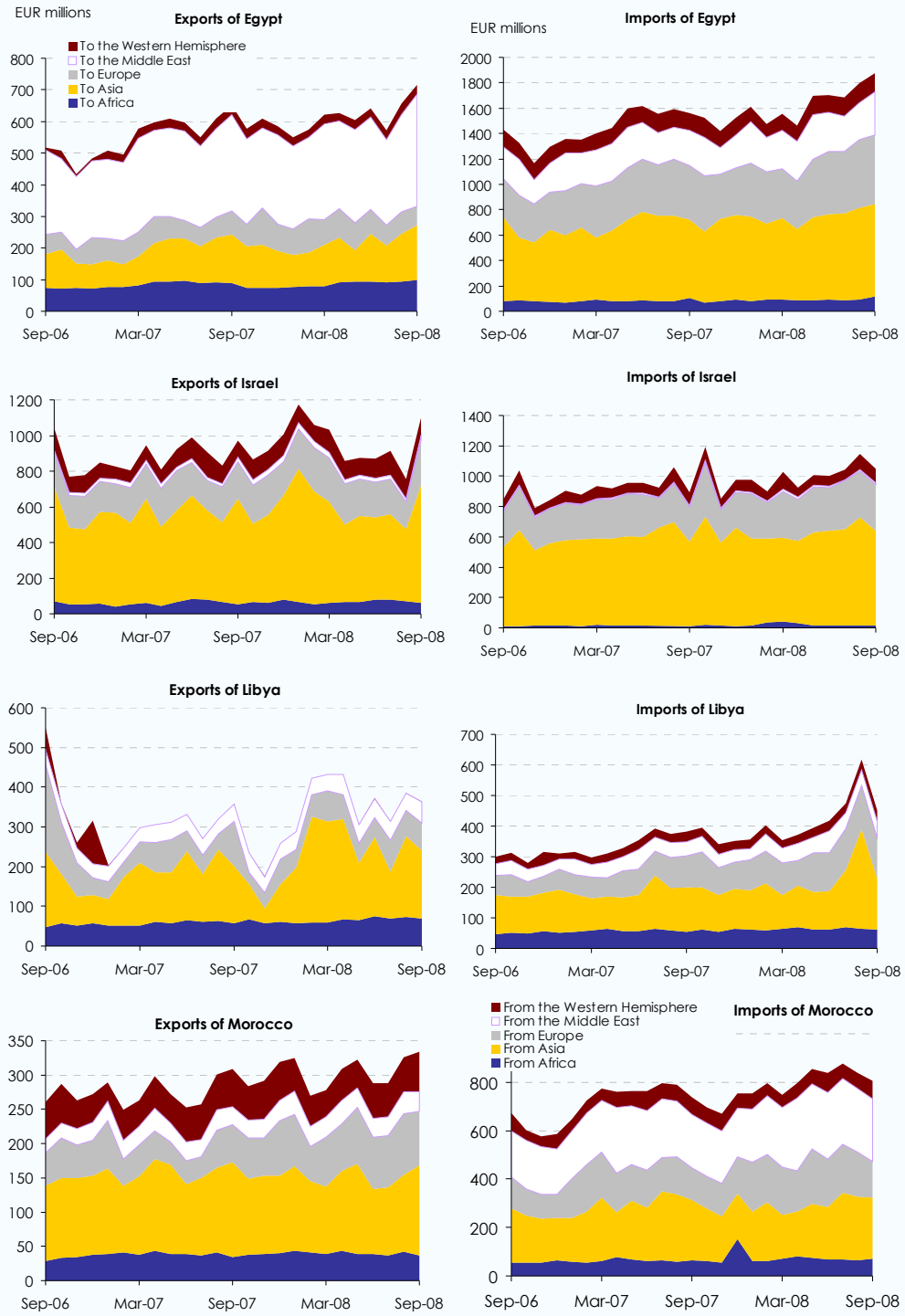
During 2008, MED countries continued to implement the provisions of the Association Agreements, **including the dismantling of tariffs on industrial products under the Free Trade Agreements (FTAs)**.<sup>12</sup> Although trade liberalisation in goods will not be achieved with all partners by 2010, a critical mass of industrial and agricultural liberalisation will be completed by this date, while agreed dismantling schedules will continue to be implemented later on. As of today two countries, Tunisia and the oPt, have a fully effective and implemented FTA with the EU; tariff dismantling continues in other MED countries reducing every year the level of tariff protection.

The final objective of the EU is to establish a fully-fledged **EuroMed regional Free Trade Area by 2010**. This implies that the coverage of the existing FTAs need to be expanded into other areas such as services and investment, further liberalisation for agricultural, processed agricultural and fisheries products, and the establishment of a dispute settlement mechanism. Bilateral negotiations on the liberalisation of services and the right of establishment have been launched so far with Egypt, Israel, Morocco and Tunisia but they make progress at a different pace; negotiations are advanced with Morocco but will take longer for the other three. Negotiations on agricultural, processed agricultural and fisheries products have been concluded with Egypt and Israel, and continue with Morocco and Tunisia. Discussions are ongoing on negotiations in industrial standards and conformity assessment with the objective to negotiate Agreements on Conformity Assessment and Accreditation (ACAAs) with the aim to encourage industrial integration and give MED partners a stake in the internal market.

<sup>11</sup> A total of 25 measures have been adopted in February 2009. They include reduction on fuel prices, reduction on the price of cement, the stop of the use of purchasing quotas, and the set of minimum prices for importing cloths (European Commission, DG TRADE).

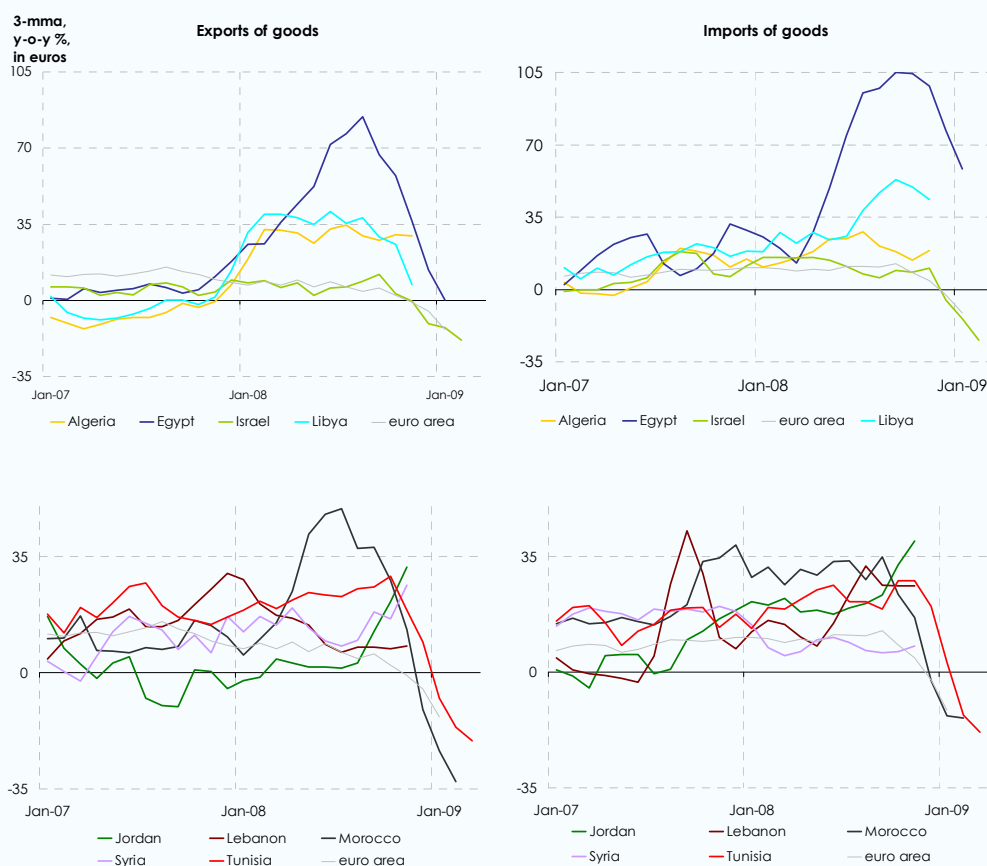
<sup>12</sup> The EU has concluded bilateral association agreements with all Med partners with the exception of Syria, but this is likely to be concluded in 2009.

Box II.1.5: MED – Trade with partners



Source: IMF Dots.

Box II.1.6: MED – Short term indicators of goods' trade



Sources: ECOWIN Reuters.

In addition, MED countries have agreed to pursue efforts towards the opening of domestic markets beyond free trade in goods and services. In this optic, **the establishment of deep and comprehensive free trade agreements (DFTAs)** covering all trade in goods and services between the EU and its MED partners as well as strong legally-binding provisions on the implementation of trade and economic regulatory issues, will be negotiated between the EU and interested MED partners, such as Morocco, and potentially Tunisia and Egypt. **Economic integration in the MED region** has been nurtured by the conclusion of a network of FTA among Southern MED countries. The Agadir agreement, which aims at establishing a FTA between Morocco, Tunisia, Egypt and Jordan entered into force in May 2007. Notwithstanding

the existence of positive lists of products exempted from customs duties, the four countries accepted the principle of a full liberalisation of their trade of goods. Agadir is also endowed with the Pan EuroMed set of rules of origin, therefore providing for diagonal cumulation of origin between 41 trade partners. Its implementation was until recently hindered by certain national sensitivities concerning the trade of agricultural products or vehicles, but in July 2008 the Ministers of Trade reached an agreement concerning the trade of vehicles. Other countries having signed a FTA are Israel and Jordan. In addition, Egypt, Israel, Morocco, the oPt, Syria and Tunisia have signed bilateral agreements with Turkey; however, these are limited in scope since they cover essentially trade in goods, which renders the liberalisation exercise incomplete,

and limits their positive impact in terms of commercial exchanges and potential GDP growth.<sup>13</sup>

MED countries commitment towards deeper **South-South economic integration** needs to be pursued if the region wants to keep attracting Foreign Direct Investment (FDI) particularly in the traditional sectors boosting job creation. The MED region will face increased competition to attract FDI given that the current worldwide financial and economic crisis has halted international investment in 2008, with FDI flows declining by 22% from a historical record of USD1.8 trillion in 2007. The fall in global FDI has been fuelled by two factors: a reduced capability of firms to invest due to limited access to financial resources, and a reduced propensity to invest due to grim economic prospects, particularly in developed countries that have been hit hard by economic recession.<sup>14</sup>

Although the crisis has not spared the MED region in terms of FDI, **MED economies have stood firm so far despite a relative slowdown of inward FDI**. In 2008 the region continued attracting close to 500 projects, but FDI inflows contracted by 6.5% (USD38 bn in 2008 down from USD41 bn in 2007). Egypt and Algeria were the regional champions and attracted USD10.9 bn and USD7.6 bn, respectively, which in the case of Algeria is a major improvement from past years. In contrast, Israel and Tunisia experienced a sharp FDI slowdown (50% and 75%, respectively). When expressed in percentage of GDP, Jordan and Lebanon recorded the highest net FDI in the region (11.8% and 24.7%, respectively). Lebanon maintained its position as favourite destination of total FDI from the Gulf countries over the 2002-08 period (no less than 30%), which has resulted in FDI-to-GDP ratios doubling over the last four

years. In Egypt, although FDI volumes were resilient in 2008, projections for 2009 show a 30% contraction (down to 5.8% of GDP).<sup>15</sup>

The combined effect of the global liquidity crisis and falling oil prices has had a great impact in the Gulf countries, resulting in **decreasing volumes of FDI directed to the MED region**. Investments in the real estate sector, which have long been privileged by Gulf investors, halved in 2008 (€7.6 bn compared with €15.3 bn in 2007) amounting to just 19% of the total FDI for 2008.<sup>16</sup> Productive investment has also been scaled down such as the participation of Nissan in the global plant at Tangiers Med factory, a joint project with Renault. The space left by Gulf countries in 2008 has been filled by European investors (mainly the UK, France, and the Netherlands) which occupy now the first position by issuing 41% of FDI inflows (compared with 17% originating in the Gulf economies). In addition, Europeans invest in a wider range of sectors than Gulf investors, with energy absorbing 31% of FDI funds and 11% of the projects, followed by financial services (15%) and telecoms (11%).

FDI in the MED region is vital for the region. But current sectoral distribution of FDIs needs to be adjusted. Very often FDI is overly concentrated in large-scale real-state and tourist projects that provide little local added-value, do little to stimulate the utilization of domestic factors of production, and have great environmental impacts; moreover, this concentration is increasing year after year. For FDI to make a difference, MED countries need to intensify efforts to attract "quality FDI inflows" conducive to the strengthening and diversification of the industrial fabric according to national priorities, and to finance the large

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<sup>13</sup> Full economic integration of the Maghreb may provide an important rise in the GDP in Tunisia (24%), Morocco (27%) and Algeria (34%) between 2005 and 2015. The establishment of deep FTAs among Med partners could help to foster intra-regional trade. As of today, Maghreb countries trade more with any other part of the world than among themselves (3.36% of the total trade of the Mediterranean region). FDI towards Med countries. Op cit. ANIMA Investment Network

<sup>14</sup> Assessing the impact of current financial and economic crisis on global FDI flows. UNCTAD, January 2009.

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<sup>15</sup> Egypt financed over one hundred projects in 2008 (e.g. concession of the Ein Sokhna port, Red Sea, to UAE's DP World for USD 1.3 billion).

<sup>16</sup> Some projects have survived despite the credit shortage, such as Saudi Arabia's Snasco project in Algeria (€ 400 mn), and Qatar's Diar projects in Egypt (€657 mn) but some others were just cancelled (Emaar Properties in Algeria and Damac in Morocco). Crisis: MED countries stand firm despite relative slowdown in inward FDI. Invest in Med. ANIMA. 19 February 2009.

infrastructure needs that are still hampering the economic activity.<sup>17</sup>

For the European industry, the MED region offers possibilities given the weak European domestic market situation. MED economies offer competitive production costs, represent new markets and have banking systems that have been relatively spared from the crisis. But for FDI to fully materialize, MED countries may want to reinforce efforts to improve the business environment and the attractiveness to foreign investors. The recent adoption of a new law of FDI in Algeria pushing foreign groups operating in its soil to re-invest locally part of the profits made, or Libya's threats about nationalising foreign oil companies may not be the right steps to attract further volumes of FDI to the region.

#### 1.4. BUSINESS ENVIRONMENT

A recent report published by the European Commission provides an assessment of policies towards the enterprise sector in the MED countries.<sup>18</sup> This document reports on the implementation of the Euro-Mediterranean Charter for Enterprise adopted in 2004 and highlights progress on a number of indicators pertinent to the business environment in the region. One of the main conclusions of the report is that over the last five years, MED countries have made considerable progress in fostering an attractive, business-friendly environment and strengthening the application of horizontal enterprise policies.

Egypt, Jordan, Morocco and Tunisia have adopted and implemented a horizontal enterprise policy conducive to improving the business environment. In most cases this entailed enhancing institutions overseeing administrative simplification, articulating a strategy for

regulatory reform, evaluating impact of policy decisions on businesses and reviewing legislation affecting various aspects of business environment as well as amplifying feedback on proposed reform through public-private consultations.

In Algeria and Syria private enterprise remains underdeveloped, and transition from traditional industrial policy is at an early stage. In Algeria there is no specific institution to oversee the process of administrative simplification and regulatory reform, and rules and regulations remain one of the most critical areas for enterprises. The country has only begun to simplify administrative procedures for company registration. In Syria regulatory simplification is also starting to grow in importance, with the revision of business regulations envisaged by the Ministry of Economy and Trade and a new law on streamlining business-related procedures in local administration and the government drafted by the Ministry of Local Administration.

Progress has also been slow in Lebanon and the oPt, since the armed conflict and political instability have either put on hold reform processes or reversed past gains. In Lebanon, efforts to eliminate redundant legislation have been rather ad hoc. In the oPt, efforts towards simplification and harmonisation of current business legislation have been rather recent, including the drafting of a new company law. However, no systematic cost-benefit analysis of new enterprise legislation is common in either country.

Overall, enterprises operating in the MED region still face cumbersome laws and regulations, and administrative barriers to enterprise development are yet to be tackled. So far, only Egypt and Israel have launched comprehensive regulatory reform programmes. In 2008, Egypt's SME unit in the Ministry of Finance adopted a strategy for regulatory reform under the Errada programme which aims to revisit all regulations and legislation related to economic activity including the adoption of the new tax law, simplified tariff schedule and the economic courts law. The Israeli Ministry of Industry, Trade and Labour also launched an in-depth review of all enterprise policy support programmes. A system of cost-

<sup>17</sup> The potential number of jobs created per each million euro invested widely varies across economic sectors. It is highest for the electrical consumer goods (50), and automotive (41) and low for tourism (8) and very low for telecom (1) and energy (1). ANIMA. Op cit.

<sup>18</sup> *The Report on the implementation of the Euro-Mediterranean Charter for Enterprise* is a joint publication of the European Commission, OECD, and the European Training Foundation. It was completed in mid-April 2008.

Table II.1.2:  
**MED - Ease of starting and closing a business**

	Overall registration process		Costs of registration	Minimum capital requirements	Closing a business		Charter for Enterprise*
	Days	Steps	% of GNI p.c.	% of GNI p.c.	Years	Cost, % of estate	
Algeria	15 to 30	14	> 10	> 40	2,1 to 3	> 23	2.2
Egypt	5 to 15	6	> 10	10 to 20	4,1 to 5	8 to 12,9	3.3
Jordan	5 to 15	10	> 10	> 40	4,1 to 5	18 to 22,9	2.6
Lebanon	> 30	5	> 10	> 40	4,1 to 5	8 to 12,9	2.5
Morocco	5 to 15	6	> 10	> 40	≤ 2,1	8 to 12,9	2.6
Syria	> 30	8	> 10	> 40	4,1 to 5	18 to 22,9	1.4
Tunisia	> 30	10	5 to 10	20 to 40	≤ 2,1	> 23	3.5
oPt	> 30	11	> 10	< 10	> 5	< 7,9	2.3
Israel	> 30	5	2,5 to 5	0	3,1 to 4	> 23	3.2

\* 'Cheaper and faster start-up and closing' (subdimension 1.3), a weighted average of scores for policy components ranging from 1 to 5 (best).

Source: Report on the implementation of the Euro-Mediterranean Charter for Enterprise 2008.

benefit analysis of new enterprise legislation was also approved but is not implemented yet.

One of the most straightforward indicators of the quality of business environment is **the ease of start-up**. Most MED countries have been relatively successful in developing policy tools to promote enterprise creation,<sup>19</sup> and company registration procedures have generally improved across the region. One-stop shops to register a company are now available in Egypt, Jordan, Morocco, Tunisia and Lebanon,<sup>20</sup> but a lot remains to be done to simplify company registration in Syria, Algeria and the oPt. Tunisia, Egypt and Israel have cheaper and faster start-up procedures, although in most countries registration process remains lengthy and costly (Table II.1.2).

**Flexibility in employment regulation** is another important feature of a favourable business environment.<sup>21</sup> Although the challenge is to strike the right balance between worker protection and labour market flexibility, labour markets in the MED countries remain

remarkably rigid, pushing employers and workers into the informal sector.<sup>22</sup>

Reform of labour policy has been generally slow across the region as it either requires legal changes or involves difficult political tradeoffs. In practice, no MED country introduced reforms in areas relating to employing workers over the period 2005-2008.

Although there has been a trend for reducing both the **administrative burden for paying taxes and corporate tax rates** across the region, by and large governments have not yet introduced a systematic evaluation of the tax regime and the tax compliance requirements imposed on SMEs.<sup>23</sup> Positive movements have been recorded in Morocco, which reduced the corporate tax rate from 35% to 30% in 2008 and in Tunisia, which cut marginal tax rates and increased its direct tax collection capacity considerably. This has made it possible for firms to file their tax returns online and determine the exact amount of their payment before paying the taxes at the tax office. The burden in terms of

<sup>19</sup> Good practices to promote enterprise creation are the Social Fund for Development in Egypt and the development of microfinance industry in Morocco.

<sup>20</sup> In Algeria a process similar to that of a one-stop shop is run at regional investment facilitation centres operated by the National Investment Promotion Agency (ANDI) for companies eligible to receive investment incentives.

<sup>21</sup> Labour market policy falls out of scope of Report on Charter for Enterprise.

<sup>22</sup> Side effects of rigidity include less job creation, small company size, less investment in R&D, longer spells of unemployment, etc.

<sup>23</sup> It is generally admitted that simple, moderate taxes and fast, straightforward tax administration mean less hassle for businesses, while more burdensome tax regimes create an incentive to evade taxes.



number of payments and time is also significantly lesser.

The overall amount of taxes facing MED companies is high. Tunisia and Algeria have some of the region's highest total tax rates, at 59% and 74% respectively (see BoxII.1.7). Algeria's tax regime is perceived as one of the most difficult in the region and the world, with the number of tax payments to be made in the course of a year, high at 34, and taking some 451 hours per year.<sup>24</sup> Paying taxes is still burdensome in Egypt, taking as much as 711 hours per year, the region's highest value.

Another policy area emphasized in the MED enterprise policy assessment is **easier access to finance**.<sup>25</sup> Credit environment and credit facilities are the two dimensions analysed. Across the MED region, there has been more progress in developing financial facilities for enterprises than in improving the credit environment.

Access to finance is one of the biggest operational handicaps in Algeria and Syria. Bank credit is channelled mainly towards large enterprises, while SMEs rely largely on self-financing. Similarly to other countries in the region, collateral requirements on bank loans are very high. Except for Jordan and Tunisia, implementation of bankruptcy legislation is still weak in many countries, with laws at the drafting stage in Lebanon and the oPt. As recovering bad loans in court is difficult, banks traditionally practice very conservative policies towards SMEs. Access to and availability of information from cadastres is also limited in many countries. With the exception of Israel, Egypt, Lebanon and Tunisia, credit information services are not yet fully developed (Table II.1.3).

In terms of available credit facilities, most MED countries have established credit guarantee schemes. Microfinance facilities are also well developed in Morocco, Egypt, Israel and Lebanon. Access to capital markets for SMEs is still problematic, mostly limited to highly capitalised companies; the availability of risk capital is also very limited.<sup>26</sup>

**Better market access** through lower barriers to trade and investment is equally important for the business environment. Traditionally, transaction costs in international trade have been high in the region and there is a need for simplification. Few countries (Israel and Egypt) have a national export strategy to that effect. However, most have established government export agencies and export promotion programmes. Egypt, Jordan, Morocco and Tunisia have progressed on simplification of procedures for export and import and are more advanced in terms of regional trade integration, while Algeria is the least integrated.

**Procedures for export and import** are becoming simpler across all the MED countries (moving fast in Egypt, Israel and Tunisia and lagging in Algeria). In Egypt, following the upgrade of port facilities and speed-up of customs clearance, the time to export was reduced by one day to 14 days and the time to import by 3 days to 15. The country boasts one of the highest ranks globally (24<sup>th</sup> position out of 181 countries) in terms of the ease of trade across borders and in the MED region is only preceded by Israel.<sup>27</sup> Morocco simplified paperwork, reducing the time to import by one day to 18 days. The entry of private banks in the Syrian market sped the issuance of letters of credit lowering the overall time to import and export (15 and 21 days, respectively). Nevertheless, costs to import and to export remain high in Algeria and Syria. A negative reform was recorded for Tunisia. The country introduced a new requirement that freight arriving at the port be accompanied by a unit of

<sup>24</sup> These were reported in the World Bank's Doing Business 2009, covering the period of June 2007 - June 2008. *Number of tax payments* takes into account the method of payment, the frequency of payments and the number of agencies involved. *Time* measures hours spent annually to prepare and file returns and to pay the corporate tax, VAT, sales tax (goods and service tax), labour taxes and mandatory contributions. *Total tax rate* measures the amount of taxes and mandatory contributions payable by the company in the second year of operation, expressed as a percentage of commercial profit.

<sup>25</sup> Report on the implementation of the Euro-Mediterranean Charter for Enterprise 2008.

<sup>26</sup> Egypt, Morocco and Tunisia have advanced in this area, while Israel has a competitive venture capital industry. In March 2009, the first Stock Exchange was inaugurated in Damascus, Syria.

<sup>27</sup> Doing Business 2009.

the customs authority which increased the time to import by one day to 23 days.

### 1.5. PUBLIC INSTITUTIONS AND GOVERNANCE SYSTEMS

The efficiency of institutions and quality of governance impact the environment in which businesses operate and largely influence a country's overall socioeconomic development and its competitiveness in the global economy. Despite advances in several key areas of the economic reform agenda under the ENP, such as trade negotiations, tax and customs reform, and improvements in the business environment, there has been a notable standstill in democratic reforms and human rights standards. The recent communication from the European Commission on the implementation of the ENP<sup>28</sup> emphasizes the overall lack of progress on governance issues in the MED region in 2008.

Low commitment to political reform was observed in **Egypt**. Despite significant progress in safeguarding women's and children's rights and in promoting access to primary education and healthcare, much remains to be done in the area of human rights and fundamental freedoms.

**Jordan** made progress in penitentiary reform, transparency and the fight against corruption, but no significant advances were noted as regards the independence of the judiciary and the freedom of association.

In **Lebanon**, progress in the fields of human rights, judicial reform, social sector reform, and administrative reform has also been slow. Several reforms could not be enacted as a result of a long political stalemate and legislative blockage.

**Morocco's** and **Tunisia's** efforts in the area of social policy have produced satisfactory results in terms of health care, schooling, poverty alleviation and the protection of women's rights.

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<sup>28</sup> COM(2009)188 – Communication from the Commission to the Council and the European Parliament – Implementation of the European Neighbourhood Policy in 2008.

The dialogue with the EU intensified on the fight against terrorism and organised crime. However, persistent deficiencies in the functioning of the judiciary constitute a risk for the reforms, and the rule of law has to be strengthened in both countries. Freedom of association and expression, and freedom of the press are yet to be made a reality.

According to the Global Competitiveness Report,<sup>29</sup> **inefficiency of government bureaucracy** is one of the factors consistently cited by entrepreneurs as hampering business environment in the MED countries. **Corruption** is also mentioned among the five most problematic factors for businesses in Morocco, Syria, Algeria and Libya. **Inadequately educated workforce** (Egypt, Jordan, Syria, and Libya) and **inadequate supply of infrastructure** (Syria, Libya, Morocco and Israel) present yet another challenge to the national leaderships.

The Global Competitiveness Index (GCI)<sup>30</sup> provides an assessment of several aspects of governance such as confidence in public institutions, corruption, rule of law and public service delivery.<sup>31</sup> Of all MED countries, Tunisia, Jordan and Israel are perceived to have more efficient institutions. In Tunisia, ranked 36<sup>th</sup> on overall GCI, institutions are one of the country's major competitive advantages (22<sup>nd</sup>), with the high public trust of politicians (16<sup>th</sup>), transparent policies (15<sup>th</sup>) and a favourably assessed efficiency of government spending (2<sup>nd</sup>). Jordan's institutions are also assessed rather positively (27<sup>th</sup>), with transparency of government policymaking somewhat lagging

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<sup>29</sup> The World Economic Forum's Global Competitiveness Report 2008-2009.

<sup>30</sup> GCI is produced by the World Economic Forum and measures the overall competitiveness of a nation on over 100 indicators grouped into 12 pillars covering areas such as institutions, macroeconomic stability, health and education, labour and financial markets as well as issues related to inequality, gender bias, mobile phone and internet subscribers, etc. The rankings are based on the Executive Opinion Survey (EOS) completed by top management business leaders around the world. GCI 2008-2009 is available for 134 countries, and for all but Lebanon and the oPt in the MED region.

<sup>31</sup> As these are limited measures of governance and because of a strong business bias (reflected in the questions of and the respondents to the underlying survey, EOS), the GCI should be used cautiously as a governance indicator.

behind (49<sup>th</sup>).<sup>32</sup> In Israel,<sup>33</sup> public institutions have received a more critical assessment, with increasing concerns about inefficient government spending (60<sup>th</sup>) and a deteriorating public trust in politicians (61<sup>st</sup>).

Egypt and Syria rank higher on institutions overall (52<sup>nd</sup> and 54<sup>th</sup> respectively), but Morocco (61<sup>st</sup>) receives better assessment on favouritism in decisions by government officials, efficiency of government spending, burden of regulation.

Transparency of government policymaking is flawed in Syria (106<sup>th</sup>), Libya (100<sup>th</sup>) and Algeria (112<sup>th</sup>). In the latter, it is also coupled with a low public trust of politicians (the region's lowest 72<sup>nd</sup>), suggesting the relations between the government and the civil society need to be enhanced.

In Egypt, Syria, Libya and Algeria, the quality of education and efficiency of goods, labour and financial markets remain weak, hampering their socioeconomic development. In addition to upgrading its institutional environment, Algeria will have to reform its labour market, which is perceived one of the most rigid labour markets in the world, and restructure the very inefficient and unstable financial system (both ranked 132<sup>nd</sup>). A rigid labour market (134<sup>th</sup>) and inadequate educational system (126<sup>th</sup>) remain a major concern in Egypt, and need to be addressed in order to enhance the country's competitiveness.

Many countries in the region have strengthened the legal and institutional framework for **combating corruption**, which in some cases proved instrumental to radically improve the business environment. All but Syria have ratified the UN Convention against Corruption (UNCAC).<sup>34</sup> Some have national anti-corruption laws. Jordan, a leader in efforts to promote the implementation of UNCAC, tops the ranking of the Arab MED countries based on the 2008

Corruption Perception Index, improving its score from 4.7 to 5.1 since the previous assessment.<sup>35</sup> The 2008 CPI shows lower perceived levels of corruption in Algeria (3.2), Libya (2.6) and Tunisia (4.4). For Lebanon (3.0) and Morocco (3.5), the CPI remained unchanged. Perception of corruption worsened for Egypt (2.8), Israel (6.0), and Syria (2.1).

## 1.6. CONCLUSIONS AND POLICY ISSUES

Two important external shocks have greatly influenced the economic performance of MED economies in 2008 and their outlook for 2009: extremely variable commodity prices and the global financial and economic crisis. In this chapter we have described the impact of these shocks on the MED economies and how they have reacted to them. Overall, the relative economic resilience we have witnessed in 2008 is expected to be followed in 2009 by a generalized deterioration of budget balance positions and sizeable deteriorating current account balances, which will test the soundness of the economic fundamentals of these economies and their ability to grow.

Maintaining positive growth rates in 2009 will depend, more than ever, on sound economic policy choices. MED countries will need to keep creating favourable conditions to attract investments, provide job opportunities and increase productivity and exports. This would entail further efforts to integrate in regional and international markets, keep their markets open, diversify exports and markets, implement investor friendly reforms, and assess the cost and benefits of current expenditure policies.

**Deepen integration in international markets:** It is generally agreed that the low international integration of the MED economies' financial sector and prudential lending policies, as well as

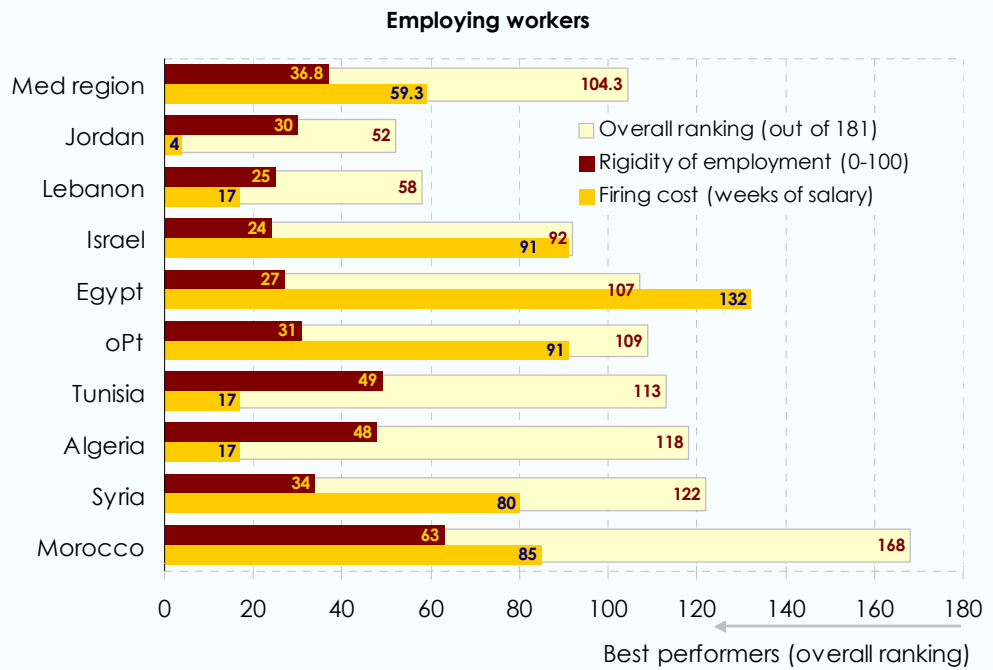
<sup>32</sup> Jordan's GCI (48<sup>th</sup>) is influenced by the country's weak and deteriorating macroeconomic position due to a growing budget deficit and resultant debt level (111<sup>th</sup>).

<sup>33</sup> Israel's GCI, high at 23<sup>rd</sup>, and the MED highest, is largely due to outstanding performance on innovation (6<sup>th</sup>) and business sophistication (23<sup>rd</sup>).

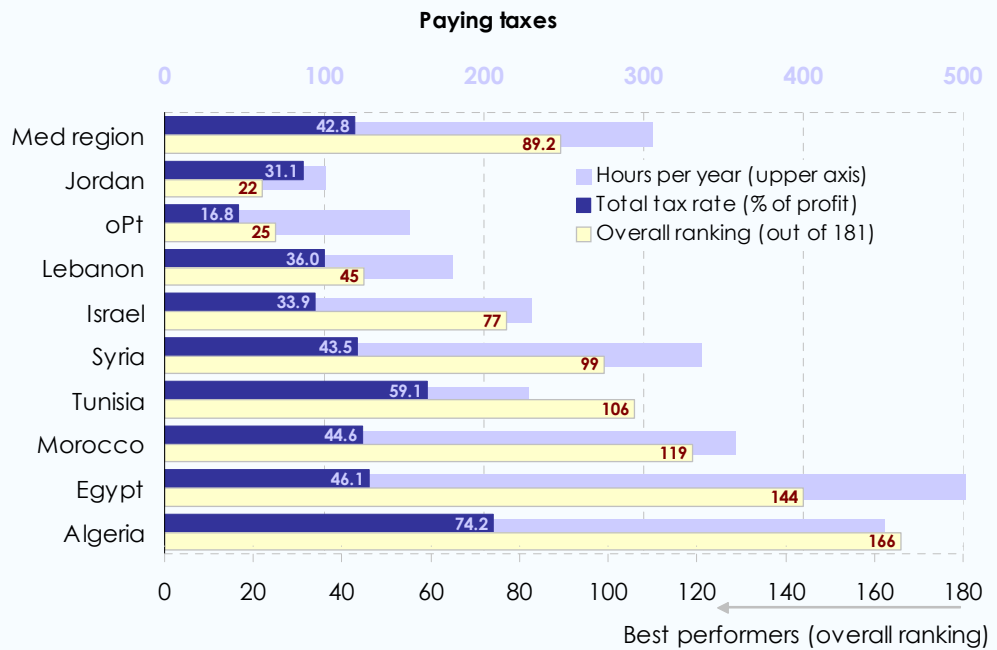
<sup>34</sup> Recent ratifications took place in Tunisia (September 2008), Israel and Lebanon (February and April 2009 respectively). Syria signed UNCAC in December 2003.

<sup>35</sup> The 2008 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 13 polls and surveys from 11 independent institutions. Countries are ranged on a scale from zero (high levels of perceived corruption) to ten (low levels of perceived corruption). The oPt is not included in the assessment.

Box II.1.7: MED – Employing workers and paying taxes



Source: Doing Business 2009.



Source: Doing Business 2009.

their relatively low reliance on external financial flows, have buffered their financial institutions from the worst consequences of the global financial crisis. However, relative isolation from markets has not come for free. Regional investors have missed investment opportunities abroad by being confined to domestic markets. Isolation has also limited the penetration of innovative production techniques from abroad and dampened productivity, therefore reducing the competitiveness of these economies. It is by deepening the economic and financial integration, rather than by isolating from international markets that the MED region can reap the benefits of globalisation. The risks and challenges embedded in deeper economic integration can be balanced by introducing buffers in the form of strengthened supervisory and financial regulations and compensatory measures for the sectors most likely to be touched by increased international competition.

**Pressing ahead with trade openness:** MED countries have felt the pinch of the crisis first and foremost through the trade channel. Exports have rapidly dropped as European economic activity collapsed and unemployment soared in several EU economies in the last quarter of 2008. Imports have also contracted but not enough to avoid a strong deterioration of trade balances. This has sparked protectionism and other trade-distorting policies in the region, which risks retarding market corrections and triggering retaliation. MED countries need to keep their markets open, reduce their dependence on a few commodity exports and increase the number of

commercial partners if they want to increase their resilience to external shocks. Current steps towards liberalization of services and the establishment of more comprehensive FTAs will help the region to better cope with external shocks by increasing their competitiveness, and granting them access to new markets.

**Continue economic reforms:** In times of high uncertainty, countries might not be particularly inclined to undertake further reform efforts. The length and depth of the current global economic downturn being marred with uncertainty, countries might be lured to hold back reforms and delay implementation. Sound economic reforms have contributed to enhance the resilience of MED economies to the effects of the crisis. The extent and nature of the fiscal policy measures MED countries have put in place to combat the crisis have depended on how much fiscal space and financial depth they managed to develop before the crisis arrived. In the case of oil exporters, the natural fiscal space derived from the oil windfall has helped them to cushion the crisis avoiding economic reforms, but has not helped them to overcome over-dependence on oil revenues and their sensitiveness to strong oil price fluctuations. In contrast, oil importers have had to create this fiscal space, which has been invariably the result of consistent and steady fiscal reform efforts. In this process, they have not only improved their public finances but they put in place the mechanisms that will allow them a better management and use of their national resources.

Table II.1.3:

**MED - Easier access to finance - Credit environment**

	Collateral and provisioning requirements	Cadastre	Implementation of bankruptcy legislation	Registry for movable assets	Access to credit information	Credit environment*
Algeria	> 200%	not fully functioning	weak	none	limited to banks	2.0
Egypt	150 to 200%	not fully functioning	weak ↑	not fully operational	broad ↑	3.0
Jordan	150 to 200%	easy, low-cost access	satisfactory	none	limited to banks ↑	2.8
Lebanon	flexible	not fully functioning	in drafting	law in drafting	broad	2.4
Morocco	150 to 200%	easy, low-cost access	weak	none	limited to banks ↑	2.5
Syria	> 200%	not fully functioning ↑	weak	none	none	1.9
Tunisia	150 to 200%	easy, low-cost access	satisfactory	none	broad ↑	2.9
oPt	> 200% ↓	law in drafting	in drafting	law in drafting	limited to banks	1.9
Israel	flexible + registry	available online	strong	available online	historical data available	4.8

\* As in the report on the Charter for Enterprise implementation, a weighted average of scores for policy components ranging from 1 to 5 (best).

Source: Report on the implementation of the Euro-Mediterranean Charter for Enterprise 2008.

As for monetary policy measures, countries where Central Banks have undertaken reform efforts and that have strengthened the prudent management of domestic banks are in a better position to weather the global financial storm. Bank's provisions of liquidity and the lowering of interest rates have helped the economies of Egypt, Israel, Morocco and Tunisia by making capital more accessible to private banks in a bid to stimulate lending. However, Central Banks would need to carefully monitor inflationary pressures before injecting more liquidity into their economies in a bid to further stimulating the economy. A proper balance between fiscal and monetary policies needs to be crafted on a case by case basis.

***Use the current crisis is an opportunity to assess the efficiency of expenditure policies:*** The tighter economic environment has revealed domestic vulnerabilities and raised challenges and opportunities that need to be seized. The decline in international commodity prices would ease pressure on the trade deficits of oil importers and help to keep inflationary pressure on check once the price retrenchment had been fully reflected in domestic prices. In addition, low oil prices are a golden opportunity to undertake a serious rethinking of inefficient food and oil subsidy schemes across the region. Their removal, when politically feasible, or their gradual phasing out, needs to be put at the forefront of economic agendas. New and more efficient mechanisms to protect the more vulnerable layers of these societies need to be developed so the impact of the crisis does not fall disproportionately on them.

Table II.1.4:

Mediterranean countries - Main economic indicators

	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
<b>Real GDP growth (domestic currency, % change)</b>					
Algeria	5.3	2.2	3.0	3.0	2.2
Egypt	4.5	6.8	7.1	7.2	4.1
Israel	5.3	5.2	5.3	4.1	-0.2
Jordan	7.2	6.4	6.0	5.5	3.5
Lebanon	2.6	0.6	7.5	8.5	2.0
Libya	5.6	5.8	6.8	6.3	3.5
Morocco	3.0	7.8	2.7	5.8	5.8
OPT	6.0	-4.8	-1.2	2.3	-3.1
Syria	4.5	5.1	4.2	5.2	2.9
Tunisia	4.2	5.7	6.3	4.5	2.0
<i>MED Region (GDP at PPP)</i>	4.8	5.3	5.4	5.2	2.7
<b>Nominal GDP (EUR billion)</b>					
Algeria	83	93	98	106	107
Egypt	73	89	97	111	145
Israel	107	115	120	135	144
Jordan	10	11	11	16	17
Lebanon	18	18	18	20	23
Libya	37	44	38	50	27
Morocco	48	53	55	60	67
OPT	4	4	4	4	
Syria	25	29	34	44	42
Tunisia	23	24	25	27	31
<i>MED Region (total)</i>	427	479	501	574	
<b>GDP per capita (EUR)</b>					
Algeria	2580	2866	2973	3183	3160
Egypt	1004	1196	1289	1441	1847
Israel	16232	16858	17337	19066	19964
Jordan	1873	2035	1915	2573	2682
Lebanon	4403	4358	4461	4821	5424
Libya	6294	7427	6322	8065	4317
Morocco	1590	1731	1770	1984	
OPT	958	946	947	881	
Syria	1306	1417	1649	2042	1922
Tunisia	2302	2374	2440	2595	2937
<i>MED Region (simple average)</i>	3854	4121	4110	4665	
<b>Inflation (% change)</b>					
Algeria	1.6	2.5	3.5	4.5	6.1
Egypt	11.4	4.2	11.0	11.7	17.1
Israel	1.3	2.1	0.5	3.8	1.5
Jordan	3.5	6.3	5.4	14.0	3.7
Lebanon	-0.7	5.6	4.1	10.8	2.7
Libya	2.0	3.5	6.3	10.3	7.6
Morocco	1.0	3.3	2.0	3.9	2.6
OPT	3.6	3.8	2.7	9.9	4.0
Syria	7.2	10.4	4.7	14.5	8.0
Tunisia	2.0	4.6	3.1	5.1	2.7
<i>MED Region (simple average)</i>	3.3	4.6	4.3	8.8	5.6

(Continued on the next page)

Table (continued)

<b>Social indicators</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
<b>Unemployment rate (%)</b>					
Algeria	15.4	12.3	13.8	11.3	13.3
Egypt	10.5	11.5	9.5	8.5	8.9
Israel	9.0	7.7	7.3	6.1	7.6
Jordan	14.8	13.9	13.5	12.6	13.5
Lebanon					
Libya					
Morocco	10.8	11.1	9.7	9.5	10.7
OPT	23.5	23.6	22.0	23.9	23.6
Syria	8.0	8.3	8.4	9.0	8.5
Tunisia	14.2	14.3	14.1	14.0	14.3
<i>MED Region (simple average)</i>	13.3	12.8	12.3	11.9	12.6
<b>Fiscal sector</b>					
<b>General government budget balance (% GDP)</b>					
Algeria (Central Government)	11.9	13.6	11.8	9.0	-10.8
Egypt	-8.4	-9.2	-7.5	-7.5	-7.8
Israel	-4.8	-1.8	-0.8	-2.8	-4.1
Jordan	-10.0	-7.4	-9.2	-9.3	-11.4
Lebanon	2.1	1.7	1.8	1.4	1.1
Libya	32.8	37.4	34.0	33.2	-13.1
Morocco	-5.5	-2.3	-0.1	0.1	-2.9
OPT	-23.4	-30.5	-26.3	-23.3	-35.7
Syria (Central Government)	-4.5	-1.2	-3.4	-3.5	-9.0
Tunisia (Central Government)	-3.0	-2.7	-2.9	-3.0	-3.8
<i>MED Region (simple average)</i>	-1.3	-0.2	-0.3	-0.6	-9.7
<b>Total gross public debt (% GDP)</b>					
Algeria	27.3	23.8	19.0	15.1	18.6
Egypt	112.8	98.8	87.1	76.5	70.0
Israel	95.9	86.8	80.6	80.0	82.5
Jordan (Net Public Debt)	84.2	73.5	73.0	62.0	62.7
Lebanon	178.0	180.0	168.0	162.0	162.0
Libya	7.0	5.4	4.9	4.3	7.3
Morocco	62.1	57.4	53.6	48.6	51.8
OPT					
Syria	35.9	36.0	28.9	22.0	37.0
Tunisia	58.3	53.9	50.9	47.5	48.5
<i>MED Region (simple average)</i>	73.5	68.4	62.9	57.6	60.0
<b>External sector</b>					
<b>Current account balance (% GDP)</b>					
Algeria	20.6	25.2	23.6	22.0	3.8
Egypt	3.2	1.6	1.7	0.5	-1.8
Israel	3.3	5.6	2.6	0.8	1.5
Jordan	-17.9	-11.3	-16.7	-23.9	-12.3
Lebanon	-13.4	-5.6	-7.1	-11.4	-9.5
Libya	38.4	45.8	43.2	48.3	-7.9
Morocco	1.8	2.2	-0.1	-4.8	
OPT	-20.1	-8.0	0.1	2.4	-4.0
Syria	-2.2	-2.8	-3.3	-4.1	-4.5
Tunisia	-1.1	-2.0	-2.6	-4.4	-3.8
<i>MED Region (simple average)</i>	1.3	5.1	4.1	2.5	

(Continued on the next page)



Table (continued)

<b>Foreign direct investment (net, % GDP)</b>					
Algeria	1.1	1.5	1.0	0.6	0.7
Egypt	4.3	5.6	8.1	7.5	4.0
Israel	1.3	-0.1	1.9	1.4	1.0
Jordan	12.0	22.1	11.5	11.8	8.5
Lebanon	8.0	7.9	5.3	4.7	
Libya	2.4	4.1	3.7	3.6	4.0
Morocco	2.7	3.1	3.1	2.7	3.3
OPT					
Syria	2.7	2.6	2.8	3.8	3.7
Tunisia	2.6	10.4	4.2	4.6	4.8
<i>MED Region (simple average)</i>	4.1	6.4	4.6	4.5	
<b>FDI inflows in Med countries</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
<b>EUR billion</b>					
Algeria	0.9	1.4	1.2	5.2	
Egypt	4.3	9.2	8.5	7.4	
Israel	3.9	11.7	7.3	3.2	
Jordan	1.4	2.6	1.3	1.6	
Lebanon	2.3	2.2	2.1	1.5	
Libya	0.8	1.6	1.9	3.1	
Morocco	1.3	1.9	1.9	1.6	
OPT	0.0	0.0	0.0	0.2	
Syria	0.4	0.5	0.6	1.1	
Tunisia	5.9	0.4	5.1	1.2	
<b>Total region</b>	21.3	31.4	29.9	26.1	
<b>MED Region (simple average)</b>	2.1	3.1	3.0	2.6	
<b>External vulnerability</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
<b>External public debt (% GDP)</b>					
Algeria	16.7	4.9	3.8	3.0	3.4
Egypt	19.6	17.6	14.9	12.9	13.7
Israel	56.7	58.5	53.3	44.8	46.6
Jordan	56.6	51.9	47.0	24.0	25.0
Lebanon	44.1	45.6	45.3	39.1	
Libya	9.8	8.7	9.1	8.9	17.0
Morocco	24.2	23.9	23.8	21.1	23.9
OPT	7.8	21.7	21.3	29.8	36.4
Syria	23.4	19.2	14.5	10.4	12.1
Tunisia	65.4	58.3	54.9	51.8	51.2
<i>MED Region (simple average)</i>	32.4	31.0	28.8	24.6	

Note: FDI figures come from ANIMA. See the country articles for the other sources and clarifications.

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

### 2.1. SUMMARY

The global downturn brought to a screeching halt a decade of strong growth for the EU's eastern neighbours, which was the second fastest growing area on the planet.

This section outlines recent region-wide macroeconomic developments and changes in key structural areas, from a regional and forward-looking perspective. It also presents the policies used to cushion the international crisis in the region. It concludes by discussing a set of policy issues that the ongoing economic crisis has brought to the fore.

### 2.2. MACROECONOMIC DEVELOPMENTS

In the wake of the global recession, average **GDP growth** in the EU's eastern neighbours fell sharply from 8.4% in 2007 to 5.6% in 2008, although this figure was still significantly above the global average (3.2%). The deceleration was general, with all western CIS countries (bar Belarus and Moldova) experiencing lower growth than in 2007. Additionally, all countries (bar Azerbaijan and Georgia) are expected to experience recessions in 2009. Russia, by far the largest regional economy, accounting in 2008 for over 84% of the combined output of the area at market exchange rates, saw real GDP growth fall from 8.1% to 5.6%. However, the sharpest fall in the region was in the second largest CIS economy, Ukraine (responsible for almost 10% of regional output). There, growth fell from 7.3% in 2007 to 2.5% in 2008, as the country was the hardest hit in the region by the collapse in commodity prices and the abrupt loss of access to international capital. These external shocks were also compounded by a less adequate policy response in some countries, most notably in Ukraine. **Aggregate real regional GDP is set to fall by around 4% in 2009** (largely due to an expected 4% fall in Russia and 10% fall in Ukraine, as those two economies are responsible for almost 95% of regional GDP).

As a result of the simultaneous downturn, all eastern neighbours (bar Azerbaijan and Russia)

have agreed IMF programmes. The general nature of the shock and consequent deceleration can be easily seen from the similar trends in industrial production indexes (see Graph II.2.1).

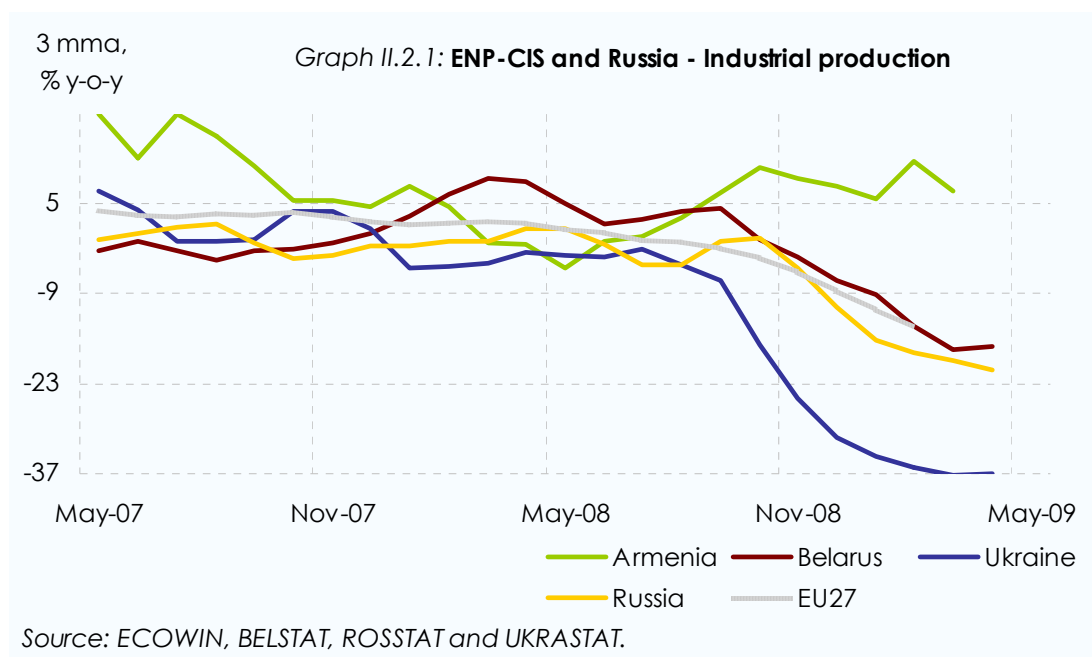
The **decline in unemployment** observed throughout the 2000s in the region has stopped, and unemployment has rebounded. The population-weighted average unemployment rate<sup>36</sup> in the seven countries of the area increased from 6% to 7% of the total labour force in 2008 (albeit there are exceptions: Belarus officially still has full employment, but this masks a large increase in unpaid leaves). This development largely reflects the significant increase in people out of work in Russia, a country with around two thirds of the total population of the western CIS countries. There, unemployment jumped from around 6% to close to 8%. The situation in Russia also has direct regional side-effects, as the country receives very large numbers of temporary migrants from other CIS countries. These also send substantial remittances back to their home countries: in the region, Moldova is the most dependent on those. **This trend is likely to continue in 2009, with unemployment projected at close to 9%.**

The fall in domestic demand (especially its investment component) in most countries in 2008 means that for most countries of the region (including Russia), **2009 growth will be largely determined by external demand**, especially in the wake of the significant, region-wide devaluations (this development will be especially marked in Ukraine, the country that saw the largest depreciation in the region).

This process, coupled with the double-digit fall in the construction sector, which was markedly affected by the global and regional reduction in credit growth, means that growth drivers will switch from **the non-tradable to the tradable sectors.**

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<sup>36</sup> The quality of unemployment statistics differs from one country of the region to another, which makes cross-country comparisons difficult.



The **GDP-weighted regional government surplus** in 2008 fell to 3.3%, from 4.4% a year earlier. In 2009, the region will see a fiscal deficit of over 5% of GDP. At national level, only one eastern neighbour — the **Russian Federation** — has had any significant **fiscal surpluses** (and consistently so, since 2000), with the worst non-oil imbalances to be found in Azerbaijan (where the fiscal deficit is financed with transfers from the off-budget local oil fund). In 2009, even the Russian Federation is expected to face a deficit, and a very significant one at 6.5%,<sup>37</sup> while all the other countries (bar Belarus) will see an increase in their fiscal deficits.

An almost decade-long trend towards **reduced government debt** was reversed in 2008, with GDP-weighted debt increasing to 8.4% of GDP from 6.6% (less than half of the 2005 figure, and very low by EU or OECD standards). This was largely due to a fairly modest (in percentage terms) increase in — mostly domestic — debt in Russia<sup>38</sup>. Again, however, the regional picture is

very diverse, with total public debt in 2008 ranging from just 7% of GDP in Russia to above 25% in Georgia. The situation will also worsen in 2009, with public debt reaching 9% of regional GDP.

For the second year in a row, **average inflation** in the region increased, from 11% in 2007 to around 15% in 2008 (Azerbaijan and Ukraine remain the regional 'champions', with rates above 20%). This was caused by the worldwide increases in commodity prices in the first half of 2008, and by the region-wide devaluations (which have significant pass-through effects on domestic prices) in the second half of that year. The trend is expected to reverse in 2009, with average inflation falling again to the high single-digit levels, as the sharp fall in economic activity will limit the remaining pass-through. On the other hand, the central bank policy rates in most of the countries, despite significant increases (mostly linked to attempts to stem capital outflows), **are still negative in real terms** (see Box II.2.1). The only exceptions (using the latest available data) are Georgia and Moldova, while real *ex-post* policy rates are especially negative in Ukraine.

<sup>37</sup> The Russian government's own estimates are above 7%, as they use lower oil prices to calculate fiscal revenues.

<sup>38</sup> Beyond the fiscal shortfall caused by the fall in oil prices (which is to be overwhelmingly financed by drawing on the oil funds), this also reflected a long-term strategy to develop the domestic financial markets by creating a

benchmark government debt, currently almost non-existent in Russia.

The region-wide **depreciation in exchange rates** — both real and nominal — will also reverse a decade-long trend: after an increase in real exchange rates by over 30% in 2008 as a whole — albeit only 7.4% if weighted by GDP — a fall of over 20% is expected in 2009. Since the summer of 2008, nominal exchange rates have depreciated in Russia (by one third), Ukraine (by more than 40%), Belarus (by about 30%) and Armenia (by one quarter). The **international reserves** of the central banks have been substantially reduced (again, by up to one third in Armenia, Moldova and Russia).<sup>39</sup>

Nevertheless, some of the currencies — notably the Russian rouble, which has even appreciated again since January 2009 — and also the level of foreign reserves in some countries (again, Russia) seem to have stabilised from early February 2009 onwards, in parallel with a levelling-off of commodity prices (see Box II.2.2).

The capitalisation of the Russian and Ukrainian **stock markets** (the two largest in the region) was also affected by the crisis and the outflow of capital, falling by nearly three quarters (before staging a relative recovery from late January 2009 onwards, on the back of a global stock market rally).

In 2008, the contrast in **trade performance** between the energy exporters (essentially Azerbaijan and Russia) and importers (all the others, although the energy transit countries — Belarus and Ukraine — previously derived some benefit from energy price increases, which led some authors to classify them as *pseudo* energy exporters) remains, but the regional GDP-weighted trade surplus fell from 8.4% to 7.8% of GDP between 2007 and 2008, and is likely to collapse to below 3% in 2009, largely reflecting a significant expected fall in the Russian surplus.

**The regional current account surplus** was around 5% of GDP in both 2007 and 2008, but in 2009 it is predicted to fall below 1%. In the

individual countries, the current account balance largely shows the same dichotomy between energy exporters and importers as the trade surplus, with significant current account surpluses in Azerbaijan and Russia (above 40% of GDP and over 6% of GDP, respectively) in 2008, and deficits in all the others (with Georgia facing an astonishing 21% of GDP in 2008). The pattern is expected to continue in 2009, with Azerbaijan and Russia still having surpluses, albeit significantly smaller, and the others having deficits.

In the wake of the global increase in risk aversion and the sharp reduction in capital flows, **net FDI** flows in the EU's eastern neighbours are expected to fall in 2009 to below 1% of GDP, after having averaged around 3.5% of regional GDP in 2007 and 2008.

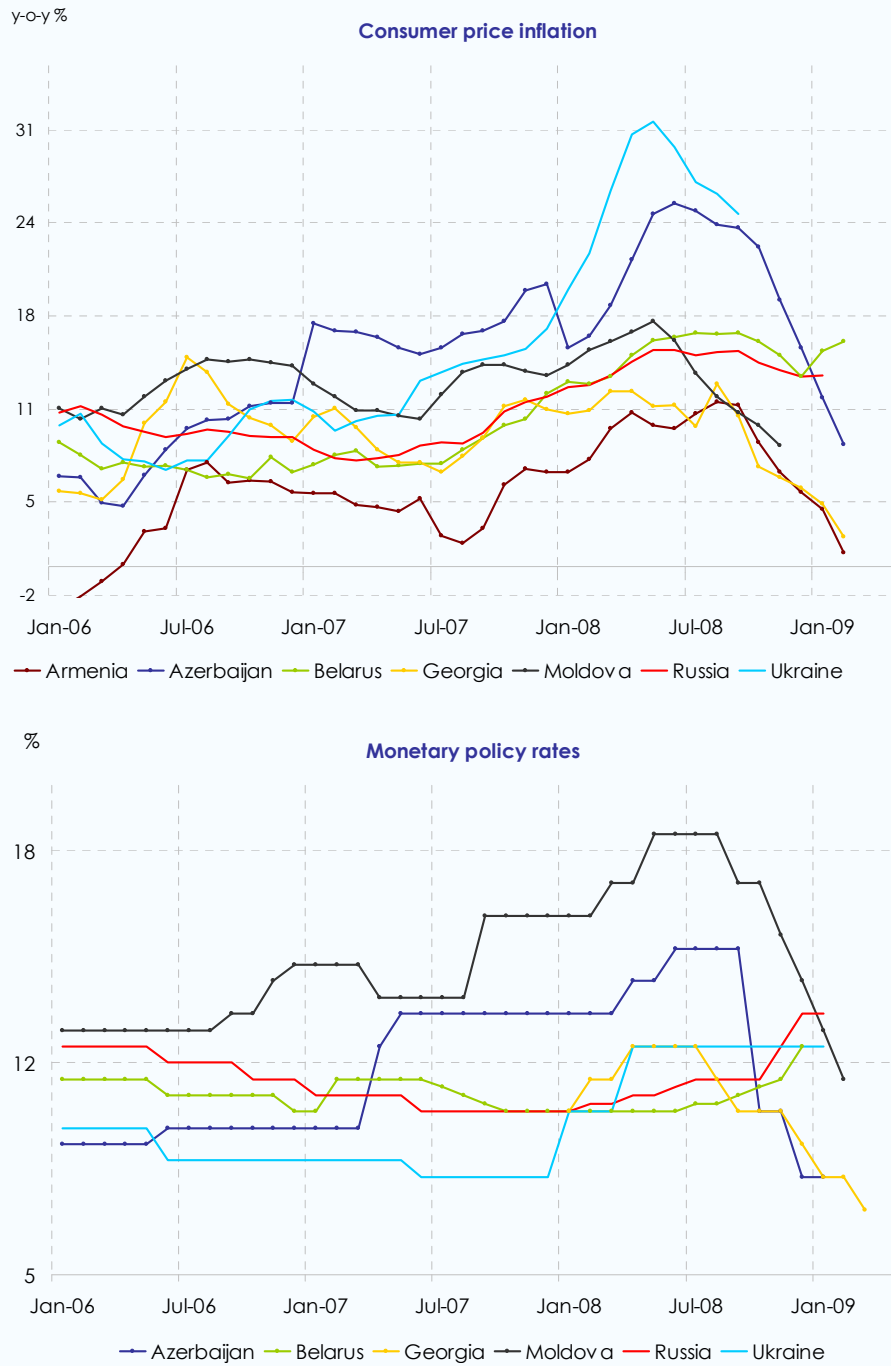
The **total external indebtedness** of the countries of the region (public and private debt), after falling in 2008 to around 33% of regional GDP, is expected to increase to almost 41% in 2009, largely related to the wave of IMF loans across the region. The figure will be particularly worrying for Ukraine, where it will effectively reach 100% of GDP.

**The regional policy responses to the crisis share many similarities:** the banking sectors across the eastern neighbours have received several forms of support, as they were strongly and speedily hit by the global credit crunch, while those countries that could afford them (notably Russia, with its huge fiscal buffers) have also introduced counter-cyclical fiscal measures (see Box II.2.3 and Table II.2.I).

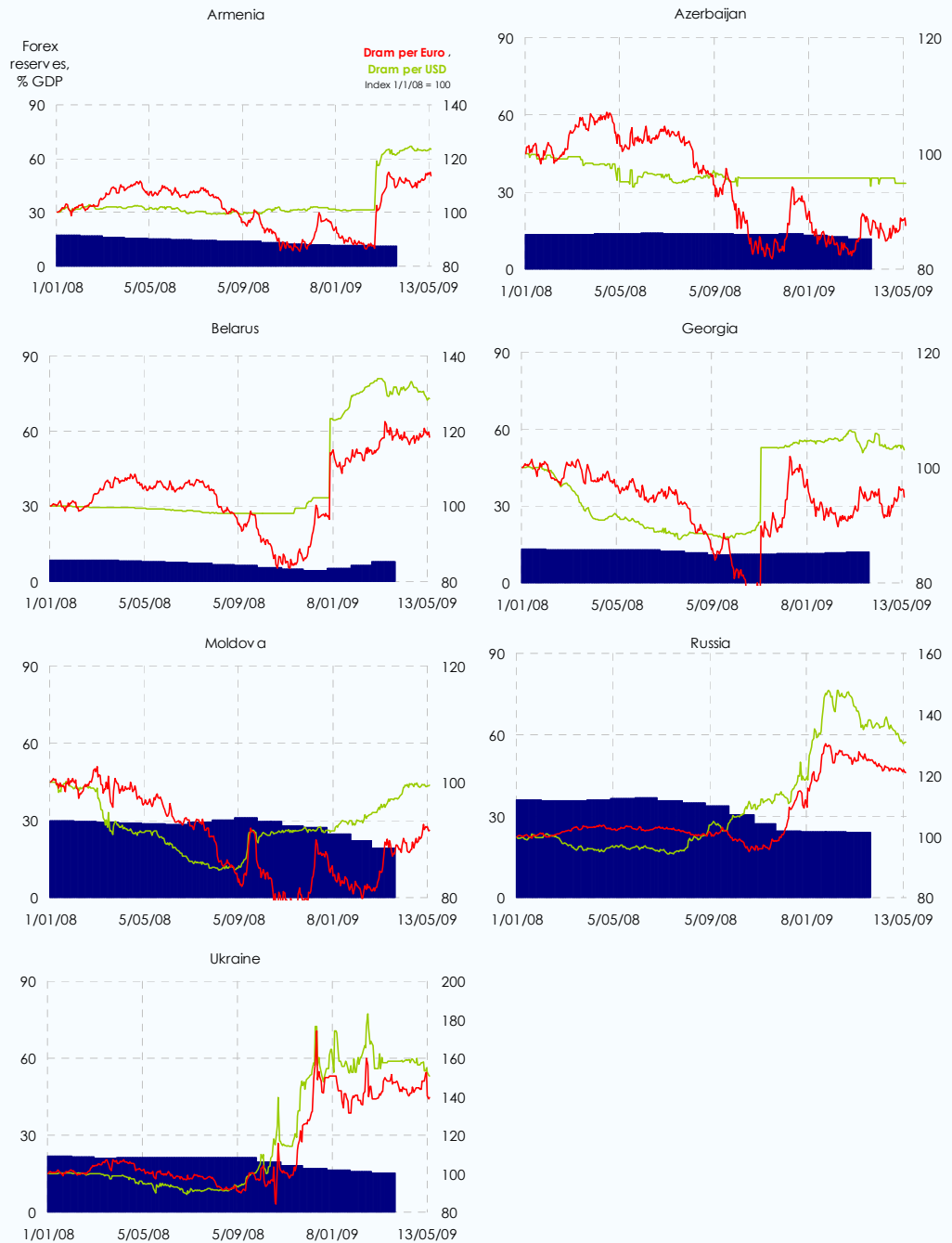
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<sup>39</sup> This capital outflow was made possible by the largely liberal regime of most of the countries in the region, which have fully liberalised capital accounts (Russia, for instance, fully liberalised its in 2006).

Box II.2.1: CIS – Consumer price inflation and interest rates



Box II.2.2: CIS - Foreign exchange reserves and exchange rates



Source: ECOWIN Reuters, IMF, Commission.

**Box II.2.3: Anti-Crisis measures in the western CIS**

The "anti-crisis" policy set adopted across the Western ENP regions share many similarities, an inevitable feature of the commonality of the shock, but also partially due to the several IMF-led external adjustment programmes.

*Russia* stands out among the group due to the scale of the support measures, and also because this policy set was essentially domestically decided and designed. An extensive set of policy measures to cushion the downturn has been enacted by Russian policy makers. They include the provision of liquidity (domestic and external –i.e., replacing international capital, both short-term and long term), direct support to the banking sector and stock markets, other support measures for companies and households and flexibilisation of the exchange rate regime. The combined value of all the measures listed above is estimated at 14% of the Russian GDP, albeit the large majority has a *quasi-fiscal* nature. Also, they are spread out through 2008-2010.

In early November 2008 the IMF approved a EUR 11.6 billion 24-month stand-by arrangement (SBA) with *Ukraine*. The programme included a tightening of fiscal policy (so no fiscal stimulus component), but this excluded the costs of banking recapitalisation. The SBA actually envisaged that the support for the domestic banking sector would be a priority. Therefore, the 2009 budget set aside EUR 5.8 billion for such actions. The policy set also included a significant level of liquidity provision (in both domestic and foreign currency) by the Central Bank of Ukraine, plus a strengthening of the regulatory and supervisory frameworks and of the deposit insurance scheme.

On December 31 2008, an agreement was announced on a SBA operation between the IMF and *Belarus*. This deal is a 15-month operation worth EUR 1.8 billion. The conditionalities associated with the IMF SBA again preclude a countercyclical fiscal stimulus, but they again leave out from the fiscal ceiling banks' recapitalisation efforts, while at the same time including also a reform of the banking supervisory structure. The Belarusian government duly recapitalised some of its largest state-owned banks in late 2008, but was not directly linked to the crisis: those state-owned banks are periodically recapitalised by the Belarusian state, as they engage in extensive programmes of direct subsidised credits to loss making sectors of their economy (notably agriculture). Other measures, like the extension of deposit insurance, were also undertaken there.

In *Azerbaijan*, the central bank reduced reserve requirements and aggressively cut interest rates when the deceleration started in the fall of 2008 (this is somewhat at odds with the regional pattern, as in other countries interest rates were actually raised, to stem capital outflow), beyond supporting the banking system with direct capital injections, while in *Georgia*, the large set of fiscal and monetary support measures (financed by official external inflows from the international community) is originally linked to the short-lived military conflict with Russia in the summer of 2008, not necessarily to the financial crisis.

The sizes of the respective measures are indicated in Table II.2.1.

Table II.2.1:

**ENP-CIS and Russia - Overview of recent fiscal, monetary and financial support**

	Armenia*	Azerbaijan	Belarus*	Georgia*	Moldova*	Russia	Ukraine*
<b>Fiscal support</b>							
Fiscal stimulus (% of GDP) ***				3.0		6.0	
Nature of stimulus							
* Infrastructure						1.0	
* Export							
* Tax cuts				1.0		0.5	
* Non-bank bail-outs						1.0	
* Other						3.5	
Fiscal stimulus (% of GDP) †				3.0		6.0	
<b>Monetary support</b>							
Monetary easing (basis points, decrease from peak)		1200		550			
<b>Financial support</b>							
Deposit guarantees		√	√			√	√
Liquidity provision		√		√		√	√
Loan guarantees						√	√
Capital injection		√	√	√		√	√
Depreciation of pegged currencies from lowest point since January 2008			25% against USD	17% against USD		33% against basket	37% against USD
Drop in reserve requirements		√		√		√	

Legend: \* Country under IMF programme, \*\*\* Announced, † Effective, √ yes

Source: Central banks of the ENP-countries, Commission.

### 2.3. TRADE LIBERALISATION AND ECONOMIC OPENING

The EU remains as the single largest trading partner of all the countries of the region, with the exception of Belarus, which has a (still incomplete) FTA with Russia (see Box II.2.3).

As a sign of the steadily growing integration of those countries with the EU, even with the economic downturn in the fall of 2008, their **total trade with the EU-27 increased by around 20% in euro terms between 2008 and 2007** (or from €290 billion to over €348 billion), that on the top of the over 180% increase between 2000 and 2007. The share of the eastern ENP countries plus Russia in total external EU-27 reached 12.2% in 2008, making this region **the second most important external trading partner of the EU-27**, after the United States (Russia by itself is the 3rd most important import partner of the EU and its 2nd export partner).

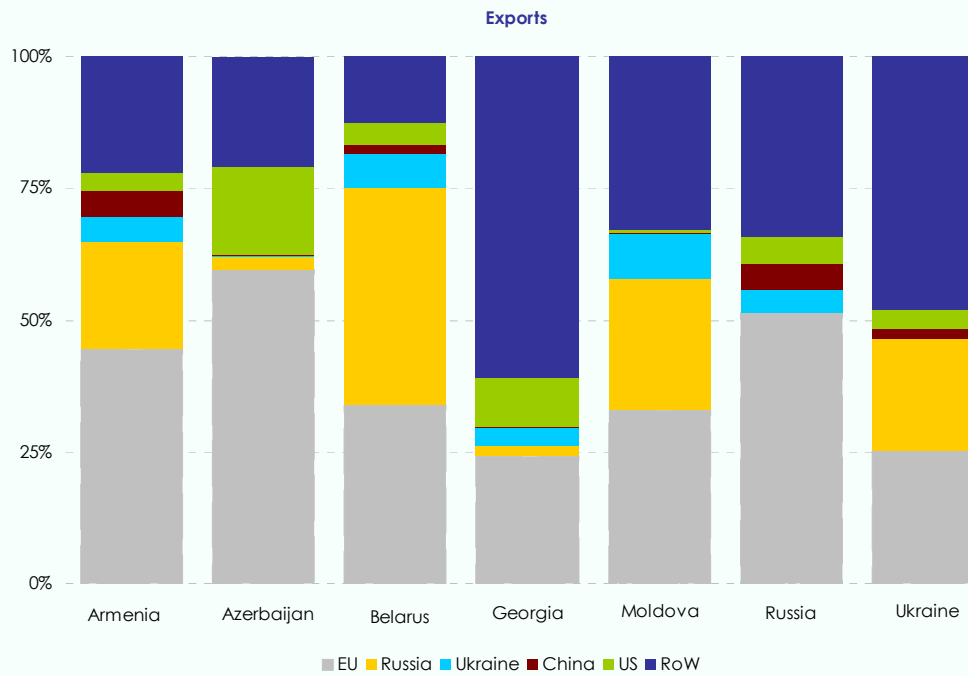
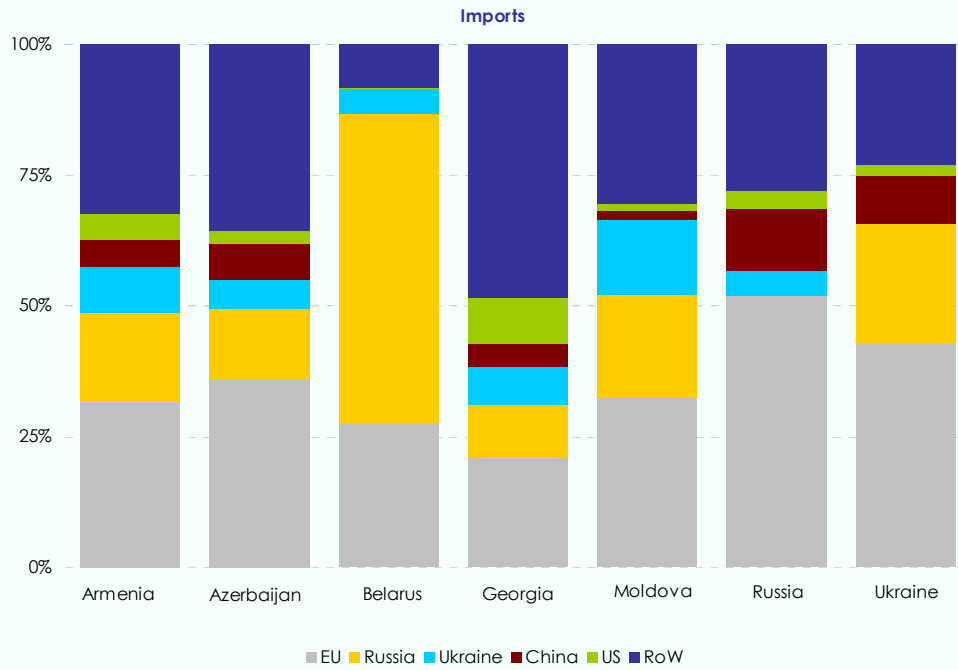
In any case, the global crisis affected the trade flows of those countries, as one can see in Box

II.2.4: commodity exporters were particularly hit, with double digit falls in exports (in value terms) in last quarter of 2008 and early 2009. Imports also reacted strongly (in some cases falling even more than exports, albeit with a lag), on the back of the region-wide devaluations and the sharp reduction of economic activity.

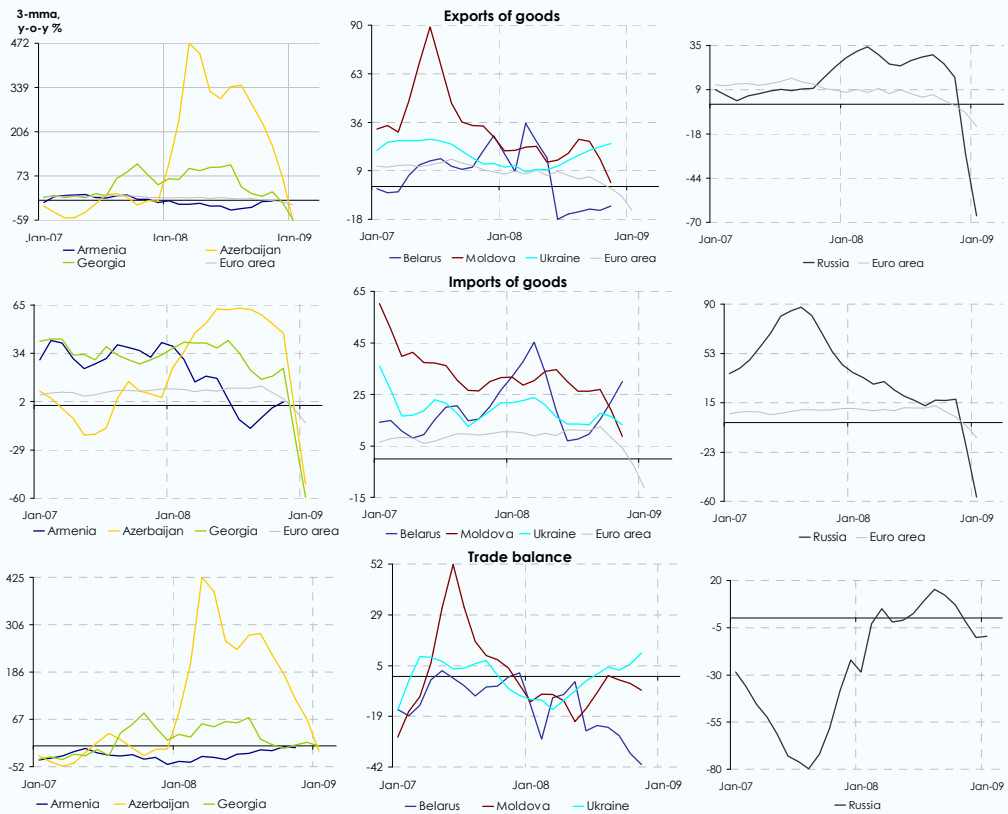
A related development has been the *relative* fall of the share of exports destined to the EU as compared to the ones sent to Asia, given the comparative resilience of the Asian (and especially Chinese) economies: as an example of that, Russian exports to the EU fell in value by over 27% in 2008, while those destined to Asia increased by over 29% (the still relatively small share of Asia in Russian exports masks this development). This is also related to the (long planned) development of energy transport infrastructure to Asian markets, namely the new oil pipelines to China and the coming online of the liquefied natural gas (LNG) terminals in Sakhalin Island, in the Russian Pacific coast.



Box II.2.4: CIS – Imports, exports by partner in 2008



Box II.2.5: CIS – Monthly trade series



Source: ECOWIN Reuters.

## 2.4. BUSINESS ENVIRONMENT

The average quality of the business environment in the seven eastern neighbour countries is still improving. This is the conclusion that can be drawn from the **World Bank's 2009 Doing Business** report, which indicates that the average ranking of the "ease of doing business" for countries in the region improved by eight places, reaching 78 (although changes in the methodology and sample of countries make inter-year comparisons difficult). This figure is better than the whole CIS average and significantly better than the BRICs average, albeit still twice the EU's average figure.

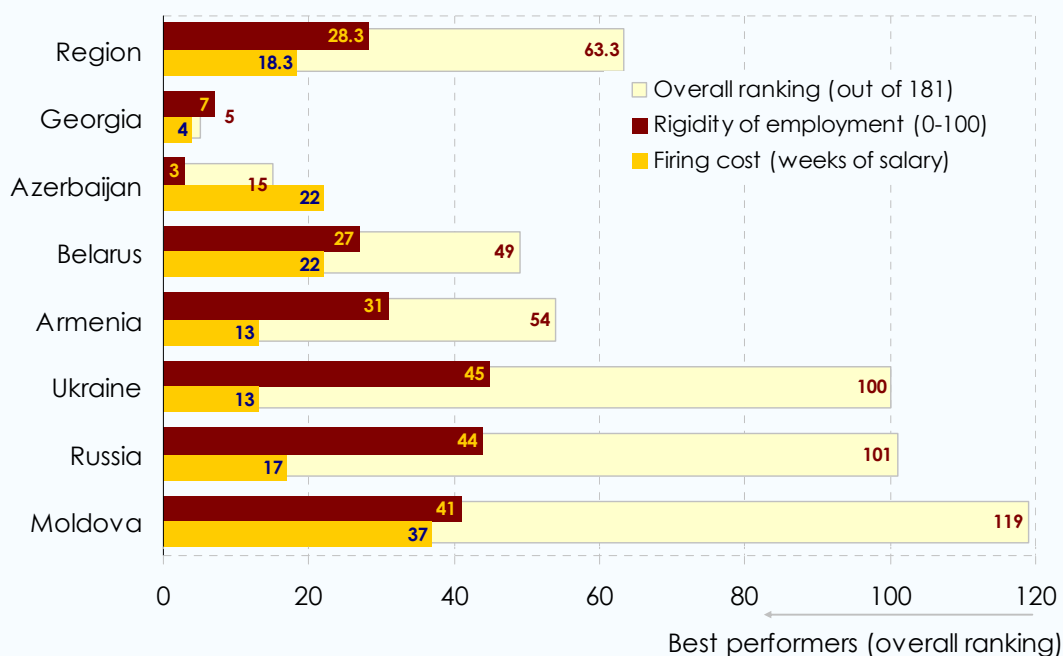
Nevertheless, again this average masks very significant differences amongst the countries: previous laggards Azerbaijan and Belarus

improved significantly their relative positions (in the case of Azerbaijan by an astonishing 63 places, in the case of Belarus by a still rather impressive 25) in a single year, while Georgia, again amongst the top 20 performers on the planet, also improved its position somewhat.<sup>40</sup> All the other countries experienced relative worsening of their rankings.

In Azerbaijan and Belarus it became significantly easier for entrepreneurs to **start a new business**, while in Armenia, Russia and Ukraine the

<sup>40</sup> If one believes the ranking of this index, it is less difficult to do business in Georgia than in 20 of the 25 EU member states for which the index is calculated (Cyprus and Malta are not covered). It is equally easier to do so in Azerbaijan than in 12 of the EU's member states, while doing business in Greece is more problematic than in Belarus.

Graph II.2.2: EU eastern neighbours - Employing workers



Source: Doing Business 2009.

reverse was true. **Dealing with permits** also improved markedly in Armenia and Belarus, while **employing workers** (or, rather, firing them) became faster and less costly in Azerbaijan (contrary to the situation in Moldova): the average costs of firing in the eastern neighbours are a fraction of those in the EU (see Graph II.2.2).

**Registering property** also became markedly speedier and cheaper in Azerbaijan and Belarus (the regional performance in this item is considerably more impressive than the EU's one), while **getting credit** improved across the region (bar in Russia), albeit of course those evaluations precede the global credit crunch. **Greater protection of investors' rights and the easier payment of taxes** were achieved in Azerbaijan. In contrast, the costs of **trading across borders** are still uniformly very high in the region. The **enforcement of contracts** became a little better in the majority of countries (*the average is ranking actually better than in the EU*), while on the other hand closing a business became somewhat costlier (bar in Georgia).

## 2.5. PUBLIC INSTITUTIONS AND GOVERNANCE SYSTEMS

The methodology used in the Doing Business report has several limitations beyond those described above; 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. There are other indexes that cover those areas than can provide a picture of the evolving performance of the eastern neighbours in them.

One of those is the **World Economic Forum's Global Competitiveness Index (GCI)**<sup>41</sup>, which provides an assessment of some of these indicators. Based on the GCI, Russia is the highest ranking of the eastern neighbours' set, at 51<sup>th</sup> out of 134 countries (an improvement of 8 places compared to the previous survey). All the other eastern neighbours are in the second half of

<sup>41</sup> For an explanation of the GCI, see the regional overview of the Mediterranean. Belarus is not included in the GCI.

the classification, below all EU member states (Russia is the only country in the region that outperforms some –namely, 7 of them– of the EU members). Moreover, they either stagnated or worsened their positions relative to the 2008 ranking. Armenia, at 97<sup>th</sup>, has the lowest place in the region.

A set of **basic requirements** that are of fundamental importance for the competitiveness of any economy, including **institutions, infrastructure, macroeconomic management, is measured by the CGI**. Among the countries of the region, Russia has the better position (56<sup>th</sup>, an improvement of 12 places compared to the previous year), with upgradings across the board, while Armenia and Moldova (at, respectively, 93<sup>rd</sup> and 95<sup>th</sup>) lag behind, either stagnating or worsening their previous positions, due to worsening macro stability and a decaying infrastructure.

In the area of **efficiency enhancers, which includes products, labour and financial markets** efficiency and flexibility, Russia and Ukraine lead, ranking 50<sup>th</sup> and 58<sup>th</sup>, respectively, due to efficiency-enhancing labour market reforms (including immigration reform in Russia, and the traditional relatively low firing costs in CIS countries) and a greater technological readiness. Here again Armenia and Moldova "bring up the rear" (at, respectively, 103<sup>rd</sup> and 98<sup>th</sup>) due to the low efficiency of their product markets and their reduced level of financial development.

As concerning innovation and sophistication factors, Azerbaijan is the best performer (at 57<sup>th</sup>), followed by Ukraine (66<sup>th</sup>), due to their relatively high level of business sophistication and openness to innovation, while once more Armenia and Moldova (at, respectively, 113<sup>th</sup> and 128<sup>th</sup>) are the laggards.

The EU itself also assesses the governance and structural reform progress of the ENP countries (so, all the countries covered in this chapter, bar Belarus, which does not have a ENP "Action Plan" and Russia, which is not covered by the ENP) in its annual "ENP Progress Reports". The 2009 ones were published in April 2009. Albeit those reports do not provide an easy, index-like single indicator, as they are descriptive in nature,

nor do they lend themselves to inter-country comparisons, they do conclude that the eastern partner countries made significant progress on implementation of the ENP in several key areas. Those include **trade liberalisation, tax and customs reform and competition policy**. The **business environment** also improved in a number of countries, in some cases linked to achievements in the fight against **corruption**, albeit corruption does remain a significant issue in several countries. Nevertheless, the reports also state that the pace of reforms has **slowed in several eastern ENP countries, particularly in democratic reforms and human rights standards**.

Finally, in December 2008 the Commission made a proposal for an "eastern Partnership" (EaP), which will cover the same set of countries under the ENP in East. The EaP contains an ambitious set of policy proposals for even deeper relations with the eastern European and South Caucasus countries, also in areas related to governance and structural reform. It was launched at a Summit on 7 May 2009 in Prague.

## 2.6. CONCLUSIONS AND POLICY ISSUES

A first conclusion that could be drawn is that those countries in the region that were mostly integrated into the world economy, for instance, via trade and capital flows, and that took further steps towards liberalisation (the large capital outflow from Russia, for instance, was facilitated by its liberalised capital account, while the most exposed banks across the region were those that were privately-owned, either domestically or foreign) were likely hardest hit.

This honest recognition of some of the costs associated with globalisation does not imply that one should fall prey to the siren calls of protectionism and autarky. Lessons from the previous synchronised global downturn, the "Great Depression", have hopefully taught global policy makers that a return to autarky (albeit not at the root of that earlier crisis) exacerbated and prolonged the downturn. Therefore, the relevant policy question is how to **design frameworks that would dampen the transmission mechanisms of negative shocks** arising from the (irreversible and ultimately welfare improving)

structural changes brought about by a greater global economic integration.

A second conclusion is that, as the financial component of the shock arguably led (or at least preceded) the real one, **reforms of the supervisory and regulatory financial frameworks** are key in this respect. Given the observed spillovers and the integration of the global financial system (which, again, must ultimately be preserved), such reforms ought necessarily to have a **global and coordinated character**.<sup>42</sup>

A third conclusion that one could derive is that macroeconomic stabilisation factors, namely sound fiscal positions (high primary surpluses, low debt), rather robust fiscal rules, large hard currency reserves and flexible exchange rates, did not insulate the countries from the crisis: even economies with very large reserves and very low (state) debt as Russia were significantly affected.<sup>43</sup> Nevertheless, beyond the long-run justifications for, for example, fiscal sustainability, the existence of such fiscal and hard currency reserve buffers at least enabled the countries that possessed them to implement policies that may potentially cushion the shock, for their economies as a whole and for particular sets of agents (like companies overleveraged in foreign currency).

Of particular importance are **well-designed fiscal policy tools and frameworks**, especially in a situation where the effectiveness of monetary policy was constrained by largely dysfunctional financial markets. For instance, while a short-term expansionary policy may be clearly justified by the crisis, the need for a long-term focus on the sustainability of public finances should also always be present, via the design of "exit strategies" to correct those

expansions in the future. This could be achieved via the introduction or strengthening of **formal fiscal rules**, of which the oil stabilisation funds (one for short-run fiscal stabilisation, the other for long-term development) in Russia and the Russian medium-term expenditure framework (MTEF) already provide a reference in the region. Also, the effectiveness of any fiscal expansion is conditional on its design: arguably the growth multipliers of public investment are considerably larger than those of other types of expenditures in emerging economies like the eastern neighbours.<sup>44</sup>

Another component of the policy mix is the **exchange rate policy**. Many countries in the region have pegged exchange rate regimes. For some countries the reason for that was either the provision of an anchor for expectations (as the memories of the 1990s instability are still fresh in the minds of economic agents), a very large degree of openness concentrated on a specific partner (such as Belarus) or a formal policy to contain the (nominal) appreciation from the commodities' surplus (as in Russia).

Finally, another conclusion that could be derived is that growth models that relied more on primary sectors (commodities broadly defined, therefore including sectors like steel, very important for a country like Ukraine) have seemingly showed themselves to be more affected by the downturn (conversely, they also arguably showed higher growth rates in the upward part of the cycle). Efforts for a diversification of growth sources towards a less commodities-biased economic structure could be intensified in the future.

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<sup>42</sup> The G-20 process, on which one of the countries of the region, namely Russia, is involved, is the best example of those global coordinated policy responses.

<sup>43</sup> Of course, that does not imply that low levels of state debt *per se* would *necessarily* translate into a greater easiness to attract additional financing, either domestically or internationally, given the current circumstances. As a matter of fact, the bulk of the recent increase in public indebtedness in the region is from concessionary lending by IFIs, which is far less sensitive to the existing level of debt than private financing.

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<sup>44</sup> Nevertheless, the still high levels of poverty and social exclusion, plus the low effectiveness of fiscal multipliers compared to the EU (for instance, typically very low unemployment benefits) may also justify an increase of current expenditures of a social nature.

Table II.2.2:

CIS countries - Main economic indicators

	2005	2006	2007	2008	2009 proj.
<b>Real sector</b>					
<b>Real GDP growth (domestic currency, % change)</b>					
Armenia	14.0	13.3	13.7	6.8	-5.0
Azerbaijan	26.2	34.5	25.0	10.8	2.5
Belarus	9.4	9.9	8.2	10.5	-3.5
Georgia	9.6	9.4	12.3	2.1	-2.5
Moldova	6.6	4.8	3.0	7.2	-4.0
Russia	6.4	7.4	8.1	5.6	-3.8
Ukraine	2.7	7.1	7.3	2.5	-9.5
CIS Region (GDP at PPP)	6.5	8.0	8.3	5.5	-4.3
<b>Nominal GDP (EUR billion)</b>					
Armenia	4	5	7	8	8
Azerbaijan	11	16	23	31	36
Belarus	24	29	33	41	31
Georgia	5	6	7	9	9
Moldova	2	3	3	4	4
Russia	614	788	942	1150	920
Ukraine	69	85	103	128	74
CIS Region (total)	730	932	1118	1371	1082
<b>GDP per capita (EUR)</b>					
Armenia	1223	1584	2081	2526	2453
Azerbaijan	1267	1886	2648	3620	4055
Belarus	2476	3018	3368	4271	3237
Georgia	1201	1415	1680	1961	2066
Moldova	668	746	956	1040	1154
Russia	4282	5521	6628	8099	6488
Ukraine	1467	1815	2218	2786	1635
CIS Region (simple average)	1798	2284	2797	3472	3013
<b>Inflation (average anual % change)</b>					
Armenia	0.6	2.9	4.4	8.9	3.6
Azerbaijan	9.6	8.3	16.7	20.8	6.2
Belarus	10.3	7.0	12.1	13.3	12.7
Georgia	8.3	9.2	9.2	10.0	3.4
Moldova	11.9	12.7	12.4	12.8	9.7
Russia	12.7	9.7	9.1	13.3	13.2
Ukraine	13.5	9.0	12.8	25.2	19.3
CIS Region (simple average)	9.6	8.4	11.0	14.9	9.7
<b>Social indicators</b>					
<b>Unemployment rate (%)</b>					
Armenia	8.2	7.2	6.7	6.3	
Azerbaijan	1.1	1.0	0.9	0.8	1.0
Belarus	1.5	1.2	1.0	0.8	1.5
Georgia	13.8	13.6	13.3		
Moldova	7.3	7.4	5.1	4.0	5.5
Russia	7.7	6.9	6.1	7.7	9.5
Ukraine	7.8	7.4	6.7	6.5	10.0
CIS Region (simple average)	6.8	6.4			

(Continued on the next page)

Table (continued)

<b>Fiscal sector</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
<b>General government budget balance (% GDP)</b>					
Armenia (Central Government)	-2.0	-2.1	-2.2	-1.2	-3.9
Azerbaijan	-2.3	-4.6	-6.2	-7.2	-10.8
Belarus (Central Government)	-0.6	1.4	0.6	-0.8	0.0
Georgia	-2.4	-3.0	-4.7	-6.0	-6.8
Moldova	1.6	0.3	-0.2	-1.0	-7.0
Russia (Central Government)	7.5	7.4	5.5	4.1	-6.5
Ukraine	-2.3	-1.3	-1.5	-0.5	-5.0
CIS Region (GDP weighted)	5.6	5.6	3.9	2.9	-6.2
<b>Total gross public debt (% GDP)</b>					
Armenia	24.3	18.7	17.4	15.8	25.0
Azerbaijan	16.2	17.5	15.0	11.7	11.0
Belarus	9.6	11.0	11.6	19.0	20.0
Georgia	36.6	28.9	23.4	27.7	31.0
Moldova	32.0	29.2	23.3	22.5	31.0
Russia	13.2	5.4	5.1	7.1	7.1
Ukraine	17.7	14.8	12.2	11.2	15.0
CIS Region (simple average)	21.4	17.9	15.4	16.4	20.0
<b>Monetary sector</b>					
<b>Degree of monetisation (M2/GDP, %)</b>					
Armenia					
Azerbaijan (M3/GDP)	14.7	19.1	22.0	22.3	21.2
Belarus (M3/GDP)	19.7	22.1	24.8	21.9	21.3
Georgia (M3/GDP)	14.8	19.5	23.7	23.2	
Moldova	29.5	27.9	34.5	34.7	26.5
Russia	28.0	33.4	40.1	32.4	30.0
Ukraine	43.8	47.7	54.3	53.9	52.0
CIS Region (simple average)	25.1	28.3	33.2	31.4	
<b>Dollarisation in bank deposits (%)</b>					
Armenia	63.6	52.3	39.6	27.7	
Azerbaijan	80.7	61.2	47.0	55.5	57.0
Belarus	27.5	29.1	30.5	31.0	30.0
Georgia	71.8	69.4	65.6	75.8	
Moldova	41.8	49.1	43.3	31.3	43.8
Russia	29.0	27.1	24.1	36.1	30.0
Ukraine	35.0	38.0	32.0	44.0	45.0
CIS Region (simple average)	49.9	46.6	40.3	43.1	
<b>External sector</b>					
<b>Trade balance (% GDP)</b>					
Armenia	-13.2	-14.0	-17.3	-22.2	-20.0
Azerbaijan	25.0	38.3	48.8	49.7	22.2
Belarus	1.0	-4.5	-9.0	-9.6	-8.6
Georgia	-18.9	-23.9	-26.8	-28.1	-20.2
Moldova	-40.6	-46.4	-52.1	-52.9	-36.5
Russia	15.4	14.3	9.9	9.4	3.6
Ukraine	0.8	-2.9	-5.6	-9.0	-2.8
CIS Region (simple average)	-4.4	-5.6	-7.4	-9.0	

(Continued on the next page)

Table (continued)

<b>Current account balance (% GDP)</b>					
Armenia	-3.9	-1.4	-6.4	-12.6	-11.4
Azerbaijan	1.3	18.4	28.9	35.5	10.8
Belarus	1.6	-1.8	-5.0	-8.2	-8.0
Georgia	-10.9	-15.1	-19.6	-22.6	-13.0
Moldova	-7.6	-11.1	-15.8	-16.7	-13.7
Russia	11.0	9.8	5.9	6.3	1.4
Ukraine	3.1	-1.6	-4.2	-6.1	-1.0
<i>CIS Region (simple average)</i>	-0.8	-0.4	-2.3	-3.5	-5.0
<b>Foreign direct investment (net, % GDP)</b>					
Armenia	5.1	5.3	7.2	5.8	
Azerbaijan	3.5	-6.2	-16.6	-4.1	-1.5
Belarus	1.0	0.4	3.0	3.6	2.7
Georgia	7.1	13.7	15.5	9.5	
Moldova	6.4	7.4	11.0	11.2	6.4
Russia	2.0	3.2	3.6	3.5	0.5
Ukraine	9.0	5.4	6.6	3.6	4.4
<i>CIS Region (simple average)</i>	4.9	4.2	4.3	4.7	
<b>External vulnerability</b>					
<b>External debt (% GDP)</b>					
	2005	2006	2007	2008	2009
Armenia (public)	22.0	19.0	16.0	14.0	22.0
Azerbaijan (public)	12.5	9.4	8.1	7.5	7.2
Belarus (public plus private)	17.4	18.5	27.9	24.6	30.0
Georgia (public)	27.1	22.0	17.5	20.7	23.2
Moldova (public plus private)	69.5	74.2	75.7	68.2	67.5
Russia (public plus private)	33.7	31.7	35.8	28.9	25.0
Ukraine (public plus private)	45.3	50.4	60.2	58.0	97.5
<i>CIS Region (simple average)</i>	32.5	32.2	34.5	31.7	38.9
	2005	2006	2007	2008	2009
<b>Real effective exchange rate (2004=100)</b>					
Armenia	97.5	106.3	123.5	305.8	
Azerbaijan	115.6	119.9	128.2	164.2	
Belarus	76.3	73.4	72.3	71.2	
Georgia (y-o-y, %)	3.7	3.7	1.3	8.4	
Moldova	102.1	96.3	95.4	103.2	
Russia	149.2	163.0	173.0	184.0	
Ukraine	110.2	115.5	117.1	127.6	

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



# Part III

Country analysis

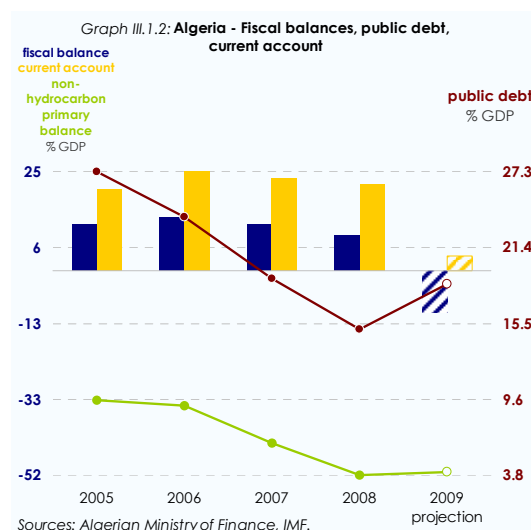
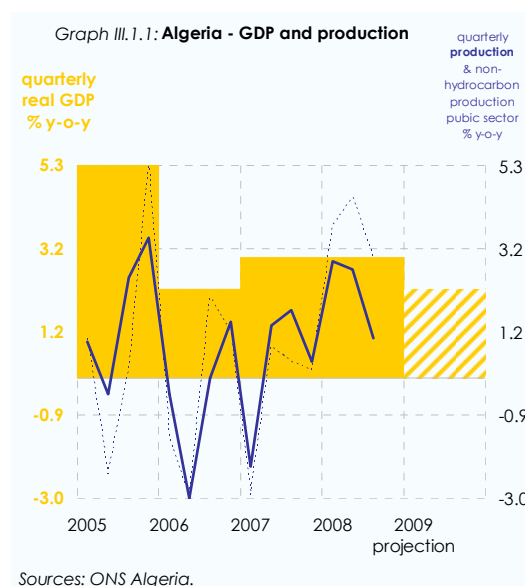
# 1. ALGERIA

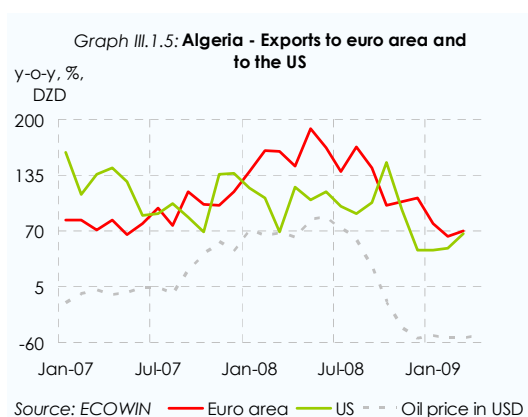
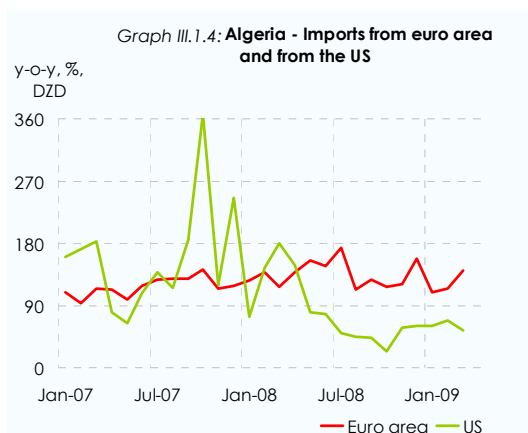
- *The fall in oil prices in the wake of the global economic and financial crisis has hit the Algerian economy hard. Lower oil revenues mean that a big government deficit is projected in 2009, and the current account surplus is expected to drop by more than 18 percentage points of GDP.*
- *In 2008 real GDP growth remained at 3.0% despite record high oil prices in the first half. While the current account surplus remained high at more than 20% of GDP, the government surplus fell below 10% of GDP in 2008, also because of the increase in food subsidies.*
- *Algeria could benefit from WTO accession. Integration in the Maghreb region and further global integration, in line with the Association Agreement with the EU, will potentially lead to more and cheaper trade and therefore higher economic growth in Algeria.*

## Macroeconomic and financial developments

The Algerian economy has established steady economic growth in recent years, and solid twin surpluses on the fiscal and current account. In 2007, despite numerous terrorist attacks all over the country, economic growth reached 4.6%. The main driving forces underlying the economic growth have been the services, industry and construction sectors.

For 2009 the economic outlook is much grimmer. Falling global commodity prices and the high dependence of the Algerian economy on hydrocarbon have been depressing government revenues since autumn 2008. The overall government balance, which already came down from a surplus of almost 14% of GDP in 2006 to 9% in 2008, will drop sharply in 2009. The trend of expansionary fiscal spending will continue in 2009. Under the assumption of an oil price of USD 35 per barrel in 2009, the forecast for the government balance will be deeply negative in 2009, due to the much lower fiscal revenues.





The Growth Consolidation Plan for 2005-09, which is basically a public investment programme, will be pursued in 2009. There may be further **wage rises** for civil servants to retain skilled staff, in particular in the security services. These additional expenditures are one reason why the non-hydrocarbon primary deficit remained at excessive high levels of around 40% of GDP in 2008.

The *Fonds de Régulation des Recettes* (FRR) was intensively used in 2008 for financing the budget. Apart from direct financing of the non-hydrocarbon deficit, as a sub-account of the government at the central bank, it allows for amortisation of government debt. Budgetary receipts from oil when the price is above the equivalent of USD 37 per barrel (previously USD 19 per barrel) flow into the fund, as do taxes on profits realised by foreign partners. In view of the sharp decline in oil prices, and the higher deficit, the accumulation of funds in the FRR has slowed down.

Despite the high oil prices in 2008, averaging USD 97 per barrel, the government surplus fell by 3 percentage points in comparison with 2007. Due to the soaring agricultural **food prices** on world markets, Algeria spent USD 8 billion on food imports, equivalent to 2% of GDP.

Higher food prices pushed total inflation upward. In response to the rise in inflation, the central bank of Algeria tightened **monetary policy**. Inflationary pressures thereafter eased and consumer price inflation reached on average 4.4% in 2008, and even 6.1% in the first quarter of 2009. This is a high level for Algeria, where prices of many goods and services are subject to government intervention.

The **exchange rate** regime remained a managed float with no pre-announced path, giving the central bank discretion to foreign exchange market interventions. The sharp decline in world oil prices and the increasing uncertainty in the financial markets affected the Algerian currency. The dinar reversed its appreciating trend in October 2008, and thereafter sharply depreciated vis-à-vis the US dollar as well as vis-à-vis the euro (see graph III.1.3).

The *Banque Centrale d'Algérie* allegedly intervened several times in the foreign exchange market to support the Algerian currency. Foreign exchange reserves kept on increasing, but at a much slower pace because of higher deficits on the income account, lower trade surpluses, and the interventions in the foreign exchange markets.

All in all, external accounts remained strong and favourable in 2008, mainly due to the high hydrocarbon prices. On average, the **current account** surplus remained high at 24% of GDP. Exports started falling as from April 2008 (see graph ), in line with the sharp slowdown of the US economy. The current account will drop 15 percentage points in terms of GDP in 2009, because of the lower oil prices and the fall in world demand.

The official external debt improved in 2008, and reaching the exceptionally low level of 1.7% of GDP. This solid external debt position, along with the foreign exchange reserves of 85% of GDP, form solid buffers to accommodate shocks.

### Risks and outlook

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

In the context of the current sharp global economic slowdown the Algerian economy runs the risk of further protectionism. Poverty in Algeria is still high and GDP per capita is still extremely low considering the abundant revenues obtained during the last years. Algeria lags behind its peer countries in this respect. Protectionist measures, such as constraints on foreign companies in Algeria, entail a cost for growth. International cooperation, opening of markets and continuing the privatisation processes could in contrast accelerate economic growth in Algeria. A higher growth path is within reach, but requires financial markets to be broadened and deepened for an optimal channelling of funds to the economy.

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

The economy is also vulnerable to a deterioration of the public finances. The current period of lower commodity prices could be a good opportunity to move to a more effective targeting of subsidies to the poor and review price ceilings on food and energy. This would provide the fiscal authorities with room for manoeuvre in discretionary spending, to stimulate growth, in particular at the trough of the current economic cycle.

### Policy reforms and measures

Government efforts to liberalise the economy are likely to be relatively small-scale and piecemeal in the near term. There has been a marked change in the government's attitude towards foreign investors since July 2008. Measures are taken to grant the government first refusal in the sale of Algerian assets by foreign investors. Some progress with the privatisation programme can be expected, as the government plans to launch a broad-based privatisation of several hundred smaller state-owned firms. On the negative side, the sale of the state-owned commercial bank *Credit Populaire d'Algerie* has been postponed indefinitely, as has the government's decision to invite strategic investors to take stakes in two smaller banks.

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

### Social development and poverty

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

The level of **unemployment** is still high. According to the official figures, it has fallen significantly from a peak of almost 30% in 2000 to around 11% in 2008. A point of concern remains that most newly created jobs are temporary and are therefore not sustainable. Government youth employment and investment plans should help relieve poverty through a careful distribution of public expenditure. Structural reforms should lead to a more diversified private sector.

Table III.1.1:

**Algeria - Main economic indicators**

	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	5.3	2.2	3.0	3.0	2.2
Real GDP non-hydrocarbon (% change)	4.7	5.6	5.8	6.0	6.0
GDP (dinar, billion)	7564	8521	9306	10051	10090
GDP per capita (EUR)	2580	2866	2973	3183	3160
GDP per capita (USD)	3205	3598	4070	4659	4133
GDP nominal (EUR, billion)	83.1	93.4	98.1	106.3	106.8
GDP nominal (USD, billion)	103.2	117.3	134.3	155.6	139.7
Inflation (average, %)	1.6	2.5	3.5	4.5	6.1
<b>Social indicators</b>					
Recorded unemployment (officially registered, %)	15.4	12.3	13.8	11.3	13.3
Youth unemployment (%)	31.0				
Population (million)	32.2	32.6	33.0	33.4	33.8
<b>Fiscal sector</b>					
Total revenues (% GDP)	40.9	43.0	42.7	44.8	33.0
Total expenditure (% GDP)	29.0	29.4	30.9	30.8	43.8
Government balance (% GDP)	11.9	13.6	11.8	9.0	-10.8
Non-hydrocarbon primary balance (% GDP)	-33.0	-34.5	-44.0	-52.1	-51.4
Gross government debt (% GDP)	27.3	23.8	19.0	15.1	18.6
<b>Monetary sector</b>					
Credit to the economy (% change)	15.9	7.1	13.8	16.0	
Money and quasi money (% change)	11.1	18.7	23.1	24.1	
<b>External sector</b>					
Trade balance (% GDP)	25.7	29.1	25.5	27.0	2.9
Current account balance (% GDP)	20.6	25.2	23.6	22.0	3.8
Import cover of reserves (months)	26.5	29.1	32.2	36.3	
Net FDI (% GDP)	1.1	1.5	1.0	0.6	0.7
<b>External vulnerability</b>					
Gross external debt (% GDP)	16.7	4.9	3.8	3.0	3.4
Gross official reserves (USD, billion, e-o-p)	56.2	77.8	108.5	143.5	134.4
<b>Financial sector</b>					
Exchange rate (dinar per USD, end-of-period)	73.1	73.4	69.3	64.0	
Exchange rate (dinar per EUR, average)	86.6	96.9	102.0	94.1	
Real effective exchange rate (% change, e-o-p) <sup>1</sup>	-3.9	-0.3	-0.5		

<sup>1</sup> Increase (or decrease) reflects appreciation (or depreciation) of the Algerian dinar.

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

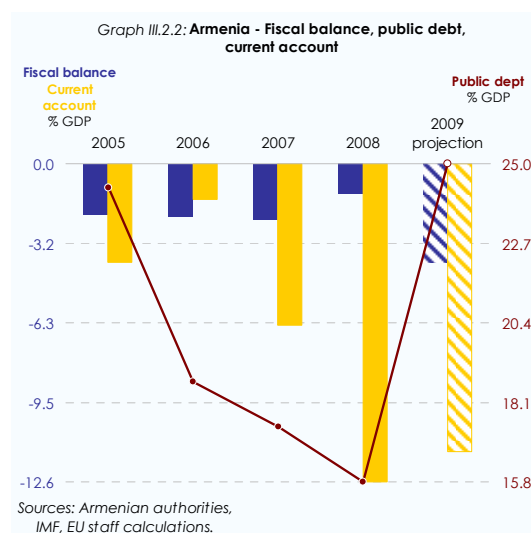
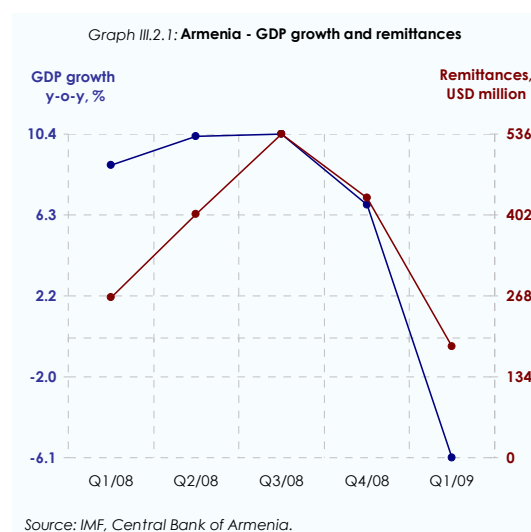
Sources: Algerian authorities, IMF, EUROSTAT, Commission.

## 2. ARMENIA

- *After six years of double-digit growth, GDP slowed down to 6.8% in 2008 affected by the deceleration in the construction and industry sectors. However, remittances from the Armenians abroad continued to be strong.*
- *Although the financial sector was not severely affected by the economic crisis due to Armenia's limited external exposure and the low level of financial intermediation, relative isolation has not come for free.*
- *The business climate is dampened by the presence of significant oligarchic and monopolistic structures, especially on the import markets.*

### Macroeconomic and financial developments

After six consecutive years of double-digit non-inflationary growth, GDP increased by only 6.8% in 2008. This was mainly the result of a sharp decrease in economic activity in the fourth quarter amid the deepening global financial and economic crisis. Growth in construction, the main contributor to economic growth in recent years, dropped from 19% in 2007 to 7% in 2008 as the demand for expensive housing and office space eased, accompanied by a slight 2% decrease in house prices. Notwithstanding the downturn, construction increased its contribution to economic activity from 24.7% in 2007 to 27.1% in 2008 as a result of the drop in industry's share of total output to 13% in 2008 from 15% in 2007. Specific industry sectors experienced the effects of the global downturn. Metallurgy, which accounts for 14% of overall industrial output, contracted by 9.6% in 2008 forcing many industries to cease production and lay off hundreds of employees or put them on indefinite leave. The diamond processing industry also contracted by 15% while the chemical subsector stood idle due to declining global demand for synthetic rubber and other chemicals. These falls in production were partially offset by a 7% growth in the food processing industry, which generated about 33% of industrial output in 2008.



Inflation averaged 9% in 2008 on the back of the surge in the price of fuel and food products, most of which are imported and in effect have been monopolised by a limited number of importing businesses. This could partially explain why the drop in fuel prices (around 30%) in the fourth quarter of 2008 was not as sharp as in other countries. A 17.4% y-o-y nominal increase in the average monthly salary also contributed to the inflationary pressure, which nevertheless eased to 5.3% by the end of 2008 as a result of tightened monetary policy and the global recession.

The Central Bank continued intervening on the foreign exchange market to reduce exchange rate volatility, effectively preventing any depreciation pressures on the Dram but sacrificing around USD 300 million from September 2008 to January 2009. Given the virulent deterioration in the economy, with expected reversals in remittances and capital flows, the authorities abandoned this policy on 3.3.2009 and reverted to a fully floating exchange rate regime. This led to a de-facto depreciation of around 22% against the euro and the USD.

Fiscal discipline was maintained in 2008, due to better revenue performance, a surge in VAT and some expenditure underexecution. As a result, the fiscal deficit reached nearly 1.2% of GDP. The deficit would have been larger if a disbursement of USD 50 million by a US company to reconstruct rural roads had not been cancelled. A notable improvement was recorded in revenues and customs collections as a result of a series of measures that were announced in April 2008 aiming to boost revenue and address the weaknesses in tax policy and administration. However, still revenues from VAT and customs contribute almost 55% of the total tax revenues and the tax-revenue to GDP ratio remains low. The debt to GDP ratio remained low and sustainable, leaving considerable fiscal space for implementing anti-cyclical policies.

During 2008, the impact of the global economic and financial crisis had not yet fed into import demand. Assisted also by the strong Dram, expenditure on imports surged by 35% driven mainly by a strong demand for industrial and transport equipment, natural gas, mineral products and raw materials. Imports of food

stuffs also increased by 40%, affected by the international increase in food prices. Another factor for the overall rise in imports could be the improved customs service, which seemed to have reduced underreported imports of consumer goods. On the other hand, export revenue decreased by 7% due to a fall in the metallurgy and diamond-processing industry, reflecting the lack of competitiveness and diversification of Armenia's export industry. As a result, the trade deficit surged to 22% of GDP, while the current account rose only to 12% thanks to continuing FDI and remittances flows, mainly from Russia.

Banks are well capitalised with satisfactory liquidity ratios but they have limited access to external borrowing, a constraint for future credit growth and deepening financial intermediation. Credit expansion continued apace with credit/GDP reaching 17.4% at the end of 2008, up from 13.4% in January 2008, despite high interest rate margins. This could be the effect of the sharp rise in reserve money created by the foreign exchange rate intervention, which reduced the effectiveness of tightened monetary policy and could add to inflationary pressure in the future. In the last quarter of 2008, some increases in the interbank rate were noted along with some signs of a re-dollarization.

Having said that, Armenia's limited external exposure and the low level of financial intermediation has not come for free. The lack of integration in international markets through foregone investment opportunities and growth has kept the economy at a rather limited welfare level.

### **Risks and outlook**

The sharp deterioration in the global and, in particular, the Russian economic outlook has a number of implications for the Armenian economy, which point to a severe downward and broad-based real economy adjustment. Both domestic demand and external trade are expected to be hurt by lower remittances and capital inflows and by export commodity prices plunging. Moreover, projects that might be put on hold and rising unemployment are expected to dampen further growth which is expected to be negative in 2009 given that the leading growth drivers become under strain. A well targeted

stimulus directed to the most vulnerable SMEs could be mitigating given the bank's high real interest rates and their difficulty in ensuring long-term funding for lending. Also, authorities aim to boost infrastructure projects, partly by using the Public Private Partnership framework.

The economic slowdown and lower energy and food prices are expected to depress inflation. However, Armenia will benefit only partially as the cost of its gas imports from Russia rose by 40 % in April 2009 and the drop in food prices will also dampen the country's revenue from this growing industry. Furthermore, the exchange rate adjustment entails the risk of adding excessively to the inflationary pressures as due to the presence of import monopolies import price responses are much larger for depreciations than for appreciations.

Implementing fiscal policy will be a challenge given the weakening economic environment, the prospects for lower grants and the dependency of revenues on indirect taxes and import customs. In this context, disbursements of infrastructure or other programs could be delayed and in case of a rapid downfall in fiscal revenues a re-allocation of the expenditures should be implemented fast. The recent improvements in the tax and customs administration should continue to respond to medium-term pressure created by potential fiscal stimulus efforts, planned infrastructure projects, pension reform and the poverty reduction scheme. Armenia's low public debt provides the fiscal leeway needed for anti-cyclical stimulus but external financing on concessional terms could be difficult to find.

The widening external current account deficit calls for accelerated structural reforms to diversify production, increase productivity and raise export potential.

#### **Policy reforms and measures**

Armenian authorities acted quickly in getting international support to mitigate the effects from the rapid downturn of the economy. On 6.3.2009, the IMF approved a USD 540 million Stand-By Arrangement while the World Bank Group will support Armenia with a scaled up lending program of USD 525 million for the period 2009-2012. According to the Armenian

authorities, they have agreed in principle on a USD 500 million loan from Russia.

The macroeconomic framework was improved in 2008. Changes in tax legislation, improvements in tax and customs administration and efforts to fight tax evasion have intensified. However, revenue collection remains below potential and the relationship between tax revenue and economic activity is weak and somewhat unpredictable. Steps have been taken to establish a multi-year approach to macro-fiscal policy including boosting public finance management systems, institutionalising the Medium Term Expenditure Framework and adopting a performance-based budgeting system in the next years. Some simplification of the VAT regime has been achieved, although more efforts are needed. Preparations for establishing an inflation-targeting framework have started and the Central Bank aims to enhance monetary operations and debt management by focusing on repo operations, while the Treasury will recommence issuing short-term T-bills. Improvements have been noted in licensing SMEs under the new corporate Law and in funding SMEs since banks have expanded available credit and liquidity facilities. However, more efforts should be made on cross-border trade and paying taxes. The banks have also taken steps to improve risk management capacity, transparency and consumer protection.

#### **Social development and poverty**

Macroeconomic stability, strong growth rates and prudent fiscal and monetary policies contributed to rising incomes and better social conditions in Armenia during recent years. In 2008 the average nominal wage increased significantly (17.7%) compared to recorded average inflation (9%). Based on the success of the first Poverty Reduction Strategy Paper (PRSP), which reduced poverty to 25 % in 2007 from 34.6 % in 2004, the authorities embarked on the second PRSP in October 2008 through the Sustainable Development Program (SDP). The SDP, which covers the period from 2009-2021, has essentially three targets: reducing poverty, including the elimination of extreme poverty; ensuring human development; and deepening economic growth and accelerating development of lagging regions. In this context, the authorities



Table III.2.1:

Armenia - Main economic indicators	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	14.0	13.3	13.7	6.8	-5.0
GDP nominal (Dram, billion)	2200	2656	3149	3650	3690
GDP nominal (EUR, billion)	3.9	5.1	6.7	8.2	7.9
GDP nominal (USD, billion)	4.9	6.4	9.2	11.9	10.3
GDP per-capita (EUR)	1223	1584	2081	2526	2453
GDP per-capita (USD)	1523	1983	2857	3695	3203
Inflation (average)	0.6	2.9	4.4	8.9	3.6
<b>Social indicators</b>					
Unemployment (off. registered, average, %)	8.2	7.2	6.7	6.3	
Poverty rate (% population)	29.8	26.5	25.0		
Income inequality (Gini, %)		0.369			
Population (million)	3.2	3.2	3.2	3.2	3.2
<b>Fiscal sector</b>					
Total revenues (including grants, % GDP)	17.8	18.0	20.1	19.9	21.1
Total expenditure (% GDP)	19.9	20.0	22.4	21.6	23.9
Central govt. balance (% GDP)	-2.0	-2.1	-2.2	-1.2	-3.9
Central govt. balance <sup>(1)</sup> (% GDP)	-2.3	-2.3	-3.0	-1.7	-4.9
Gross public debt (% GDP)	24.3	18.7	17.4	15.8	25.0
<b>External sector</b>					
Current account balance (% GDP)	-3.9	-1.4	-6.4	-12.6	-11.4
Trade balance (% GDP)	-13.2	-14.0	-17.3	-22.2	-20.0
Remittances (inflows, USD million)	752	960	1319	1635	
Remittances (% GDP)	15.3	15.0	14.3	13.7	
Foreign direct investment (net, % GDP)	5.1	5.3	7.2	5.8	
<b>External vulnerability</b>					
External public debt (% GDP)	22.0	19.0	16.0	14.0	22.0
Debt service ratio (% of exports of goods and services)	4.4	3.9	2.9	3.0	5.8
Gross reserves (excl. gold, USD million)	667	1072	1657	1405	
<b>Financial sector</b>					
Exchange rate (DRAM per EUR, average)	570.4	521.2	467.8	447.3	470.0
Exchange rate (DRAM per USD, average)	457.7	416.0	342.1	305.8	360.0
Real effective exchange rate (2000=100)	97.5	106.3	123.5	305.8	320.8
<b>Human development</b>					
Human development index	0.732	0.695	0.735	0.767	0.777

<sup>(1)</sup> Central Government Balance excluding grants and external interest payments

Sources: IMF, EIU, Armenian authorities.

aim to have established a fully developed fiscal and inflation targeting framework within three years. However, the protracted economic downturn in Russia and the unprecedented lack of visibility poses serious negative risks to implementing the program.

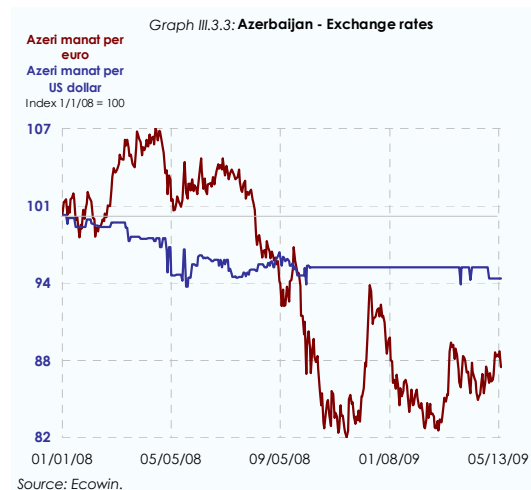
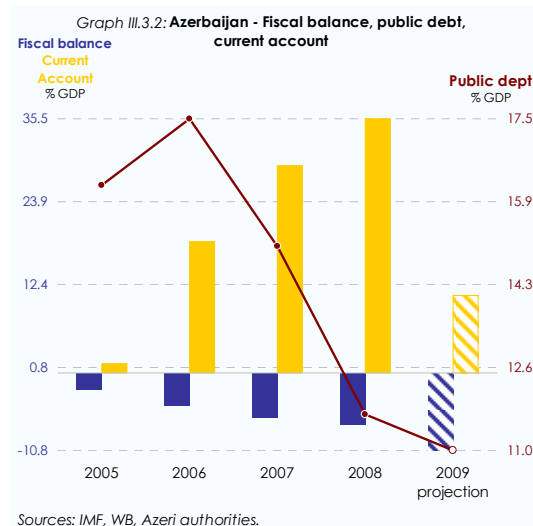
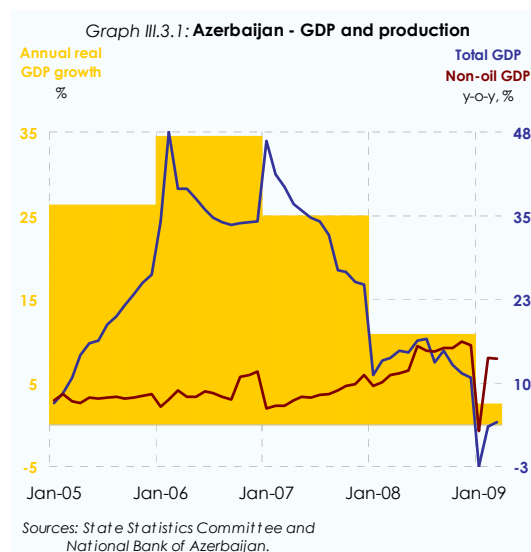
### 3. AZERBAIJAN

- *Despite slowing to 10.8% p.a., Azerbaijan's economy was among the fastest growing in the world for the fourth consecutive year in 2008. The deceleration will continue in 2009-2010 as a result of the serious worsening of the global economy, which will affect the country's oil exports and private consumption.*
- *The non-oil sector grew by 15.7% p.a. in 2008, the highest rate in five years. Diversifying the economy away from oil and supporting non-oil activity remains a key policy objective in the medium term.*
- *Fiscal expansion will moderate under the 2009 budget. More exchange rate flexibility will be essential for the central bank to move to inflation targeting in future.*

#### Macroeconomic and financial developments

Over the past few years, the Azerbaijani economy has seen remarkably high growth rates, peaking at 34.5% in 2006. In 2008, the economy grew by 15% on average throughout the first three quarters but slowed towards the end of the year, posting an annual growth rate of 10.8% (down from 25% in 2007). However, reflecting a much less favourable external economic environment and, in particular, plummeting oil prices, real GDP growth is slowing in 2009. It plunged to -2.6% y-o-y in January but then improved to 4.1% y-o-y in January-March.

The oil sector, the backbone of the Azerbaijani economy and the major driver of its growth, grew at 7%, notwithstanding some slowdown since August, due to external events and technical disruptions to offshore production. Led by a robust expansion in construction, services and agriculture in response to the exceptional fiscal stimulus, the non-oil sector outpaced oil industries, accelerating to 15.7% from 11.3% in 2007. Since August, non-oil GDP kept growing faster than that of the entire economy and amounted to EUR 12.5 billion, or 39.7% of total GDP, by the end of 2008. In January-February 2009, total non-oil growth was sustained at 14% y-o-y, with construction where growth accelerated to 57.5% y-o-y (36% in 2008) being



the major contributor.

Investment also remained an important contributor to growth in 2008, up to 34.3% (from 17.8% in 2007). Domestic and public investments were the main sources (75.5% and 62.6% of total investment in 2008).

The private sector accounted for 84.5% of the country's GDP. In February 2008, the government sold its 35.7% stake in the country's largest mobile phone operator *Azercell Telecom*. In July 2008, the government's stake in the second largest state owned bank *Kapital Bank* was reduced to zero.

At 28% of GDP, actual government expenditure increased by 76.6% over the 2007 budget, with significant increases in military spending, social assistance, wage increases and capital spending. Part of the increase in expenditure was financed by revenue from the oil fund, from which a fiscal transfer of an equivalent of EUR 3.2 billion, or 10% of GDP, was made, thus slashing an otherwise notable budget deficit.

Driven by an expansionary fiscal policy and an accommodative monetary stance, inflation rose to 20.8% in 2008, compared with 16.7% in 2007. Domestic demand remained strong, but with little diversification away from oil and the presence of monopolistic importers, constraints on domestic supply persisted. In March 2009, consumer prices fell by 0.7% m-o-m, which would have pushed annual consumer price inflation down to around 8.4%, its lowest level since mid-2006.

The Azeri manat depreciated slightly against the US dollar in August-October 2008, owing to disruptions to oil output and exports, but appreciated y-o-y. The use of the two-currency basket regime, which had been implemented since late March 2008, was suspended in view of excess volatility in the EUR/USD exchange rate to avoid a basket-induced depreciation of the USD/AZN exchange rate.

The National Bank of Azerbaijan (NBA) raised the refinancing rate of 13% (effective as of June 2007) to 14% in April 2008 and again to 15% as of June 9 2008 to tighten liquidity and slow down the rapid credit growth (80% in Q1). It

also strengthened prudential regulations and supervision. When the external and domestic liquidity conditions reversed in October, the NBA reduced reserve requirements and cut the rate first to 12%, then to 10% in November and to 8% in December. In an attempt to further ease liquidity constraints on the country's banks, the refinancing rate was cut to 5% in February 2009 and to 3% in March 2009 and reserve requirements were again slashed from 3% to 0.5%.

Notwithstanding a 12.4% contraction in net lending in the last quarter of 2008, banks expanded their loan portfolios 53% y-o-y (98% in 2007). By 2009, the aggregate loan portfolio reached EUR 6 billion, with loans extended in 2008 worth EUR 8.4 billion (27% of GDP). In January 2009, new loans shrank by 10% y-o-y and net lending declined, largely driven by stricter collateral requirements which the NBA raised from 120% to 150% in December 2008, partly in anticipation of deteriorating real estate prices.

At the end of 2008, the aggregate capital of the banking sector stood at EUR 1.3 billion, or 4% of GDP, and its aggregate assets roughly doubled to EUR 8.7 billion (28% of GDP).<sup>45</sup>

A massive current account surplus, equivalent to 35.5% of GDP, as a result of booming oil exports and prices, allowed the accumulation of substantial foreign assets. By 2009, Azerbaijan's gross official reserves and oil fund assets reached USD 17.3 billion (EUR 11.8 billion), about six times the size of the public external debt.

### Risks and outlook

Its high reliance on hydrocarbons<sup>46</sup> remains the economy's major vulnerability, even more so in the global slowdown. Because of a slacker global demand and substantially lower oil prices, a 40%

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

<sup>46</sup> The oil sector provides around 95% of country's total export earnings, 50% of its GDP and around 60% of its budget revenue.

increase in the volume of oil extraction projected to reach 61.8 million tons in 2009 is at risk and, even if achieved, would only partially compensate for a slump in export revenue.

Lower oil prices will also affect the proceeds from corporate taxes. The assumed oil price of USD 70 per barrel inherent in the 2009 state budget poses a risk to expenditure, with revenue falling well short of targets. Oil fund assets are likely to be seriously depleted to finance the government's spending commitments and to cover a hefty budget deficit of over 10% of GDP as forecast for 2009.

A long-awaited expansion of the non-oil sector may be difficult to achieve under current circumstances as risk aversion towards emerging markets grows, raising foreign capital becomes a real challenge for banks and so does access to bank credit for businesses. A strengthening REER is also likely to undermine the growth of import competing industries.

Slower real GDP and money supply growth, and falling global commodity prices, will contribute to disinflation in 2009, with annual growth dropping into single digits, well below the government's 13% target.

Due to much weaker oil prices, the current account surplus will substantially contract to about 10.8% of GDP in 2009 but is likely to recover as oil prices pick up in 2010.

#### **Policy reforms and measures**

The government's intention to adopt a sustainable expenditure framework in view of the long-term oil revenue profile is commendable. To strengthen the quality and efficiency of public investment to support non-oil activity, the government has developed clear rules for the selection, execution, monitoring and auditing of public investment projects and is to finalise new guidelines to that effect.

As part of a stimulus package for the private sector, in particular non-oil industries, and to strengthen national competitiveness in general, the profit tax is likely to be cut by 2 percentage points and VAT by one percentage point.

Improved coordination between fiscal and monetary policy is needed to mitigate the repercussions of the global slump. Easing inflationary pressures give more room for the NBA to support economic activity and liquidity in the financial sector. It has still to ensure that inflation expectations are set firmly on a downward trend before cutting rates further. For now, the transmission mechanism seems not to work well, so rate cuts are not translated into lower bank lending rates and a broader access to bank credit.

In 2008, Azerbaijan progressed on streamlining business regulations, including introducing a one-stop shop for business start-up and a unified property registry, an online tax filing, and greater protection for minority shareholders. Nevertheless, the Azerbaijani business environment remains difficult, owing to corruption and the presence of formal and informal monopolies in many sectors.

#### **Social development and poverty**

Although the oil sector is not a large employer, oil-boom spill-over effects on sectors such as retail trade, construction and telecommunications probably benefited employment and income distribution. Some 120 000 jobs were reportedly created in 2008 (766 000 in the past five years). The poverty rate dropped to 13.2% in 2008 from 15.8% in 2007 (49% in 2003).

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

In August, the government adopted the *Food Security Programme* for 2008-2015. Agriculture is set to increase to about 10% of GDP and employs some 1.5 million people, with 44% of the country's population living in rural areas.

Table III.3.1:

Azerbaijan - Main economic indicators	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	26.2	34.5	25.0	10.8	2.5
GDP nominal (EUR, billion)	10.6	16.0	22.8	31.5	35.7
GDP nominal (USD, billion)	13.2	20.2	31.2	46.3	47.1
GDP per capita (EUR)	1267	1886	2648	3620	4055
GDP per capita (USD)	1571	2376	3628	5322	5352
GNI per capita, PPP current prices (USD)	3940	5380	6260	6936	7109
Inflation (period average)	9.6	8.3	16.7	20.8	6.2
<b>Social indicators</b>					
Unemployment rate (officially registered only)	1.1	1.0	0.9	0.8	1.0
Poverty rate (% population)	24.0	21.0	15.8	13.2	13.0
Inequality (Gini index consumption/income)	2.3				
<b>Fiscal sector</b>					
Total revenue (% GDP)	20.3	22.8	23.0	30.9	18.9
Total expenditure (% GDP)	22.7	27.4	29.2	38.1	29.8
Budget balance (% GDP)	-2.3	-4.6	-6.2	-7.2	-10.8
Gross public debt (% GDP)	16.2	17.5	15.0	11.7	11.0
<b>Monetary sector</b>					
Domestic credit to private sector (% GDP)	11.8	13.3	17.6	19.3	
Broad money (M3) (% change)	22.3	86.3	71.4	44.0	9.1
Degree of monetisation (M3/GDP, %)	14.7	19.1	22.0	22.3	21.2
Foreign currency deposits in total bank deposits (%)	80.7	61.2	47.0	55.5	57.0
<b>External sector</b>					
Current account balance (% GDP)	1.3	18.4	28.9	35.5	10.8
Trade balance (% GDP)	25.0	38.3	48.8	49.7	22.2
Foreign direct investment (net, % GDP)	3.5	-6.2	-16.6	-4.1	-1.5
Import cover of reserves (months)	3.0	4.8	5.6	7.2	
<b>External vulnerability</b>					
Total external debt (% GDP)	34.7	28.2	22.3	19.2	17.5
Public external debt (% GDP)	12.5	9.4	8.1	7.5	7.2
Debt service ratio <sup>1</sup>	55.2	42.3	31.0	26.6	
Gross reserves (excl. gold, USD billion)	1.2	2.5	4.3	6.5	3.5
Reserves/M3	0.6	0.6	0.6	0.6	0.3
<b>Financial sector</b>					
Short-term interest rate	9.9	10.4	9.2	10.1	
Lending rate	17.0	17.9	19.1	19.8	
Exchange rate (local currency per EUR, average) <sup>2</sup>	1.18	1.12	1.17	1.20	
Exchange rate (local currency per USD, average) <sup>2</sup>	0.95	0.89	0.86	0.82	
Real effective exchange rate (2000=100)	85.8	89.0	95.1	121.8	
Real effective exchange rate (% change)	15.6	3.7	6.9	28.1	

<sup>1</sup> External debt-to-exports ratio in % <sup>2</sup> Recalculated for the new manat=5000 old manat

Sources: Azeri authorities, IMF, WB.

## 4. BELARUS

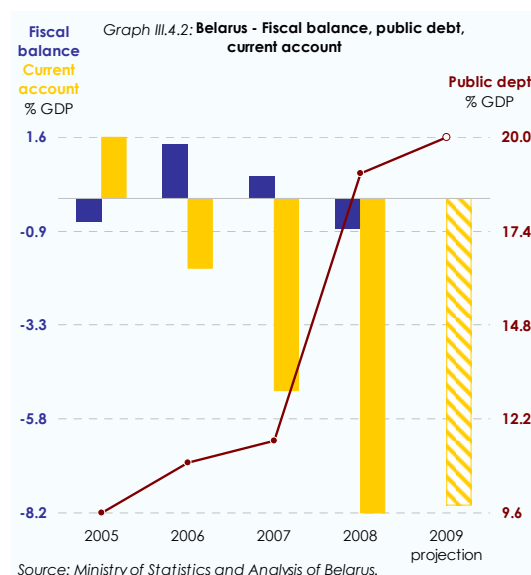
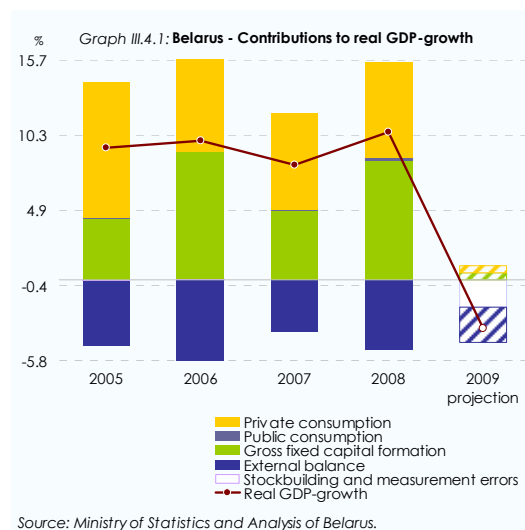
- **2008 was yet another year of very strong growth, at around 10%. In contrast, the forecast for 2009 is for a -4% GDP contraction.**
- **The worldwide slowdown forced Belarus into signing an SBA with the IMF.**
- **After years of restrictions, better relations with the EU are developing.**

### Macroeconomic and financial developments

Belarus has had a rather impressive economic performance during most of the 2000s: the average annual growth in 2001-08 is estimated at 8.3%. Nevertheless, the global economic and financial instability that spread to emerging markets during the second half of 2008 has now caught up with it: growth is expected to fall from an impressive 10% in 2008 to a -3.5% recession in 2009. Belarus has also joined the increasing list of countries have negotiated international support packages (fully half of the 12 CIS countries now have IMF programmes, and Russia is the only Western CIS country without one).

This reflects the worsening prospects for all the largest economic partners of the very open Belarusian economy (exports plus imports were over 120% of Belarusian GDP in 2008), Russia, the EU and Ukraine, whose economies are now *all* expected to face significant contractions in 2009.

While GDP still seems to be holding up in the face of the deceleration – the figures for February 2009 still show growth of 2.3% (down from 10.3% in February 2008), supported by an increase in (largely state) investment of 23% y-o-y and by inventory accumulation – industrial production fully reflects the slowdown: the February 2009 industrial production was down by -6.5% y-o-y (compared to an increase of 16% y-o-y in February 2008). The fall is significantly larger for the most important sector of Belarusian industry, machinery (responsible for 20% of industrial output, and catering mostly for Russian and Ukrainian markets): a 23% fall in February 2009 (compared to a 17% increase in 2008).



Belarus's main vulnerability is its traditionally weak external position, as its hard currency reserves were only enough for around a month of imports, and have fallen even from this low point recently, to EUR 2.6 billion by February 2009, from EUR 3 billion in mid-2008. Additionally, the country is almost completely dependent on imports for its energy needs.

The trade balance deficit increased very considerably in 2007, as the energy price shocks hit the economy: it virtually doubled from 4.5% of GDP in 2006 to around 9%, and approached 10% of GDP in 2008. 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 growth in the trade deficit with Russia, due to the partial removal of preferential energy trade terms).

In early 2009 the situation worsened, with the trade deficit for January 2009 increasing by almost 120% (to EUR 340 million) compared with January 2008: this would imply a trade deficit of around 13% of GDP in that month (which would make it virtually impossible for Belarus to finance on an annualised basis). This happened because exports collapsed by over 45% (significantly more than the 33% fall in imports), notably owing to exports to the CIS falling by 55% y-o-y.

The budgetary data for 2008 indicate a budget surplus of almost 1.5% of GDP, due to an increase in revenues to 51% of GDP (almost two percentage points above 2007). Inflation increased from 8.4% in 2007 to 14.8% in 2008 (average over the year), but further increases in 2009 should be moderated by the economic slowdown, even considering the pass-through effects of the devaluation (see below).

### Risks and outlook

As described below, the IMF Stand-By Agreement (SBA) was based on more optimistic economic assumptions than currently apply, which also reflects the worse growth prospects of Belarus's main economic partners. Given the degree to which the country relies on external financing for its funding needs and the downside

risks during the short-term horizon, the Belarusian economy may be faced with a very significant external gap. The budgetary stance will also be placed under strain, given Belarus's dependency on taxes of processed oil products (due to falling prices) and the inevitable increase in social expenditures.

On the other hand, after years of restrictions, and also due to the crisis, EU-Belarus relations have been evolving rapidly since the decision of the 13 October 2008 General Affairs and Economic Relations Council (GAERC) for a progressive re-engagement with Belarus, followed by the European Council temporarily lifting sanctions and instructing the Commission to intensify technical cooperation with Belarus in areas of mutual interest (these decisions were confirmed in March 2009 by another GAERC meeting). Also, the participation of Belarus in the "Eastern Partnership" framework enhances further the scope for engagement with the EU.

### Policy reforms and measures

On December 31 2008, an agreement was announced on an SBA between the IMF and Belarus. This deal is a 15-month operation worth EUR 1.8 billion ("exceptional access" to 420% of Belarus's IMF quota), which was approved by the IMF Board on 12 January 2009. Roughly a third of the SBA funds were immediately disbursed, and the rest will be paid in quarterly instalments linked to IMF review missions. The programme included a 21% devaluation of the currency on 2 January 2009, and the currency was re-pegged to a basket (with a +/- 5% band) that includes the USD, the EUR and the RUR in equal weights. The SBA conditionalities are briefly described below:

#### -Macroeconomic

- 1) exchange rate framework reform;
- 2) balanced budget via smaller fiscal expenditures (net of banks' recapitalisation).

#### -Financial sector

- 1) re-capitalisation of banks;<sup>47</sup>
- 2) reform of the banking supervisory structure;
- 3) elimination of interest rate caps;<sup>48</sup>
- 4) eventual privatisation of banks.

#### **-Energy sector**

- 1) implementation of cost-recovery pricing for utilities.

#### **-Structural reform**

- 1) privatisation of the non-financial sectors of the economy;
- 2) elimination of wage growth targets and price controls;
- 3) reduction of the size of the state in the Belarusian economy, reduction of taxes,<sup>49</sup> improvement of the investment climate for domestic and foreign private capital.

As can be seen from this list, the SBA conditionalities go beyond sheer macro stabilisation aims, as they incorporate significant structural and liberalisation reforms. The liberalisation element of the package reflects the continuation of an already ongoing cautious economic opening-up process that started earlier. Measures so far taken include the elimination of the infamous "golden share" rule (which enabled the government to re-nationalise any previously state-owned company), the "52 points" list of reforms enacted in early 2009, and greater efforts

towards privatisation (for example, the drawing up of a long list of enterprises to be privatised) and attraction of FDI.

The overall external financing needs of Belarus during the duration of the IMF programme (2009-2010) were initially estimated at EUR 2.9 billion, which would leave an external funding gap of EUR 1.1 billion for the period 2009-2010. Of this, two-thirds would be covered by the 2<sup>nd</sup> tranche of a second "economic stabilisation" loan from Russia<sup>50</sup> (the first tranche of which was disbursed in late 2008), while the remaining was expected to be covered by "other external donors".<sup>51</sup> The IMF has recently indicated a significant worsening of the economic situation compared to the macroeconomic assumptions that underpin the SBA agreement (for instance, the programme was based on a low but positive growth rate for 2009), which may imply larger external funding needs than the ones initially foreseen.

In mid-March 2009 the Central Bank of Belarus signed a "currency swap" arrangement with the Central Bank of China. This three-year agreement totalling EUR 2.2 billion is apparently designed to work as a trade credit facility to support Belarusian-Chinese bilateral trade.<sup>52</sup> In an apparent response to this development, Russia announced that a similar facility could also be provided.

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<sup>47</sup>The banking system in Belarus is mostly state-owned, and it was duly recapitalised by the state already in late 2008. The third largest bank in the country is a subsidiary of the Austrian bank *Raiffeisen* (though Russian banks also have a significant presence in the country).

<sup>48</sup>This measure, plus the elimination of preferential lending to sectors such as agriculture, was also enacted in late 2008.

<sup>49</sup>In January 2009 a flat-rate income tax of 12% was introduced, replacing the previous five brackets (9%, 15%, 20%, 25% and 30%). Other tax rates have also been reduced, including: the tax on purchase of transport vehicles (from 5% to 3%), the tax for supporting agriculture (from 2% to 1%) and the tax on securities transactions (from 40% to 24%). However, income tax for individual entrepreneurs has been increased from 16% to 20%, i.e. to the level of corporate tax.

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<sup>50</sup>In 2007 the Russian government agreed to provide Belarus with a first EUR 1.1 billion "economic stabilisation" 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 remainder of the second stabilisation loan is now apparently to be paid in two equal separate tranches in 2009.

<sup>51</sup>This may include a potential World Bank "Development Policy Loan" (or DPL). No concrete figures are available, as the programme is still to be negotiated, but a possible tranche of EUR 150-200 million in 2009, with the possibility of a further EUR 150 million in 2010, conditional on the success of the first DPL, has been mentioned.

<sup>52</sup>China gave similar swap facilities to other countries in 2009.



Table III.4.1:

Belarus - Main economic indicators	2005	2006	2007	2008	2009
<b>Real sector</b>				prel.	proj.
Real GDP growth (domestic currency, % change)	9.4	9.9	8.2	10.5	-3.5
GDP nominal (EUR, billion)	24.3	29.4	32.7	41.0	30.8
GDP nominal (USD, billion)	29.5	36.9	44.8	60.3	45.2
GDP per-capita (EUR)	2476	3018	3368	4271	3237
GDP per-capita (USD)	2986	3808	4619	6281	4761
GNI per-capita (PPP, current prices, USD)	7890				
Inflation CPI (% end of period)	10.3	7.0	12.1	13.3	12.7
<b>Social indicators</b>					
Unemployment (%)	1.5	1.2	1.0	0.8	1.5
Population (million)	9.8	9.7	9.7	9.6	9.5
<b>Fiscal sector</b>					
Total revenue (% GDP)	48.3	48.2	50.0	52.1	48.0
Total expenditure (% GDP)	48.9	46.9	49.4	52.9	48.0
Central government balance (% GDP)	-0.6	1.4	0.6	-0.8	0.0
Gross domestic public debt (% GDP)	5.8	6.5	6.3		
Gross public debt (% GDP)	9.6	11.0	11.6	19.0	20.0
<b>Monetary sector</b>					
Private sector credit (% change)	48.7	52.4	52.4	59.7	12.7
Private sector credit (% total credit)	74.6	74.9	93.0	79.0	78.0
Broad money (M3, %)	42.0	39.3	35.9	15.0	15.0
Degree of monetisation (M3/GDP, %)	19.7	22.1	24.8	21.9	21.3
Dollarisation in bank deposits (%)	28	29	30	31	30
<b>External sector</b>					
Current account balance (% GDP)	1.6	-1.8	-5.0	-8.2	-8.0
Trade balance (% GDP)	1.0	-4.5	-9.0	-9.6	-8.6
FDI (net, % GDP)	1.0	0.4	3.0	3.6	2.7
Import cover (months)	0.9	0.7	1.8	1.0	1.9
<b>External vulnerability</b>					
External debt (public plus private, % GDP)	17.4	18.5	27.9	24.6	30.0
Gross reserves (excluding gold, USD, million)	1297	1383	4200	2865	5200
Reserves/M3 (%)	4.5	16.3	44.5	46.0	25.0
<b>Financial sector</b>					
Short-term interest rate (%)	11.4	12.9	10.4	12.0	
Exchange rate (rouble per EUR, end of period)	2550	2812	3167	3143	
Exchange rate (rouble per USD, end of period)	2152	2140	2150	2137	
Real effective exchange rate (2000=100)	76.3	73.4	72.3	71.2	

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

### Social development and poverty

Belarus has one of the lowest official unemployment rates in Europe, at a mere 1%. And indeed the Belarusian social model is based on full employment, as unemployment benefits are relatively limited. *Open* unemployment so far remains very low, even with the current downturn, but there are reports of forced

temporary leave in many industries, a direct effect of larger unsold inventories, which have increased very significantly (up 66% y-o-y by February 2009, and up by over 80% for the machinery industry). The number of employees on part-time work doubled in January 2009 compared with November 2008, and the number on unpaid leave was 3.6 times higher.

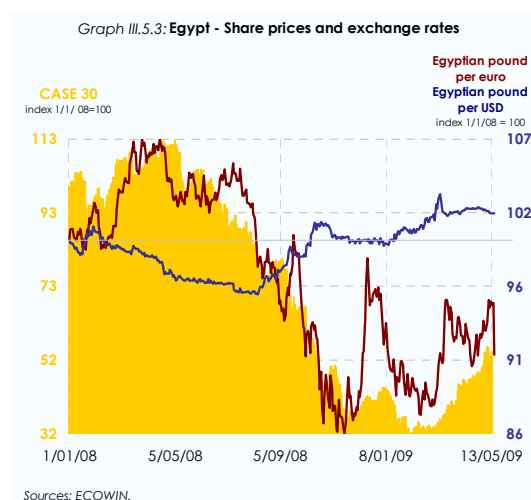
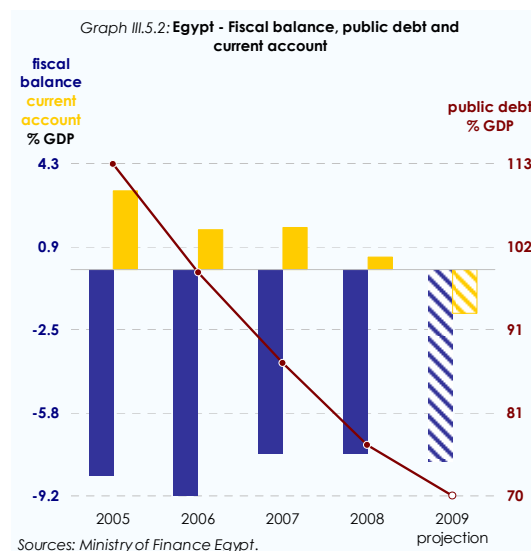
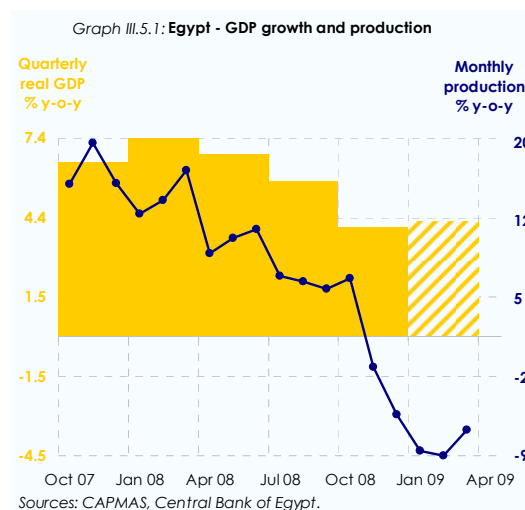
## 5. EGYPT

- *In the second half of 2008, the real side of the Egyptian economy started to feel the effect of the global chill. GDP growth decelerated to 4.1% in the fourth quarter of 2008, after robust annual growth of 7% annual GDP growth in the years 2006-2008.*
- *The financial side of the economy had already been affected earlier in the year. The stock market had decreased from May 2008 onwards, as foreign investors started to withdraw their funds in a reaction to the global financial and economic crises.*
- *The key priority is to maintain macroeconomic stability through the use of prudent monetary easing, fiscal stimulus and other measures. In view of this, sticking to a sustainable fiscal stance is now a greater challenge. Structural reforms should be pursued. Further improvements in the tax system are welcome and lower energy and food prices offer the opportunity to continue the reforms in the subsidy system towards more effective targeting.*

### Macroeconomic and financial developments

Falling stock markets were the first significant negative impact of the unfolding global **financial** crisis on Egypt. Foreign portfolio investors and less confident domestic investors started to withdraw their money. From May 2008 until February 2009 prices fell almost 70%. The negative effects of the global economic slowdown on the **real economy** in Egypt, in line with the sharp drop in world trade, were the drops in production growth and exports in November 2007 (see graphs and III.5.4). In February the decline continued, production fell 9.2% and exports 16%.

The economic slowdown follows three consecutive years of robust **economic growth**, of 7.2% in the fiscal year FY08 (fiscal year running from July 2007 to June 2008) and 7.1% in FY07 and 6.8% in FY06. The growth was fuelled by investment, especially FDI, and exports of goods and services. A decline in tourism revenues and exports triggered a drop in GDP growth to 5.8% y-o-y in FY09Q1, to 4.1% in FY09Q2 and 4.3% in FY09Q3.



Also, an erosion of purchasing power due to food and energy prices, which soared until autumn 2008, did little to help economic growth.

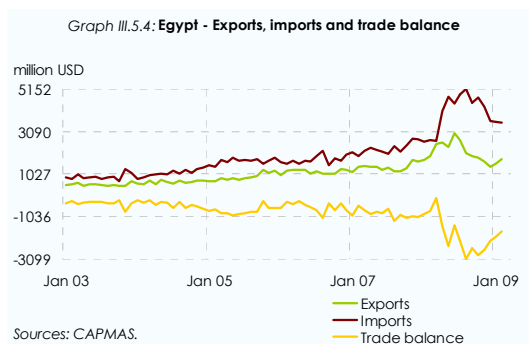
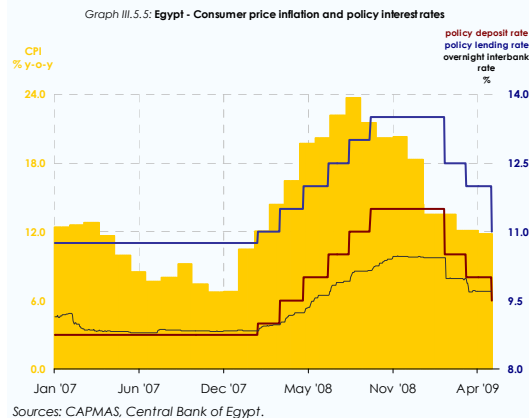


Table III.5.1:

Egypt - Government expenditures

	FY07	FY08	FY09 budget
as percentage of the total expenditures, unless otherwise indicated			
Wages and salaries	23	22	23
Interest payments	21	18	15
Subsidies	24	30	28
Food subsidies	4	5	6
Energy subsidies	18	21	18
Total expenditures (Egyptian pounds, in billions)	222	282	344

Source: Ministry of Finance of Egypt.



The soaring commodity prices brought with them much higher government food and energy subsidies than in the years before FY08 (see III.5.1), burdening the **government budget**. Despite the additional government expenditures, the government deficit is expected to widen by only 0.3 percentage points from 7.5% to 7.8% in FY09 due to reforms in the VAT. The government gradually starts to reap the fruits of a better targeted subsidy system. However, the debt stock of the general government remains high at more than 75% of GDP. In response to the economic slowdown, the fiscal authorities launched an economic stimulus

package of LE 15 billion in FY09, which amounts to some 1.5% of GDP. LE 9.9 billion was allocated for budget sector investments, mainly in water and sewage and infrastructure, LE 0.6 billion for improving railways and airports, LE 2.8 billion for export promotion, infrastructure for internal trade and support to industrial zones and LE 1.7 billion custom tariff reductions.

After the rapid monetary tightening in eight steps to mitigate inflation - in particular second round effects - during 2008, the central bank eased monetary policy in three steps by 250 basis points in January, February and May 2009 (see III.5.5). During the last move the interest corridor was narrowed, in that lending became relatively cheaper. The fall in inflation from 24% in August 2008 to 11.8% in April 2009 gave leeway for lowering borrowing rates to help stimulate economic activity.

While lower global commodity prices have helped Egypt in that domestic inflation came down from its high levels, lower global cotton prices have led to insecurity in the cotton industry. Employees fear job losses as a consequence of Egypt's falling cotton market share and lower cotton profits.

The currency regime is a managed float. The central bank further pursues an inflation targeting regime. In 2008 Egypt's relatively strong economic growth, with high inflows of FDI and high portfolio inflows, made the Egyptian pound stronger, mainly against the sliding euro. Volatility in the Egyptian exchange rate increased at the end of 2008, in line with international financial markets. In support of the Egyptian pound, the central bank intervened in the foreign exchange market. Nonetheless, **official foreign exchange reserves** remain at a stable level, at more than 20% of domestic GDP.

During recent years, the **balance of payments** has remained positive; large inflows of revenues from tourism, private transfers, remittances from workers abroad, FDI and Suez Canal revenues have compensated for the trade deficit. For FY09 a sharp drop in exports is forecast, as the recession in the developed countries will lower demand for Egyptian goods. The sharp decline in global energy prices will also affect the balance

of payments significantly. Further to this, the turmoil at the international financial markets has already meant that foreign investors withdrew EUR 900 million of portfolio investment from Egypt in FY08. In sum, this will result in a negative balance of payments for FY09.

As Egypt is still largely a **cash-based economy**, where only 10% of the population and 18% of SMEs have a bank account, mortgage loans and consumer credit are still in their infancy. Public banks account for around 50% of the domestic banking sector in terms of assets and the state is the owner of the largest banks in Egypt. So, a liquidity crisis would therefore burden the government directly. The average deposit to loans ratio is still high, at 50%, and the Egyptian interbank market functions on a limited basis. Nonetheless, the **interbank market rate** slightly peaked temporarily in 2008, as a result of the lack of confidence among commercial banks fearing liquidity shortages.

### Risks and outlook

Due to the grim current global economic and financial crisis, the Egyptian economy will be faced with stormy weather. While the main risk for the economy has a different origin than in 2008 when Egypt suffered from soaring commodity prices and subsequently high government outlays on subsidies, it is essentially again **fiscal sustainability** that is most at stake.

In 2009, the fiscal stimulus package of LE 15 billion could burden the fiscal budget, and this may decelerate the reduction in the government debt stock. The strong increase in the compensation for government employees (see III.5.1) can further depress the budget while no large revenues from the sale of state companies are expected. Successful reforms in the VAT can though help to keep the deficit under control.

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

This is compounded by the persistently relatively high food prices. Downward rigidities in food

prices and inefficient and bureaucratic organisation of food imports keep inflation high.

### Policy reforms and measures

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

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

Partly pressed by the unfolding financial crisis the Central Bank has started the implementation of Basel II. In line with international regulation, Egypt will adhere to **transparent and strict financial regulations**, not only for banks, but also for the stock exchange, insurance and pension funds. Broadening and deepening of the financial sector will be conducive for private sector development and enable households to move to higher welfare levels, but a parallel strengthening of the supervisory framework alongside is indispensable.

The EU-Egypt Action Plan, adopted in March 2007 in the framework of the ENP, still provides a good framework for deepening economic and trade relations.

### Social development and poverty

Poverty is widespread in Egypt, where 42.8% of the Egyptians live on a mere USD 2 per day. Life expectancy at birth is low at 71.6, adult illiteracy above the age of 15 is high at around 30%, and almost 25% of the population get no formal education. Youth employment is high, even among males.

Table III.5.2:

**Egypt - Main economic indicators**

	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	4.5	6.8	7.1	7.2	4.1
GDP (Egyptian pounds, billion)	539	618	745	897	1032
GDP nominal (EUR, billion)	73	89	97	111	145
GDP nominal (USD, billion)	93	108	127	163	199
GDP per-capita (EUR)	1004	1196	1289	1441	1847
GDP per-capita (USD)	1276	1456	1682	2114	2527
Inflation (consumer price, average)	11.4	4.2	11.0	11.7	17.1
<b>Social indicators</b>					
Unemployment (off. registered, average, %)	10.5	11.5	9.5	8.5	8.9
Life expectancy at birth (years)		70.2	70.7	71.6	
Adult literacy (% ages 15 and older)		71.4			
Domestic population	72.9	74.2	75.5	77.1	78.6
Income inequality (Gini, %)			34.4		
Human development index	0.575	0.613	0.659	0.708	
<b>Fiscal sector</b>					
General government revenues (% GDP)	24.8	28.6	27.7	27.8	26.2
General government expenditures (% GDP)	31.8	36.3	32.9	34.1	32.3
General government balance (% GDP)	-8.4	-9.2	-7.5	-7.5	-7.8
General government primary balance (% GDP)	-2.3	-3.4	-2.3	-3.2	-3.2
Gross public debt (% GDP)	112.8	98.8	87.1	76.5	70.0
<b>Monetary sector</b>					
Broad money M2 (% change)	13.6	13.5	18.3	15.7	12.2
Dollar/Euro/other currency-isation (% of broad money)	24.5	24.4	23.2	20.8	
Credit to private sector (%)	3.6	8.6	12.3	12.6	13.5
<b>External sector</b>					
Current account balance (% GDP)	3.2	1.6	1.7	0.5	-1.8
Trade balance (% GDP)	-11.6	-11.2	-12.5	-14.4	-14.0
FDI (net, % GDP)	4.3	5.6	8.1	7.5	4.0
Remittances (% GDP)	4.9	5.0	4.9	4.9	4.3
Import cover of reserves (months)	5.8	5.9	5.2	6.4	
<b>External vulnerability</b>					
External public debt (% GDP)*	19.6	17.6	14.9	12.9	13.7
Gross reserves (USD, billion)**	19.3	22.9	28.4	32.2	
<b>Financial sector</b>					
Official discount rate (end-of-period, %)	10.0	9.0	9.0	10.0	
Lending rate (average, on less than one year loans, %)	13.4	12.7	12.6	12.2	
Exchange rate (LE per EUR, average)	7.2	7.2	7.5	8.1	
Exchange rate (LE per USD, mid FY)	6.0	5.8	5.7	5.5	
Real effective exchange rate (% + is apprec.)	4.2	8.1	4.4	3.0	
Stock market (CASE-index, % change FY)	235	-1	63	26	

\*For FY09 December 08. \*\*End-October 2008.

Sources: Central Bank of Egypt, CAPMAS, Ministry of Finance of Egypt, IMF, EUROSTAT, EIU, Commission.

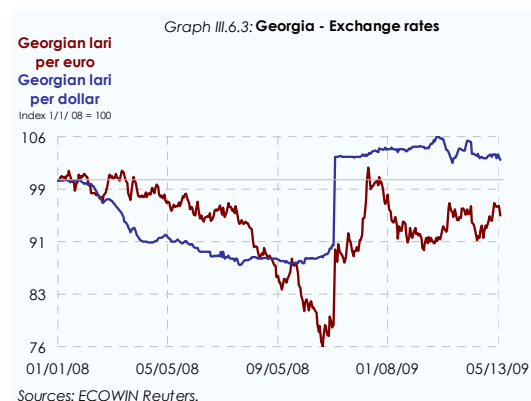
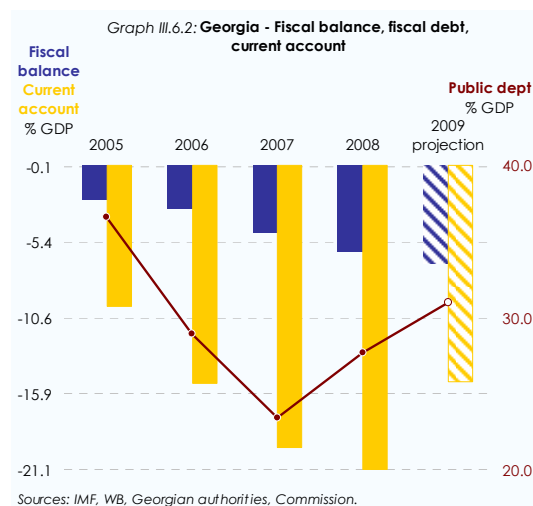
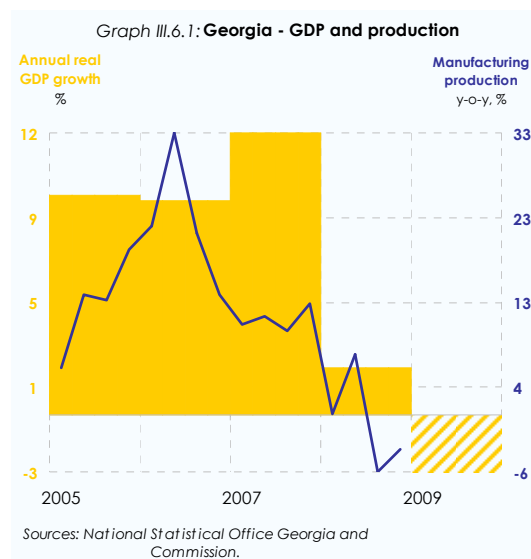
At the same time poverty among senior citizens is growing, which is a serious problem because the number of people in this age group is expected to overtake the number of young people for the first time in Egypt's history by the year 2050.

## 6. GEORGIA

- *Georgia is expected to face a sharp economic slowdown. The negative impact of the military conflict with Russia is being compounded by the unfolding global crisis.*
- *Assistance pledged by donors in the aftermath of the military conflict and funding under an IMF stand-by agreement are being used to finance a fiscal stimulus as private capital flows reverse.*
- *The lari depreciated in November 2008 amidst tightened liquidity in the foreign exchange markets. External imbalances remain wide and vulnerabilities in the financial sector have increased, although inflationary pressures have receded.*
- *The need to strengthen the legal and institutional framework is slowing progress in trade negotiations with the EU.*

### Macroeconomic and financial developments

The military conflict with Russia which erupted in August 2008 cut short Georgia's strong economic performance into the first part of 2008, when there had been signs of overheating. Apart from the direct damage caused by the conflict, the ensuing displacement of people, contraction in liquidity, capital outflows, weakening of confidence and decline in tourism took a toll on economic activity. The continued Russian military presence in South Ossetia and Abkhazia means that these regions remain outside the control of the Georgian authorities. In the autumn of 2008, in the immediate aftermath of the war, an extensive international assistance package was swiftly put in place in order to finance reconstruction and mitigate the economic and budgetary fallout. At an international donor's conference in October 2008, the donor community pledged a total amount of USD 4.5 billion (consisting of approximately USD 2 billion in grants and USD 2.5 billion in loans) over a three-year period. This included about USD 800 million to the private sector, mostly IFI lending to the banking sector. The EU pledged to



contribute to the country's needs with up to € 500 million for the period 2008-2010, the promised assistance consisting both of regular and specific post-conflict programmes.

Donor financing helped cushion the shock from the conflict with Russia, which led to foreign inflows largely falling away. Efforts to stabilise the markets and the banking sector (compensating for deposit withdrawals) were also broadly successful. They included post-conflict liquidity injections via central bank repo and special lending facilities, reductions in reserve and liquidity requirements, and reductions in policy interest rates. Liquidity injections partly fuelled the demand for foreign exchange, feeding into pressures on the exchange rate that had to be countered by interventions.

The combination of the dramatic worsening of the global financial crisis and Georgia's emergence from the war pushed its country risk, as measured by international bond yield spreads up to a peak in early October 2008 amidst general risk aversion towards emerging markets. This made any near-term revival in private foreign inflows unlikely, dented hopes for a quick recovery, and in turn led to further pressures on the financial sector and the exchange rate. This put the newly-implemented monetary policy framework of inflation targeting to the test. During the August conflict, the authorities had announced a temporary peg of the lari to the US dollar in order to provide a confidence-boosting anchor. However, interventions in the exchange markets proved unable to counter the pressure on the lari which had resurfaced as the global financial crisis deepened in the autumn. Consequently, in early November 2008 the authorities allowed it to rapidly depreciate –by around 17%– against the US dollar.

The concomitant decline in domestic confidence, tightening of domestic credit, and contraction of the monetary base depressed domestic demand. The combined negative shocks triggered a sharp slowdown in economic activity in the second half of 2008. For 2008 as a whole, economic growth slowed markedly to 2.1%. The current account deficit narrowed significantly in the second half of 2008 on the back of declining

economic activity, after reaching a high of more than 20% during the overheating phase.

### Risks and outlook

Economic prospects for 2009 are severely dented, even though the strong fiscal and monetary easing measures taken by the authorities should cushion the negative impact of military conflict and crisis on growth. Real GDP is expected to shrink modestly in 2009. To a large extent this reflects the drying up of the foreign inflows that had fuelled the rapid economic expansion of the past years. Similarly, remittance inflows are expected to diminish, in particular as a result of the slowdown in the Russian economy. Due to the expected sharp deceleration in inflation, driven by decreases in commodity prices and economic retrenchment, consumer price inflation in 2009 is expected to fall well short of the inflation target of 9%.

As regards the external environment, Georgia remains vulnerable to a significant deterioration in the economic conditions of regional partners. The limited access to the financial markets and exchange depreciation has increased vulnerabilities in the financial sector, which require close monitoring. Measures to bolster confidence in financial institutions and to strengthen supervision are important to address vulnerabilities. The recent involvement of international financial institutions (notably the EBRD) in recapitalising a number of systemically important banks was a welcome step in this direction.

The fiscal stimulus currently in place is largely financed by official inflows as the fall in private inflows has affected the current account. A part of the proceeds of the April 2008 Eurobond issue (500 million USD) were another important source of funding for government expenditure. Going forward, sustainable government funding will be an issue, especially if the economic recovery is slower than anticipated. Similarly, the potential drain on reserves that prolonged strains on foreign exchange markets would represent could be a challenge to exchange rate policy.

### Policy reforms and measures

With the aid of the international community, the authorities have taken measures to address the impact of military conflict and financial crisis (see above). The policy response aimed at substituting official stimulus for faltering external funding and involved a combination of aggressive monetary easing, adjustments in the exchange rate policy and exchange rate level, and sizeable fiscal easing. In view of the financial vulnerabilities that have come to light, stringent supervision of the financial sector is crucial. In addition, it is important to improve the National Bank of Georgia's lender-of-last-resort function.

In the area of fiscal policy, in early 2009 the government announced a gradual reduction in tax rates. The legal commitment to strive for fiscal surpluses was confirmed by Parliament, albeit with an exception for 2009 in view of the extraordinary economic conditions.

As regards trade policies, Georgia has been a WTO member since 2000 and conducts a liberal trade policy, with import tariffs only in place on some agricultural goods and construction materials. Negotiations with the EU have been ongoing with the aim of removing non-trade barriers and identifying priority areas where Georgia would need to achieve progress to be ready to negotiate a free trade agreement with the EU. As regards the minimum legal and institutional framework that will be covered in a free trade agreement, problems have been identified in several areas, notably standardisation, competition and intellectual property rights enforcement. In addition, Georgia will need to achieve sufficient institutional and administrative capacity and to have control over its customs territory. The latter is a WTO requirement, and Georgia's constraints in this respect are obvious.

Georgia continues to be among the top performers in international rankings on the ease of doing business. However, progress remains limited with respect to competition policy. Civil service reform has also experienced bottlenecks. The systematic under-resourcing of the statistics department is an important case in point. A reform of the statistical system (with EU

support) is under consideration, with the aim of establishing an independent statistical agency by end-2009. In the area of public finance management, improvements in budget planning and preparation and treasury management have progressed, but efforts to improve the control and oversight functions (also in the financial sector) have not kept pace.

### Social development and poverty

The vigorous economic growth in recent years has not yet markedly improved the aggregate employment situation; instead it has been characterised by large shifts of labour from the public sector to the private sector. Registered unemployment has thus remained fairly stable at about 14%. Agricultural employment remains high (over half of total employment), typically on small farms with low productivity levels, hindering poverty reduction. Better education and training to address skills mismatches will be crucial in restructuring the Georgian economy to cope with the difficult economic climate. Despite the progress in reducing poverty rates in recent years (due to higher social and educational spending), most households are under pressure from the surge in food and energy prices, displacement and loss of (agricultural) activity due to war, and the impact of the crisis on incomes and employment. The population most directly impacted by the conflict with Russia is largely rural and poor. On the whole, poverty rates are likely to increase in the coming years. Some measures to address poverty were taken during the reporting period, including a doubling of minimum old-age pensions. The government also provided a number of one-off cash and in-kind benefits, including winter fuel subsidies, flour provisions for rural households and birth grants in families which are eligible for targeted social assistance.



Table III.6.1:

**Georgia - Main economic indicators**

	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	9.6	9.4	12.3	2.1	-2.5
GDP nominal (EUR, billion)	5.2	6.2	7.4	8.6	9.1
GDP nominal (USD, billion)	6.4	7.7	10.2	12.7	11.5
GDP per capita (EUR)	1201	1415	1680	1961	2066
GDP per capita (USD)	1491	1760	2313	2880	2617
GDP per capita (PPP current prices USD)	3644	4038	4694	4851	
Inflation (period average)	8.3	9.2	9.2	10.0	3.4
<b>Social indicators</b>					
Population (million)	4.3	4.4	4.4	4.4	4.4
Unemployment rate (ILO definition)	13.8	13.6	13.3		
Poverty rate (% population) <sup>1</sup>	24.1	24.3	24.3		
Inequality (Gini index consumption/ income)			40.4		
<b>Fiscal sector</b>					
Total revenue (incl. grants) (% GDP)	23.4	26.7	29.2	29.9	28.9
Total expenditure (% GDP)	24.9	29.8	34.0	35.9	35.6
General government balance (% GDP, cash basis)	-2.4	-3.0	-4.7	-6.0	-6.8
Gross public debt (% GDP)	36.6	28.9	23.4	27.7	31.0
<b>Monetary sector</b>					
Domestic credit to private sector (% GDP)	14.8	19.7	27.1	30.5	
Broad money (M3) (% change)	26.5	39.7	49.7	6.9	
Degree of monetisation (M3/GDP, %)	14.8	19.5	23.7	23.2	
Dollarisation in bank deposits (%)	71.8	69.4	65.6	75.8	
<b>External sector</b>					
Current account balance (% GDP)	-10.9	-15.1	-19.6	-22.6	-13.0
Trade balance (% GDP)	-18.9	-23.9	-26.8	-28.1	-20.2
Foreign direct investment (net, % GDP)	7.1	13.7	15.5	9.5	
Import cover of reserves (months)	1.8	1.8	2.1	2.4	
<b>External vulnerability</b>					
External public debt (% GDP)	27.1	22.0	17.5	20.7	23.2
Debt service ratio <sup>2</sup>	7.4	7.2	4.4	4.5	
Gross reserves (excl. gold, USD million)	479	881	1361	1378	
Reserves/M3	0.45	0.58	0.56	0.48	
<b>Financial sector</b>					
Money market rate	7.7	9.5	7.4	10.0	
Lending rate (3-month)	21.6	18.8	20.4	10.2	
Exchange rate (lari per EUR, average)	2.3	2.2	2.3	2.2	
Exchange rate (lari per USD, average)	1.8	1.8	1.7	1.5	
Real effective exchange rate (% change)	3.7	3.7	1.3	8.4	

<sup>1</sup> Poverty incidence with respect to 60% of median consumption

<sup>2</sup> Public external debt service as % of exports of goods and services

Sources: IMF, WB, Georgian authorities and Commission.

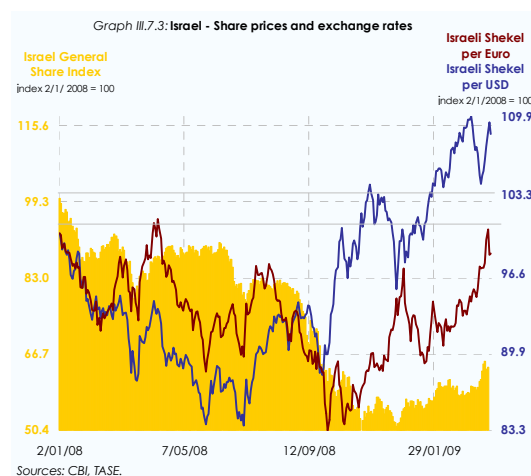
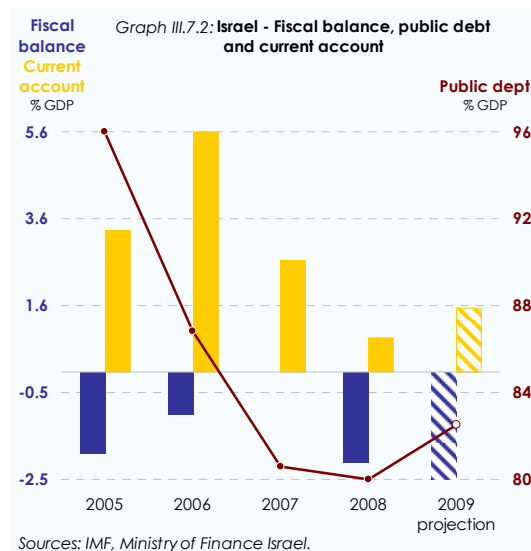
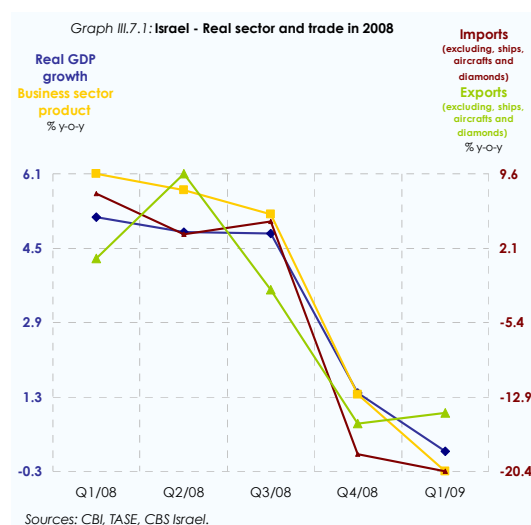
# 7. ISRAEL

- *Israel entered the global financial turmoil in a favourable economic position with high growth rates, sound macroeconomic policies, historic low unemployment, current account surpluses and a strong Shekel.*
- *The domestic banking sector was not severely affected during 2008, nevertheless, due to weaker external demand, growth slowed to 4.1%, and the fiscal position deteriorated, a trend which is expected to continue in 2009.*
- *Poverty and inequality remain a major challenge, and despite recent improvements, about 1.68 million people live below the poverty line, including over 773 000 children.*

## Macroeconomic and financial developments

After four years of strong growth rates above 5%, Israel's economy slowed to 4.1% in 2008. Sound macroeconomic policies, improved security and buoyant external demand allowed the economy to grow vigorously by 5.3% in the first semester based on private consumption, investments and solid export performance, despite the hike in energy prices. However, GDP growth started to slow down during the third quarter as the foreign economic environment became less supportive and contracted during the last quarter of 2008 with exports and manufacturing production, in particular, declining steeply.

Average inflation rose to 3.8% for 2008. In the first three quarters, inflation reached 4.4%, outside the limits set by the Central Bank (1%-3%), affected by the increase in world prices of raw materials, in particular oil and food, and by the buoyant level of demand in Israel. The steep rise in prices in the third quarter was largely due to the high 8.2% increase in the housing sector as the value of the houses and rental contracts began to be quoted in shekels. These effects would have been even more pronounced if there had not been an ongoing appreciation in the exchange rate that worked to moderate price increases. The Bank of Israel, under its inflation targeting regime, raised its rate to 4.25% to face inflationary pressures.



The drop in world oil and raw material prices and the rapid deterioration in global economy activity in the last quarter of 2008 resulted in negative inflation, which spurred the change in monetary policy. The Central Bank reduced the rate from 4.25% at the beginning of the last quarter to 1.75% in January 2009 and 1% in February — its lowest levels ever. However, the effectiveness of monetary policy to provide an anti-cyclical boost further increasing the demand for investment and private consumption is limited, mainly because of the increased risk premium on credit interest deriving from the economic crisis.

After four years of decreases, the fiscal deficit increased to 2% of GDP in 2008, above the budget target of 1.6%, due to the slowdown in the economy and numerous legislative changes which reduced the collection of direct taxes. The drop in durable goods purchases, especially cars, which are heavily taxed, was exacerbated by the impact of job insecurity and heavy financial losses on overall consumer spending and hence on value-added tax (VAT) receipts. In addition, corporate profits and tax revenue from capital gains decreased. In response, the Ministry of Finance sought to restrain spending to prevent a budget deficit from developing. Nonetheless, the large budget surplus recorded in the first quarter of 2008 was eroded to less than NIS 5bn (USD 1.4bn) by the end of November.

Public debt fell to 80% of GDP, remaining a constraint to implementing social and anti-cyclical policies. Nevertheless, after the rapid deterioration in economic activity, authorities announced a fiscal stimulus package of NIS 22bn (USD 5.7 bn) or 0.7% of GDP, mostly related to infrastructure projects and to providing liquidity to the banking sector.

The current account surplus narrowed to 0.8% of GDP in 2008, mainly because of the slowdown in exports and the fall of investment income from abroad. Nevertheless, the surplus in the current account and the widening of interest rate differentials with the US continued to support the shekel, which appreciated markedly during 2008 despite the central bank's decision to purchase around USD \$10bn in foreign exchange.

During 2008, the financial crisis did not have a severe impact on the relatively stable main Israeli banks but was an issue of concern for the capital markets. The drop in the price of shares and corporate bonds resulted in massive losses in the value of pension and provident funds triggering heavy withdrawals and, most importantly, eroding the value of pensions. The government intervened with a plan to provide limited support to elderly pension savers, depending on future market conditions. As in other countries, commercial banks either did not fully pass on the reductions in the Central Bank's rate to borrowers or they raised the credit-risk premiums for many. Consequently, at the end of 2008, overdraft rates for individuals were around 10%-12% per year whereas rates for small business were 6-7%. These rates were relatively high in real terms, demonstrating the unwillingness of banks to lend in a worsening environment or their preference to build a cushion of reserves against future losses. The most significant problems appeared in the non-banking credit market (accounting for 50% of business credit in Israel), which experienced a sharp drop. The main problems were debt refunding, the low trading volume and the issuance of new bonds, as according to estimations around USD 4.9 billion of existing bonds have to be refinanced and around USD 1.7 billion of new bonds are to be issued in 2009.

#### **Risks and outlook**

Although the Israeli economy was well placed when the financial crisis hit, recording a current account surplus, low inflation, high rates of private saving and a sound banking system, it will be severely affected in 2009 mainly because of its high degree of exposure to the US and European export markets. Furthermore, the military operations in Gaza in early 2009 temporarily disrupted production in the south and may have a negative effect on the export of tourist services. As a result, growth is expected to be negative, -0.2% in 2009. Unemployment, having fallen due to economic growth in recent years to a historic low rate of 6.1% in 2008, is expected to rise again to 7.6% in 2009.

The fiscal situation will deteriorate in 2009 as the military operations in Gaza incurred a non-negligible fiscal cost (around 1.2% of GDP) and

economic growth is expected to contract, resulting in a fiscal deficit of 4.1% and public debt totalling 82.3% of GDP. However, if the structural fiscal balance of 2009 remains unchanged compared to 2008 (excluding expenditure on the fiscal stimulus and banking liquidity measures) it would leave considerable room for further intervention if downside risks materialise, which will underscore the commitment to fiscal sustainability.

The external sector is going to be affected severely by the slowdown in the US, therefore exports to the US are expected to contract by around -1.5% in 2009. On the other hand, due to the more modest oil prices, the current account balance is expected to remain in surplus in 2009.

While the exposure of the banking sector to toxic assets seems to be limited, the economic slowdown could impair credit quality and prices of bank securities could decline further. Threats to financial stability could come with little warning from domestic bonds markets if any major default occurs.

#### **Policy reforms and measures**

The Israeli economy has proved capable of rapid adjustments in similar past economic shocks and was also strongly cyclically placed when this financial crisis broke out. Nevertheless, the authorities launched a series of stimulating measures to minimise the consequences — including infrastructure investment, extending credit to SMEs, establishing public-private corporate bond funds, and guaranteeing new capital raised by banks.

Israel had a rules-based approach to fiscal policy, which served the economy well, contributing to debt reduction and to inflation containment in times of robust growth rates. This approach was abandoned in early 2009 (due to the war in Gaza, the fiscal stimulus measures and the government election). While the medium-term focus on fiscal policy should be restored to ensure the continuous reduction of public debt and its related vulnerability, it is essential to accommodate greater fiscal flexibility to respond to the economic downturn.

As financial stability improves, and transmission mechanisms are relatively undisturbed by the recent financial turmoil, monetary policy can help to support economic activity, especially given the restrictive fiscal conditions and diminishing inflationary pressures.

In this context, it is important to take measures to improve the regulatory framework for banking risk management and to strengthen the inflation targeting framework.

#### **Social development and poverty**

In 2007, there were 412 900 poor families in Israel, encompassing 1 630 400 persons, of whom 773 900 were children. Despite the reduction of poverty rates to 18.5% in 2008, the scale of poverty and inequality in Israel is still large, both from a historical and international perspective. Much poverty stems from the fact that large swathes of the population are not connected to the rising industrial and high-technology sectors. Also, the large gaps between the poor and the non-poor in both salary and the level of employer compliance with the minimum wage indicate that government intervention is necessary. The government has set a cumulative poverty objective for the income of families in the bottom quintile to increase on average between 2008 and 2010 at a rate at least 10% faster than the product per capita. Also, programs for intervention in the labour market, such as Lights for Industry and Negative Income Tax began or continued in 2008, although on such a small scale that they will not bring about short-term changes to the social situation. Better social policies will be of vital importance for stabilising or further reducing the poverty rates as socio-economic conditions are set to worsen in 2009.

Table III.7.1:

**Israel - Main economic indicators**

	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	5.3	5.2	5.3	4.1	-0.2
GDP nominal (NIS, billion)	598	641	674	713	746
GDP nominal (EUR, billion)	107	115	120	135	144
GDP nominal (USD billion)	133	144	164	199	187
GDP per capita (EUR)	16232	16858	17337	19066	19964
GDP per capita (USD)	20218	21176	23749	28067	25903
Inflation (period average)	1.3	2.1	0.5	3.8	1.5
<b>Social indicators</b>					
Unemployment	9.0	7.7	7.3	6.1	7.6
Poverty rate (% of households)		20.0	20.5	18.5	
Population, annual growth rate (%)	1.5	1.5	1.5	1.5	1.5
Human development index	0.927	0.930			
Life expectancy at birth, annual (years)	80.3	80.5			
Adult literacy rate (% aged 15 and older)	97.1	97.1			
Gini index (%)	39.2				
Population (million)	6.6	6.8	6.9	7.1	7.2
<b>Fiscal sector</b>					
Central govt. revenues (% GDP)	35.3	35.2	36.1	35.8	35.0
Defense expenditure (% GDP)	8.9	9.2	7.9	7.9	7.9
Central govt. balance (% GDP)	-1.9	-1.0	0.0	-2.1	-2.5
General govt. balance (% GDP)	-4.8	-1.8	-0.8	-2.8	-4.1
Total public debt	95.9	86.8	80.6	80.0	82.5
<b>Monetary sector</b>					
Domestic credit to private sector (change %)	7.1	4.3	6.7	10	
Broad money (M3, % change)	7.9	7.4	12.9	5.3	
Narrow money (M1, % change)	17.5	13.7	15.3	15.2	
<b>External sector</b>					
Current account balance (% GDP)	3.3	5.6	2.6	0.8	1.5
Trade balance (% GDP)	-2.9	-2.3	-3.5	-3.8	-2.5
Foreign direct investment (net, % GDP)	1.3	-0.1	1.9	1.4	1.0
Foreign reserves (billion USD)	28.3	29.4	28.4	42.7	40
<b>External vulnerability</b>					
Gross reserves (excl. gold, USD billion)	27.2	29.1	28.4	36.2	
External debt (% GDP)	56.7	58.5	53.3	44.8	46.6
<b>Financial sector</b>					
BOI policy rate (average, %)	3.7	5.1	3.9	3.7	
Exchange rate (local currency per USD, average)	4.5	4.5	4.1	3.6	
Exchange rate (local currency per EUR, average)	5.6	5.6	5.6	5.3	
NEER (period average)	-0.8	0.4	3.9	11.0	
REER (period average)	-2.1	0.0	1.8	11.7	
Terms of trade	89.2	87.5	85.0		

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

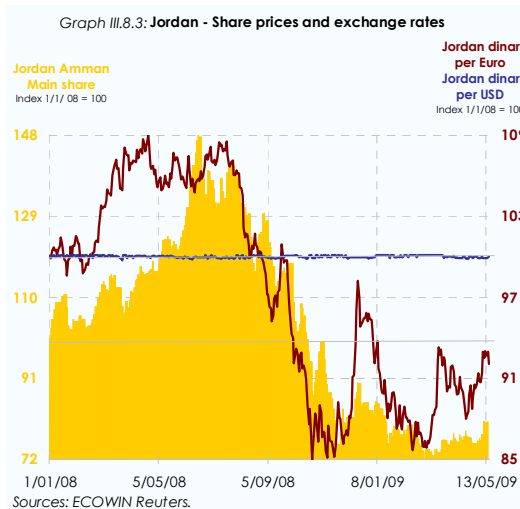
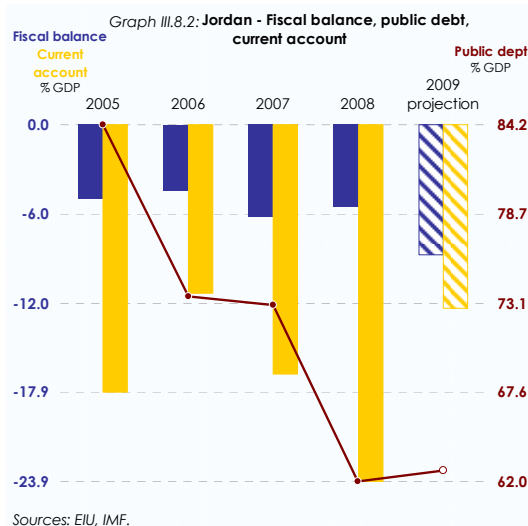
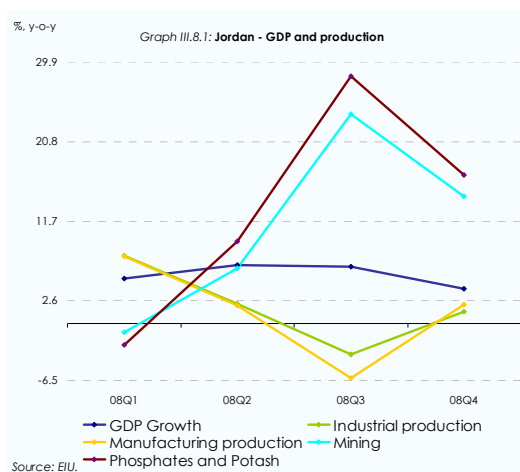
## 8. JORDAN

- *Jordan's GDP growth rate slowed to 5.5% in 2008. Inflation surged on the back of fuel and food prices.*
- *The authorities eventually took the step to fully remove fuel subsidies, which were replaced by a broad range of compensatory measures targeting large segments of the population. As a result, the fiscal deficit narrowed to 5.5% of GDP but still depends greatly on foreign grants.*
- *The current account deficit also surged to 24% of GDP, despite strong flows of investments and remittances.*
- *Structural imbalances and the weaker economic environment remain sources of vulnerability. In the absence of significant fiscal leeway the economic outlook is likely to deteriorate in the short to medium term.*

### Macroeconomic and financial developments

The Jordanian economy continued to grow robustly in 2008, despite the sharp increase in food and oil prices and the slowdown in the economy in the second semester. Real GDP growth averaged around 5.5% led by the growth in finance and tourism sectors and by gains in productivity. Tourism inflows increased substantially by 6%, contributing to 8% of GDP. An important factor for growth and the energy supply of the economy was the agreement of the Jordanian government with Iraq (as of August 2008) to receive low priced crude oil. Despite that, Jordan has initiated discussions with the west to develop nuclear energy.

Inflation rose rapidly during the first three quarters of 2008 on the back of high food and oil prices. The negative effect on prices was exacerbated by abolishing energy subsidies and the weakness of the dollar, to which the dinar is pegged. To combat inflation and dampen liquidity growth, the Central Bank of Jordan raised the reserve ratio twice, before easing its policy towards the end of 2008 following the sharp fall in commodity prices and the stronger USD. Average inflation for 2008 eventually reached an estimated 14%.



Notable progress was made on the fiscal front. Abolishing the oil subsidies, improvements in tax collection and higher revenues from grants allowed the budget to withstand the pressure of the increased cost of food subsidies and the fiscal deficit narrowed to 5.5% of GDP. Nevertheless, introducing a link between public wages and past inflation could increase the rigidity of the budget in the future. Furthermore, Jordan managed to reduce public debt at a time when the economy was more robust, via a USD 2.1 billion buyback of Paris Club obligations. As a result, public debt fell to 62% of GDP by the end of 2008 compared to 73% at the end of 2007.

The dinar's peg with the USD maintained monetary confidence while helping to protect the competitiveness of Jordanian exports to the US, the largest single export market. Foreign reserves were maintained at healthy levels (USD 8.6 billion at the end of 2008), having recovered swiftly after the buyback of the Paris Club debt.

The surge in oil and food prices combined with the fall in the price of important export products, such as chemicals, had a major negative impact on the current account deficit, which surged to 24% of GDP in 2008.

The impact of financial turbulence was manageable for the Jordanian banking sector. The country's 23 banks, which started to adopt the Basel II Accord in 2008, have benefited from the recent growth in the corporate sector and have avoided overexposure to housing or equity markets. The absence of sophisticated financial instruments and the limited scale of most banking operations allowed banks to build a buffer against future short-term instability. The authorities nevertheless have been active in overhauling the sector with a set of new reforms concerning risk management and transparency, while boosting capitalisation requirements. Over the course of 2008, the Central Bank of Jordan imposed a strict loan classification and provided guidelines on sector lending, thus reducing banks' unnecessary exposure. Also, prompted by the housing troubles in the US and elsewhere, it set interest rates at 10.5% for housing loans, thus limiting the scope for growth but ensuring long-term stability. Some signs of ebbing banking confidence became apparent by rising interbank rates which reached 6.39% on November 24th,

to fall again below 6% after intervention by the CBJ. Authorities boosted confidence by announcing a guarantee scheme of bank deposits, however, questions were raised on the feasibility of this scheme since Arab Banks' asset size (around half of total assets) is larger than the country's GDP. Turbulence in the global financial markets had a minimal impact on Jordan's capital market. During 2008 the general weighted index fell by around 19% (around 34% drop since September 2008) however, in contrast with other equity markets, foreign inflows remained positive.

### Risks and outlook

Although easing international commodity prices and a relatively expansionary fiscal policy will support the small and vulnerable economy of Jordan, growth is expected to slow to 3.5% in 2009. This will be the effect of declining investment growth as many Arab states seek to repatriate their capital in the wake of falling prices and tightening liquidity conditions. Also, export growth will be restrained by the sharp economic slowdown in the US, although this could be partly offset by a fast-rising import demand from Iraq.

With a fixed exchange rate and an open capital account, fiscal policy remains the main channel of adjusting to maintain macroeconomic stability. However, despite abolishing energy subsidies, exercising tight fiscal policy will be a challenge because of the rise in public spending, the 36% increase in the monthly minimum wage and the significant slowdown in the economy. As the budget continues to be dependent on foreign grants, the fiscal deficit is expected to reach around 8.7% of GDP (including grants) or even higher if the flow of foreign grants is reduced as a result of tighter liquidity conditions.

Vulnerabilities remain in the external sector. Falling commodity prices will help the current account deficit to narrow to 16% in 2009. However, it remains a large deficit, which could expand even more if there is a considerable slowdown in remittance inflows, which surged to 14% of GDP in 2008. Tight macroeconomic policies and efforts to diversify exports should continue to reduce the external imbalances in this challenging environment.

With a lack of fiscal leeway, easing prices of international commodities and the economic slowdown, monetary policy could provide an anti-cyclical boost as long as inflation returns to healthy levels.

Despite the relative solid structure of the banking system, there are a few risks associated with exogenous factors, like the exposure of some large Jordanian banks to the Palestinian market, the possibility of lower trading income and brokerage fees from the Gulf region and the possibility that creditors might become more wary of lending if local or regional instability increases.

#### **Policy reforms and measures**

While vulnerabilities still remain, Jordan took important structural measures which will support the economy given the weakened economic environment. Abolishing oil subsidies was a bold step towards fiscal stability. However, part of the fiscal benefits was offset by establishing the ‘social safety net’, which provides a more efficient social spending system than the universal benefits system.

Efforts to make structural improvements to public finance management continued in 2008, with the launch of a Government Financial Management System, the introduction of a Medium-Term Expenditure Framework and a boost to the framework for Public-Private Partnerships. Also, the government prudently reduced external public debt to 24% of GDP in times of robust economic activity, sending a strong positive signal to international donors and creditors.

The government made substantial progress in the investment climate by implementing a series of trade agreements, helped by the solid banking sector. The liberalised environment enabled substantial FDI flows in various productive sectors, in the Qualifying Industrial Zones and in real estate. An essential reform was the creation of regulatory bodies in a number of sectors: telecoms, energy, civil aviation and public transport. Although the overall investment strategy has been successful, a more comprehensive approach will be needed for the future as the economic environment becomes

weaker and global investment competition intensifies. This is also indicated by the World Bank report ‘Doing Business 2009’ in which Jordan slips to 101st place from 94th place. Apart from other improvements, a real challenge would be to promote Jordanian entrepreneurship and a substantial rise in employment among Jordanian citizens, given the rapid rise in the labour force by 4.5%.

#### **Social development and poverty**

Despite the growth in recent years, unemployment has not substantially improved. It fell only to 12.6% in 2008 from 13.5% in 2007, partly because of the presence of a large number of foreign workers in growing sectors of the Jordanian economy, such as manufacturing, telecommunication and construction. The government is trying to boost employment in small firms through employment policy and by activating the development and employment fund.

The official poverty rate is 14.5%, although unofficial sources raise this figure to 27%. Through the EU-supported program ‘Poverty Alleviation through Local Development’, the authorities aim to reduce poverty, focusing on the main aspects of economic development, social protection, human capital development and governance. Also, an USD 7 bn affordable housing project and a nationwide information and communication technology policy have been introduced to alleviate persistently severe poverty in outlying areas.



Table III.8.1:

<b>Jordan - Main economic indicators</b>	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (% change)	7.2	6.4	6.0	5.5	3.5
Inflation (consumer price, year average)	3.5	6.3	5.4	14.0	3.7
GDP per-capita (EUR)	1873	2035	1915	2573	2682
GDP per-capita (USD)	2317	2533	2796	3295	3507
GDP (Jordanian dinar, billion)	8.9	10.0	11.7	14.2	15.6
GDP (EUR, billion)	10.2	11.4	11.3	15.7	16.9
GDP (USD, billion)	12.6	14.1	16.5	20.1	21.8
<b>Social indicators</b>					
Unemployment (off. registered, average, %)	14.8	13.9	13.5	12.6	13.5
Domestic population growth (%)	2.3	2.3	2.3	2.3	2.3
Human development index	0.763	0.769			
Population (in million)	5.5	5.7	5.9	6.1	6.3
<b>Fiscal sector</b>					
General government revenues, excl. grants (% GDP)	28.2	31.2	34.9	34.9	33.6
General government expenditures (% GDP)	38.3	38.4	41.1	40.4	38.8
General government balance, incl. grants (% GDP)	-5.0	-4.4	-6.2	-5.5	-8.7
General government balance, excl. grants (% GDP)	-10.0	-7.4	-9.2	-9.3	-11.4
Net public debt (% GDP)	84.2	73.5	73.0	62.0	62.7
<b>External and Monetary sector</b>					
Broad money (% change)	17.0	14.1	10.0	9.3	12.7
Current account balance, incl. official transfers (% GDP)	-17.9	-11.3	-16.7	-23.9	-12.3
Trade balance (% GDP)	-42.0	-37.6	-38.0	-44.7	-37.5
FDI (net, % GDP)	12.0	22.1	11.5	11.8	8.5
Remittances (% GDP)	17.0	15.3	15.5	14.7	14.0
Import cover of reserves (months)	4.7	5.6	5.0	3.6	3.4
<b>External vulnerability</b>					
External public debt (% GDP)	56.6	51.9	47.0	24.0	25.0
Gross reserves (USD, billion)	4.7	6.2	7.9	8.6	7.7
<b>Financial sector</b>					
Exchange rate (JOD per USD, period average)	0.71	0.71	0.71	0.71	0.71
Exchange rate (JOD per EUR, period average)	0.88	0.89	0.97	1.03	0.91
Real effective exchange rate (% change, + is apprec.)	7.0	-1.3	-4.1		

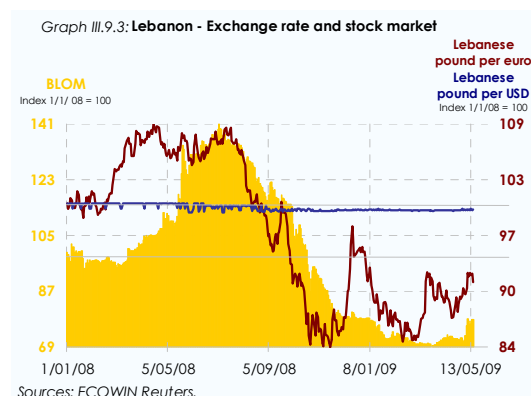
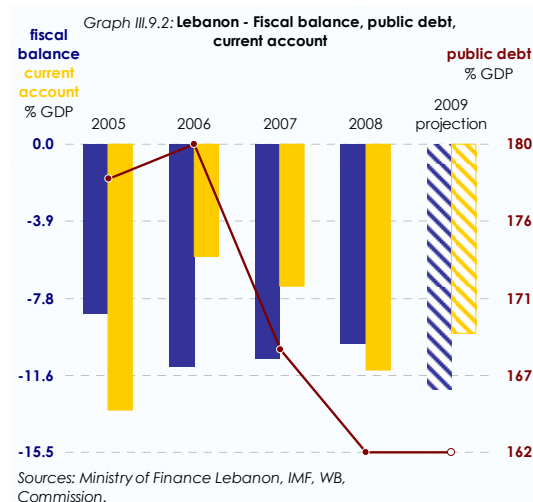
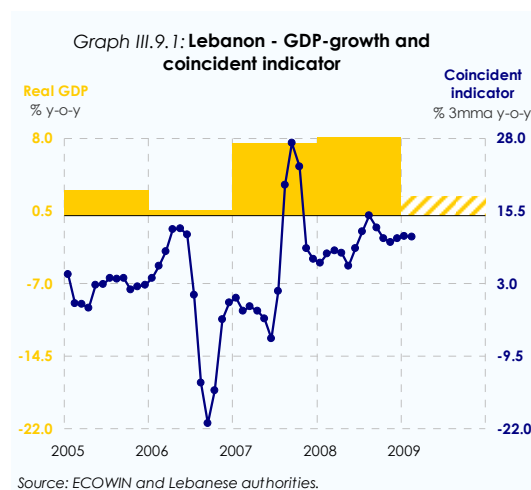
Sources: Ministry of Finance Jordan, IMF, World Bank, EIU, Commission.

## 9. LEBANON

- *After fairly robust growth in 2008, economy set to slow down markedly in the wake of the global slump.*
- *Relatively robust development of highly leveraged financial system despite the crisis, reflecting limited exposure to structured products and strong deposit base. Difficult fiscal situation leaves limited scope for stimulus.*
- *Second IMF emergency post-conflict arrangement put in place; first tranche of EU macro financial assistance disbursed.*
- *Ongoing political paralysis hampers progress in structural reforms.*

### Macroeconomic and financial developments

The latest economic indicators suggest a sharp deceleration of growth in Lebanon in the wake of the global financial crisis. Real GDP growth is expected to decrease to 2% in 2009, from the 8.5% growth estimated to have been reached in 2008. During the first part of the year, economic activity was still strong. Economic activity and the financial sector proved remarkably resilient to the politically uncertain environment, which culminated in violent clashes before a deal on the formation of a transitional national unity government was struck in May 2008. But the negative impact of the global financial crisis was increasingly felt towards year-end, in the first instance via external transmission channels. As an open economy, Lebanon is exposed to the crisis via the trade channel. Trade volumes decelerated rapidly from the last quarter of 2008 onwards, mirroring the slowdown in major trading partners, notably Arab countries and the countries in the European Union, which account for around 50 and 17 percent of Lebanese exports respectively. Another important channel of transmission is via the sizable remittance flows of Lebanese working abroad, estimated at no less than 24.4% of GDP in 2007. Strong remittances were an important factor supporting buoyant consumer expenditure during the recovery from the 2006 conflict between Israel and Hezbollah.



From the third quarter of 2008 onwards, remittance inflows decreased markedly in view of the spreading slowdown and concomitant labour shedding in the Gulf region, where many Lebanese expatriates had been working. Against the background of a general increase in investor's risk aversion, the planned issue of a government euro bond had to be postponed. Strong inflationary pressures abated somewhat in the latter part of 2008. Consumer prices as measured by the CPI increased by more than 10% in 2008, with inflation moderating in the latter part of the year and into 2009 on the back of falling commodity prices. However, the delayed pass-through of commodity price shocks and inefficiencies and mark-ups in the distribution chain add to upside risks. On the back of still relatively strong growth in 2008, the current account deficit widened to around 11% of GDP in 2008, from around 7% of GDP in 2007. The total external debt ratio is estimated to have declined only moderately, to 190% of GDP in 2008.

The elevated external debt ratio goes hand in hand with a high public deficit and debt. The government budget balance (including grants) is estimated to have improved slightly in 2008, to a deficit of 10.0% of GDP (from 10.8% in 2007). But the public debt ratio remained high, even though in 2008 it declined strongly on the back of high nominal GDP growth, to 162% of GDP in 2008, from the peak of 180% of GDP reached in 2005. International support should help alleviate the pressure on public finances. On 18 November 2008, a second IMF emergency post-conflict assistance programme (EPCA II) was launched, equivalent to SDR 25.375 million (about US\$ 38 million). The first tranche of grants and loans (€15 and €25 million respectively) committed under the EU macro financial assistance (MFA) facility already concluded in late 2007 were finally disbursed. The payments were made in December 2008 and May 2009 and will be primarily used for debt reduction.

### Risks and outlook

Economic activity is expected to remain weak in the near term, with risks stemming from the degree to which the global downturn can be mitigated and from the internal political

situation. The high external deficit, heavy debt burden, and leveraged financial system (with private sector bank deposits accounting for around 270% of GDP at end-2008) render the Lebanese economy and banking sector sensitive to conditions in global financial markets, notably liquidity. The fiscal situation is particularly vulnerable to a stronger-than-expected economic slowdown and to changes in investor confidence, given the high public debt level. The limited progress in implementing reforms makes it difficult to address the structural fiscal deficit. Restructuring in the energy and telecom sectors has been postponed, even though lower transfers to *Electricité de Liban*, which amounted to 5.5% of GDP in 2008, would offset part of the budgeted spending increases on public wages and investment. Remigration of Lebanese workers who have lost their jobs abroad will depress remittance inflows and add to the domestic labour supply (though those remigrating bring valuable skills and experience).

On the positive side, the Lebanese economy has so far been quite resilient to the direct impact of the global financial crisis on the financial system, in particular as regards the effects on banks. Lebanese banks have long-standing experience in operating in a strained economic and political environment, have had limited exposure to structured products under long-standing directives by the central bank supervisors, and have not borrowed heavily on international markets. Together with a healthy development of the deposit base and a relatively strong reserve position (which helped sustain the currency peg to the US dollar as a strong nominal anchor)<sup>(53)</sup>, and high liquidity ratios, this has helped shield the financial sector. In fact, there is evidence that Lebanese banks benefited from their image as a safe haven and from relatively high deposit interest rates in attracting funding inflows in the aftermath of the global financial crisis. Thus, aggregate profits of listed banks increased by around 24% in 2008. To date, the construction sector has also held up well. Nevertheless, ongoing vigilance is needed, as there are further

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<sup>(53)</sup> The dollarisation rate of deposits is very high in Lebanon, hovering around 70% in 2008.

risks from the feedback loops of the global financial crisis.

### Policy reforms and measures

The continued political divisions and consequent paralysis of legislative activity in the run-up to the June 2009 parliamentary elections held up progress on the reform agenda, notably on key aspects of the Paris III programme. The economic headwinds make it difficult to proceed with intended privatisations and tax increases which in turn are weighing on already stretched public finances. The government is likely therefore to turn to the financial sector to meet its increasing financing needs.

The decision to substantially increase public wages retroactively from May 2008 runs counter to earlier commitments by the government to contain the wage bill. The minimum wage in both the public and private sector was increased by two thirds. In addition, overall salary scales and public pensions were raised while public sector wage increases decided around the turn of the century but not so far implemented will be paid retroactively. The estimated cost to the Treasury for the period 2009-2011 is estimated at around 3 percent of GDP per year. Several, potential countervailing measures to raise revenue have been put on ice. The 2009 budget no longer mentions the increases in the VAT rate from 10% to 12% and in taxes on interest income from 5% to 7% pledged in the Paris III programme. That said, the government did take advantage of the decline in oil prices to introduce excises on gasoline. But the intended privatisation of state-owned assets, in particular the two mobile phone networks and *Electricité de Liban*, have been postponed in view of the difficult market circumstances. For similar reasons the privatisation of stakes in the national air carrier MEA and in the operation of the *Casino du Liban*, held by the central bank have also been delayed.

Draft laws on WTO-related issues, pension reform, capital market reform and public procurement, and the reform of the heavily subsidised electricity subsidy system have all been held up by the political deadlock. Insufficient progress was made in improving the business climate. However, Lebanon continued

to implement the 2007 administrative simplification programme, involving the Lebanese post office *LibanPost*, with the aim of establishing a one-stop shop in post offices to obtain company registration. Some progress has been made in reducing administrative regulation while tax procedures have been simplified as from 2009. The central bank has continued to take steps to improve its operating procedures in financial services and towards adopting International Financial Reporting (IFRS) standards. Regarding public finance management, measures aimed at improving budget formulation and execution as well as medium-term planning and prioritisation of expenditures along with efforts to improve cash management and implement a single treasury account, remain key parts of the Medium-Term Public Financial Management Reform Action Plan. But concrete measures carried out in 2008 were limited; noteworthy ones include the setting up of a cash management unit and a public debt department within the Ministry of Finance. The preparation of a modern procurement code was launched recently, with international assistance.

For the international assistance pledged by donors and international institutions to have effect, it is important that the authorities demonstrate increased commitment to reforms. Notwithstanding the major fiscal challenge posed by the economic slowdown, fiscal consolidation remains a key longer-term objective to ensure sustainability.

### Social development and poverty

The Ministry of Social Affairs and the United Nations Development Program recently estimated that nearly 28% of the population (approximately 1 million Lebanese) qualify as poor, with 8% (300 000 individuals) living in extreme poverty. Those within the top quintile of the income distribution account for roughly 44% of the volume of private consumption, whereas those in the bottom quintile only consume around 7% of the total. The regional distribution of poverty is very uneven, with the highest incidence of extreme poverty in the north. Nearly half of the people who were identified as very poor live in this region. By contrast, the Beirut and Nabatieh (South) regions have much lower poverty rates. The incidence of poverty is

Table III.9.1:

**Lebanon - Main economic indicators**

	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	2.6	0.6	7.5	8.5	2.0
GDP (Lebanese pounds, trillion)	33.0	33.8	37.8	43.6	46.7
GDP (EUR, billion)	17.6	17.9	18.3	19.8	22.8
GDP per-capita (EUR)	4403	4358	4461	4821	5424
Inflation (consumer price, average)	-0.7	5.6	4.1	10.8	2.7
<b>Social indicators</b>					
Life expectancy at birth (years)	71.5				
Adult literacy (% ages 15 and older) <sup>z</sup>	86.6				
Resident population (million) <sup>1 z</sup>	4.0	4.1	4.1	4.1	4.2
Income inequality (Gini coeff. for nominal consumption, %) <sup>z</sup>	37.0				
Human development index	0.772				
<b>Fiscal sector</b>					
General government revenues, incl. grants (% GDP)	22.8	25.1	24.4	24.8	25.2
General government expenditures (% GDP)	31.2	36.3	35.2	34.7	37.5
General government balance, incl. grants (% GDP)	-8.5	-11.2	-10.8	-10.0	-12.3
General government primary balance, incl. grants (% GDP)	2.1	1.7	1.8	1.4	1.1
Gross public debt (% GDP)	178	180	168	162	162
<b>Monetary sector</b>					
Broad money (% change) <sup>o</sup>	4.0	8.7	13.3	13.8	
Bank assets (% GDP)	313.1	331.0	328.4	325.7	
Degree of monetisation (M5/GDP, %)	239	246	258	258	
Dollarisation of deposits (%)		76.2	77.3	69.6	
<b>External sector</b>					
Current account balance, incl. official transfers (% GDP)	-13.4	-5.6	-7.1	-11.4	-9.5
FDI (net, % GDP)	8.0	7.9	5.3	4.7	
Remittances (% GDP)	4.9	5.2			
<b>External vulnerability</b>					
External debt (% GDP)	190	199	194	191	
External public debt (% GDP)	44.1	45.6	45.3	39.1	
Gross reserves (EUR, billion)	7.7	9.0	8.4	12.8	
<b>Financial sector</b>					
Government's Eurobond rate (marginal)	7.0	7.5	8.9	9.0	
Two-year T-bill yield	8.5	8.7	8.7	8.6	
Exchange rate (L£ per EUR, period average)	1873	1893	2064	2207	
Exchange rate (L£ per USD, period average)	1508	1508	1508	1508	
Real effective exchange rate (% change, + is apprec.)	-4.1	2.1	-4.0		
Stock market index	1309	1185	1502	1178	

<sup>1</sup> Resident population, except those living in Palestinian refugee camps

particularly high among agricultural workers. In 2008, the government kept regulating the price of the standard loaf of bread in order to mitigate the impact of soaring food prices and in May 2008 customs duties were lifted on many basic food products not produced in Lebanon, notably varieties of frozen meats, milk powder, rice, vegetable oils, pastas, tea, coffee, and sugar. The difficult socio-economic situation nevertheless led to several demonstrations and social tensions.

This fed into the decision in September 2008 to increase the minimum wage (the first increase since 1996) and public sector wages. Looking ahead, the economic slowdown and ensuing increases in unemployment will weigh on the living conditions of the Lebanese.

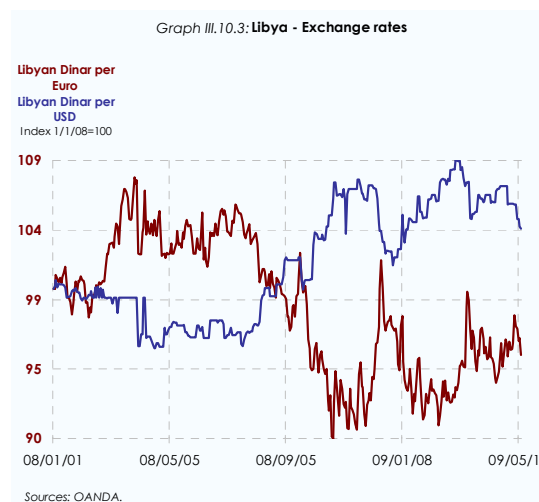
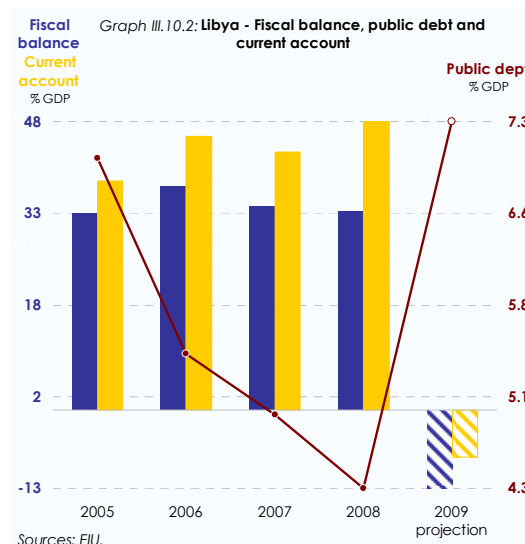
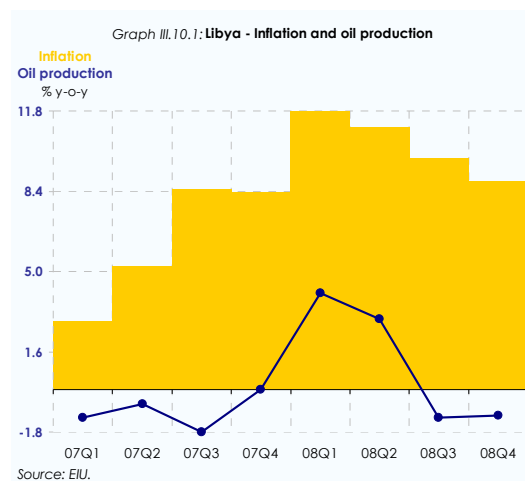
# 10. LIBYA

- *In 2008, GDP growth was underpinned by rising oil output and high oil prices allowing the government to launch large infrastructure investment projects.*
- *Thanks to the record oil prices, fiscal and external accounts recorded phenomenal surpluses. However, the situation will be completely reversed in 2009.*
- *With the exception of the banking sector, reforms to open up the economy and develop the private sector have been limited and in some cases reversed.*
- *The key challenge is to sustain the ongoing reforms, including reducing the size of the public sector.*

## Macroeconomic and financial developments

The increasing foreign interest in Libya's economy, especially in the hydrocarbons sector, coupled with relatively strong government consumption, kept real GDP growth at the healthy level of 6.3% in 2008. Non-oil GDP was supported by an expansion in construction, transportation and trade. As oil prices picked up the government continued to spend on infrastructure projects to upgrade the outdated public infrastructure. However, diversifying the economy into manufacturing industries remains a long-term challenge. The agricultural sector remains the second largest in the economy, despite the fact that Libya imports around 90% of its food.

After years of low inflation, consumer prices picked up sharply — in line with the increases in food and oil prices — as the government has slowly relaxed its control over the domestic market. Economic growth was boosted from the liquidity provided by high oil prices. Domestic liquidity rose sharply on the back of high oil prices (year-on-year money supply growth exceeded 65% in September 2008), demonstrating the difficulty of controlling the flow of money to the economy through monetary policy. As a result, inflation averaged around 10.3% in 2008.



Government expenditure rose to around 40% in 2008, continuing the trend since 2007, reflecting the deployment of record oil revenue to overhaul the dilapidated infrastructure. However, the ratio of current to capital expenditure only marginally increased in 2008 as a result of the failure to reduce bureaucracy. The fiscal surplus amounted to 33.2% of GDP in 2008 as a result of unprecedented oil revenues, but the fiscal situation is expected to be completely reversed in 2009.

During 2008, the public sector experienced two major policy reverses. The long-announced plan to cut public sector employees by 400 000 seems to have been put on hold or to progress very slowly. The plan to replace some structures of the existing government system with local administrative structures, which would be responsible for distributing oil revenues under the Wealth Distribution Program, was also postponed by the General People's Congress on the ground of inadequate preparation.

The dinar is pegged to the IMF's special drawing rights (SDR) and is managed by tight official controls. Libya's huge stocks of foreign reserves (around USD 92 bn at the end of 2008) enable the authorities to defend the exchange-rate regime should any pressure on the currency arise over the short term. The relative stability of the Libyan dinar, along with weakening global oil and non-oil commodity prices, should also contribute to lower imported inflation.

The current account surplus widened significantly in 2008 (48.3% of GDP) on the back of the increase in oil prices, despite the hike in the import bill which increased by 43% due to demand for imports of machinery and consumer products.

The impact of the financial crisis has not been directly felt in Libya due to its low exposure to toxic assets and to tight controls of the Central Bank. Financial intermediation is still low, the insurance sector is underdeveloped and the capital market in its infancy (the stock exchange consists of eight companies). However, the economic downturn and the reverses in Libya's economic policy reforms can increase risk aversion among international investors and temporarily limit investment inflows (in the non-

oil sector), despite the broader opportunities in Libya's weak economy.

Despite some privatisation activity, most notably in the banking sector, where two of the five state banks have been merged and a further two sold to foreign investors in 2007 and 2008, and moves to increase transparency in public finances, progress on overall economic reform appears limited. To stimulate private investment, Libya has announced USD 120 billion for infrastructure projects (during the next five years) and is encouraging citizens to set up small businesses. It will still provide welfare for the poor and cheap apartments for young families. On the other hand, while foreign businessmen (who are required to partner with locals to set up a business in Libya) commend the government as an increasingly reliable partner, they have raised concerns about the reliability of some Libyan private-sector counterparts, who fail to pay bills or insist on renegotiating contracts after they are signed.

Diplomatic opening continued in 2008 with the launch of negotiations between the EU and Libya on a framework agreement.

Although opening the private sector advances at slow pace, Libya's sovereign wealth fund (LIA) has been very active in investing abroad. In February 2009, its assets totalled USD 50.6 billion, recording profits of USD 2.4 billion since its establishment in 2006. In February 2009, LIA raised its stake in the largest Italian bank UniCredit and it established a joint investment with another Italian bank Mediobanca. At the same time, with cash of around USD 80 billion, it is looking into other opportunities, mainly in banks hit by the financial turmoil.

### **Risks and outlook**

Libya's real GDP growth is expected to slow down to 2.9% in 2009 as OPEC output cuts are implemented and the impact of the global slowdown will be felt in the domestic economy. Domestic demand will ease in case the government proceeds to extensive expenditure cuts. On the other hand, the attempts to raise the proportion of locals in the workforce together with the continuation of large infrastructure

projects could stimulate greater private consumption and generate faster non-oil growth.

The simplification of import tariffs, the introduction of alternative price control measures and reduced government spending should contribute, along with the expected slowdown in the economy, to bringing prices down to about 8% in 2009. To make further reductions in inflation, it could help to boost the effectiveness of monetary policy by introducing indirect monetary instruments, gradually develop the banking sector and bring increased competition to import markets.

The fall in oil prices and the production cuts dictated by OPEC are expected to lead to a massive fall in fiscal revenue (-56%), resulting in a fiscal deficit of 16% of GDP, despite cutting expenditure and reducing the wage and subsidies bill.

Similarly, the current account is expected to run a deficit (-12.4%) in 2009, owing to OPEC output cuts and to falling international oil prices. Despite continued demand for input into capital projects and a growing domestic appetite for consumer items, the rise in import spending is expected to reverse in 2009, due to the sharp fall in government revenue. The services and income balances are expected to continue to run a combined deficit in 2009 as services costs associated with imports and the repatriated profits of foreign oil firms both remain high. The current transfer surplus is expected to widen gradually as inflows from Libyan expatriates rise after several years of stagnation, as more investment opportunities become available. However, comparably strong growth in outflows of workers' remittances will keep the surplus in check.

#### **Policy reforms and measures**

In the medium term, the Libyan economy will remain dependent on the oil sector for future growth and therefore exposed to oil-price shocks. Despite foreign interest in investment opportunities following the international recovery, development of the non-oil private sector could be delayed if uncertainty as to the direction of policy discourages private investors through a lack of confidence. Efforts to diversify

the economy should continue and be well coordinated to take advantage of the momentum boosting the private sector, as shown by the rapid increase in private-sector borrowing in 2008. Such efforts should be accompanied by upgrades in administrative systems and financial infrastructure as well as by a more flexible lending regime. This will help Libya improve its domestic credit position, where government net deposits exceed the borrowing of all other entities, limiting the absorption capacity of the local economy and delaying the deployment of productive investments.

Restructuring the public sector and upgrading dilapidated infrastructure will be important to promote the private sector. However, despite its comfortable financial position, Libya should carefully prioritise infrastructure projects to increase the quality of spending and to avoid bottlenecks and shortages.

#### **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 still employs one million civil servants in around 50% of the total labour force. The government's decision to cut 400 000 jobs in the public sector is expected to increase unemployment, although it had not been fully implemented in 2008. The scarcity of scientific and technically-skilled staff remains an issue and the failures in Libyan education have raised fears that locals will lack the skills needed to fully exploit growing investment. At the same time, the employment problem is compounded by the high rate of population growth, which exceeds the rate of job creation. Nevertheless, many direct and indirect subsidies and free services funded by abundant oil revenues have helped raise the economic status of low-income families, a policy which has prevented extreme poverty and social polarisation. As a result, Libya has the highest ranking in the UN Human Development Index 2008 among African countries and among the Arab ENP countries.



Table III.10.1:

**Libya - Main economic indicators**

	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (% change)	5.6	5.8	6.8	6.3	3.5
GDP (EUR, billion)	36.5	43.8	37.9	50.0	27.2
GDP (USD, billion)	42.8	55.1	53.8	68.2	37.0
GDP per capita (EUR)	6294	7427	6322	8065	4317
GDP per capita (USD)	7379	9339	8967	11000	5873
GDP (Libyan Dinars, billion)	59.5	72.3	67.9	83.0	47.1
Inflation (average, %)	2.0	3.5	6.3	10.3	7.6
<b>Social indicators</b>					
Unemployment (off. registered, average, %)			17.0	20.7	
Life expectancy at birth (years)	73.4	73.6			
Adult literacy (% ages 15 and older)	84.2	86.2			
Population (annual growth rate %)	1.9	1.9	1.9	1.9	1.9
Human development index	0.836	0.840			
Population (in millions)	5.8	5.9	6.0	6.2	6.3
<b>Fiscal sector</b>					
General government revenues (% GDP)	66.8	68.5	79.6	85.1	68.5
of which: Oil - revenues (% GDP)	63.7	66.8	71.7	75.8	51.1
General government expenditures (% GDP)	38.6	33.1	45.6	51.9	81.7
General government balance, excl. grants (% GDP)	32.8	37.4	34.0	33.2	-13.1
General government non - oil balance (% GDP)	-27.6	-24.7	-29.0	-26.0	-36.0
General government debt (% GDP)	7.0	5.4	4.9	4.3	7.3
<b>Monetary sector</b>					
Broad money (M2, % change)	29.2	14.0	38.0	49.6	19.0
Credit to the economy (% change)	4.9	5.7	6.9	8.5	5.5
Credit to the private sector economy (% change)	0.9	0.9	2.6	3.0	2.6
<b>External sector</b>					
Current account balance (% GDP)	38.4	45.8	43.2	48.3	-7.9
Trade balance (% GDP)	41.2	48.1	47.0	50.8	-2.8
FDI (net, % GDP)	2.4	4.1	3.7	3.6	4.0
<b>External vulnerability</b>					
Total external debt (% GDP)	9.8	8.7	9.1	8.9	17.0
Gross reserves (USD, billion)	39.3	59.2	79.5	92.2	85.4
<b>Financial sector</b>					
Lending rate (average, %)	6.1	6.3	6.0	6.0	
Exchange rate (LD per USD, mid FY)	1.3	1.3	1.2	1.3	
Exchange rate (LD per EUR, mid FY)	1.6	1.7	1.8	1.7	
Real effective exchange rate (% + is apprec.)	9.1	-3.1	0.4	2.0	

Sources: IMF, EIU, EUROSTAT and Commission..

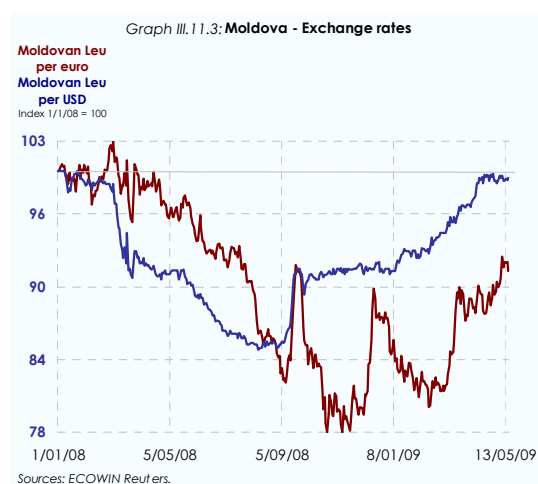
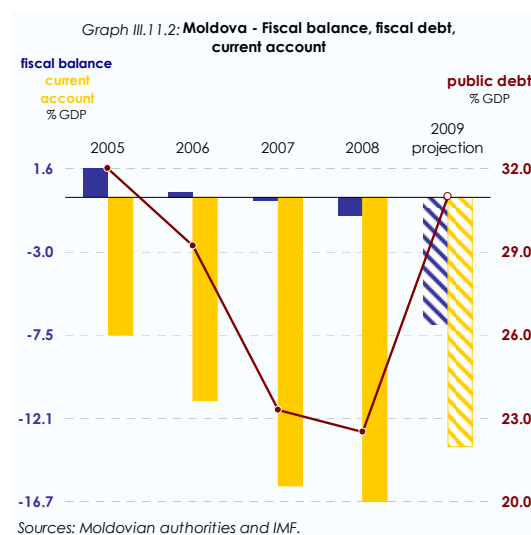
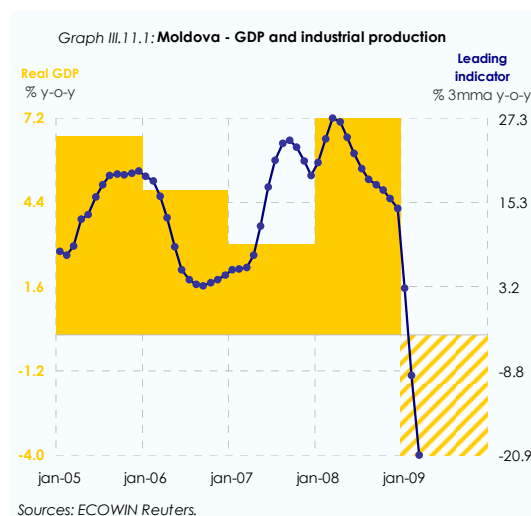
# 11. MOLDOVA

- *Moldova has been hit hard by the global recession. GDP in 2009 is expected to shrink by 4%, which is in sharp contrast with the +7.2% GDP growth in 2008. External shocks, such as the falling remittances and FDI inflows are the main causes for the deep recession. The unemployment rate is rising at a rapid speed and the government deficit is widening. A disinflationary process dampens the falling purchasing power.*
- *The government needs to do much to overcome this crisis. Monetary and fiscal instruments can help to cushion the shocks. The main reform agenda remains the diversification of the economic activity and improvements in the business environment and the public and private governance.*

## Macroeconomic and financial developments

Moldova is facing a difficult year. In Europe's poorest country violent protests in the aftermath of a disputed Communist election victory added to political grievances in April 2009. On top of this, tumbling remittances have been crippling Moldova's economy that depends for one third of its EUR 4 billion GDP on remittances. Moldova suffers from the economic recession in Russia, the Ukraine, Belarus and the EU. Industrial production dropped to 21% in February 2009, after a rather long period of positive economic growth (see graph III.11.1).

Economic activity in Moldova rebounded strongly in 2008, from 3% in 2007 due to droughts. In the first three quarters of 2008, real GDP increased by 7.6%. The deceleration of activity in the last months of 2008 resulting from the global financial turmoil started to affect the Moldovan economy, although economic growth in 2008 was still 7.2%. The improved performance in 2008 was mainly attributable to agriculture where output increased by more than one-third and to the services sector, mainly trade and transport. At the same time, the industrial output increased only marginally, and the production of the services expanded by less than 4%, after a 14% growth. The deceleration of growth in the services sector reflects primarily the sharp slowdown in construction, reflecting in its turn lower domestic investment demand, the



main engine of growth and, together with the household consumption, in the previous years. According to preliminary figures, for the whole of 2008, investment in fixed assets increased by less than 2%. Contribution to growth of fixed investment in 2008 was merely 0.6%. The main contributors to growth in 2008 were private consumption and net exports. This reflects a stronger contraction of real imports than that of real exports, a direct impact of the economic crisis unfolding in the end of 2008.

The increase in the output of the tradables sectors (industry and agriculture) in 2008 does not mean any fundamental change in the nature of Moldova's growth model based on the transfer of resources from abroad to accommodate a fast growing domestic demand. Like in previous years, for most of 2008, disposable income continued expanding reflecting strong wage growth and accommodative monetary policy of the National Bank of Moldova (NBM). The ever growing domestic demand translated in additional imports and widening trade deficit (export cover of imports remained in 2008 less than half and the trade deficit exceeded 50% of GDP). Once again, the trade deficit could be financed by capital from abroad: remittances from Moldovan workers (still close to one-third of GDP) maintained the current account deficit at around 16% of GDP; growing foreign direct investment (FDI – about 11% of GDP for the second year in a row) or bank credit financed the current account deficit.

Despite this overall benign picture, the global financial crisis started affecting Moldova's economy already in the last months of 2008. The first elements of the crisis were (a) the deceleration of trade growth, reflecting both lower demand of main Moldova's trading partners (Russia, Ukraine, Belarus and the EU, all hit by the crisis at varying degrees) and fading access to trade finance, and (b) lower remittances and FDI inflows. The contraction of external trade accelerated sharply in the beginning of 2009: in January-February 2009, exports were nearly one-quarter below their level in the corresponding period of 2008. The contraction of remittances is equally accelerating.

The result of this double external shock was the building up of pressures on the national currency

that the NBM could, however, counter in using part of the country's official reserves. Those were reduced between September 2008 and April 2009 by nearly 40%. The bulk of this reduction took place in 2009.

The impact of the global slowdown is spreading further in Moldova's economy. The slowdown in construction, already visible in the end of 2008, was followed by a severe contraction of the industrial production. Unemployment that had gone down in 2008 is increasing again. In the course of this year seasonal emigration is expected to reduce drastically, and a large number of Moldovans working permanently abroad will have to return. On the fiscal side, the strong reduction of imports is leading to a severe shortfall of fiscal revenue. Faced with a substantial revenue shortfall, the government has recently decided to cut expenditure by 20% across the board.

#### **Risks and outlook**

The outlook for Moldova for the short to medium term is grim. From the beginning of the current year, with the more pronounced contraction of external trade in the first two months of 2009, the dollar value of imports fell sharply. Domestic investment started slowing down sensing the impact of the economic crisis.

Given that Moldova's main trading partners – Russia, Ukraine, Belarus, but also the EU – are all severely affected by the global crisis and that the external financing conditions, notably the availability of credit resources for transition economies like Moldova's and prospects for further growth of remittance flows have deteriorated sharply since the start of the global financial turmoil, the country's economic growth is likely negative in 2009. In particular, domestic demand is expected to fall and therefore imports are expected to contract, after years of positive growth.

The main risk for Moldova is that the Moldovan government does not find employment for the Moldovans that come back home or runs out of funds to provide them social support.

The Moldovan economy is also becoming more vulnerable in that stock of foreign exchange

reserves is shrinking quickly. The falling remittances reduced the demand for the Moldovan leu, which prompted the NBM to intervene. Between September 2008 and February 2009, the NBU cut its main refinancing rate from 18.5% to 11.0%. Official reserves were reduced by nearly 40%.

The severe slowdown in domestic demand towards the end of 2008 has helped in reducing inflation drastically. Inflation peaked in May 2008 at 16.9% and came down to -0.3% in April 2009. In case this disinflationary trend would continue and deflation would persist for a longer period, economic recovery would be at risk.

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.

### Policy reforms and measures

In the run-up to parliamentary elections in April 2009, the authorities put nearly all the weight of the maintaining of macroeconomic stability on monetary policy, while allowing some fiscal expansion. But, the authorities refused to make any adjustment to the lowering fiscal revenue, which had, by the time of the elections, led to the near depletion of the government deposits. This, together with the budget performance in 2008 prevented the authorities from drawing the two last instalments under the Poverty Reduction and Growth Facility financing arrangement with the IMF that expired in May 2009. At mid-May, the preparation of a new arrangement was still in its very early stages.

The falling inflation allowed the NBM to cut several times its interest rates, in order to stimulate domestic economic activity. The fiscal policy remained restrictive, and the consolidated general government budget remained within the limits set by Moldova's economic programme agreed with the IMF (on track for all of 2008). However, the situation changed in the beginning

of 2009, when the economic slowdown has brought about a severe contraction of fiscal revenue.

In addition to avoiding adjusting the fiscal framework, the authorities postponed number of crucial structural reforms in 2008 and early 2009. They should now be put in place rapidly a comprehensive stabilisation programme that could warrant financial support from the International Financial Institutions and bilateral donors. Moldova remains highly dependent on international official financial flows. Such a programme would need to comprise an ambitious package of fiscal reforms necessary to widen the tax base and restore some fiscal space for infrastructure investments, part of which would in any event be financed domestically in addition to external financing. It would also need to address such areas as the weaknesses of the financial sector and the reform of the utilities sectors, still weighing on the government spending.

The alternative choice – risk isolation and turn the back to the European ambition developed in the last years – is clearly not viable as own resources and own economic base are modest.

### Social development and poverty

The fact that Moldova is relatively poor makes the impact of the economic recession more acute on living standards. With a GDP per capita of 1000 euro, about 30% of Moldova's population live in absolute poverty and 4.5% live in extreme poverty. Social spending remains thus a major component of the public expenditure. About two thirds of Moldova's State budget is spent on health, education and social assistance. In the run up to the 2009 parliamentary elections social spending – including wages and pensions – was increased.

Aligned with the reform agenda, the main priority for Moldova at this stage is to provide the adequate policy responses to stimulate the economy.

Table III.11.1:

**Moldova - Main economic indicators**

	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	6.6	4.8	3.0	7.2	-4.0
GDP nominal (EUR, billion)	2.4	2.7	3.2	4.1	4.2
GDP per-capita (EUR)	668	746	956	1040	1154
Inflation (average)	11.9	12.7	12.4	12.8	9.7
Inflation (end-year)	11.0	14.1	13.1	7.3	
<b>Social indicators</b>					
Unemployment (ILO definition, %)	7.3	7.4	5.1	4.0	5.5
Poverty rate (% of population)	29.1	30.2	n.a.	n.a.	
<b>Fiscal sector</b>					
Total revenues (% GDP)	38.6	39.9	41.8	40.6	35.0
Total expenditures (% GDP)	37.0	39.6	42.0	41.6	42.0
General government balance (% GDP)	1.6	0.3	-0.2	-1.0	-7.0
Gross public debt (% GDP)	32.0	29.2	23.3	22.5	31.0
<b>Monetary sector</b>					
Domestic credit to the private sector (% GDP)	26.5	30.8	39.1	40.0	38.1
Broad money (M2, % change)	36.7	12.2	47.3	18.4	-21.2
Degree of monetisation (M2/GDP, %)	29.5	27.9	34.5	34.7	26.5
Dollarisation in bank deposits (%)	41.8	49.1	43.3	31.3	43.8
<b>External sector</b>					
Current account balance (% GDP)	-7.6	-11.1	-15.8	-16.7	-13.7
Trade balance (% GDP)	-40.6	-46.4	-52.1	-52.9	-36.5
FDI (net, % GDP)	6.4	7.4	11.0	11.2	6.4
Remittances (% GDP)	30.6	34.5	33.9	31.2	25.5
<b>External vulnerability</b>					
External public and private debt (% GDP)	69.5	74.2	75.7	68.2	67.5
External public debt (% GDP)	25.2	25.2	21.1	15.6	23.7
International reserves (USD, million)	597	775	1334	1672	1000
<b>Financial sector</b>					
Real effective exchange rate (% + is apprec.)	2.1	-5.7	-1.0	8.2	
Exchange rate (Moldovan leu per EUR, average)	15.6	16.5	16.5	15.2	
Exchange rate (Moldovan leu per USD, average)	12.6	13.1	12.1	10.3	

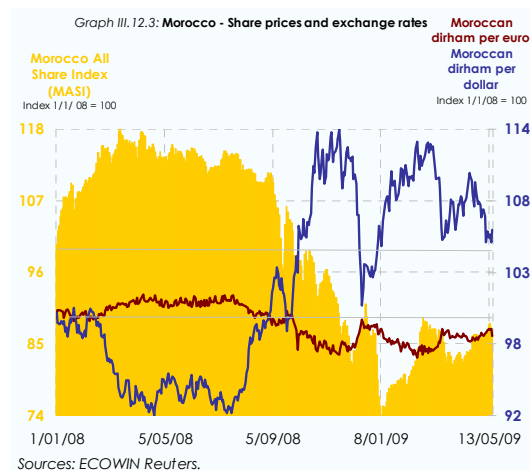
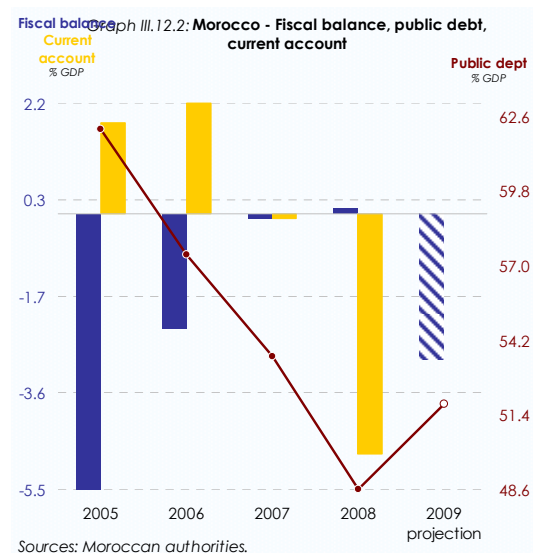
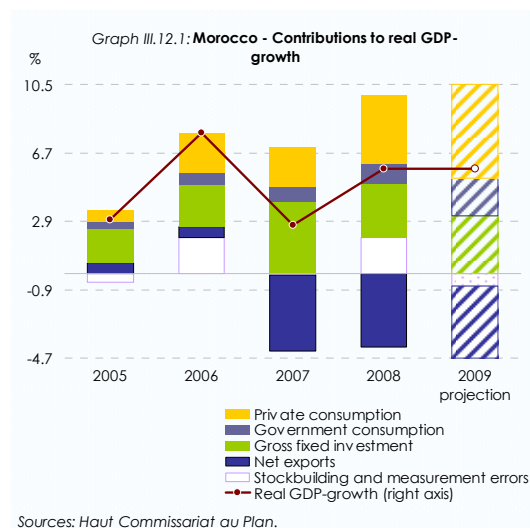
Sources: Moldovan authorities, IMF, EBRD, WB, NBM, Commission.

# 12. MOROCCO

- *Sound economic fundamentals have helped Morocco to resist the impact of the global financial crisis. Economic growth jumped to 5.8% in 2008 on the wave of an extraordinary agricultural campaign. The performance of the non-agricultural sector (close to 6% average growth rate over the 2005-2008 period) slowed down to 5% as some sectors started feeling the first impacts of the global economic crisis. Overall, global economic growth remains hostage of agricultural output.*
- *The excellent performance of total revenues in 2008 helped to balance the extraordinary increase in food and oil subsidies that resulted from hiking oil and commodity prices for most of the year. The budget balance stands in 2008 at 0.4% of GDP up from 0.2% in 2007, but prospects for 2009 point to a 2.9% budget deficit in account of heavy load on the budget of ambitious plans of public investment, particularly in infrastructure, education and security.*
- *Unemployment (9.5%) and poverty (9%) remain at unacceptable high levels. Achieving the targets announced by the government –6% real GDP growth, 250,000 new jobs and 150,000 new housing units a year for the next five years – remains a serious challenge if structural reforms are not accelerated.*

## Macroeconomic and financial developments

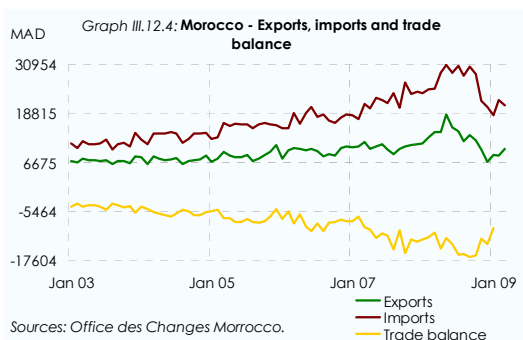
The Moroccan economy experienced an impressive growth rate of 5.8% in 2008 fuelled by an extraordinary agricultural campaign (agricultural GDP has grown by 11%), strong domestic demand and gross investments. Although overall economic growth is still vulnerable to the weather vagaries affecting agricultural output, the contribution of the non-agricultural sector to GDP is gradually increasing as manufacturing develops and the construction industry expands on the back of government-financed housing projects. Non-agricultural GDP growth reached 5% in 2008 down from 6.6% in 2007 on account of a lower world demand and high oil prices for most of 2008; but these downside risks might be balanced in 2009 by



strong public investment, bringing non-agricultural GDP growth back to around 6%.

**Domestic demand, particularly consumption, continues driving GDP growth.** Public and private consumption have strongly accelerated fuelled by urban wage growth, rapid credit expansion (+26%) and the positive evolution of the labour market (130,000 net jobs created in 2008). Strong investment owes much too big infrastructure projects (mainly tourism and energy industry) and the expansion of the housing market.

The Consumer Price Inflation (CPI) has been low in recent years (1.8% in average), largely owing to extensive government subsidies and the managed exchange rate. Preliminary estimates reveal a peaking CPI **reaching 3.9% end-2008 up from 2% in 2007**, as a result of high international oil and commodity prices. **Inflation should moderate in 2009 to 2,6%** owing to a cooling in international commodity prices and the global economic recession.<sup>54</sup> The Bank Al Maghrib (BAM) closely monitors inflation. In September 2008, it raised its key intervention rate from 3.25% to 3.5%, on the belief that inflation poses a greater risk to sustainable economic growth than global financial difficulties. Cooling global inflationary pressures and the expectations of a lower inflation rate in 2009 have intervened for the BAM to lower again its intervention rate at 3.25% in March 2009.



During 2008, the government experienced great difficulties in implementing a declared policy of

reducing current spending. High inflation combined with hiking international oil and food prices resulted in: a raise by 10% in the minimum wage of civil servants over the 2009-2010 period (following the enormous pressures from the trade unions in the framework of the social dialogue) and extraordinary spending on food and oil subsidies (5% of GDP compared with 2.6% in 2007). **The overall fiscal balance is projected at 0.4% of GDP in 2008 (excluding privatization receipts)**, broadly in line with a close-to-balance position in 2007 (0.2% of GDP). Morocco has managed to avoid a deficit thanks to the extraordinary performance of fiscal revenues (overall +27.4%; corporate tax +55%, and VAT +23%) resulting from the considerable efforts made to streamline tax expenditures and improve the tax administration. However, fiscal revenues largely outperforming budget estimations for the third consecutive fiscal year puts into question the capacity of the government to provide accurate estimates during the preparation of the budget law. These large revenues have compensated for the substantial increase in spending (+35% on investment expenditures and +93% on oil and food subsidies). The public wage bill remains stable around 10% of GDP (2008: 10.3%). **Public debt has contracted in 2008** for a fourth consecutive year (48.6% of GDP: 2008; 53.6%: 2007) in account of substantial GDP growth combined with a positive budget balance.

The current exchange rate regime which pegs the MDH to a euro-dominated basket of currencies has resulted in an MDH effective appreciation in line with the EUR-USD exchange rate. The BAM stays firm on the peg in spite of pressures for a more competitive exchange rate arguing that this system has been useful in anchoring the economy and keeping inflation down. **The authorities have taking gradual steps to lessen currency controls, with the aim of introducing a fully floating currency at an unspecified date** but the pace might slow down on account of mounting tensions in the international markets. On average the Moroccan dirham (MDH) appreciated against the USD in 2008 (MDH/USD 7.7 down from 8.2) and is expected to have remained fairly stable against the € (MDH/€ 11.3 end-2008 up from 11.2 in 2007).

<sup>54</sup> This rate overshoots the government's end-2008 inflation target of 2.3%. Inflation targets are 2.5% for 2009, 2.3% for 2010 and 2.1% for 2011.

The external environment remains shaped, for a fifth consecutive year, by a **substantial trade deficit** standing in 2008 over 22% of GDP (2007: 19.2%), with imports expected to grow in value by 32% and exports by 29% in 2008. Morocco's disappointing trade performance owes 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.

The traditional offsetting transfers, tourism revenues and remittances of Moroccans living abroad, have declined in 2008 by 3.5% and 2.4% respectively, resulting in a strong deterioration of the **current account deficit which is expected to reach 4.8% of GDP end-2008**. Net foreign exchange reserves have contracted y-o-y to 5.5% of GDP end-2008. In spite of a difficult international environment, Morocco continues attracting substantial, but decreasing, volumes of foreign direct investment (USD 4 billion in 2008 down from USD 5 billion in 2007, or over 20% contraction) with tourism and housing sector absorbing over 50%.

The budget balance for 2009 is expected to deteriorate strongly to around -3% of GDP on account of the stabilisation of fiscal revenues, after years of extraordinary performance, the weight of subsidies and the government spending on public infrastructure.

### Risks and outlook

The poor outlook for European growth will have a **negative impact in Morocco's real growth estimates for 2009** as the EU is Morocco's main export market. The Moroccan authorities forecast real GDP growth at 5.8%, although economic analysts table for growth not exceeding 4.5% in 2009. Lower estimates reflect the downside risks to Morocco's economy, with 2.5 million Moroccan expatriates living in contracting Europe, delays in foreign investments as a result of the liquidity crisis, and lower expected tourism and remittances revenues.

So far, **the consequences of the global financial crisis have not significantly affected Morocco's financial markets**. The low international integration of Morocco's financial

sector has buffered it from the worse consequences of the sub-prime fallout; domestic banks have not been affected by the global credit crunch and credit keeps flowing into the economy.<sup>55</sup> Trading activity in the Casablanca Stock Exchange (CSE) started to slow only in Q3 2008 after five years of positive growth. At the end of December 2008 the volume of exchanges had decreased by 32% and the stock exchange capitalisation by 9%. However the correction seems to be more related to psychological factors than to any sign of structural weakness.<sup>56</sup>

Although the impact of the global financial crisis might have been limited on the CSE, the crisis has triggered a series of reforms aimed at boosting the capital market and improving accountability. On January 2009 the Minister of Finance launched a set of proposals aimed at increasing the financial market regulator's independence and improvements in the management structure of the CSE.<sup>57</sup>

**The global financial crisis may damage some key economic sectors in Morocco in 2009** such as holiday real estate, tourism and exports (particularly textile and leather). The recession in Europe, where an equivalent of 20% of Moroccan's domestic workforce is employed, is likely to impact household consumption in Morocco, as employment of Moroccan expatriates in Europe falls and so does the level of remittances. Export growth will be constrained by competition from lower-wage countries and by declining European demand.

### Policy reforms and measures

Important fiscal reforms have helped Morocco to cushion the impact of the turmoil in the international markets. From a fiscal perspective,

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<sup>55</sup> Total credit extended by banks reached MDH 102 billion in 2008. Credit to the real estate sector increased by 37.7% in 2008, up from 32% in 2007.

<sup>56</sup> The Moroccan All Share Index (MASI), which includes all 77 stocks traded on the CSE, surged by 34% y-o-y in 2007, but fell by 13.5% in 2008.

<sup>57</sup> These measures include, for instance, allowing companies to buy back their own shares without a minimum set price in the event their share price falls below a certain level, and the possibility for insurance companies to hold up to 60% (instead of 50%) of their listed shares to cover their liabilities. The Oxford Business Group. *Correcting Itself*, 21 January 2009.



some positive developments are taking place, such as the growing contribution of the VAT (36.7% in 2008) and the corporate tax (28.1%) to global fiscal revenues and the reduction and streamlining of tax expenditures. However, curbing spending is a more complicated task. Although Morocco has succeeded in maintaining a wage bill stable at a level around 10% of GDP for the last three years, food and oil subsidies have skyrocketed, growing by almost 700% over the 2002-2008 period.

A review of the food and oil subsidy scheme would contribute to creating the necessary fiscal space for the country to be able to fund the wide array of policies that have been announced in the 2009 Budget Law. These include a 9% wage bill expansion, the consolidation of public investment and the reduction or marginal taxation rates on income. However, the recent easing in oil prices (down to USD50/barrel in 2009 from USD97/barrel in 2008) should contribute to relief the pressure on the government to attack important reforms.

The fiscal consolidation exercise would be helpful if the Moroccan authorities manage: i) to maintain the public wage bill around 10% of GDP by continuing the freeze on net hiring policy in the civil service and the redeployment of civil servants to priority sectors; ii) to review food and energy subsidies, and their replacement with direct subsidies targeted to the most vulnerable; and iii) to complete the tax reform program. Specific efforts are particularly required to further widen the tax base and rationalise tax expenditures in order to reduce the tax burden and improve the fairness of the fiscal system. Similarly, the completion of the VAT reform and the streamlining of tax administration should aim at deepening and ensuring the sustainability of the fiscal reform.

### **Social development and poverty**

Social problems in Morocco remain acute, although social indicators have moved in a positive direction since the authorities decided to make fight against poverty their immediate political priority. Official poverty is expected to have dropped from 14% in 2005 to 9% by end-2008, although its distribution is highly unequal with strong variations between urban and rural

poverty (two-thirds or poor people live in rural areas). An additional 25% of the population living at or below 50% above the poverty line are considered "economically vulnerable." Thus, over 30% of Morocco's population struggles to get by on a daily basis. Morocco ranks 126<sup>th</sup> (out of 177 countries) in the UN 2007/08 HDI, between Namibia and Equatorial Guinea, and last among 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 (61.5% in 2007), adult illiteracy still affects almost 40% of the population aged 15 years or older. Life expectancy at birth rose to 72.2 in 2007; however, after making steady progress for many years, health indicators have deteriorated: only half of the rural population has access to proper healthcare, less 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.

Such situation underlines the need for the national authorities to develop a comprehensive social protection strategy targeted on the poor as well as to increase the impact of public expenditure programmes on beneficiaries through further deepening the ongoing public expenditure management reform.

Table III.12.1:

**Morocco - Main economic indicators**

	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	3.0	7.8	2.7	5.8	5.8
Non-agriculture real GDP growth (% change)	5.6	5.4	6.6	5.0	6.4
GDP nominal, (USD billion)	59.5	65.6	75.1	88.3	97.3
GDP per capita (USD)	1973	2152	2422	2901	3116
Inflation CPI (period average, % change)	1.0	3.3	2.0	3.9	2.6
<b>Social indicators</b>					
Unemployment (off. registered, average, %)	10.8	11.1	9.7	9.5	10.7
Life expectancy at birth (years)	71.7	72.0	72.2		
Adult literacy (% ages 15 and older)	52.3		61.5		
Domestic population (million)	29.9	30.2	30.5	30.8	
Income inequality (Gini, %)	40.0				
HDI <sup>1</sup> index (2005 ) most recent	0.646				
<b>Fiscal sector</b>					
Total revenues, including grants (% GDP)	23.7	25.2	27.4	26.5	
Grants (% GDP)	0.5	0.4	0.4	1.5	0.4
Total expenditures, excl.Fond Hassan II (% GDP)	29.6	27.5	28.5	31.2	31.1
Government balance excluding grants (% GDP)	-5.5	-2.3	-0.1	0.1	-2.9
Total government debt (% GDP)	62.1	57.4	53.6	48.6	51.8
<b>Monetary sector</b>					
Credit to the economy (% change)	13.1	17.0	29.2	26	15.2
Credit to the economy/GDP (in %)	53.9	57.6	69.9	77.5	82.1
Broad money (Money + quasi money, % change)	14.0	17.2	16.1	15.2	13.0
Degree of monetisation (M3/GDP, % change)	8.8	7.5	9.3	7.8	3.4
<b>External sector</b>					
Exports of goods (% GDP)	18.9	19.3	19.4	19.5	18.8
Imports of goods (% GDP)	32.4	33.1	33.6	35.3	35.1
Trade balance (% GDP)	-13.8	-14.8	-19.2	-22.1	-22.5
Current account balance, including official transfers (% GDP)	1.8	2.2	-0.1	-4.8	
FDI flows (USD billion)	2.7	3.1	2.6	2.4	
FDI flows (% GDP)	2.7	3.1	3.1	2.7	3.3
<b>External vulnerability</b>					
Total external debt (% GDP)	24.2	23.9	23.8	21.1	20.1
Debt service ratio <sup>2</sup> (%)	11.3	8.6	7.9	6.8	4.7
Gross reserves (USD billion)	16.1	20.2	24.0	28.2	29.8
Gross reserves (months of imports)	7.4	7	7.9	6.2	6.7
<b>Financial sector</b>					
Short-term interest rate (money market rate, average)	3.3	3.3	3.3	3.5	
Exchange rate (MAD/EUR, average)	11.0	10.9	11.2	11.3	
Exchange rate (MAD/USD, average)	8.9	8.8	8.2	7.7	
Real effective exchange rate (1992=100)	119.9	120.8	129.7		

<sup>1</sup> The HDI (maximum value 1) is a composite index measuring health, access to knowledge and standard of living.<sup>2</sup> Excluding privatization revenues.<sup>3</sup> Excluding Hassan II Fund, and including balance on special treasury accounts.

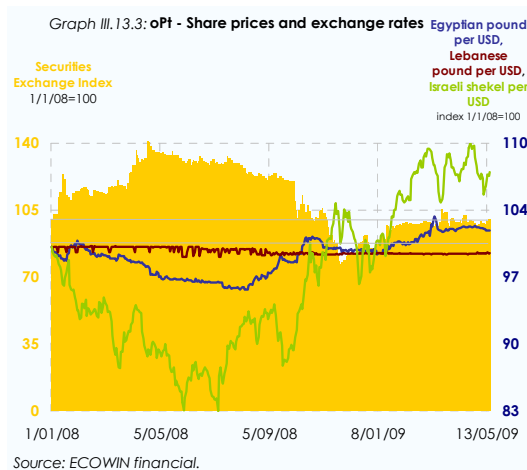
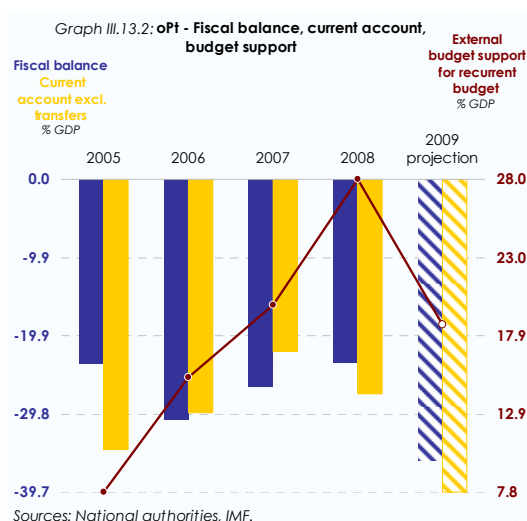
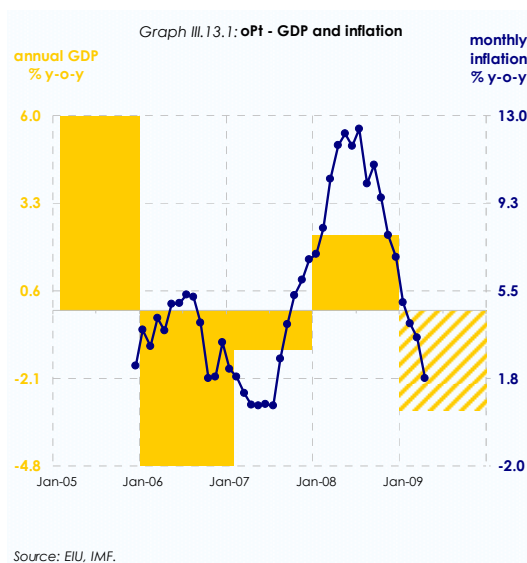
Sources: Haut Commissariat au Plan Morocco, IMF, Moroccan Ministry of Finance, EIU and Commission.

# 13. OCCUPIED PALESTINIAN TERRITORY

- *Real GDP growth projected at 2.3% in 2008 has been fuelled by a stimulus on domestic demand associated to the full repayment of wage and private sector arrears by the Palestinian Authority. Had the Gaza Strip been allowed to contribute to economic growth through the opening of its borders, real growth might have approached the Palestinian Authority objectives at 3.5%.*
- *Public finance reform efforts put in place by the Palestinian Authority are producing results. The estimated recurrent fiscal deficit is projected at 19% of GDP in 2008 down from 24% in 2007. External funding for recurrent expenditures will be reduced to USD 1.15 bn in 2009 down from USD 1.8 bn in 2008. Public investment in development projects is expected to double, initiating a transition towards a more sustainable economic model.*
- *The Palestinian Authority remains committed to the fiscal targets of the Palestinian Reform and Development Plan and the international donor community is fully supporting the Authority's efforts.*

## Macroeconomic and financial developments

Economic growth is projected at 2.3% in 2008, first positive growth since 2005, although lower than envisaged at the December 2007 donors' conference in Paris (3.5%). This rate results from uneven developments in the two territories composing the oPt: while in the West Bank growth has been fuelled by improved security and full repayment of wage and private sector arrears by the Palestinian National Authority (PNA), the Gaza Strip has progressively been transformed into an economy fully dependent on external aid. Israel's restrictions on entry of food, fuel and cash needed by commercial banks have negatively impacted Gaza's economy over 2008; this situation was only aggravated in December as a result of



Israel's military operation.<sup>58</sup> **Per capita GDP** is expected to reach USD 1289 in nominal terms in 2008, a figure that remains under 1999 levels at USD 1610, implying a steady decline in the value of all final goods and services produced within the oPt during the last decade. The living standards also keep deteriorating, with a 2% real GDP growth lagging behind a 4% population growth.

**GDP growth in 2008 has been driven by government and private consumption** (supported by remittances and foreign aid); however, the Palestinian Authority is making efforts to revive public investment through reorienting development expenditures. By focussing on labour intensive community projects<sup>59</sup> rather than on big infrastructure projects, the PNA has managed to give a boost to the local economy. Development expenditures contributing to capital formation are expected to reach USD 250 million, substantially under the USD 492 million projected in the Palestinian Reform and Development Plan (PRDP).

Growth forecasts for 2009 are highly uncertain. A decline of some 3% of GDP is expected based on the assumption that the Palestinian Authority continues reforms, Israel maintains its current restrictions and donors maintain adequate levels of budget support; indeed, current circumstances do not point to Israel undertaking a major dismantling of the closure regime. Was this fundamental fact to radically change, growth projections could reach 3%.

**Expected inflation stands at close to 10% end-2008** up from 2.7% in 2007 (last IMF report points to 7% but reported figure is 9.9%). The rise was much more pronounced in Gaza (10%) than in the West Bank (4.5%) and is the

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<sup>58</sup> First estimates by PCBS of the economic losses for the Gaza Strip stand at USD 1.4 billion. 14% of the infrastructure has been damaged, more than 20,000 buildings have been hit, 80% of the agricultural farms have been destroyed. Industrial businesses are closed and the 35,000 people employed in the industrial sector have lost their jobs. The Portland Trust. Palestinian Economic Bulletin. January 2009.

<sup>59</sup> By the end November 2008, over 800 projects were completed or being executed with a total commitment of USD 278 million. The bulk of these funds amounting to USD 300 million will be disbursed in 2009.

consequence of high international food and oil prices<sup>60</sup> and of Israeli's restrictions on movement and access,<sup>61</sup> which have contributed to create an artificial shortage of productive assets. In spite of recent actions by the Government of Israel to ease the internal movement within the West Bank, the movement continues to be impaired by an increasing number of physical obstacles<sup>62</sup> and the persistent construction of the Separation Barrier (with close to 60% of its overall route completed).

**The official unemployment rate reached 23.9% in 2008**<sup>63</sup> (19%: West Bank; 40%: Gaza Strip) up from 22% in 2007 (17.7%: West Bank; 30%: Gaza Strip), which highlights an increasing disparity between the two territories. These figures are particularly worrisome because private sector workers do not benefit from unemployment benefits, and therefore fall into poverty once the informal social safety mechanisms are exhausted. Labour force participation rates are low and dropping (from 44% in 2007 to 42.3%: West Bank; and from

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<sup>60</sup> Oil and food prices started to moderate in the second half of 2008. However, up to that point, high food prices had taken a heavy toll on living standards. The consumer price index for food rose by 28% in Gaza and 21.4% in the West Bank between June 2007 and June 2008, which has resulted on increased food insecurity in both territories. Despite the large inflows of aid, food insecurity is estimated to have increased in the oPt from 34% in 2006 to 38% in 2007 (56% of households in Gaza). Almost 66% of income earned in Gaza is spent on food while in the West Bank the figure is 56%.

<sup>61</sup> Movement restrictions have been implemented by the Government of Israel for the last eight years (beginning of the 2<sup>nd</sup> intifada). They are widespread and include a wide range of modalities: closure obstacles, the Separation Barrier, prohibitions to access vast areas of the West Bank combined with a permit regime, restrictions on the use of main roads, random checkpoints, curfews, and age and gender restrictions. OCHA Closure Update, 11 September 2008.

<sup>62</sup> A survey carried out by OCHA in September 2008 reported 630 closure obstacles blocking movement within the West Bank (including 93 staffed checkpoints) compared to 561 checkpoints as of October 2007. Numbers are increasing because obstacles are getting installed in larger numbers than removed. Barrier gates -56 crossing points-are not included in the count. The same survey found that almost three quarters of the main roads leading into the 18 most populated Palestinian cities and towns in the West Bank are either blocked or controlled by an Israeli Defence Force (IDF) checkpoint. Idem

<sup>63</sup> 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.

38% to 37.5%: Gaza; both figures correspond to the first quarter of 2008). The public sector remains a main employment provider accounting for 14% of total employment in the West Bank and 48.8% in the Gaza Strip. The private sector has nearly collapsed in the Strip where the majority of people have become dependent on external aid.

**The fiscal picture in the oPt has been difficult for years and will continue to be so.** The unpredictability of revenues, together with an expanding list of expenditures for essential and relief needs creates budget tensions that cannot be solved without external assistance. Clearance revenue is the cornerstone of the Palestinian Authority's public finance, representing over 70% of revenues in 2008. The frequent unpredictability of such revenue makes medium-term budget planning extremely difficult and deprives the Palestinian Authority of the fiscal policy tools it needs to stimulate the economy. The Palestinian Authority often resorts to short-term liquidity management to balance the budget.<sup>64</sup>

The Palestinian Authority's strong commitment to implement politically challenging fiscal measures in times of crisis is producing positive results. **Fiscal consolidation has proceeded reasonably well and the recurrent fiscal deficit on a commitment basis is projected to decline to 19% of GDP (down from 24% in 2007), reflecting restraint on the wage bill and reduced subsidies for utilities. This is lower than projected in the 2008 Budget Law.**<sup>65</sup>

**Revenue performance during 2008** was better than envisaged in the budget, with gross revenues exceeding budgeted figures both on clearance and domestic taxes.<sup>66</sup> Other revenues came from the Wataniya Communication Company<sup>67</sup> that paid a license fee of USD 80

million in August, and the Palestinian Investment Fund (PIF) that paid a dividend amounting to USD 25 million. **On the expenditure side,** the wage bill (on a commitment basis) is projected to be in line with the 2008 budget since wage rates were not increased and public employment remained relatively stable.<sup>68</sup> **All arrears to some 145,000 public sector employees were cleared by end-October,** which pushed the wage expenditure on a cash basis over the budget to reach USD 1.48 billion or 23% of GDP in 2008. **Social allowances** to the poor and the unemployed (around 9% of GDP), and arrears to government suppliers and service providers in the private sector (USD 64 million) were also paid during 2008. In addition, net lending is projected to have declined substantially (-27% from 2007 levels), reflecting the effective implementation of measures to raise utility bill collection rates.<sup>69</sup>

**A further reduction of the recurrent deficit to 18% of GDP** was envisaged by the draft 2009 Budget Law through continued expenditure restraint and improved cash management;<sup>70</sup> however, a likely increase in emergency spending and heavily damaged infrastructure reconstruction resulting from the Gaza conflict late December might alter this positive forecast.<sup>71</sup> Before the conflict the recurrent

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awaiting Israel's approval of service frequencies. The Portland Trust, Palestinian Economic Bulletin, November 2008.

<sup>64</sup> A total of 3,000 new hires in the health and education sectors have been compensated with the retirement of 4,000 security personnel.

<sup>65</sup> These measures include: the obligation for utility consumers to show a "certificate of payment" to keep their access to services; improved incentives to municipalities to ensure that consumer's utility payments are passed on to electricity companies; and the installation of pre-paid meters in the West Bank.

<sup>66</sup> The 2009 draft budget provides for a 6% increase in the wage bill (2% coming from new employees in the health and education sectors, and a maximum 4% increase in the wage rate (first general wage rate increase since end-2007). In all remaining sectors employment will remain frozen.

<sup>67</sup> The PNA has maintained full support for the Gaza economy since the blockade was established in June 2007. Some 66,000 PNA permanent employees live in Gaza and receive their salaries through transfers into their bank accounts. The PNA also pays for fuel required by the Gaza Electricity Generation Company, and for the electricity consumption in Gaza. All payments to Gaza represent 22% of GDP, or about half of total PNA recurrent expenditures. This amount is likely to grow in

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<sup>64</sup> Report on UNCTAD assistance to the Palestinian people. UNCTAD, 15 July 2008.

<sup>65</sup> On a cash basis, the recurrent fiscal deficit is higher than budgeted in 2008 due to the front-loading of arrears repayment. All wage arrears have been cleared in 2008.

<sup>66</sup> The Government of Israel repaid a total of USD 95 million in concept of withheld clearance revenues.

<sup>67</sup> Wataniya Mobile is the second mobile phone service provider in the oPt. It will begin operations in the West Bank at the beginning of 2009. Service in Gaza is

deficit for 2009 was estimated at USD 1.65 bn (down from 1.9 bn in 2008), USD 1.15 bn to cover recurrent expenditures and USD 0.5 bn for community projects. This was in line with projections presented in the PRDP<sup>72</sup> at the 2007 donors' conference in Paris but the overall budget deficit projections might change given recent estimates of the economic impact of the conflict in Gaza (USD 1.2 billion). The Palestinian Authority announced that the GERRP will be implemented as an integral of the broader Palestinian Reform and Development Plan (PRDP).

**Palestinian trade volumes remain small.**

Costly and unpredictable border crossings, undiversified markets and products, security concerns and a trade-hostile political situation have all hampered Palestinian trade flows. During 2008, there has been no relaxation of Israel's policy of closure and restrictions in the West Bank have been increased. Gaza remains isolated. The commitments included in the 2005 Agreement on Movement and Access (AMA) have not been implemented.

Total trade flow estimates for 2008 show increasing exports (13.1% of GDP in 2008 up from 10.3% in 2007) and increasing imports (71.6% of GDP in 2008 up from 68% in 2007), resulting in a **trade deficit of over 65% of GDP**. The 2007 trade deficit with Israel was equivalent to almost 90% of total net current transfers (mainly donor support), which points to the need to reduce trade dependence on Israel and reorient Palestinian trade and integration into Arab and regional markets, where favourable trade deals can be negotiated and stable access guaranteed. The estimated **current account deficit** in 2008 (excluding official transfers) is expected to worsen to 27.2% of GDP (2007: 21.8%).

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2009 in response to the damages inflicted by the Israeli military operation.

<sup>72</sup> The PRDP is a national plan which sets out the PNA's medium-term agenda for Palestinian reform and development. Covering both the West Bank and Gaza, it provides a coherent policy framework for the allocation of government and donor resources through an integrated planning and budgeting process. The PRDP provides a strategic context for prioritizing the recovery and reconstruction needs of Gaza, integrating aid projects into National Programs, and fostering an effective dialogue with internal and external development partners.

**The Palestinian Monetary Authority (PMA) is the body charged with regulating and supervising the banking sector.** Its monetary powers remain limited since the oPt has no national currency, which limits the scope for influencing monetary and economic conditions. The PMA has made considerable progress during 2008 in internal reform and capacity building, including in strengthening the supervisory framework and governance. A macroprudential division was created and progress was made in establishing an early warning system. The financial legal framework has also been strengthened: an Anti Money Laundering Law has been in force since 2007, and a new Banking Law and new Central Bank Law are expected to be enacted in 2009.<sup>73</sup>

As in most developing countries, **the banking sector dominates the financial sector**. Palestinian banks are generally in sound financial condition and products and regulatory infrastructure are well developed.<sup>74</sup> However, the banking sector remains vulnerable to its dependence on the Jordanian and the Israeli banking system.

Political instability and a depressed economic activity result in banks having a limited role in the financing of the Palestinian economy. **Banks are cautious to extend credit because clients miss suitable collateral** (related to insufficient land registration) and because of uncertainty on debt collection. The PMA has taken important steps to develop the banking system and to improve its stability, such as: enacting a new banking law to be able to implement the Basel Core Principles, extending the network of the credit bureau, and completing the installation of the payment system. A new credit registry will allow banks to better evaluate risks, reduce collateral requirements, and improve credit flow. Two bank loan guarantee programs for SMEs have been launched in order to substitute for the

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<sup>73</sup> 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.

<sup>74</sup> West Bank and Gaza. Financial Sector Review. The World Bank. December 2008.

lack of acceptable collateral and keep functioning even under economic distress.

### Risks and outlook

**The global financial crisis has not substantially affected the Palestinian economy.** A limited exposure of domestic banks to global financial markets together with conservative lending practices has kept the oPt insulated from the global financial storm.

**Local banks have not been significantly affected by the global financial turmoil** because deposits are made into the local financial market which has limited exposure to the world. Total investment of Palestinian banks abroad reached USD 3.3 bn in Q2 2008 (55% of gross assets). Out of this, USD3 bn were deposits in financial institutions that have not been affected by the crisis. In addition, the Palestinian mortgage market is too small a market to be affected by the downturn in the US mortgage market and is strictly regulated by the PMA. Palestinian assets have been saved because there is little investment by Palestinians in foreign companies.

However, domestic banks are getting affected by a restrained economic activity (with private deposits contracting by 6% in real terms in the year to September 2008) and by severed relations with Israeli banks, which are threatening to discontinue relations with banks operating in both territories. Private sector credit fell to 25% by September 2008 (30% end-2007)

**The Palestinian Stock Exchange (PSE) has suffered a limited impact of the global financial crisis due to its size (just 35 companies are listed) and relative isolation.** There are no major foreign investors or investments at the PSE. Listed companies have few or no external investments, do not rely on exports and have limited foreign contacts. Three companies currently account for more than 80% of the total value of the PSE. Six local companies, including Wataniya Mobile, might be listed in the index in 2009. The Al Quds index has experienced some volatility since October 2008 but there is no evidence of this contraction

responding to the crisis in the global financial markets.<sup>75</sup>

The main impact of the financial turmoil will hit Palestinian exports through Israel's expected lower growth. Trade dependence on Israel persists, judging by the overwhelming reliance on it as a source of imports and a destination for exports. Remittances can also be affected given labour market contractions in the Gulf countries.

### Policy reforms and measures

**Public finance reforms** have helped the Palestinian Authority to regain control over the management of public funds in a very short time and under very difficult circumstances. Major progress has been made in: i) restoring the integrity of the financial management system; ii) moving towards fiscal sustainability and progressive reduction of the dependence on external assistance for recurrent expenditures; and iii) launching an economic recovery strategy adapted to quasi-permanent Israeli restrictions on movement and access.

**The integrity of the financial system** has been improved by establishing a budget department in the West Bank and a new Cash and Debt Management Department, which will help to avoid arrears accumulation and to minimize interest payments to the banks. An Accountant General Department has also been established for executing all payments and recording all revenues. A new computerized accounting system linking the MoF to ten ministries will improve revenue and expenditure flows management. Fiscal reports on budget execution and quarterly analysis of public revenue and expenditure are regularly produced, which has contributed to improve the transparency and accountability of the public finances.

Given current rates of poverty and rampant unemployment, the Palestinian Authority's fiscal reform efforts should be sensitively sequenced and preceded by a steady flow of foreign aid,

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<sup>75</sup> Some local experts consider that the recent volatility of the PSE index is related to an exaggerated and unjustified reaction from investors who, having seen the effects of the crisis on foreign markets, also wanted to escape from the Palestinian market.

efforts to lift the closure and public investment targeted to stimulate private investment in activities with high employment and spillover potential.

economic growth might not be enough to keep pace with population growth or to curb unemployment rates, particularly in Gaza.

### Social development and poverty

Human development in the oPt continued to be negatively affected in 2008 by a highly unstable political situation and the socio-economic crisis associated with it. Massive flows of external aid have soothed the current socio-economic crisis; however, poverty rates are still unacceptably high. The quality of social services, particularly education and health are rapidly deteriorating,

Growing unemployment and the encroachment of the closure policy have pushed poverty rates up in both territories. In Gaza, **the official poverty rate based on actual consumption** rose from 47.9% in 2006 to 51.8% in 2007 and deep poverty<sup>76</sup> rose from 33.2% in 2006 to 35% in 2007. In the West Bank poverty slightly declined, falling from 22% in 2006 to about 19.1% in 2007.

**Income-based estimates** confirm that poverty is unevenly distributed in the oPt and increasingly so: 80% of households are below the poverty line in Gaza, compared with 45% in the West Bank.<sup>77</sup> Differences between rural and urban poverty remain negligible. Poverty data for 2008 are not yet available; however, Gaza's poverty rate is likely to have risen as a result of the tightening of the blockade resulting from the military conflict in December 2008 and from the cash constraint on household's liquidity imposed by Israel. The livelihoods of half a million Gazans have been severely constrained due to the inability of public employees to draw their salaries from banks.

Further increases in urban poverty rates are not excluded in 2009 because the projected

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<sup>76</sup> 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 poverty line in 2007 was established at NIS 2,362 (equivalent to USD 572) in monthly expenditures. The latest available household survey dates back to 2007.

<sup>77</sup> Income-based poverty estimates are much higher than consumption-based poverty estimates because the former excludes remittances and food aid. PCBS: Poverty and Living Conditions in the Palestinian Territory, 2007



Table III.13.1:

oPt - Main economic indicators	2005	2006	2007	2008	2009
<b>Real sector</b>				prel.	proj.
Real GDP growth (domestic currency, % change)	6.0	-4.8	-1.2	2.3	-3.1
Real GDP (USD billion)	4.9	4.4	4.3	4.4	4.6
Nominal GDP (EUR billion)	3.6	3.7	3.8	4.4	
Nominal GDP (USD billion)	4.5	4.6	5.2	6.5	6.3
Nominal GDP per capita (EUR)	958	946	947	881	
Nominal GDP per capita (USD)	1190	1187	1296	1289	1214
Inflation CPI (% average)	3.6	3.8	2.7	9.9	4.0
<b>Social indicators</b>					
Unemployment rate (ILO definition)	23.5	23.6	22.0	23.9	23.6
Life expectancy at birth (years)	72.9				
Adult literacy (% ages 15 and older)	92.4				
Domestic population	3.5	3.6	3.7	3.8	3.9
HDI index (2005 ) <sup>1</sup> most recent	0.731				
<b>Fiscal sector<sup>2</sup></b>					
Revenue (% GDP)	27.5	24.9	24.4	24.2	25.8
Total expenditure (% GDP)	44.5	49.3	48.2	43.6	44.0
Public sector wage bill (% GDP)	22.4	25.9	24.6	22.4	22.3
Non-wage expenditure (%GDP)	14.5	16.2	13.3	14.3	15.7
Net lending (%GDP)	7.7	7.3	10.3	6.9	6.0
Recurrent balance- before external support (% GDP)	-17.0	-24.4	-23.8	-19.4	-18.2
Donor financed development expenditure (% GDP)	6.0	6.2	2.0	3.1	8.7
Overall fiscal balance- before external support (% GDP)	-23.4	-30.5	-26.3	-23.3	-35.7
External budget support for recurrent budget (% GDP)	7.8	15.2	19.9	28.0	18.6
External budget support for recurrent and capital expenditures (USD million)	349	1000	1106	1935	2300
<b>External sector<sup>3</sup></b>					
Exports of goods and nonfactor services (% GDP)	13.1	11.6	10.3	13.1	13.2
Imports of goods and nonfactor services (% GDP)	80.3	75.3	68.0	71.6	86.3
Net factor income (% GDP)	11.8	11.6	14.6	12.3	11.7
Trade balance (% GDP)	-67.2	-66.7	-66.7		
Net transfers (% GDP)		44.2	43.3	48.6	57.4
Official transfers (% GDP)	14.2	21.7	21.9	29.6	35.7
Current account balance (% of GDP, including official transfers)	-20.1	-8.0	0.1	2.4	-4.0
Current account balance (% of GDP, excluding official transfers)	-34.3	-29.6	-21.8	-27.2	-39.7
<b>Financial sector</b>					
Credit to the private sector (annual % change)		7.6	-5.7	-2.3	12.4
Private sector deposits (annual % change)		6.2	21.9	22.7	7.4
Al-Quds stock market index (annual % change)	-46.4	-12.8	-16.2		
Israeli Shekel (per EUR, eop)	5.7	5.6	5.6	5.3	
Israeli Shekel (per USD, eop)	4.6	4.5	4.1	3.8	
Jordanian Dinar (per EUR, eop)	0.88	0.89	0.97	1.03	
Jordanian Dinar (per USD, eop)	0.71	0.71	0.71	0.71	

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

2 On a commitment basis 3 Trade data needs to be treated with caution and has been taken from several sources.

Source: IMF.

# 14. RUSSIA

- *A terms-of-trade shock and a sudden stop in capital flows have pushed Russia into a recession.*
- *The policy response has been rapid and vigorous, but may be reaching its limits.*
- *The intensity of the adjustment once again highlights the vulnerability of Russia to commodities prices.*

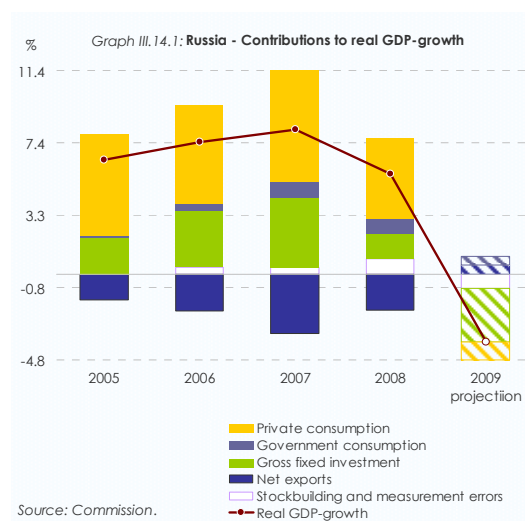
## Macroeconomic and financial developments

2008 was the 10<sup>th</sup> straight year of strong growth for Russia. The 5.6% growth brought the average for 1999-2008 to 6.9%. The strong performance was sustained until the summer of 2008, with GDP growth of around 8% in the first half, supported by investment growth of 17%. The economy started decelerating in the summer, initially due to the financial turmoil on the international markets, but later due to the transmission of the global economic slowdown. GDP growth in January-September fell to a still robust 6.2%, while investment growth fell to 10.4% in the same period (the full-year figures are, respectively, 5.6% and 9.1%). In stark contrast, indicators for "basic sectors"<sup>78</sup> and industrial production collapsed between September 2008 and April 2009, from, respectively, +7% to -12.4% and +6 to -16.9% y-o-y. GDP itself fell by -9.5% in the first quarter of 2009 (a result largely driven due to a massive de-stocking by companies).<sup>79</sup> There were also large capital outflows from Russia in 2008/early 2009: the estimates by the Central Bank of Russia (CBR) show a net capital outflow of EUR 89 billion, while hard currency reserves fell by EUR 116 billion from their peak, to EUR 289 billion by early May 2009.<sup>80</sup>

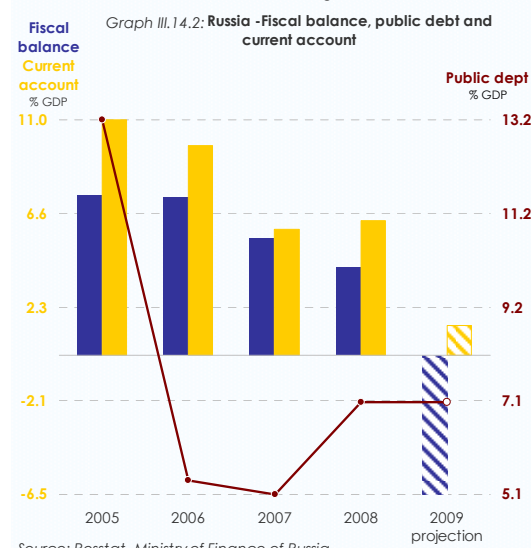
<sup>78</sup>This indicator is based on changes in the production volume of agriculture, mineral output, processing manufacturing, production and distribution of electrical power, gas and water, construction, transport and retail and wholesale. It is considered as good GDP proxy.

<sup>79</sup>This last figure actually conceals m-o-m positive growth, which, together with other indicators such as positive growth of the Russian PMI in the 4 first months of 2009, indicate some early stabilisation signs.

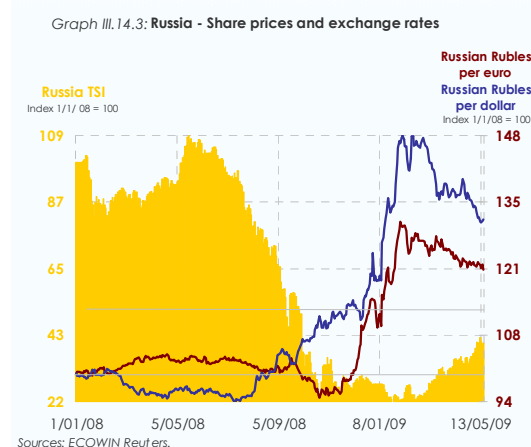
<sup>80</sup>Those figures include the amounts accumulated in Russia's two oil funds, the Stabilisation Fund and the National



Source: Commission.



Source: Rosstat, Ministry of Finance of Russia.



Sources: ECOWIN Reuters.

Welfare Fund, which together reached EUR 146 billion as of 1 May 2009.

This last figure is around 34% lower than their mid-2008 high, but it has roughly remained stable since late January 2009.

According to the CBR's figures, Russia still ended 2008 with both a significant trade surplus (at EUR 121 billion) and a current account surplus (of EUR 68 billion). These figures represent 9.4% and 6.3% of 2008 GDP. The Commission forecast is for a fall in the trade surplus from 9.4% in 2008 to below 2% in 2009, while the current account is expected to swing from a surplus of around 6% in 2008 to a deficit of -0.3% in 2009.

Another aspect of the global shocks' effect on the Russian balance of payments is to be found in exchange rates. For a long time there had been only relatively small changes, the CBR's aim being to stabilise the rouble against a nominal euro-dollar currency basket (set at 0.45 EUR cents and 0.55 USD cents). In November 2008, faced with the pressure on the currency, the CBR changed its policy to one of greater flexibility. It introduced periodic rouble "mini-devaluations" against the basket, of around 1% per step, which gained speed as the year progressed: from one per week in November 2008 to three per week in December 2008, and four by mid-January 2009. On 22 January 2009, the CBR announced another change, now to an apparent "dirty float" within a wide band (26 to 41 to the basket). After initially falling towards the lower part of band, the rouble appreciated by around 7% up to early May. The devaluation since October 2008 is around 25%.

The budget surplus is estimated at 4.1% in 2008. Due to the fall in oil prices (on which the Russian budget significantly depends), the slowdown in economic activity and the fiscal support measures, this figure is expected to swing into a deficit of -5.2% in 2009. Importantly, these fiscal deficits are to be mainly financed by drawing on the oil stabilisation funds (a process that already started in February 2009).

The Russian banking system has seen its capacity to extend credit reduced, and several banks have been downgraded by international rating agencies, though the policy response was successful in preventing the collapse of any systemically important bank, and in swiftly

organising the absorption of those that faced difficulties (and given the importance of Russian banks in other CIS economies, this also has regional implications). The (net) reliance of the Russian banking system on foreign finance, at around 13% of assets by mid-2008, is relatively limited and concentrated in a sub-set of banks,<sup>81</sup> but has been growing very significantly (the net position turning from positive to negative by 2003 and increasing almost fourfold since then). The figures for the whole of 2008 already indicate a significant decrease, which illustrates the effect of a more difficult and costly access to international finance. Additionally, one must keep in mind that the relatively low importance of the Russian banking system for GDP<sup>82</sup> and in terms of investment financing<sup>83</sup> also curtails the potential transmission of those problems in the banking sector to the real economy.

### Risks and outlook

The largest downside risks concerning the outlook for Russia are most likely to be found in the behaviour of commodity prices. In any case, after their very steep fall from the historical highs of mid-2008, they seemed to have

<sup>81</sup>Foreign assets are largely concentrated in the *foreign banks in Russia – mostly EU-based*, which in 2008 had a share of foreign liabilities twice that of their assets (40% as against 20%), and also in *some* state-owned banks (namely VTB, which seems to have used the opportunity to exploit an implicit or explicit sovereign guarantee to attract foreign funding at lower rates). The very significant exception is *the* systemically important – and conservatively run – Sberbank ("Savings Bank"), which is responsible for over a quarter of the assets of the Russian banking system and has only a very low level of foreign assets (an estimated 2% of the total).

<sup>82</sup>The share of bank assets to GDP in Russia stood at 60% in the first half of 2008 (as opposed to over 100% in the EU). This relative financial underdevelopment is also illustrated by the still comparatively low level of monetisation of Russia, as measured by the ratio of M2 to GDP, which is only 40% (compared to 55% in a emerging market like Mexico).

<sup>83</sup>Over 40% of all investment in Russia was financed via own funds in 2007, with 21% coming from government funds and 12% more coming from inter-company loans. Only slightly more than 11% came from bank financing and access to capital markets (and of this, around 3% was from foreign banks and the capital markets). This share is more than three times higher than in 2000, but has not changed significantly since 2005 (which indicates that the significant increase in foreign capital inflows, and especially loans, in 2007, does not seem to have markedly affected the way Russian companies finance investment).

stabilised during the first quarter of 2009, and futures' prices point to some degree of recovery (this likely lies behind the observed stabilisation in other variables, real and financial, described above). Of course, this will depend on the status of the global economy itself (namely, the speed and strength of the recovery). Another downside risk for Russia is that international capital markets may be slow to normalise, given their currently high risk aversion.

In a nutshell, the short-run outlook for Russia is relatively bleak. In the light of the global economic downturn, Russia's growth is expected to be negative in 2009 (-3.8%). Inflation is likely to remain in double-digit levels, but the fall in economic activity and the reduction in commodity prices should cushion the inflationary effects of the rouble devaluation. The budget is expected to swing sharply from a hefty surplus to a large deficit, due to the reduction in commodity prices and in economic activity, plus the large fiscal stimulus packages. Russia is also forecast to see a significant fall in both its trade and current account surpluses.

From a more long-term perspective, the crisis again highlights the need for the Russian economy to diversify away from commodities and towards more sustainable growth drivers. External anchors may help in this process, including the ongoing negotiations for a successor to the framework that regulates relations between the EU and Russia.

### Policy reforms and measures

An extensive set of policy measures has been taken by Russian policy makers to cushion the downturn. They relate to the provision of liquidity (domestic and external, short-term and long-term), direct support to the stock markets and the banking sector, fiscal support for the maintenance of the level of economic activity and flexibilisation of the exchange rate regime (described above). This policy package is rather similar to what was adopted in other countries:

#### *Provision of domestic liquidity, support of stock markets*

- The CBR and Ministry of Finance provided frequent direct injections of short-term liquidity.

- The CBR has provided uncollateralised loans to banks, and has also compensated banks for losses incurred on the interbank lending market.

- Long-term credit facility of RUR 950 billion, offered to banks in the form of subordinated loans with a ten-year maturity.

- Banks with lower credit ratings able to borrow on a repo basis from the CBR.

- The Russian Development Bank (the VEB) is to spend RUR 350 billion from the NWF in financial assets in Russian stock markets (as an attempt to "put a floor" under the markets, by partially replacing the liquidity provided by external investment that has left the country).

#### *Provision of external liquidity*

- Companies and banks to apply to VEB to obtain re-financing for maturing external debt.

- VEB's capital will be increased by RUB 75 billion to support its lending activities, while the CBR has placed EUR 35 billion with VEB to fund this plan (VEB would then be involved in defining the external debt strategy of the institutions that access these funds).

#### *Other support measures*

- Package of fiscal support measures. Cut in oil export duties and corporate income tax. VAT payments phased out. Direct buying of unsold real estate. Increase in unemployment benefits. Rise in certain import duties.

- Bank deposit insurance extended. Takeover and re-capitalisation of several banks, usually with government support/prodding. Support for consolidation of banking system. Short-selling of stocks prohibited, caps imposed on currency swaps and foreign assets of banks.

A rough estimation would indicate that the combined value of all the measures listed above would add up to almost 14% of the Russian GDP, though only about a third of this figure amounts to additional fiscal impulse. They are also spread out over the whole period 2008-10.

Table III.14.1:

Russia - Main economic indicators	2005	2006	2007	2008	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	6.4	7.4	8.1	5.6	-3.8
GDP nominal (EUR, billion)	614	788	942	1150	920
GDP nominal (USD, billion)	764	979	1300	1677	1341
GDP per-capita (EUR)	4282	5521	6628	8099	6488
GDP per-capita (USD)	5322	6856	9142	11807	9459
GNI per-capita (PPP, current prices, USD)	10640	11630	14400		
Inflation CPI (average, %)	12.7	9.7	9.1	13.3	13.2
<b>Social indicators</b>					
Unemployment (%)	7.7	6.9	6.1	7.7	9.5
Life expectancy (years)	65.3	66.6			
Under 5 mortality rate (per 1000)	18	16	14		
Literacy (total, %)	95	95			
Population (million)	143.5	142.8	142.2	142.0	141.8
<b>Fiscal sector</b>					
Total revenue (% GDP)	23.7	23.2	24.3	26.2	17.6
Total expenditure (% GDP)	16.2	15.8	18.7	22.0	24.1
Central government balance (% GDP)	7.5	7.4	5.5	4.1	-6.5
Gross public debt (% GDP)	13.2	5.4	5.1	7.1	7.1
General govt non-oil balance (% GDP)	-5.9	-6.9	-7.1	-7.5	-6.5
<b>Monetary sector</b>					
Private sector credit (% change)	35.2	48.3	50.9	43.0	2.0
Private sector credit (% total credit)	124.6	144.0	151.5	170.0	95.0
Broad money (% M2)	38.6	48.8	47.5	1.7	2.0
Degree of monetisation (M2/GDP, %)	28.0	33.4	40.1	32.4	30.0
Dollarisation in bank deposits (%)	29.0	27.1	24.1	36.1	30.0
<b>External sector</b>					
Current account balance (% GDP)	11.0	9.8	5.9	6.3	1.4
Trade balance (% GDP)	15.4	14.3	9.9	9.4	3.6
FDI (% GDP)	2.0	3.2	3.6	3.5	0.5
Import cover (months)	17.5	17.4	19.7	14.0	11.0
<b>External vulnerability</b>					
External debt (public plus private, % GDP)	33.7	31.7	35.8	28.9	25.0
Debt service/exports (%)	7.4	7.9	-5.9	-6.7	-8.0
Gross reserves (excl. gold, USD, billion)	182	296	466	426	300
Reserves/M2 (%)	1.5	0.8	0.9	0.8	0.7
<b>Financial sector</b>					
Short-term interest rate (average, %)	2.7	3.4	6.3	12.0	
Exchange rate (rouble per EUR, end of period)	33.9	34.7	35.8	41.4	
Exchange rate (rouble per USD, end of period)	28.8	26.3	24.6	29.4	
Real effective exchange rate (2000=100)	149	163	173	184	

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

### Social development and poverty

After falling for years, unemployment has started to increase again in Russia, on the back of a reduction of economic activity. From a June 2008 low of 5.3%, it reached 9.5% by March 2009 (ILO-compatible figures: officially registered unemployment is much lower, mainly

due to the rather low unemployment benefits). Real wages growth decelerated from double-digit growth to -5.7% y-o-y by March 2009. Income inequality and poverty are again on the rise.

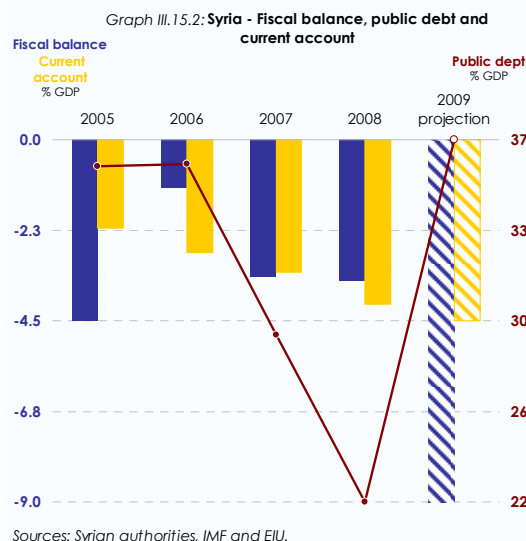
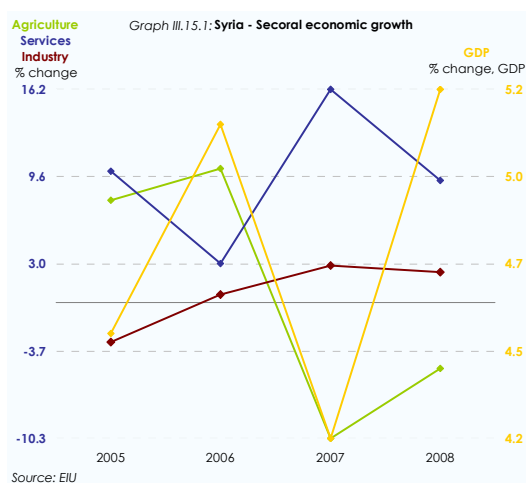
# 15. SYRIA

- **Growth reached 5.2% despite the decline in oil output and the adverse weather conditions affecting agriculture.**
- **The authorities took a significant step to gradually eliminate subsidies by almost tripling the price of oil in May 2008. However, this was partially offset by a 25% increase in government salaries and pensions.**
- **Although the banking system was not hit by the financial crisis due to its low degree of integration with international banking markets, the relative isolation of Syria has not come for free. Regional investors could have taken advantage of investment opportunities abroad by not being confined to domestic markets.**

## Macroeconomic and financial developments

The Syrian economy performed well in 2008, despite the continuing decline in oil production and the drought conditions, which negatively affected the agricultural sector. Non-oil GDP increased by an estimated 6%, but overall growth is estimated at 5% due to the fall in oil production (Syria has become a net oil importer). Growth was based on construction, services, tourism but also on inflows from remittances and increased regional demand for Syrian exports. Worsening financial conditions had only a mild impact on the Syrian economy due to the limited integration of the Syrian financial system with the global financial system and the strict rules set by the Central Bank of Syria on banks' foreign exposure. The large number of Iraqi refugees continued to stimulate growth but also posed economic and social challenges.

Inflation averaged around 14.5%, in line with the rise in oil and food prices in 2008. The reduction in energy subsidies fuelled inflation as gasoline and diesel prices increased by 33% and 240% respectively. Inflation also intensified by the extension of credit to the private sector around 25% and by substantial directed credit from state banks. Demand from the Iraqi population also contributed to inflationary pressure. Real interest rates became negative in 2008 due to high inflation. The Central Bank of Syria increased



the reserve requirements from 5% to 10% in October 2008 to reduce excess liquidity but since

reserves requirements are not remunerated it is likely that the increase has widened the spread between deposits and interest rates. Monetary policy should be boosted by adopting indirect monetary policy instruments (the first market based Treasury bills are to be launched in 2009) and further liberalising interest rates.

The Syrian pound, which has been trading within a narrow band against the SDR, appreciated against the USD by about 7% in September 2008. Although some laws were relaxed and authorities allowed the use of credit cards to pay for foreign transactions in June 2008, they still impose heavy restrictions on the currency, placing a high priority on exchange rate stability.

Despite the bold step to reduce oil subsidies, the fiscal deficit improved only marginally to 3.5% in 2008 because public-sector salaries and crop purchases both increased sharply, offsetting the fiscal savings. The authorities aim to improve the non-oil fiscal balance to adjust to reduced oil output. In this respect, preparations to implement VAT have stepped up, although the measure will not be implemented before 2010.

The current account deficit widened slightly to around 4% in 2008 as a result of declining oil production. However, non-oil exports, tourism and remittances rose sharply as a result of strong regional demand, slashed trade fees (as a result of free-trade agreements) and relaxed foreign exchange controls. Syria has implemented free-trade agreements with Turkey and is also a member of the Arab Free Trade Agreement with neighbouring Arab countries. Syria has applied to join the WTO and is preparing for accession.

Syria's banking system has not been directly impacted by the global financial crisis, mainly due to low exposure to toxic loans as a result of the restrictions imposed by the central bank and sanctions by the US on many Syrian banks. By the middle of the year, total banking assets amounted to USD 35.4bn, up 3.25% since the beginning of 2008, while deposits rose by 9% to USD 21.64bn. State banks hold around 79% of total assets and financial intermediation remains low, with the total assets to GDP ratio around 64%. Private banks are well capitalised (13% capital adequacy ratio) and their non-performing loans ratio was estimated at 5% at the start of

2008. However, the classification of data in state banks remains weak, therefore the calculation of the capital adequacy ratio is questionable.

### **Risks and outlook**

Syria is likely to be affected by a regional slowdown resulting from economic links with other countries in the region and the Gulf countries in that FDI, worker remittances and demand for Syrian exports may fall. Therefore overall growth is expected to slow down to around 3% in 2009.

Prices are expected to ease in 2009 as a result of the fall in global prices. Additionally, any significant return of Iraqi refugees to Iraq would help ease demand pressures.

Despite concerns over oil and non-oil revenues, the Syrian government has embarked on an expansive fiscal policy in 2009, which will not focus on available revenue and will be driven by substantial increases in capital expenditure and recurrent expenses. As a result, according to the 2009 budget, the fiscal deficit will reach 9% of GDP. In early 2009, the government had secured around USD 600 million (including €275 million from the EIB) to fund electricity and other development projects. Even though Syria has the fiscal leeway for anti-cyclical policy, improvements in revenue collection are essential as the reduction in both oil and non-oil revenues are worrying. Also, the planned restructuring of the broader public sector will be of great importance as only 20 public companies out of 520 generate revenue for the state.

On the external sector, the current account is expected to widen marginally as a result of lower exporting oil prices and an expected slowdown in remittances and FDI inflows. Also, tourist receipts are also expected to fall due to the global slowdown.

### **Policy reforms and measures**

Syria has been making progress in structural reforms. Although, there are still significant gaps to be bridged between the present legal framework and best international practices in the field of economic laws, major steps have already been taken in 2008 with the entry into force of

new legislation for consumer protection, competition, trade, and enterprises. Advances are noticeable in trade liberalisation in the context of bilateral and regional free-trade agreements, and in the significant reduction in tariffs. However, the exportation of key agricultural products requires the government's approval. Efforts to combat the under-invoicing of imports have intensified with two decrees: the first allows the customs department to purchase goods at invoiced prices and the second requires importers to open letters of credit through domestic banks, even though its implementation is on hold. The government's future reform agenda includes streamlining agricultural subsidies, introducing a one-stop-shop for company registration, incorporating the Syrian Telecommunication Company and creating an independent regulatory body. Efforts to improve the business environment need to accelerate, especially regarding the cost of doing business.

Progress has been made in preparing VAT. Although implementing VAT will boost state revenues, efforts to combat the informal economy should accelerate since the private sector contributes around 65% of GDP but its share in taxes paid is only 35%. A high-level financial intelligence unit has been created to combat economic fraud and anti-laundering cases with the scope to cover foreign currency exchangers, insurance companies and brokerage firms. The significant reduction in oil subsidies improved the non-oil budget deficit (to 8.2% of GDP in 2008 from 8.4% in 2007). The authorities are considering scrapping energy subsidies entirely until 2010 and replacing fuel coupons with cash transfers, as a secondary market has developed for illegal trading. Efforts to reduce large quasi-fiscal operations should continue as well as efforts to improve Public Finance Management, especially reporting operations and times.

The authorities continued their efforts to enhance the monetary policy framework. In the absence of indirect monetary policy instruments, the Central Bank of Syria held two trial auctions of Treasury Bills during 2008 and is expected to issue fully fledged Treasury Bills in 2009. This would increase the sophistication of monetary tools and help contain the inflationary impact of fiscal deficits. It is also likely that the Central

Bank of Syria will ease the restrictions on foreign-currency transactions, a process that started in 2008 to facilitate investment.

Banking supervision has improved. Off-site surveillance techniques and methodologies to calculate capital adequacy have been improved. Emphasis has been put on supervising state-owned banks and on new reporting requirements.

Finally, the Damascus Stock Exchange was launched on March 10, 2009 and is expected to improve further the climate in the corporate sector.

### **Social development and poverty**

Progress has been made on the rate of poverty, which is estimated at around 13%, down from 14.4% in 2004, due to the positive impact of gradually liberalising the Syrian economy. However, the reduction in fuel subsidies and the high inflation rates had a negative impact on poverty rates in 2008. Also, if the poverty threshold is set at USD 2 per day, the poverty rate rises to around 30%. The presence of Iraqi refugees mainly in urban areas has significantly increased prices, putting pressure on low-income households. Syria ranks 57th out of 135 developing countries according to the Human Poverty Index of the UN. Poverty is strongly correlated with the literacy rate of 82.5% and even a moderate improvement in education can reduce the ranks of the poor. Several anti-poverty programs are currently implemented in Syria. The authorities have focused on developing a Social Welfare Fund, which will provide a secure safety net mechanism for the ultra poor after fuel subsidies are scrapped. Programs to develop rural areas are also being implemented as the income of population in these areas is very unstable due to their dependency on weather conditions. The government also aims to launch projects to help Iraqi refugees and similarly vulnerable Syrian people in urban areas.



Table III.15.1:

Syria - Main economic indicators	2005	2006	2007	2008	2009
<b>Real sector</b>				prel.	proj.
Real GDP growth (% change)	4.5	5.1	4.2	5.2	2.9
Real non-oil GDP growth (% change)	7.5	6.9	5.8	6.0	4.7
GDP nominal (SYR £, billion)	1491	1709	2025	2567	2477
GDP nominal (EUR, billion)	25.2	28.9	34.3	43.5	41.9
GDP nominal (USD billion)	28.6	33.5	40.6	55.2	50.7
GDP per capita (EUR)	1306	1417	1649	2042	1922
GDP per capita (USD)	1482	1642	1952	2592	2326
Inflation (period average)	7.2	10.4	4.7	14.5	8.0
<b>Social indicators</b>					
Unemployment (officially registered)	8.0	8.3	8.4	9.0	8.5
Life expectancy at birth (years)	73.6	73.9			
Adult literacy (% ages 15 and older)	80.8	82.5			
Population (annual growth rate %)	2.2	2.2	2.2	2.2	2.2
Poverty (HPI %)	13.6	13.0			
Human development index	0.731	0.736			
Population (million)	19.3	20.4	20.8	21.3	21.8
<b>Fiscal sector</b>					
Total revenues (% GDP)	24.0	25.5	22.3	21.4	19.0
Oil-related revenues	7.1	7.3	4.9	4.7	3.0
Non-oil revenues	16.9	18.2	17.3	16.7	16.0
Total expenditure (% GDP)	28.5	26.6	25.7	24.9	27.6
Current expenditures	18.1	16.3	16.1	15.4	16.5
Development expenditures	10.4	10.3	9.6	9.5	11.5
Central govt. Balance (% GDP)	-4.5	-1.2	-3.4	-3.5	-9.0
Non-oil budget balance	-11.6	-8.5	-8.4	-8.2	-11.3
Gross public debt (% GDP)	35.9	36.0	28.9	22.0	37.0
<b>Monetary sector</b>					
Credit to private sector (% change)	45.9	17.9	20.2	25.8	18.0
Credit to private sector (% of GDP)	14.5	14.9	15.1	15.0	18.3
Broad money (M2) (% change)	11.5	9.4	9.8	19.0	13.0
Broad Money (SYR £ billion)	1101	1205	1323	1575	1780
Degree of monetisation (M2/GDP, %)	73.8	70.5	65.3	61.4	71.9
<b>External sector</b>					
Current account balance (% GDP)	-2.2	-2.8	-3.3	-4.1	-4.5
Balance of goods and services (% GDP)	-3.1	-4.8	-6.1	-5.0	-6.0
Non-oil export of goods and services (% GDP)	26.9	27.2	27.6	24.5	28.0
Non-oil import of goods and services (% GDP)	-36.4	-35.5	-34.0	-28.3	-32.9
Oil balance (% GDP)	2.1	0.0	-2.4	-2.6	-2.7
Remittances (% of GDP)	2.7	1.8	2.0	1.5	1.5
Foreign direct investment (% GDP)	2.7	2.6	2.8	3.8	3.7
Import cover of reserves (months)	16.4	13.7	11.6	9.4	10.5
<b>External vulnerability</b>					
External public debt (% GDP)	23.4	19.2	14.5	10.4	12.1
Debt service to exports ratio	4.7	5.4	7.3	7.5	
Gross reserves (excl. gold, USD billion)	6.1	6.7	6.4	6.7	6.0
<b>Financial sector</b>					
Lending rate	8.0	7.5	7.5	7.0	
Weighted avg. of nominal exch. rate (per USD, avg.)	52.2	51.0	49.9	46.5	
Real effective exchange rate (1990=100)	59.8	66.0	67.9		
Real effective exchange rate (in %)	1.7	10.7	4.9	9.0	

Sources: Syrian authorities, IMF and EIU.

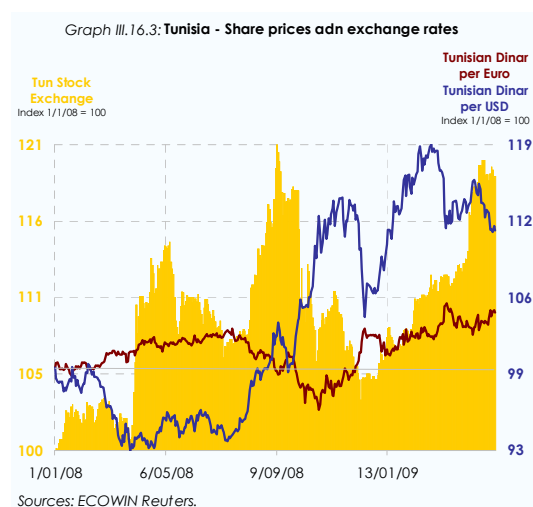
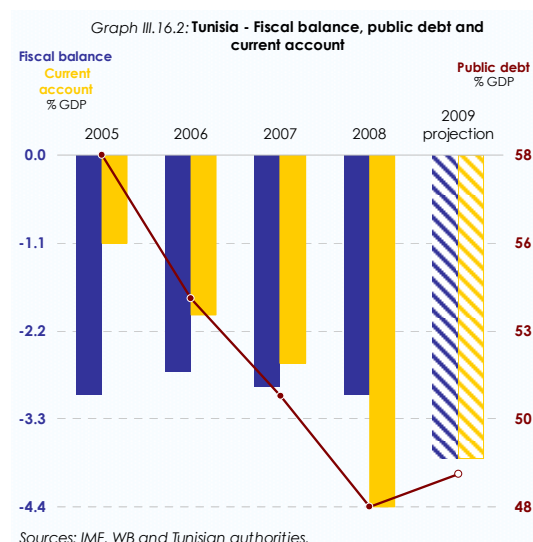
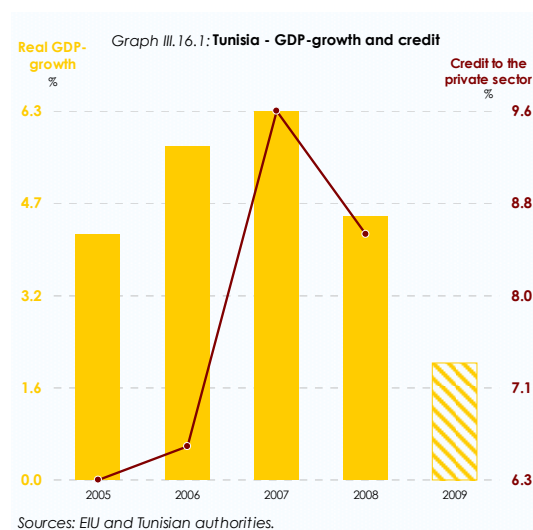
# 16. TUNISIA

- *Tunisian economy is set for a sharp slowdown in 2009 in the wake of the financial crisis.*
- *Export industries are worst hit amidst signs that the drying up of credit weighs on investment projects.*
- *Fiscal policy to feel the strain from economic headwinds.*
- *Full liberalisation of industrial goods trade with the EU is an important milestone.*

## Macroeconomic and financial developments

The impact of the global financial crisis is increasingly being felt in Tunisia, especially in exporting industries. Against this background, real GDP growth is expected to decrease markedly in 2009, to 2%. That said, the performance of the Tunisian economy remained quite robust for most of 2008. For the year as a whole, a growth rate of real of GDP of 4.5% is expected, down from 6.3% in 2007. Consumer price inflation averaged 5.1% (up from 3.1% in 2007), but moderated from the peak of 6.0% year-on-year in April 2008 to 3.0% in April 2009. As elsewhere in the region, a sharp pick-up and subsequent deceleration in food and energy prices was the main determinant of overall inflation trends. The cushioning of the initial price shocks via transfers and subsidies helped stabilise inflation but did imply an additional fiscal burden. The current account deficit widened to around 4% of GDP on the back of slowing exports and the spike in prices for basic commodities and raw materials. The labour market remained sluggish. In Tunisia, the unemployment rate has been persistently high and according to the government stands at around 14%. The number of young people entering the job market is expected to peak in 2010.

While the direct impact of the crisis on Tunisia's financial sector has so far been relatively muted, reflecting its closed character, the lack of currency convertibility and the presence of capital controls, indirect effects are being increasingly felt, in particular via the trade channel. For 2008, short-term indicators already



show a slowing in growth dynamics towards year-end, as the effects of the slump in major Tunisian export markets were being felt. Exports to the EU, which accounts for nearly 80% of Tunisian exports, were particularly affected.

Real GDP growth averaged 4.6% in 2008. The slowdown in exports and industrial production in the second half of 2008 likely continued into 2009, in particular in export-sensitive industries such as chemicals, engineering and textiles where production volumes fell by 20 to 30% year-on-year in January/February 2009. A large state-owned fertiliser manufacturer halted production at several plants in response to declining demand and falling prices for phosphoric acid. Tourism receipts slowed sharply in the fourth quarter of 2008, as the recession in the EU led to a decrease in the number of visitors. A sharper-than-expected slowdown would pose particular problems in the labour market. Against the background of heightened uncertainty and increasing financing constraints, some large investment projects already have been cancelled or delayed. The development of the Hasdrubal offshore gas field ran into funding problems, due to the increased scarcity and cost of international finance. A Dubai-based real estate enterprise responsible for a number of large-scale construction projects in Tunisia has suspended overseas operations for 2009. The completion of other major investment projects planned by foreign companies (primarily from the Gulf countries) may be at risk. In response to the crisis, the government announced measures to support exporting companies (in particular export guarantees and less stringent exchange restrictions), to increase investment incentives, to reduce social security contributions for affected companies, and to facilitate access to finance for SMEs. Easier monetary policy supported the economy via lower policy interest rates and a reduction in reserve requirements.

As regards fiscal policy, the authorities expect the government deficit for 2008 to reach the targeted 3% of GDP, as figures on intermediate budgetary execution suggest a slowdown of tax revenues and expenditure compared to the previous year. The 2009 budget foresees a 20% increase in public infrastructure expenditure to partly offset the expected decrease in private investment. The public debt ratio is forecast to

increase slightly, to 48.5% of GDP, from 47.5% of GDP in 2008. Over the medium term, the authorities have committed themselves to an ongoing process of fiscal consolidation and debt reduction, inter alia by gradually phasing out food and energy subsidies which weighed heavily on public finances as commodity prices rose sharply. Direct fuel and food subsidies accounted for an estimated 4% of GDP in 2008, with indirect subsidies adding to the bill. Improved expenditure targeting should help reduce the fiscal burden in future.

### Risks and outlook

In view of the much worsened global environment, there are clear downside risks to the growth projections for 2009. These relate to exports, tourism revenues, and remittance flows. In addition, the drying up of credit—in particular for project finance—in response to the severe distress in financial markets may lead to the postponement or cancellation of planned investments, notably in construction. If the impact of the crisis on locally active banks is more severe than anticipated, this would also weigh negatively on the economy. In this regard, the persistently high non-performing loans ratio (estimated at around 17%), underlines the vulnerability of the Tunisian banking sector to adverse shocks. Moreover, since the banking sector is relatively strongly involved in the tourism sector, weak tourism receipts will also impact negatively.

However, there are also some signs of resilience. The fall in share prices was comparatively limited after the September 2008 peak compared to the much larger drops witnessed in many other emerging markets. Also, despite the global surge in food and energy inflation which peaked in the summer of 2008, price increases remained relatively contained by comparison with the sharp peaks in inflation registered in some other countries in the southern Mediterranean region.

While the recent decreases in inflation would help relieve some of the pressures on government expenditure, the economic slowdown poses considerable downside risks to revenue. Fiscal risks are aggravated by tax exemptions, notably on VAT, that reduce the tax base. In addition, weak targeting of expenditures,

for instance subsidies, reduces fiscal flexibility. If increased wage demands on account of earlier sharp price increases spill over into the public sector, this would further limit the budgetary room for manoeuvre. On balance, the fiscal targets for the coming years might well be out of reach in the absence of measures.

### **Policy reforms and measures**

The year 2008 marked the final dismantling of tariff barriers for industrial products with the EU. Tunisia thus became the first southern Mediterranean country to achieve the objective of establishing a euro-Mediterranean free trade zone for industrial products. The enhanced trade integration is supportive of foreign direct investment, productivity, and external competitiveness. Follow-up negotiations on the liberalisation of trade in agricultural produce and services with the EU have started but progress has been slow so far. A further liberalisation and increased competition in services could lead to significant benefits for consumers and for employment, as services account for some 25% of total exports and domestic competition is comparatively weak.

The continuation of a cautious fiscal policy, consolidation measures and the phasing out of subsidies will all be necessary to achieve and maintain a sound fiscal policy stance in the face of severe economic headwinds. In response to the worsened economic outlook, in December 2008 the authorities announced measures to support the cash flow to exporting firms facing delays in payments by creditors and to support foreign businesses in financing new investment in the country. In support of these measures, the Bank of Tunisia lowered reserve requirements in January 2009 to boost liquidity. As regards public finance management, in 2008 the government took further steps to implement a system of budgetary controls by objective by identifying pilot ministries for projects and by fixing an indicative reforms calendar until 2012. Reforms aimed at strengthening the efficiency of tax and custom administrations progressed. Tunisia undertook to work towards setting up a monetary and exchange rate policy framework based on inflation targeting. Technical assistance from EU central banks will be sought. However, no firm timetable has been set as the change

from the prevailing exchange rate and monetary policy arrangements would be a significant one and the severe disruption in global financial markets may well prolong the change-over.

Tunisia has continued to progress towards improving its business environment, and to rank among the best performers on the African continent in international surveys on the ease of doing business. As regards concrete measures, the minimum capital requirement to start a business was removed in 2008 and filing and paying taxes was made easier by expanding electronic options. Nevertheless, despite ongoing improvements, the low efficiency of financial markets, substantial rigidities in the labour market, gaps in infrastructure, still weak investor protection, and the need for further improvements in the public sector hamper the resilience of the economy to adverse events. In addition, financial headwinds notwithstanding, efforts to increase competitiveness and consolidation of the relatively fragmented banking sector should remain the focus in the longer run, in order to enhance the functioning of financial transmission mechanisms and reduce vulnerabilities as Tunisian banks continue preparations for the transition to Basel II by 2010. There have been some steps in the right direction to reduce the incidence of unsound and nonperforming loans by improving credit risk appraisals, raising provisioning, and improving access to credit information. However, no significant advances have been registered in the field of capital account liberalisation and the operation of non-resident accounts. But one concrete measure taken concerned the possibility for a Tunisian company engaged in foreign transactions to open a foreign bank account for the duration of those transactions.

### **Social development and poverty**

Among the main reform challenges for Tunisia is tackling the relatively high incidence of unemployment, in particular among the young and highly educated. Within certain categories of those with higher qualifications, unemployment rates have increased to around 25%, compared to an overall rate of around 14%. And the expected increase in unemployment as a result of the foreseen slowdown will be a key issue in 2009, whereas in 2008 a main concern was the sharp

Table III.16.1:

**Tunisia - Main economic indicators**

	2005	2006	2007	2008 prel.	2009 proj.
<b>Real sector</b>					
Real GDP growth (domestic currency, % change)	4.2	5.7	6.3	4.5	2.0
GDP nominal (EUR, billion)	23.0	24.2	25.1	27.0	30.8
GDP nominal (USD, billion)	28.6	30.4	34.4	39.5	41.9
GDP per capita (EUR)	2302	2374	2440	2595	2937
GDP per capita (USD)	2860	2980	3340	3798	3994
Inflation (period average)	2.0	4.6	3.1	5.1	2.7
<b>Social indicators</b>					
Unemployment (officially registered)	14.2	14.3	14.1	14.0	14.3
Human poverty index (HPI-1, %)	17.9				
Population growth rate (%)	1.0	1.0	1.0	1.0	1.0
Adult literacy rate (%)	74.3				
Life expectancy at birth (years)	73.5				
Human development index	0.766				
Population (mn)	10.0	10.2	10.3	10.4	10.5
<b>Fiscal sector</b>					
Total revenues (% GDP)	23.6	23.8	24.2	24.6	24.0
Total expenditure (% GDP)	26.9	26.6	27.2	27.5	27.8
Central govt. Balance, incl. grants (% GDP)	-3.0	-2.7	-2.9	-3.0	-3.8
Gross public debt (% GDP)	58.3	53.9	50.9	47.5	48.5
<b>Monetary sector</b>					
Credit to private sector	6.3	6.6	9.6	8.5	
Broad money (M3) (% change)	11.0	11.4	12.5	10.5	
Degree of monetisation (M2/GDP, %)	59.5	61.9	64.5	63.6	
Dollarisation in bank deposits (%)					
<b>External sector</b>					
Current account balance (% GDP)	-1.1	-2.0	-2.6	-4.4	-3.8
Trade balance (% GDP)	-6.8	-8.2	-8.2	-8.4	-9.4
Foreign direct investment (net, % GDP)	2.6	10.4	4.2	4.6	4.8
Import cover of reserves (months)	3.7	5.0	4.6	4.1	4.2
Terms of trade (deterioration - )	-2.3	-3.7	-5.4		
<b>External vulnerability</b>					
External debt (% GDP)	65.4	58.3	54.9	51.8	51.2
Debt service ratio <sup>1</sup>	14.8	18.8	13.0	9.9	9.3
Gross reserves (excl. gold, USD bn)	4.4	6.8	7.9	8.9	10.2
<b>Financial sector</b>					
Short term interest rate	5.0	5.1	5.2	5.2	
Exchange rate (local currency per EUR, average)	1.6	1.7	1.8	1.80	
Exchange rate (local currency per USD, average)	1.3	1.3	1.3	1.23	
Real effective exchange rate (annual average, %)	-4.5	-0.8	-2.9		

<sup>1</sup> Percent of exports of GNFS

Sources: IMF, EIU, UN and Tunisian authorities

surge in prices for basic goods, notably food, which put particular pressure on low-income groups. In the past two decades, improved access to clean water and sanitation facilities has helped bring down infant mortality appreciably. Tunisia ranked 45<sup>th</sup> among 108 developing countries

according to the UN Human Poverty Index in 2004, with a poverty rate of 17.9%.

# 17. UKRAINE

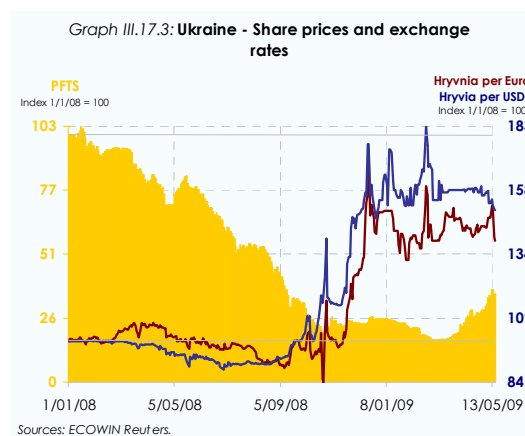
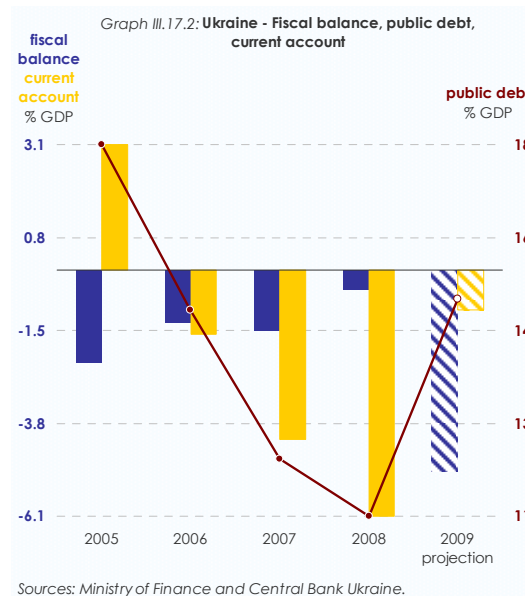
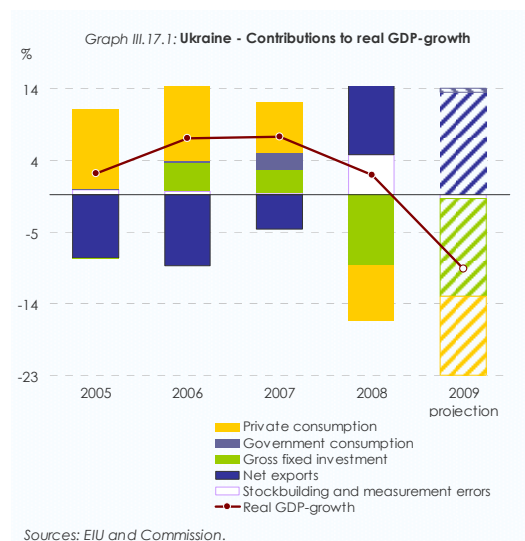
- *Ukraine will face the deepest recession in the Eastern Neighbourhood.*
- *Ukraine agreed a programme with the IMF in November 2008.*
- *Disputes on gas between Ukraine and Russia have been going on.*

## Macroeconomic and financial developments

Ukraine has been hit very hard by the terms of trade shock resulting from the fall in commodity prices (steel products are Ukraine largest single export item) and the sudden halt in its access to international capital markets. Real GDP growth decelerated strongly between 2007 and 2008, falling from 7.6% to 2.5%, and is foreseen as contracting by almost 10% in 2009. Although the average for the period 2001-2008 (at 7%) is similar to other Western CIS countries, the standard deviation of Ukrainian growth rates is significantly above the regional average (and almost three times the that of Russia), indicating that the country is prone to boom-bust cycles.

This precipitous fall in economic growth in 2008 was driven by a reduction in the expansion of domestic demand especially in investment (gross fixed investment growth fell from almost 25% to an estimated 3% between 2007 and 2008). Private consumption growth fell from 15.3% to 6.5% in the same period. All this happened on the back of the reduction of domestic credit growth and a severely curtailed capability of the domestic financial system to access external financing (on which it is strongly dependent), as the global downturn hit Ukraine. All these factors led to an IMF Stand By Agreement (SBA) programme (see below), a common theme among the countries in the EU Eastern Neighbourhood.

The deceleration accelerated in early 2009. The most graphic example was the 31.2% y-o-y drop in industrial output in April 2009, the deepest contraction in the region. Output plunged in virtually every significant industrial subsector, with metallurgy falling by 46% y-o-y. This reflects a significant fall in exports, as Ukraine exports 80% of its metals output. On the



domestic demand side, household consumption is also falling, with real wages decreasing by 11.8% y-o-y in January. Investment growth is also expected to face a double digit fall in 2009 (it had already fallen from a growth of 25% in 2007 to a paltry 2.5% in 2008).

The government is constrained in providing fiscal support to the economy, both by the reduction in fiscal revenue related to the economic downturn and the fall in external trade. Inflation has also increased, to above 22% by early 2009, due to the devaluation of the hryvnia, plus increases in utility tariffs linked to the rising cost of gas imports (notably the 35% rise in the price of natural gas to households in December 2008).

Ukraine's banking sector has been significantly affected by the global crisis, after a credit boom that was largely financed by foreign capital. The main risk factors for banks based in Ukraine are (i) foreign currency lending to unhedged borrowers (ii) a high concentration of corporate loans and related-party lending, and (iii) a large external debt rollover risk. Parent bank lending seems to be still available but the syndicated loan market and other sources of private capital have largely dried up. The country was also faced with a run on banks' deposits, which was contained by the imposition of limits on term deposits' withdrawals<sup>84</sup> (that were lifted in May 2009). The Ukrainian authorities have prepared a comprehensive stabilisation and restructuring programme for the banking system with technical support from the World Bank and the EBRD.<sup>85</sup>

On the external front, the depreciation of the Ukrainian hryvnia has accelerated the adjustment in the external balance. The hryvnia underwent a nominal depreciation of over 50% in 2008 against the USD (to which it was previously pegged). The current account is expected to improve from a deficit of over 6% of GDP in

2008 to a surplus of 1-2% of GDP in 2009 (figures for March 2009 show a trade surplus of almost EUR 230 million, once "in kind" gas transit payments are taken into account).

The international gross reserves of the National Bank of Ukraine totalled EUR 23 billion at the end of 2008, which was equivalent to about four months of imports, but by April 2009 they had fallen to EUR 18 billion (increasing to EUR 20 billion in May, after the disbursement of the second tranche of the IMF loan). Contrary to the country's programme targets agreed with the IMF the official hryvnia exchange rate has again been *de facto* re-pegged to the USD since late December 2008.

A brief "gas war" with Russia, about pricing and non-payment of gas supplies, led to the interruption of the supply of gas to Ukraine and to parts of Western Europe in January 2009. The dispute led to a 10 year deal (with the intermediation of the EU) under which the price of Ukrainian gas imports will be linked to so-called "European prices" from 2009, with an initial 20% discount, followed by a rise to full European rates in 2010. European gas prices will fall during 2009 (as Russian gas contracts are linked to the price of oil, albeit with a 6 to 9 month lag), but the price paid by Ukraine in 2009 should still be up by around 30% when compared with 2008. Although Ukraine and Russia have reached a deal on prices, there are still a number of uncertainties related to the agreement, including the future of the controversial *RosUkrEnergo* trading intermediary.

### Risks and outlook

Clearly, the main risks for Ukraine arise from continued political instability, which compromises the implementation of consistent policies. Nevertheless, some tentative signs of economic stabilisation (smaller reserve loss in February/March 2009, less pressure on the hryvnia, a faster external trade adjustment) and a certain improvement of domestic policy implementations (as indicated by agreement with the IMF for the disbursement of the 2<sup>nd</sup> tranche of the programme and a beginning of real action in banking sector reform) should also be noted.

<sup>84</sup>In January 2009 Ukrainians withdrew EUR 800 million of deposits from the banking system, more than the amount withdrawn in November and December 2008 combined.

<sup>85</sup>According to announcements, 7 Ukrainian banks also could be recapitalized with up to UAH 20 billion (or EUR 2 billion). The budget for 2009 foresees a total of UAH 44 billion for the recapitalization of Ukrainian banks.

### **Policy reforms and measures**

In early November, the IMF approved a EUR 11.6 billion, 24-month stand-by arrangement to help Ukraine to cope with its financial and economic crisis. The programme includes a sharp tightening of fiscal policy. It also requires a tightening of monetary policy once domestic liquidity conditions allow, and a significant reform of exchange-rate policy, including the implementation of a flexible exchange rate. Support for the domestic banking sector is to be a priority. In the area of structural reform, invigorating the privatisation process is to receive increased attention, and agricultural land reform is also targeted. The authorities have also committed themselves to bringing domestic gas prices into line with import prices by 2012.

The 2008 consolidated fiscal deficit is estimated at around 1.5% of GDP. The 2009 budget adopted by the Parliament on 26 December projects a deficit of 2.9%, whereas the original IMF programme targeted a zero overall balance in 2009 (net of bank recapitalisation requirements, which are not specified in the programme). Given the bigger than projected economic contraction, the IMF in April 2009 agreed it would accept a deficit of up to 4% of GDP.

Another "anchoring" of reforms can be provided by the EU: A further deepening of links is under way through the negotiation of a new Association Agreement with the EU, including a deep free-trade area, to replace the existing Partnership and Co-operation Agreement (PCA).

### **Social development and poverty**

Officially registered unemployment doubled to 3.1% by March 2009, but this significantly understates the level of unemployment in the country: ILO methodology data for late 2008 puts the unemployment rate at 6.5%. Total population continues to fall by 0.6% per year, the worst fall in the region.



Table III.17.1:

<b>Ukraine - Main economic indicators</b>	2005	2006	2007	2008	2009
<b>Real sector</b>				prel.	proj.
Real GDP growth (domestic currency, % change)	2.7	7.1	7.3	2.5	-9.5
GDP nominal (EUR, billion)	69	85	103	128	74
GDP nominal (USD, billion)	86	106	141	180	90
GDP per capita (EUR)	1467	1815	2218	2786	1635
GDP per capita (USD)	1835	2282	3046	3922	1978
GNI per capita (PPP current prices, US\$)	5520	6120	6810		
Inflation (period average)	13.5	9.0	12.8	25.2	19.3
<b>Social indicators</b>					
Unemployment (ILO definition)	7.8	7.4	6.7	6.5	10.0
Population (million)	46.7	46.5	46.1	45.9	45.5
Poverty rate (% of population)	8				
Inequality (Gini index consumption/ income)	27.6				
<b>Fiscal sector</b>					
Total revenue (% GDP)	41.8	43.7	42.3	42.5	37.0
Total expenditure (% GDP)	44.1	45.1	43.8	43.0	42.0
General government balance (% GDP)	-2.3	-1.3	-1.5	-0.5	-5.0
Gross public debt (% GDP)	17.7	14.8	12.2	11.2	15.0
<b>Monetary sector</b>					
Domestic credit to private sector (% GDP)	32.2	44.9	59.1	70.8	50.0
Broad money (M2) (% change)	53.9	34.3	50.8	31.0	15.0
Degree of monetisation (M2/GDP, %)	43.8	47.7	54.3	53.9	52.0
Dollarisation in bank deposits (%)	35	38	32	44	45
<b>External sector</b>					
Current account balance (% GDP)	3.1	-1.6	-4.2	-6.1	-1.0
Trade balance (% GDP)	0.8	-2.9	-5.6	-9.0	-2.8
Foreign direct investment (net, % GDP)	9.0	5.4	6.6	3.6	4.4
Import cover of reserves (months)	5.1	5.0	5.3	4.8	5.7
<b>External vulnerability</b>					
External debt (public plus private, % GDP)	45.3	50.4	60.2	58.0	97.5
Of which: public external debt (% GDP)	14.7	12.2	10.5	11.1	20.0
Debt service ratio <sup>1</sup>	13.0				
Gross reserves (excl. gold, USD billion)	19.0	21.8	32.5	31.1	28.0
Reserves/M2	2.0	2.3	2.4	2.0	2.4
<b>Financial sector</b>					
NBU discount rate	9.50	8.50	8.00	12.0	
Lending rate	16.2	15.2	14.0	16.0	
Exchange rate (hryvnia per EUR, average)	6.4	6.3	6.9	7.6	
Exchange rate (hryvnia per USD, average)	5.1	5.1	5.1	5.4	
Real effective exchange rate (2004=100)	110.2	115.5	117.1	127.6	

<sup>1</sup> Public external debt service as % of exports of goods and services.

Sources: IMF, WB, Ukrainian authorities and Commission.

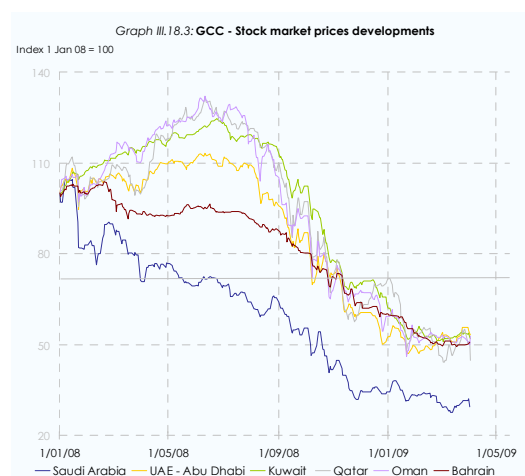
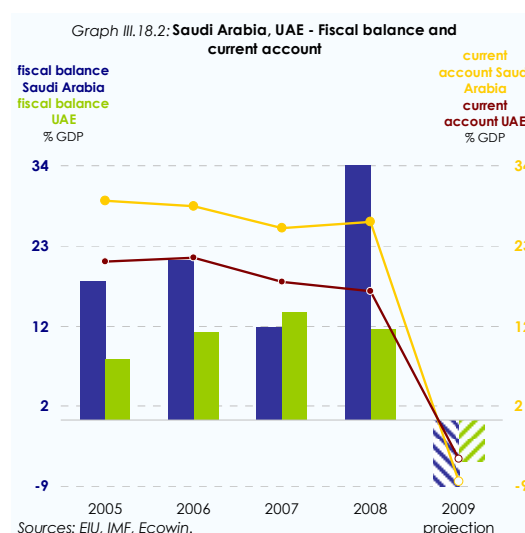
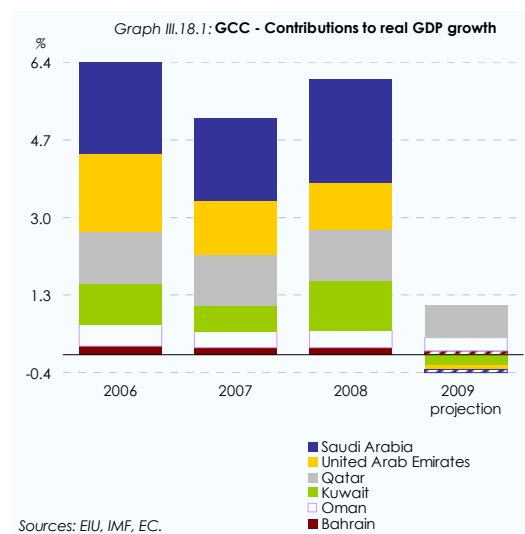
# 18. GCC COUNTRIES

- *The Gulf Cooperation Council (GCC – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) will not escape the fallout from the global financial and economic crisis. Economic growth in the GCC will be less than 1% in 2009, a far cry from the strong economic growth of almost 6% in 2006-08.*
- *The financial sector already felt the chill early on. Stock market prices headed downwards from the beginning of 2008 as confidence fell and (foreign) investors started withdrawing their funds in a reaction to the global financial and economic crisis.*
- *The real economy is being hit hardest by the lower revenues from oil exports. Most GCC countries will run twin deficits in 2009, in sharp contrast to the years 2006-08.*
- *In addition to the fall in trade and capital inflows, there is the risk of a reversal in the real estate sector. Nonetheless, in comparison with many other countries worldwide, the GCC countries are in a relatively good position to weather the storm in view of their ample resources and the improvement in their macroeconomic fundamentals.*

## Macroeconomic and financial developments

Stock markets in Saudi Arabia and Bahrain coupled with the negative developments on the financial markets in the developed economies from early 2008 onward. Later in the year, the stock markets of the other GCC countries followed. Since March of 2007, GCC stock markets have lost between 25 and 70%. These developments have hurt the balance sheets of companies quoted on the stock exchange, and consequently, via this channel, real economic activity.

The drop in world oil prices in the fall of 2008, as well as the decrease in world demand, is impacting the GCC economies even more directly. Government revenues are expected to be much lower in 2009 than in 2008, even



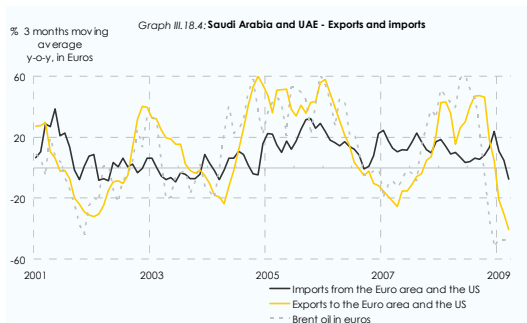


Table III.18.1:

GCC - SWFs market share by country

end-2008	USD bn	% of total
<b>United Arab Emirates</b>	<b>957</b>	<b>25</b>
China	764	20
Singapore	464	12
<b>Saudi Arabia</b>	<b>433</b>	<b>11</b>
Norway	301	8
<b>Kuwait</b>	<b>264</b>	<b>7</b>
Russia	225	6
Others	492	13
Total	3,900	100

Source: SWF Institute, IFSL estimates.

leading to large fiscal deficits in Saudi Arabia and, to a lower extent, in other GCC countries.

The fall in exports from the GCC was actually fairly limited until the end of 2008 (see graph III.18.4), despite world trade falling by more than 20% in 2008Q4. However, exports from the GCC are dropping sharply during the first months of 2009. Only Kuwait and Qatar will escape negative current account balances in 2009.

Table III.18.2:

GCC - Official foreign exchange reserves

end-2008	USD bn	% of total
China	2,243	30
Japan	1,031	14
Russia	387	5
India	248	3
South Korea	201	3
Brazil	201	3
Hong Kong	183	2
Singapore	166	2
Algeria	138	2
Germany	133	2
Others	2,469	33
Total	7,400	100

Source: Wikipedia, CIA-The World Factbook, IFSL estimates.

The lower exports and lower consumer and business confidence leading to lower private consumption and business investment will depress domestic economic activity. After several years of solid economic growth of almost 6%, growth will not exceed 1% in 2009 (see graph III.18.4). On the positive side, the lower global commodity prices and fall in global demand is putting downward pressure on consumer prices and bringing inflation down from its high levels in 2008.

Foreign exchange reserves in the GCC are still low in relation to GDP (see Table III.18.4). At the end of 2008 there were still ample buffers, in particular in the UAE, Saudi Arabia and Kuwait.

In order to strengthen monetary policy and boost intra-regional trade, an agreement has been reached for the creation of a central bank and single currency. This agreement still needs to be ratified.

The agreement on a monetary union will need to be complemented by the following: (i) agreement on the nature and scope of the GCC monetary

Table III.18.3:

GCC - Intrade and bilateral trade with the EU

Exports - Intrade and exports to the European Union (% of total exports) in 2008

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE	GCC	European Union
Bahrain		0.8	1.5	0.7	3.8	2.8	9.6	4.6
Kuwait	0.1		0.1	0.2	0.6	0.7	1.7	12.0
Oman	0.3	0.4		0.6	1.3	7.5	10.1	2.5
Qatar	0.2	0.1	0.0		0.6	3.9	4.8	7.0
Saudi Arabia	2.6	0.6	0.2	0.4		1.3	5.1	11.0
United Arab Emirates	0.3	0.5	2.3	0.9	1.6		5.6	5.1

Imports - Intrade and imports from the European Union (% of total exports) in 2008

	Bahrain	Kuwait	Oman	Qatar	Saudi Arabia	UAE	GCC	European Union
Bahrain		0.6	0.7	0.7	39.6	4.5	46.0	18.1
Kuwait	0.9		0.5	0.1	6.8	3.5	11.9	28.9
Oman	2.1	0.5		0.1	3.0	19.0	24.7	26.2
Qatar	0.7	0.5	0.7		4.8	5.7	12.5	40.4
Saudi Arabia	1.1	0.4	0.4	0.3		2.6	4.8	33.0
United Arab Emirates	0.5	0.3	0.0	1.2	2.1		4.2	26.8

Source: ECOWIN REUTERS.

authority; (ii) harmonisation of key regulatory and supervisory frameworks, especially for the financial sector, statistical methodologies for key financial and economic indicators; and (iii) agreement on the customs union and the issues outstanding with regard to the sharing of customs revenue (iv) introduction of a common currency.

In May 2009 the Saudi capital Riyadh was selected as home to the group's monetary council, a precursor to the future GCC central bank.

### Risks and outlook

The grim world economic outlook is affecting the short- to medium-term outlook for the GCC. In the face of tighter credit and global demand contraction the oil revenue losses are increasing and growth in the non-oil sectors is slowing.

Kuwait will be most at risk of recession. It is highly dependent upon oil and the lack of diversification of the economy makes it the slowest-growing GCC member. Moreover, there is some political instability.

The chief risk for the United Arab Emirates is that the property market bubble will burst. In particular Dubai, but to lesser extent Abu Dhabi, is exposed to the global trends.

Saudi Arabia carries the largest burden of oil production cuts. Net foreign assets decreased rapidly quickly during December 2008 and January 2009. Nonetheless, the stock of reserves is still high.

The risk for Oman is that the income from tourism will fall. For this reason it will likely have to cut spending, which will hurt economic growth.

Bahrain is trying to develop as a financial hub. It has the largest banking sector in the GCC and is therefore vulnerable in this international financial crisis.

Qatar is best placed to weather the storms. Its economic growth was highest of all GCC members in 2008, due to the fact that it is the world's biggest liquefied natural gas (LNG) exporter and due to rapid business and residential

investment. The population grew at 8% in 2008, because of high immigration. Thanks to the long-term LNG contracts with trading partners the Qatari economy should maintain robust economic growth in the coming years.

### Policy reforms and measures

How hard the economic slowdown hits the GCC will depend very much on the policy measures that the authorities take. Fiscal expansion and monetary easing could help stimulate the economic activity, and possibly even avoid a depression. In comparison with countries in other parts of the world, the GCC is well-endowed with resources for such policies, in view of its high stock for reserves (mainly Sovereign Wealth Funds).

Since the start of the financial turmoil various measures have already been taken. Saudi Arabia eased its monetary policy by 350 basis points to 2.0% and guaranteed the bank deposits. It also injected funds in the form of long-term deposits into the banking system, invested at the stock exchange, and reduced its reserve requirements on bank deposits significantly. Some banks with loan-to-deposit ratios exceeding 100 have started deleveraging to protect their capital base and meet central banks' guidelines. Saudi Arabia has also established a Sovereign Wealth Fund with an initial capital of USD 5.3 billion to provide credit to low-income citizens with difficulty getting access to loans, and plans to spend USD 400 on development projects over the years 2009-13.

Table III.18.4:

GCC - Main economic indicators

	2004	2005	2006	2007	2008	2009 proj.
<b>Real GDP growth (domestic currency, % change)</b>						
Saudi Arabia	5.3	5.5	3.2	3.4	4.2	-0.2
United Arab Emirates	9.7	8.2	9.4	7.7	7.4	-1.6
Bahrain	5.6	7.9	6.7	8.1	5.6	2.4
Kuwait	10.7	11.4	6.3	4.7	8.5	-1.8
Oman	5.4	5.8	7.5	5.8	6.4	1.9
Qatar	20.8	6.1	12.2	17.3	13.4	8.5
<b>Inflation (average, %)</b>						
Saudi Arabia	0.4	0.6	2.3	4.1	9.9	1.3
United Arab Emirates	7.0	12.5	13.5	13.3	20.0	4.5
Bahrain	2.3	2.6	2.0	3.8	7.0	0.8
Kuwait	1.3	4.1	3.0	5.5	10.6	7.0
Oman			3.0	5.9	12.5	6.8
Qatar	6.8	8.8	11.8	13.8	15.1	9.2
<b>Fiscal balance (% GDP)</b>						
Saudi Arabia	11.4	18.4	21	12.3	33.6	-8.7
United Arab Emirates	-0.4	8.1	11.6	14.2	12	-5.4
Bahrain	2.7	6.2	3.4	2.6	2.7	-7.4
Kuwait	24.9	39.4	29.1	42.4	30.8	-5.6
Oman	2.4	2.0	3.6	0.3	4.2	-2.3
Qatar	6.8	8.8	11.8	13.8	15.1	9.2
<b>Current account balance (% GDP)</b>						
Saudi Arabia	21.3	29.0	28.3	25.3	26.2	-8.0
United Arab Emirates	11.7	20.9	21.4	18.3	17.0	-5.1
Bahrain	4.2	11.0	13.6	16.6	7.0	-0.5
Kuwait	30.6	42.5	50.7	42.4	40.0	6.2
Oman	3.7	16.1	13.9	4.6	9.1	-6.3
Qatar	23.8	17.6	16.6	14.5	17.4	0.9
<b>Foreign exchange reserves (USD, billion)</b>						
Saudi Arabia	28	27	28	34	31	23
United Arab Emirates	19	21	28	77	35	30
Bahrain	2	2	3	4	4	4
Kuwait	8	9	13	17	17	16
Oman	4	4	5	10	12	9
Qatar	3	5	5	10	10	9
<b>Sovereign Wealth Funds (USD, billion)</b>						
Saudi Arabia				300	433	
United Arab Emirates				875	957	
Bahrain						
Kuwait				174	264	
Oman						
Qatar				50		
<b>Gross public external debt (% GDP)</b>						
Saudi Arabia	14.0	13.9	12.7	17.1	15.9	17.6
United Arab Emirates	37.4	42.4	46.2	53.3	50.2	59.4
Bahrain	50.8	48.3	48.1	49.3	56.3	56.7
Kuwait	20.4	20.4	25.2	30.0	25.9	31.3
Oman	15.8	13.0	13.1	14.3	12.9	13.4
Qatar	47.3	48.1	52.4	58.0	51.6	66.3

Sources: Economist Intelligence Unit, IMF, own judgement.