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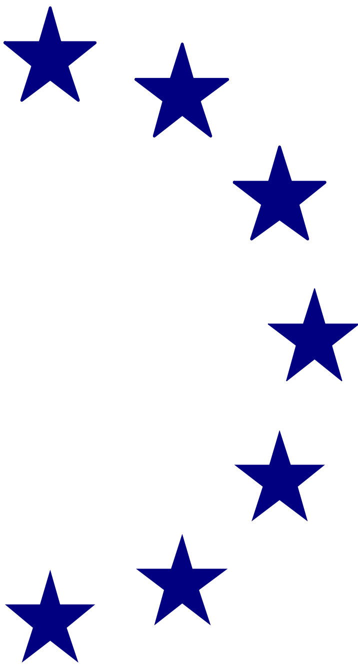

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European Neighbourhood Policy:
Economic Review of ENP Countries

by

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Foreword

This is the first issue of the "European Neighbourhood Policy: Economic Review of ENP Countries". It reflects ongoing work in the Unit "Economic Affairs of Mediterranean Countries, Russia and the New Independent States. Economic Aspects of the Neighbourhood Policy" in the Directorate for International Economic and Financial Affairs (DG ECFIN).[1] This report does not necessarily reflect the official views of the European Commission.

The main purpose of this issue is to provide, first, an assessment of the economic aspects of the European Neighbourhood Policy and, secondly, to give an overview of recent macroeconomic and structural developments in participating countries.[2] The structure of this issue is as follows:

- A paper on the economic dimension of the European Neighbourhood Policy.
- Country-specific sections on the main economic developments in 2004.

This Occasional Paper has been prepared by a team led by José Leandro and Andreas Papadopolous, including Arno Bäcker, Michaela Dodini, Marco Fantini, Frank Ø. Hansen, Gerhard Krause and Sirpa Tulla. António de Lecea provided management support and offered valuable suggestions. Sophie Bland and Sarah J. Ortelli reviewed the report and provided critical and efficient editorial assistance.

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[1] Previous DG ECFIN publications on Mediterranean countries are available on the Europa website at: http://europa.eu.int/comm/economy_finance/publications/occasionalpapers_en.htm
[2] Belarus and Libya, although ENP countries, have not been included in this issue due to the fact that the EU-Belarus Partnership and Cooperation Agreement is frozen and that there are no formal relations with Libya.

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Acronyms

AA	Association Agreement
AMD	Armenian dram
AP	Action Plan
AZM	Azerbaijanian manat
BLOM	Banque du Liban et d'Outre-Mer
BS	Banque du Sud
BTC	Baku-Tbilisi-Ceyhan
BYR	Belarussian ruble
CASE	Cairo and Alexandria Stock Exchange
CBA	Central Bank of Armenia
CBE	Central Bank of Egypt
CBJ	Central Bank of Jordan
CBT	Central Bank of Tunisia
CIH	Crédit Immobilier et Hotelier
CIS	Commonwealth of Independent States
CNCA	Caisse Nationale de Crédit Agricole
CPI	Consumer Price Index
DZD	Algerian dinar
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECB	European Central Bank
EDL	Électricité du Liban
EEA	European Economic Area
EFTA	European Free Trade Association
EGP	Egyptian pound
EGPRSP	Economic Growth and Poverty Reduction Strategy Paper
EIB	European Investment Bank
EITI	Extractive Industries Transparency Initiative
EIU	Economist Intelligence Unit
ELFTA	EFTA-Lebanon Free Trade Agreement
ENP	European Neighbourhood Policy
ENPI	European Neighbourhood Partnership Instrument
EPA	Export Promotion Agency
EU	European Union
EXIM	Export-Import Bank of the United States
FDI	Foreign Direct Investment
FEMIP	Facility for Euro-Mediterranean Investment and Partnership
FIAS	Foreign Investment Advisory Service
FSAP	Financial Services Action Plan
FTA	Free Trade Agreement
GAFTA	Great Arab Free Trade Area
GCC	Gulf Co-operation Council
GDP	Gross Domestic Product
GEL	Georgian lari
GFS	Government Finance Statistics
GNI	Gross National Income

GSP	General System of Preferences
GST	General Sales Tax
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
IBRD	International Bank for Reconstruction and Development
IFI	International Financial Institutions
IFS	International Financial Statistics
ILO	International Labour Organisation
IMF	International Monetary Fund
JOD	Jordanian dinar
JSA	Joint Staff Assessment
LBP	Lebanon pound
MAD	Moroccan dirham
MDL	Moldova leu
MED	Mediterranean Countries
MEDA	EU's financial instrument for the Euro-Mediterranean Partnership
MENA	Middle East and North Africa region
MFN	Most Favoured Nation
MP	Mediterranean Partner
MTDP	Medium-Term Development Plan
MTEF	Medium-Term Expenditure Framework
NBG	National Bank of Georgia
NBM	National Bank of Moldova
NBU	National Bank of Ukraine
NC	Neighbourhood Country
NGO	Non Governmental Organisation
NH	Non-Hydrocarbon
NIS	New Israel shekel
OECD	Organisation for Economic Cooperation and Development
PA	Palestinian Authority
PAFTA	Pan Arab Free-Trade Area
PCA	Partnership and Co-operation Agreement
PER	Public Expenditure Review
PIF	Palestinian Investment Fund
PLC	Palestinian Legislative Committee
PMA	Palestine Monetary Authority
PSET	Plan for Social and Economic Transformation
QIZ	Qualified Industrial Zone
ROSC	Report on Observances of Standards and Codes
SBA	Stand-By Arrangement
SFD	Social Fund for Development
SIFs	Social Insurance Funds
SMEs	Small and Medium-sized Enterprises
SOCAR	State Oil Company for the Azerbaijan Republic
SODEA	Société de Développement Agricole
SOFAZ	State Oil Fund of the Republic of Azerbaijan
SOGETA	Société de Gestion de Terres Agricoles
SYP	Syrian pound
TACIS	EU's financial instrument for Eastern Europe and Central Asia
TND	Tunisian dinar
TPR	Trade Policy Review
UAE	United Arab Emirates

UAH	Ukraine hryvnia
UN	United Nations
UNDP	United Nations Development Program
US	United States
VAT	Value Added Tax
WB	World Bank
WB&G	West Bank and Gaza
WEO	World Economic Outlook
WPI	Wholesale Price Index
WTO	World Trade Organisation

Part A

Horizontal Issues

The Economic Dimension of the European Neighbourhood Policy[1]

- **The European Neighbourhood Policy (ENP), launched in 2003 as an ambitious policy initiative, offers the prospect to gradually move from traditional trade and cooperation towards closer integration between the EU and its neighbours.**
- **On the economic front, the ENP offers neighbours (i) enhanced preferential trade relations, (ii) a stake in the EU Internal Market, (iii) improved interconnection with the EU (such as in energy, transport and telecoms), (iv) the possibility of participating in some EU programmes, as well as (v) increased financial and technical assistance.**
- **The economic benefits associated with the ENP are potentially large. Greater legislative and regulatory convergence with the EU, particularly in those areas that are important for improved market access, should lead to higher investment and growth, especially if accompanied with greater liberalisation of trade in services and agricultural products.**
- **Compared to the existing framework agreements between the EU and its neighbours, the ENP offers the potential of a greater catalytic role for structural reforms and sound macroeconomic policies, but progress will continue to depend on domestic commitment to reform in neighbouring countries.**
- **For the successful implementation of the ENP, participating neighbouring countries will need to ensure that commitments undertaken under the policy are supportive of their national development strategies and consistent with their institutional and technical capacity, while the EU will have to guarantee the integrity and proper functioning of its Internal Market.**

1. Introduction

This paper aims to give a first qualitative analysis of the economic effects expected from the European Neighbourhood Policy (ENP). The main focus is on the neighbouring countries (NCs), which are small economies compared to the EU, and for which the economic effects should be more significant. A quantitative analysis of the effects will be possible once the ENP instruments - notably the Action Plans - are fully deployed and implemented. The article identifies also a number of conditions for successfully implementing the ENP and maximising its potential to bring about economic growth and stability in the EU neighbourhood.

The paper is organised as follows: section two offers a brief overview of the ENP's political context and describes the Action Plans, which are its main implementing instrument. Section three presents the constituent elements of the policy on the economic front. Section four discusses the potential economic effects of the ENP in three main areas: enhanced trade preferences, participation in the EU Internal Market and support for sound macroeconomic policies. Sections five and six discuss the potential for the ENP to foster reforms in neighbouring

[1] This paper was prepared by Michaela Dodini, Marco Fantini and José Leandro as part of a wider research project on the ENP. A forthcoming article by the Michaela Dodini and Marco Fantini on "The EU Neighbourhood policy: implications for economic growth and stability" will discuss in more detail the potential risks associated with the implementation of the ENP.

countries and the conditions for its successful implementation. The last section recapitulates and draws some policy conclusions.

2. Background to the European Neighbourhood Policy

The ENP, initially known as "Wider Europe", was launched in 2003 as an ambitious framework for relations between the EU and the countries in its vicinity.[2] The countries covered by the policy include the EU neighbours to the east (the Western New Independent States[3] and the South Caucasus countries[4]) and those on the southern and eastern Mediterranean shores (the EU Mediterranean partners[5] and Libya).

Box 1. State of play –April 2005

After the launch of the ENP in 2003, implementation has now begun. Following the issue of a European Commission Strategy Paper and of Country Reports for a first group of seven neighbours (Moldova, Ukraine, Morocco, Tunisia, Jordan, Israel and the Palestinian Authority)[6] in May 2004, ENP Action Plans were negotiated and finalised with this first group of countries over the course of the year.[7] These Action Plans were adopted by the European Council in February and will formally enter into force upon approval by the competent authorities in the neighbouring countries (as of April 2005 approval had already been granted in some countries -Israel, Moldova and Ukraine- and the others should follow in the course of 2005). For each country, the Action Plan identifies a set of jointly agreed measures to be implemented by each party over the next three to five years. Implementation of the Action Plans will be monitored through various sectoral sub-committees. It is envisaged that Action Plans will be updated every 2-3 years, as required.

In March 2005 Country Reports were prepared for a second wave of neighbour countries (Egypt, Lebanon, Armenia, Azerbaijan and Georgia). Subject to agreement by the European Council, these Country Reports will be followed by the negotiation of Action Plans during 2005. Preparations have also advanced on the European Neighbourhood and Partnership Instrument (ENPI), the financial assistance arm of the ENP. In September 2004 the Commission submitted to the Parliament and Council a draft regulation establishing the ENPI with an allocation of nearly EUR 15 billion for the budget period 2007-2013. This is nearly double the amount that was available to NCs for 2000-2006 under the MEDA and TACIS budget lines.

Building on existing agreements between the EU and its neighbours[8], the ENP aims to move from traditional trade and cooperation toward closer political, social and economic integration, but excludes accession. The assumption is that greater interdependence, and the reforms that it entails, can promote peaceful, co-operative and lasting relations in the EU neighbourhood -a "ring of friends". The ENP was thus conceived as a way of "externalising" some of the benefits

[2] European Commission (2003), Communication from the Commission to the Council and the European Parliament, "Wider Europe – Neighbourhood: A New Framework for Relations with our Eastern and Southern Neighbours", Reference: COM (2003) 104. Two Council Conclusions have been adopted on 16th June 2003 and 13th October 2003.

[3] Belarus, Moldova and Ukraine.

[4] Armenia, Azerbaijan and Georgia.

[5] Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and the Palestinian Authority. The remaining Mediterranean partners are not covered by the ENP: Cyprus and Malta have joined the EU in May 2004 and Turkey is a recognised candidate country.

[6] These countries were selected from the neighbours with which the EU already maintained an advanced level of relations - notably those with whom an Association or Cooperation Agreement had been signed and ratified - since these provide the necessary legal and institutional framework for intensified cooperation.

[7] The Action Plans were approved and published by the Commission in December 2004.

[8] Partnership and Co-operation Agreements in the case of Armenia, Azerbaijan, Georgia, Moldova and Ukraine and Association Agreements in the case of the Mediterranean partners. Belarus' PCA agreement with the EU is currently frozen.

of participating in the EU -in terms of stability, peace and prosperity- without however entailing membership.[9]

The ENP has the ambition to be more effective in promoting growth and prosperity in the neighbourhood than existing agreements between the EU and these countries, and reflects geopolitical developments at the onset of the 21st century. Ten years after its launch, it has become clear that the Euro-Mediterranean Partnership has not reached all its objectives and in particular has not led to the hoped-for catching up of Mediterranean living standards with those of the EU.[10] The 2004 enlargement also made it necessary to revise the EU framework of relations with the new neighbours to the east. In particular, the ENP is an attempt to respond to the fears that, following enlargement, a "fortresses Europe" would emerge. A number of neighbours expressed concerns about a possible diversion of trade flows, a decrease in EU financial assistance and a loss of privileged relations with countries in central and eastern Europe that were joining the EU. Finally, as successive enlargements have confirmed the EU as the main political and economic player on the European continent, this role requires it to be more involved, and more pro-actively so, in its immediate neighbourhood.

The main instruments for the implementation of the ENP are the so-called Action Plans. Negotiated and agreed jointly by the European Commission (on behalf of the EU) and the authorities of the participating countries, the Action Plans identify a number of specific measures to be undertaken by each party. Based on the assessments carried out in the Country Reports, the specific measures laid out in the Action Plans relate to all key areas of EU-neighbourhood relations: political dialogue and reform; economic and social reforms and development; trade, regulatory and institutional measures preparing neighbours to progressively participate in the EU Internal Market; justice and home affairs; energy, transport, information society, environment and research and innovation; social policy and people-to-people contacts.[11] Financial and technical support for implementing these measures and achieving the ENP objectives is to be provided by the European Neighbourhood and Partnership Instrument.

3. The ENP economic proposition

The ENP covers a wide range of policy issues. With specific reference to the economic field, the focus of this article, the ENP envisages the gradual reinforcement of economic integration between the EU and its neighbours through a number of measures:

a) ***enhanced trade preferences***, which could lead in the medium run to Free Trade Areas (FTA) in some cases. This is particularly relevant for the EU eastern neighbours which, unlike its neighbours in the Mediterranean, do not benefit from free trade agreements with the EU. However, Mediterranean countries are also set to benefit from improved market access to the EU if trade in agriculture is included in existing FTAs and accompanied with the reduction of EU agricultural export subsidies. In addition, the liberalisation of trade in services has the potential to yield considerable economic benefits for all NCs.

[9] While successive EU enlargements have been a powerful instrument of political and economic stabilisation, enlargements beyond those already foreseen are unlikely for the time being.
[10] The difficult political and security situation in the region, the unfavourable domestic political economy environment for reforms and vulnerability to external shocks also contributed to dragging down economic performance in the region.
[11] See http://europa.eu.int/comm/world/enp/pdf/strategy/Strategy_Paper_EN.pdf .

b) in the medium-term, ***the prospect of NCs participating in the EU Internal Market,*** subject to progress in legislative and regulatory convergence toward the *acquis communautaire*.[12] This is the most novel element of the ENP proposition in the economic area. The EU neighbours are effectively invited to participate, albeit progressively, in the EU area of free movement of goods, services and factors of production, i.e. the cornerstone of EU economic integration.[13] It will require a major upgrade of NCs institutions on EU standards, a process that in most cases is expected to take years.

c) greater emphasis on ***sound macroeconomic policies and steady progress of structural reforms*** in the NCs. In order to be successful and beneficial for both parties, high levels of economic integration and interdependence need to rely on macroeconomic policies promoting economic growth and stability. They also require progress by NCs in the transition towards fully functioning market economies supported by sound institutions, so that they are able to withstand the competitive dynamics brought about by closer integration with the EU.

d) ***improved interconnection with the EU*** in sectors such as energy, transport and telecommunication, and the possible participation of NCs in selected EU programmes (such as research and education).

e) implementation of the Action Plans and the achievement of their priorities will be supported by ***increased and enhanced financial and technical assistance*** through a single, dedicated European Neighbourhood and Partnership Instrument (ENPI) from 2007. The European Commission has proposed to endow the ENPI with more financial resources than current allocations for financial assistance to the neighbourhood. The ENPI should also bring about efficiency gains by replacing existing separate budged lines.[14] Priorities for assistance for each NC will be drawn from the Action Plans, ensuring closer links between EC financial and technical assistance and the ENP strategic goals.

The prospect of closer economic ties is not a one-sided, uniform offer from the EU to its neighbours: the ENP is founded on the key principles of joint ownership, partnership and differentiation. The objectives and implementation modalities specified in the ENP Action Plans are negotiated and agreed jointly by the EU and the neighbours' authorities. Privileged economic relations will be built up gradually, on the basis of progress made in implementing the priority measures of the Action Plans and the respect of common values in the fields of the rule of law, good governance, human rights, and of market economy and sustainable development principles. Finally, the level of ambition with regard to the strengthening of relations varies from one neighbouring country to the other, depending on how far the common values are shared, as well as each side's interests and capacities.

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[12] The *acquis communautaire* is the totality of rights and obligations applicable to all EU member states; it includes all regulations and directives in their present form adopted by the EU. The Internal Market *acquis* is part of the *acquis communautaire* and includes all legislation covering the free movement of goods, services, capital and people.

[13] Given its sensitivity, the liberalisation of capital and labour movements with the EU neighbours is, for most NCs, a rather long term goal.

[14] Notably, the TACIS and MEDA geographical budget lines and a number of thematic programmes covering the EU neighbouring countries. Although Russia did not wish to be involved in the institutional set up of the ENP, the ENPI will also support the development of the EU-Russia strategic partnership through the creation of four common spaces. The ENPI will also facilitate cross-border programmes bringing together regions of EU Member States and ENP countries.

4. The expected economic effects of the ENP

Overall, the economic policy measures foreseen by the ENP have the potential to stimulate investment and growth in the NCs. This paper focuses on the first three measures identified above, namely a) the enhancement of preferential trade relations, b) the prospect of NCs' gradual participation in the EU Internal Market and c) greater emphasis on sound macroeconomic policies. Although not dealt with in this paper, improved energy, transport and IT interconnections between the NCs and the EU, as well as the participation in a number of Community programmes and enhanced financial assistance through the ENPI are also clearly expected to generate positive economic effects for NCs.

4.1. Enhanced trade preferences

The enhancement of reciprocal trade liberalisation under the ENP should further reinforce the existing close trade relations with the EU.[15] Indeed, the EU is in almost all cases the first trade partner for ENP countries and its share in their total trade has grown further with the 2004 enlargement (Table 1). The extent of the welfare gains from further trade liberalisation will depend on the degree to which the ENP effectively reduces tariff and non-tariff barriers to trade in those sectors that are important for the NCs. Undoubtedly, the economic impact will be stronger if greater market access for services and agricultural products is included.

Table 1: Share of trade with the EU-15 in the ENP countries (2003)

	Exports to EU15 as % of total exports (rank)	Imports from EU15 as % of total imports (rank)
Algeria	60.0 (1)	64.7 (1)
Armenia	44.6 (1)	32.5 (1)
Azerbaijan	72.7 (1)	33.9 (1)
Belarus	35.9 (2)	21.8 (2)
Egypt	42.4 (1)	36.5 (1)
Georgia	17.2 (3)	37.8 (1)
Israel	28.7 (2)	42.6 (1)
Jordan	3.4 (8)	27.3 (1)
Lebanon	19.3 (1)	56.0 (1)
Moldova	26.7 (2)	36.1 (1)
Morocco	71.2 (1)	58.2 (1)
Syria	49.8 (1)	32.9 (1)
Tunisia	81.0 (1)	72.4 (1)
Ukraine	32.7 (1)	32.3 (2)

Source: European Commission (2003), DG TRADE, I-Centre Database

The welfare gains associated with the ENP proposition of enhanced trade relations are potentially large. These will differ across the ENP region and across types of traded goods due to different tariffs applied (Table 2).[16] The EU eastern neighbours presently still face some tariffs

[15] It should however also be noted that most NCs are pursuing several trade liberalisation initiatives, regionally or on a bilateral and multilateral basis, which may affect trade patterns and EU relations. Several Mediterranean countries have concluded regional free trade agreements between themselves. Furthermore, some countries have bilateral trade agreements with the US. In the East, Russia, Ukraine, Kazakhstan and Moldova have established a Single Economic Space. A number of NCs are WTO members or in the process of acceding to it.

[16] The data supplied here should be interpreted with caution. Calculations of tariff levels are complex and often yield different results in the theoretical literature. Also, simple averages may not fully reflect tariff escalation and tariff peaks used in some cases. Moreover, the WTO reports no data on specific duties, which are usually comparatively

on their exports of **manufactured goods** to the EU and apply MFN treatment on imports from the EU.[17] To the extent that it would lead to greater and more stable market access (for example in the context of a future FTA), the ENP proposition of enhanced trade relations is therefore highly relevant to them, and the potential welfare gains may be significant as NCs' tariffs on imports from the EU are currently high. Additional benefits are expected to result from the dynamic efficiency gains brought about by increased competition. The impact on the Mediterranean neighbours is likely to be more limited, as these countries already enjoy duty-free and quota-free access to EU markets for industrial products, and as the establishment of the Euro-Mediterranean Free Trade Area is progressing.[18] Notwithstanding the benefits of tariff reductions, NCs' ability to benefit from improved market access to the EU will also depend on the effective removal of other constraints, including non-tariff barriers, and the simplification of the rules of origin.[19]

Table 2: Tariff level in selected ENP countries (%)

	Simple average of applied *ad valorem* duties (all goods)	Simple average of applied *ad valorem* duties (non-agricultural goods)	Simple average of applied *ad valorem* duties (agricultural goods)	import duties collected as % of total merchandise imports[1]	Trade-to-GDP ratio (2001-2003)[2]
EU-15	4.2	4.0	5.9	n.a.	26.2
Armenia	3.0	2.3	7.2	n.a.	77.3
Azerbaijan	8.7	8.1	12.7	4.4	95
Belarus	10.0	10.1	9.0	0	136.6
Egypt	19.9	19.4	22.8	18.7	41.6
Georgia	10.6	10.4	11.9	3	72.7
Israel	5.6	4.0	15.9	0.9	77.5
Jordan	13.1	12.1	19.8	7.3	113.3
Lebanon	5.4	4.0	14.7	8.4	n.a.
Moldova	4.9	4.1	10.3	1.6	132.3
Morocco	30.2	27.5	48.6	16	69.6
Syria	19.6	19.4	21.3	36.4	68.4
Tunisia	28.6	22.1	70.4	6.3	96.2
Ukraine	7.0	6.8	10.8	2.3	110.1

Source: WTO (2003), Statistics Database

1 2000-2002 except for Azerbaijan (1997-99), Egytp (1995-97), Morocco and Syria (1997-99)

2 except for EU-15 (1998-2000), and Israel (2000-2002)

Standard trade theory holds that the welfare gains from free trade should be weighted against the costs of possible trade diversion associated with the reorientation of trade towards ENP participants. These will depend on the intensity of NCs' trade with the EU and the level of initial tariff protection. This effect may be stronger for those NCs that do not trade predominantly with the EU.

higher than *ad valorem* duties. Finally, tariffs represent often only one aspect of protection; other aspects, such as rules of origin or antidumping investigations, may in some cases act as deterrents to trade.

[17] Although most exports qualify for the EU Generalised System of Preference (GSP), tariff protection remains on EU imports of sensitive products (e.g. chemical products, wood and metals).

[18] Association Agreements have already been concluded with all Mediterranean partner countries (initialled in the case of Syria). They confirm free access to the EU market for manufacturing goods and allow for improved access in agriculture, while providing for the gradual removal of barriers on imports from the EU over a transition period of (usually) 12 years.

[19] As an illustration, the growth impact of the 2004 EU accession round may provide an indication of the maximum benefits from trade liberalisation. The Wim Kok (2003) report on the enlargement of the EU estimates the trade-induced economic benefit from EU membership between 1.5% and 8% of GDP for the accession countries and at 0.2% for the EU-15. A quantification of the possible effects of the ENP would require further research once the details of the policy implementation are known.

Across the ENP region, trade in **agricultural products** is currently subject to a higher level of tariff protection than trade in manufactured goods. Agricultural exports from the Mediterranean countries to the EU enjoy some level of preferential treatment in the form of tariff quotas (some of which is duty-free) negotiated in the framework of the Euro-Mediterranean Association Agreements.[20] On the other hand, eastern NCs do not benefit from an EU preferential scheme in agricultural trade and in some instances face relatively high tariff barriers (as these products are in most cases excluded from preferences under the GSP). Mediterranean and eastern NCs also protect their domestic agricultural sectors from external competition.

Table 3: The agricultural sector in the NCs (2002)

	Agriculture in % of GDP	Rural population (%)
Algeria	10.0	41.7
Armenia	26.2	32.6
Azerbaijan	15.5	48.1
Belarus	10.9	30.3
Egypt	16.8	57.2
Georgia	20.6	43.2
Israel	n.a.	8.1
Jordan	2.2	2.1
Lebanon	11.7	9.7
Libya	n.a.	11.8
Moldova	24.1	58.0
Morocco	16.1	43.3
Syria	22.6	49.7
Tunisia	10.3	33.2
Ukraine	15.3	31.9
West Bank & Gaza	6.3	n.a.

Source: World Bank development indicators (2004)

Clearly, the positive impact of further market access to the EU will largely depend on the extent to which trade in agricultural products will be liberalised and whether it will be accompanied with further reductions in EU agricultural subsidies.[21] Agriculture is a key sector for most NCs, both in terms of GDP share and rural population (Table 3). Lower tariff barriers could lead to increases in NCs' imports of EU agricultural goods in specific product ranges and countries. Overall, however, liberalisation is likely to result in a boost to NCs' net exports as the agricultural sectors of many NCs are highly competitive in terms of unit costs compared to the EU. Given the large size of the EU market, even a modest degree of opening may lead to a substantial rise in NCs export levels and, given the high share of agriculture in GDP, to higher living standards.

Liberalisation of trade in **services** has also the potential to yield considerable economic benefits to the NCs.[22] The improvements in information and communication technologies have

[20] The main imports from Mediterranean countries compete directly with EU and are produced and marketed during the same seasons. The most sensitive of these products are also subject to an entry price system designed to stabilise prices during their marketing period in the EU.

[21] At least on the side of the Mediterranean, the Euro-Med Ministers of Foreign Affairs meeting in the Hague (November 2004) confirmed progress in the strategy for accelerating the liberalisation of trade in agriculture, which should lead to Ministers agreeing on measures for reciprocal agricultural trade liberalisation -including a specific roadmap.

[22] In the Mediterranean region, Euro-Mediterranean Trade Ministers endorsed a Framework Protocol on trade in services at the conference of Istanbul in July 2004. This Protocol will constitute the basis of negotiations on trade in services. As of April 2005 the Commission was preparing to open negotiations with interested Mediterranean

significantly facilitated the international provision of services, and their benefits have yet to be fully realised. Although only a limited portion of services is tradable, the benefits from services trade liberalisation are widely recognised: greater competition leads to efficiency gains in both the service sector itself and all other sectors of the economy relying on services as an input. This is particularly relevant for the liberalisation of "backbone" services such as financial services, energy and telecommunications.[23] For those services involving direct commercial presence, liberalisation entails FDI flows and generates employment in the recipient country. In most NCs, services are an important, often the main, contributor to GDP (Table 4). Liberalisation of service sectors is particularly important for NCs given their background of traditionally inefficient and/or underdeveloped services.

Table 4: Services (as % of GDP, 2002)

Algeria	37.3
Armenia	40.9
Azerbaijan	35.3
Belarus	51.2
Egypt	50.2
Georgia	57.3
Israel	n.a.
Jordan	74.6
Lebanon	67.3
Libya	n.a.
Moldova	50.7
Morocco	52.8
Syria	49.4
Tunisia	60.5
Ukraine	43.8
West Bank & Gaza	80.4

Source: World Bank countries at a glance (2004)

Within the service sector, international trade in financial services involves particularly sensitive issues. Although this is one of the cornerstones of a functioning market economy, historically financial markets have tended to be one of the last areas in which steps were taken towards integration, even in the EU, owing to the complexity of regulatory issues, the high potential for financial destabilisation and issues of national sovereignty over a key sector. Even now, the EU Internal Market for financial services has not been fully achieved.[24] The liberalisation of trade in financial services between the EU and most of the NCs is thus likely to be a long-term objective. The EU regulatory framework for financial services is sophisticated, building on highly developed regulatory and supervisory systems at national level and mutual trust among market participants, and is not immediately suitable for low- to middle-income countries with a weak regulatory capacity.

countries with a view to concluding agreements on services and investment. For all Mediterranean ENP countries, negotiations on trade in services and investment are mentioned as short term goals in all Action Plans.

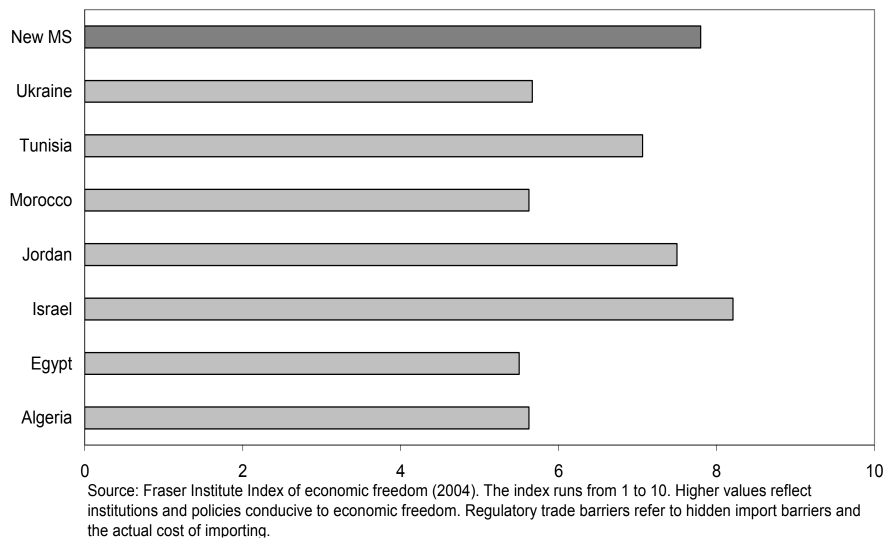
[23] Müller-Jentsch, D. (2004), "Deeper Integration and Trade in Services in the Euro-Mediterranean Region: Southern Dimensions of the European Neighbourhood Policy", Draft Paper, PPMI, January.

[24] The so-called Financial Services Action Plan was launched in 1999 as an ambitious and wide-ranging set of integration and regulatory measures with the purpose of co-ordinating the minimum requirements for the different type of institutions and create equivalent standards. However, common or equivalent rules are only a first step, and need to be complemented by converging regulatory and supervisory practices in each Member State.

4.2. NCs' gradual participation in the EU Internal Market

For the first time, the ENP opens the prospect for the participation in the EU Internal Market to non-European countries of a lower development level, subject to progress on legislative and regulatory convergence toward the *aquis communautaire*.[25] In most cases, this will be a very gradual process that will materialise only in the medium to long run, but it is definitely the most novel element of the ENP in the economic front, and is both an opportunity and a challenge.

Deepening market access



The non-alignment on Internal Market legislation (e.g. standards and conformity assessment) represents in some cases significant non-tariff barriers to exports toward the EU. Their removal through legislative and regulatory convergence will reduce trading costs and positively affect NCs' export potential to the EU.[26] At the same time, alignment on Internal Market rules should entail a decrease in NCs' levels of behind-the-border protection, with potentially large efficiency gains from more liberal economic regimes. Indeed, NCs currently display a number of regulatory barriers to trade, usually higher than those found in new EU Member States (Chart 1). In general, adopting the EU *acqui*s, or at least converging on some key principles, should reduce uncertainty and transaction costs between the EU and its neighbours, promote economic efficiency and facilitate economic transactions.[27]

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[25] The possibility for non-EU members to participate in the EU Internal Market is in itself not new, but has so far been reserved for the highly developed neighbours of the EU. Norway, Iceland and Liechtenstein have participated in the Internal Market since 1994 via the European Economic Area (EEA). Switzerland has concluded a number of agreements in specific areas of the Internal Market.

[26] Full integration in the Internal Market for industrial products requires the full implementation of Internal Market legislation in the so-called harmonised sectors and the application of the principle of "mutual recognition" for non-harmonised sectors. The former requires negotiating trade agreements on specific sectors with the NCs. In non-harmonised areas, the ENP foresees actions to remove discrimination against imported products and to improve exchange of information about applied and planned regulations. The ENP also encourages NCs to use European and international standards. However, it will probably take decades before the level of trust needed to make mutual recognition work is achieved.

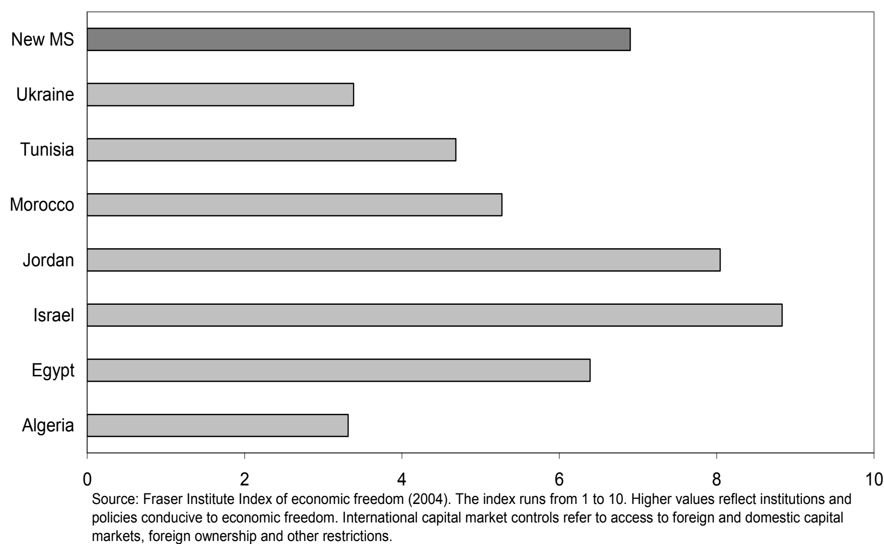
[27] In the Mediterranean, work to harmonise technical legislation is already in progress based on the Euro-Mediterranean Trade Ministerial Conference in Palermo (July 2003). After having identified with each Mediterranean partner the priorities for legislative alignment, work is under way on legislative approximation,

If the ENP succeeds in effectively involving most NCs and if it covers a substantial part of the *acquis*, participation in a common regulatory space may also facilitate regional integration between the neighbours themselves. Subscribing to a common set of rules, or at least to some common basic standards, should remove some of the non-tariff trade barriers that currently hamper economic integration at the regional level. In this, the ENP could complement regional trade liberalisation initiatives such as the Agadir Agreement among some Mediterranean countries and the Single Economic Space to the East.[28]

Liberalising trade in factors

Internal Market rules provide for the liberalisation of movement of factors of production (i.e. capital and labour) in addition to the free movement of goods and services. However, given its sensitivity, the liberalisation of factor movements between the EU and the NCs should be seen only as a long-term goal. In particular, liberalisation of **capital movements** has the potential for large efficiency gains, provided it takes place within a sound macroeconomic environment. It leads to efficiency gains in the allocation of savings, increases access to foreign markets in order to finance trade and investments, expands the opportunities for portfolio diversification, and enhances the efficiency of the financial markets by exposing them to increased competition.[29] The liberalisation of long-term capital movements allows foreign direct investments, usually a vehicle for technological transfers and efficiency improvements. Many NCs still display relatively high levels of control with regard to international capital movements (Chart 2), and thus the benefits to be reaped from liberalisation are potentially significant.

Chart 2: International capital market controls (2002)



Source: Fraser Institute Index of economic freedom (2004). The index runs from 1 to 10. Higher values reflect institutions and policies conducive to economic freedom. International capital market controls refer to access to foreign and domestic capital markets, foreign ownership and other restrictions.

However, in view of the high mobility of capital, the liberalisation of the capital account is more sensitive than that of trade in goods and services, and must be accompanied by sound policies

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regulatory and infrastructure upgrading. Once the alignment effort is accomplished and equivalent legislation in place, Agreements on Conformity Assessment and Acceptance (ACAAs) of industrial products will be negotiated wherever possible, establishing regulatory 'trade corridors' to the benefit of economic integration.

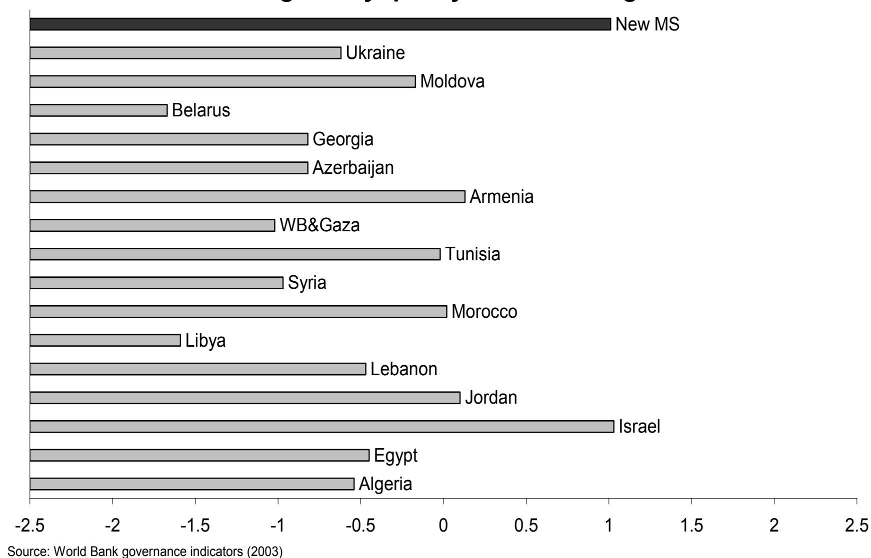
[28] The Agadir Agreement provides for free trade between Egypt, Jordan, Morocco and Tunisia. It still awaits ratification by some of the signatories in order to enter into force.

[29] François, J. F. and L. Schuknecht (1999), "Trade in Financial Services: Procompetitive Effects and Growth Performance", *CEPR Discussion Paper*, No. 2144.

and institutions in order to minimise the risk of financial and macroeconomic turbulence.[30] For the foreseeable future, NC's financial and capital markets will remain much less deep than the EU's, so that there is a potential for destabilising capital flows. Therefore, any ENP commitment in this area will have to be assessed on a case-by-case basis. For the long term, some principles have been identified as crucial for an orderly and welfare-enhancing liberalisation of capital movements. They emphasise the importance of macroeconomic stability, the choice of an appropriate exchange rate regime and sound financial markets and institutions. The proper sequencing of capital liberalisation and other reforms is also very important for the success of liberalisation. In most cases it is desirable to liberalise long-term flows, especially FDI flows, before short-term flows.

The extent to which the ENP will bring about **free movement of labour** is still unclear, as both the wording of the Commission Communication and that of the Council Conclusions endorsing it are rather cautious.[31] The prospect of large-scale liberalisation of workers' movement from the NCs to the EU is politically very sensitive. Nevertheless, the issue of economic immigration is a long-term one and political orientations may well evolve over the period of ENP implementation. A (partial) liberalisation of movements in labour between the EU and the NCs would be in line with recent trends in migration, which have seen a sharp increase in the number of NC nationals taking up residence in the EU. Increased immigration could help address the problem of population ageing in the EU, while diminishing the demographic pressure on the labour market in those ENP countries with high population growth, i.e. the Mediterranean NCs.

Promoting a pro-growth regulatory environment



The adoption of parts of the *acquis communautaire* could result in a growth-enhancing upgrade in the regulatory environment. A comparison between the regulatory environment of NCs and the new EU Member States, which had to transpose the *acquis communautaire* into their national law as a prerequisite for joining the EU, can provide useful insights. Chart 3 reports the scores obtained by NCs on an indicator of regulatory quality based on World Bank governance research. The chart shows a clear positive difference between the overall scores of new EU

[30] A recent discussion of these issues is found in Karacadag, C., V. Sundarajan and J. Elliott (2003), "Managing Risks in Financial Market Development: The Role of Sequencing", IMF Working Paper, No. 03/116, June.

[31] The Commission Communication refers to "perspectives for lawful migration and movement of persons", the Council conclusions of 16th of June 2003 to "enhanced co-operation on matters related to legal migration".

members and those of NCs, suggesting that adopting the EU *acquis* would represent an improvement over the current regulatory environment.

Finally, there is broad consensus on the key role played by EU accession in fostering structural reforms.[32] By offering to NCs the prospect of participating in the EU Internal Market, the ENP may therefore be seen as a way of spreading the benefits of the EU accession process beyond the current circle of eligible countries. Nevertheless, the ENP cannot be a substitute for domestic commitment to reforms. The ENP will only be successful if the basic political economy conditions and a national agenda of reform are in place.

4.3 Greater emphasis on sound macroeconomic policies

Compared to existing agreements, the ENP Action Plans offer a more specific focus on sound macroeconomic policies. Issues such as fiscal consolidation, public debt, public finance management and monetary policy are typically covered in the jointly agreed Action Plans.

Although these commitments are less prominent than those concerning the Internal Market *acquis*, they are no less important as they anchor NCs' macroeconomic policies in a transnational framework. Apart from its beneficial growth impact, macro stability boosts the positive effects of liberalisation and is crucial to minimise the risks inherent to a higher level of integration with the EU Internal Market.[33] In particular, the liberalisation of financial flows needs to rest on sound macroeconomic policies to reduce the risk of financial turbulence. Economic liberalisation is also more likely to succeed if it takes place under conditions of satisfactory economic growth, as NCs can more easily bear possible costs of adjustment.[34] The degree of macroeconomic stability is therefore a key element determining the pace and level of NCs integration with the EU.

Table 5 gives a snapshot of the ENP area in terms of selected macroeconomic indicators. Notwithstanding country differences, most NCs have made remarkable progress in stabilising their economies and appear to be starting their economic integration with the EU from fairly favourable macroeconomic terms. However, macro imbalances remain in a number of countries. All countries in the region displayed positive growth rates in 2004, generally accompanied by moderate levels of inflation (except for Belarus, Egypt and Moldova where inflation was over 10%). Most neighbours recently managed to improve fiscal sustainability (except Lebanon), in some cases owing to favourable oil price developments, but some of them remain heavily dependent on foreign grants for redressing their fiscal balance net of foreign grants (e.g.

[32] The EBRD Transition Report 2003 notes that EU accession countries have outperformed other transition economies in terms of structural reforms. See European Bank for Reconstruction and Development (2003), *Transition Report 2003: Integration and Regional Cooperation*, November.
[33] Nsouli, S. M., M. R. Rached and N. Funke (2002), "The Speed of Adjustment and the Sequencing of Economic Reforms: Issues and Guidelines for Policymakers", *IMF Working Paper*, No. 02/132, August.
[34] See also Gupta, S., E. Baldacci, B. Clemens, E. R. Tiongson (2003), "What Sustained Fiscal Consolidation in Emerging Market Countries?", *IMF Working Paper*, No. 03/224, November.

Table 5: Key macroeconomic indicators of EU neighbouring countries (2004)

	Algeria	Armenia	Azerbaijan	Belarus	Egypt[1]	Georgia	Israel	Jordan	Lebanon	Libya est. 2003	Moldova	Morocco	Syria	Tunisia	Ukraine	WB&Gaza
Real GDP growth (% change)	5.5	10.1	10.2	11.0	4.4	8.4	4.3	6.0	4.0	9.1	7.3	3.5	3.2	5.6	12	3
Unemployment rate (% of workforce)	17	9.5	NA	1.9	10.7	12.7	10.4	12.5	NA	NA	8	10.4	12	13.9	NA	27.5
GNI per capita (USD)[2]	1890	950	810	1590	1390	830	16,020	1850	4040	3900	590	1320	1160	2240	970	1110
CPI inflation (%)	4	7	6.7	13.7	10	5.8	1.2	3.4	3.0	-2.1	12.5	1.5	5	3.8	9	3
Government balance (% of GDP)[3]	5.3	-1.3	1.3	0.0	-3.3	-1.8	-6.1	-13.4	-8.2	10.6	-1.5	-5.9	-2.7	-2.8	-4.6	-16.4
Public debt, gross (% of GDP)[4]	43.7	35	NA	9.0	120.8	47.8	107	92	178	25.2	41.2	66.4	NA	59.2	27.1	NA
External debt (% of GDP)[5]	24.7	31.3	17.5	3.3	44.2	36.8	60.8	67.4	166.0	NA	63.3	15.9	19.6	57.4	19.2	NA
Current account balance (% of GDP)	16.8	NA	-27.1	0.7	3.7	-7.5	-0.1	2.0	-12.1	13.2	-4.7	2.2	5	-2.1	10.5	-17.5
Import cover (months)[6]	23.7	4	2.8	0.6	9.9	1.9	6.1	6.5	9.9	22.1	2	10.7	9.4	2.9	3.8	NA

1 Fiscal year 2003/04 for Egypt
2 WB, Atlas method for 2003 except for Libya
3 Excluding grants except in Ukraine and Moldova, including Fonds Hassan II for Morocco and Price Stabilisation Fund for Syria. Central government balance for Algeria, Israel, Lebanon, Tunisia, WB&Gaza
4 2002 data for Algeria and Libya, domestic public debt for Libya, external public debt for Moldova
5 2002 data for Libya. External public and private debt for Moldova. Officially recognised debt for Syria.
6 Official reserves in months of imports of goods and non-factor services

Armenia, Israel and Jordan). On the external side, in 2004 most NCs were characterised by relatively sound current account positions (except for the large imbalance in Azerbaijan, Lebanon and West Bank and Gaza) and high levels of foreign currency reserves.

On the other hand, major challenges remain on the social front. The vast majority of neighbouring countries display very high levels of unemployment and in many cases low per capita income levels. Ensuring that the ENP project leads to improved living standards will be one of the benchmarks of its success.

5. The potential for a deeper reform process

The ENP has an explicitly strong reform content that matches the EU's increased ambition for the relations with its neighbours. Compared to the existing framework agreements between the EU and its neighbours, the ENP offers the potential of a greater catalytic role for structural reforms and sound macroeconomic policies. However, progress will continue to depend on domestic commitment to reforms. The ENP's potential catalytic role rests on the offer of a set of economic and political incentives and of a useful framework of reference to the NCs, by means of:

(i) An attractive offer. As discussed above, participation in the EU Internal Market has the potential to deliver substantial economic benefits to the NCs. The example of the European Economic Area, where countries have voluntarily given up sovereignty over market regulations to achieve full integration with the EU Internal Market suggests that there are considerable potential economic benefits associated with such a process. The prospect of participating in the Internal Market should thus provide positive incentives to NCs to subscribe to the ENP and carry out the necessary reforms. The same could be expected from the possible increase in EC financial cooperation and its closer targeting to ENP priorities. Nevertheless, these incentives cannot succeed in the absence of a domestic commitment to reforms. In addition, as explained below, the cost and difficulty for NCs in effectively implementing the *acquis* should not be underestimated.

(ii) Peer pressure. The neighbours' initial reaction to the ENP has been positive: only Russia, for specific reasons, has decided not to participate. The regional dimension of the ENP might generate political and peer pressure to carry and sustain the pace of reforms in order to avoid falling behind other participating countries which are moving closer to the EU.

(iii) External anchor. The ENP can support NC policymakers to undertake stability-oriented policies and structural reforms by referring to international agreements they have to adhere to. This may provide some help in overcoming short-term political economic constraints to reforms. However, it is not a substitute for a domestic reform agenda and progress will depend mainly on a national commitment to reform.

(iv) Package effect. The broad range of issues typically covered in ENP Action Plans allows for a "package effect" - proposals that would not be accepted in isolation find backing if they are bound together in a comprehensive package.

(v) A useful reference framework. For countries wishing to put in place a modern regulatory framework, the EU *acquis* can provide a useful reference framework, accompanied by a time table for implementation as well as monitoring mechanisms and technical assistance from the EU. At the same time, the differentiation provided for in the ENP framework offers the

advantage of preserving some flexibility with respect to which parts of the *acquis* to adopt, and when.

(vi) Socialisation. By promoting continuous and high levels of interaction between the EU and NCs at various levels (government, business, civil society), the ENP may be expected to induce some behavioural changes in the direction of Europeanisation, including convergence to the EU model, through lessons learning, model emulation, etc.

6. Making a success of the ENP

While the ENP has the potential to deliver substantial economic benefits, a number of considerations need to be addressed by policymakers both in the EU and the NCs, the main ones being listed below:

Supporting NCs' domestic reform agendas

The experience of the EC and other international donors in supporting economic reforms in the EU neighbourhood and elsewhere clearly show the limits associated with "buying reforms" through trade or other economic incentives. So while the ENP contains a number of economic and political incentives to carry out sound economic policies, it cannot be more than a catalyst for reforms, and not a trigger. Its success will thus very much depend on the existence of a conducive domestic environment for reform particularly given that the ENP, and especially the implementation of the Internal Market *acquis*, is a demanding and long-term endeavour that will require a sustained level of commitment to change.

In addition, it will be critical to ensure that commitments undertaken under the ENP are supportive of each NC's national development strategy. This would allow the ENP to serve NCs interests and to generate the expected economic benefits. In this context, it could also be useful to more systematically involve the main stakeholders beyond government and EU officials, such as the business sector, local governments and the civil society. This could have the additional advantage of improving the domestic political economy climate for reforms.

Keeping a balance between requests and incentives

In order to be effective in promoting reforms, each Action Plan should provide a balanced, coherent and properly sequenced package of requests and incentives. The ENP's success will depend on the extent to which the benefit of closer integration with the EU will outweigh the political and economic costs of meeting the benchmarks and conditions associated with such an integration. To succeed in the long run, the ENP should be concrete and ambitious and effectively cover a wide range of priority policy areas. In particular, the positive effects on NCs' economies would be significantly stronger should the ENP lead to greater market access in agricultural products.

Avoiding over-regulation

Greater legislative and regulatory convergence toward the EU Internal Market rules should not be goals *per se* but should only be pursued to the extent that they deliver tangible economic benefits to the NCs. The Internal Market consists of a very extensive body of legislation,

standards and regulations, often highly technical, which were not designed to be adopted by low-middle income countries such as most of the NCs. Many of the Internal Market provisions are certainly inappropriate, irrelevant, and may even be harmful for developing countries. Too hasty and extensive adoption of the *acquis* would risk saddling economic operators with compliance costs and divert scarce financial, technical and administrative resources away from higher priority tasks.

It is therefore essential to follow a pragmatic and realistic approach to the adoption of Internal Market rules. To optimise the cost-benefit balance from ENP participation, NCs must follow a proactive approach to adopting Internal Market rules, focusing as a matter of priority on those areas of the *acquis* that can deliver better market access to the EU.

Preserving the integrity of the Internal Market

Notwithstanding the above considerations, participation by NCs in the Internal Market must not lead to its de-fragmentation and unravelling of what has been achieved at a considerable cost in Europe over the last decades. Safeguarding the integrity of the Internal Market, particularly on issues of health and consumer protection, requires the effective compliance with the rules as well as a high level of mutual confidence. Any substantial failure to apply the common rules in any part of the Internal Market puts the rest of the system at risk. Thus, in order to preserve the integrity of the Internal Market and its benefits for current participants, the EU will not only have to ensure that NCs adjust their legislation to the *acquis* but also that they upgrade their supervisory and compliance power to effectively implement the rules.

Delivering on improved living standards

The capacity of the ENP to translate into visible improvements in living standards in NCs will be key to ensure its success. Empirical evidence shows that those countries that have embarked on a sustained process of transition toward market economies experience higher growth rates.[35] Greater trade openness, in particular, is generally associated with higher economic growth. However, the impact of trade and economic liberalisation on poverty and inequality depends greatly on the extent to which it is implemented as part of a broader development strategy that pays attention to vulnerable groups.[36] In particular, trade liberalisation can lead to noticeable shifts in the employment structure, with negative repercussions on some segments of the workforce in the short run. As the vast majority of NCs are lower-middle income countries and suffer from high unemployment rates, particular attention should be paid to these issues.

Anticipating and managing possible instability

The ENP is not, in itself, likely to create major risks of economic and financial instability. Liberalisation should be implemented gradually over the medium-long term, and can be tailored through negotiations to suit specific local conditions. Moreover, in the sensitive areas of capital and labour mobility, there are few or no short-term commitments. Nevertheless, closer integration to the EU may involve specific risks, including fiscal imbalances resulting from the

[35] European Bank for Reconstruction and Development (2004), *Transition Report 2004: Infrastructure*, November.
[36] Berg, A. and A. Krueger (2003), "Trade, Growth and Poverty: A Selective Survey", *IMF Working Paper*, No. 03/30, February.

loss of tariff revenues, and labour market disruptions. These risks will need to be anticipated and properly managed on a case-by-case basis.

7. Conclusions

The analysis contained in this paper shows that, in addition to its political significance, the ENP has the potential to deliver large economic benefits to neighbouring countries through enhanced trade preferences, deeper integration into the EU Internal Market and by playing a catalytic role for sound macroeconomic and structural policies. These benefits will add to those stemming from improved transport, energy and IT interconnection with the EU and increased technical and financial assistance. Overall, the ENP appears to offer "added value" compared to the existing framework of EU relations with NCs.

Nevertheless, in order for the ENP to succeed in the long run and deliver on its ambitions, a number of conditions need to be ensured during its implementation in both the EU and the NCs. While the ENP contains a number of economic and political incentives to carry out sound economic policies, it can be at best a catalyst for reforms, not a trigger. Its success will depend mainly on the existence of a conducive domestic environment for reform. Ownership of the ENP programme by the NCs and consistency with their development goals are also key to its sustainability and to the capacity to deliver actual benefits. In this respect it could be desirable to widen the scope of consultations to other stakeholders in the ENP, such as the business sector, local governments and civil society, who will ultimately bear the effects of liberalisation and closer integration with the EU. With specific reference to the Internal Market, choices will have to be made about where the greatest potential benefits for the NCs lie and about the proper sequencing of legislative approximation and other economic reforms. From the NCs' perspective, priority should be given to legal and regulatory approximation for greater market access to the EU.

The EU, for its part, should take care to manage the gradual integration of NCs in such a way as to preserve the functioning of the EU Internal Market and the benefits that accrue to its current participants. Both the NCs and the EU should take full advantage of the ENP principle of "differentiation" and keep a pragmatic, benefit-based approach to regulatory alignment.

Part B

Country Analysis

ALGERIA

- **Real growth was 5.5% in 2004, down from 6.9% in the previous year. Key growth factors were the increased hydrocarbon output and a rich harvest. The unemployment rate receded from September 2003 to 2004 by eight percentage points to about 17%, but this was mainly due to the creation of public sector jobs.**
- **The budget surplus (5.3% of GDP) remained almost unchanged in 2004. While hydrocarbon income stayed high, total government revenues decreased slightly, to 37.1% of GDP, due to a slower growth of non-oil revenue. Expenditure also decreased slightly because of cuts in current spending. Hydrocarbon income led to a new record current account surplus (16.8% of GDP) and foreign reserves increased to 24 months.**
- **Trade liberalisation is progressing. WTO membership is likely in 2005 and the EU-Algeria Euro-Mediterranean Association Agreement signed in 2002 is expected to be ratified in the first half of 2005. However Algeria has not yet embarked on regional trade integration (having not yet signed the Agadir Agreement).**
- **In other fields economic reform has been more timid. The dominance of inefficiently run state enterprises has stifled the tiny private sector. Moreover, abundant hydrocarbon revenues have been used to increase the number of public sector jobs rather than accompanying structural reforms to foster growth and sustainable employment.**

1. Macroeconomic developments

Real sector developments

In 2004 the Algerian economy kept growing at a strong pace (5.5%) thanks to large increases in crude oil and gas production coupled with high hydrocarbon prices, and a pro-cyclical fiscal policy which boosted demand. The hydrocarbon sector accounts for more than 40% of GDP and was therefore decisive in this strong growth. The oil and gas boom led to 8% growth in the industrial sector, whereas agriculture (+4%), manufacturing (+4%) and services (+5.2%) grew below average. In 2004 petroleum production alone expanded by 0.3 million barrels per day (b/d) to about 1.4 billion b/d.[1] In addition, new rich gas fields were tapped, in particular the massive “In Salah” field, which quickly reached its peak production of 9 billion cubic metres per year.[2]

The government reported a sharp decrease in the unemployment level from September 2003 to 2004 on the basis of a modified annual census. It showed a fall of eight percentage points to about 17%. This result is surprising, despite the strong growth rate, because the labour market is under serious demographic pressure.[3] The figures will therefore need further scrutiny. In addition the hydrocarbon sector is capital-intensive, relies on foreign experts, and is located very far from the labour-rich coastal area. The lack of skills and inefficient organisation of the resident labour force has even favoured the employment of foreign workers in the construction sector. However,

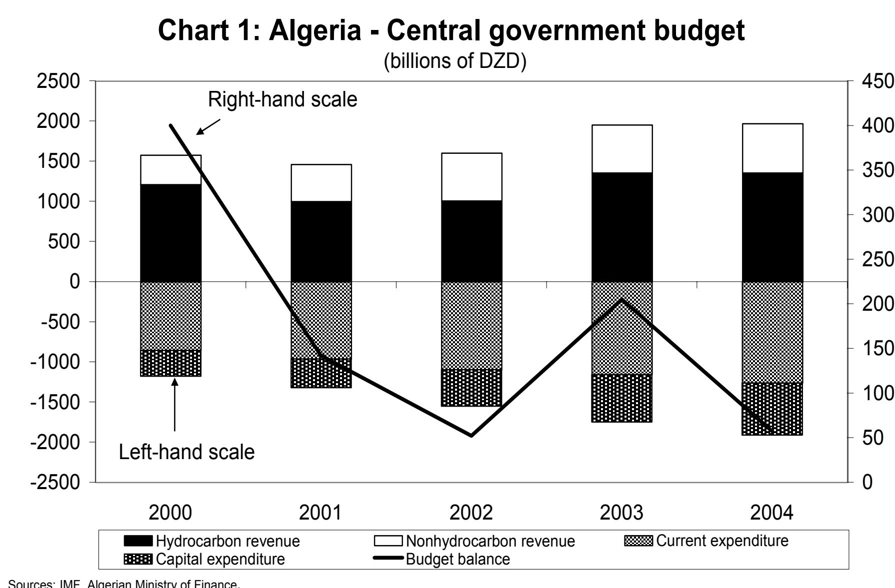
[1] Petroleum reserves increased by 0.6 billion b/d to 11.9 billion b/d. Source: EIU.
[2] Algeria is the largest natural gas provider to the EU.
[3] About 280 000 people every year, according to estimates, will enter the labour market over the next two decades.

the government continued to expand public sector employment, most likely in order to cope with the rapidly rising labour force.

In 2004 the average inflation rate rose to 4%, up from 2.6% in 2003. Inflationary pressures were fuelled by the depreciation of the dinar against the euro (Chart 2), increased government spending mainly before the April elections, and increased wage payments. Since most of Algeria's basic imports come from the EU, the exchange rate is of particular importance to price developments. The Algerian dinar, in line with the US dollar, depreciated substantially against the euro (by 13.7% from the last quarter of 2003 to the last quarter of 2004). Faced with strong capital inflows linked to hydrocarbon exports, the Central Bank succeeded to some extent in containing inflation by absorbing excess liquidity.

Fiscal policy

Current central government spending fell from 33.1% to 31.8% of GDP in the face of IMF warnings against procyclical spending, concerns about the size of the public sector, and doubts about the quality of capital expenditure. The reduction of current spending by 3.4% of GDP was partially offset by an increase in capital expenditure. Against the background of high non-hydrocarbon deficits, the authorities defended sustained high-level spending by reconstruction and social needs as well as efforts to support growth in the tiny non-oil sector. Non-hydrocarbon revenue fell by 1.3% of GDP despite the sale of the 3rd GSM (mobile phone) licence, while hydrocarbon income increased slightly to 26.4%, of GDP. This led to a small improvement in the budget surplus to 5.3% of GDP (up from 5.1% in 2003).



The abundant fiscal proceeds were partly used to repay debt in advance of maturity, mainly to Saudi Arabia and the African Development Bank. Consequently the public debt ratio fell to 43.7% of GDP (from 48.6% in 2003). The Fonds de régulation des recettes (a financial buffer fund created in 2000) was used to absorb some of the excess liquidity.[4] Finance Minister Benachenhou announced that the Regulation Fund was expected to reach a volume of DZD 640

[4] The Regulation Fund is made up of the difference in the actual oil price obtained for oil exports and the price of oil expected in the budget. The receipts of the Regulation Fund are largely utilised to pay off foreign debt.

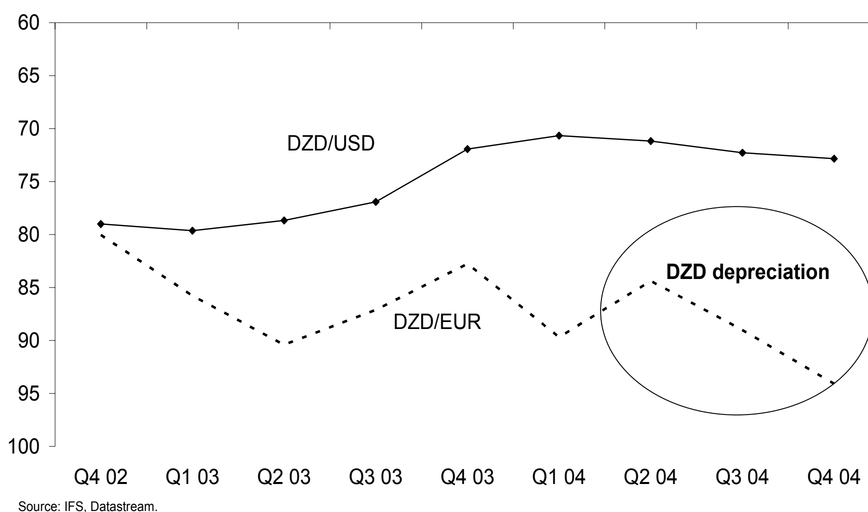
billion (USD 8.9 billion, 10.8% of GDP) in 2004. All in all, public finances, like the economy in general, continued to depend strongly on hydrocarbon revenue, which accounted for more than 71% of total fiscal revenue (Chart 1).

The non-hydrocarbon (NH) primary balance deficit expanded to a record high of almost 32% of NH GDP (up from 29.5% of GDP in 2003) because the pro-cyclical fiscal expansion was not backed by NH revenues. However, the October 2004 IMF Staff Mission reported that the 2005 budget law represented a turning point in the direction of government finances, reducing the NH deficit over the medium term gradually to a sustainable level. Furthermore, the government reported that it had started to replace the huge quasi-fiscal operations of state banks by direct subsidies which are included in the budget. Nevertheless, the authorities still need to address the problem of contingent liabilities in the local authorities and social security system.

Monetary and exchange rate policy

The continuing rapid expansion of foreign exchange reserves as a result of higher oil export proceeds kept liquidity growing at a rate which was not fully backed by economic activity. However, the authorities started to address the issue and mopped up some excess liquidity. In 2004 M2 grew by 15.8%; this is too high to keep inflation at bay. In addition, inflation was nourished by a considerable expansion of credit, in particular to loss-making state enterprises, which also endangers the soundness of the banking system.

Chart 2: Algeria - Exchange rate developments



Source: IFS, Datastream.

The Banque d'Algérie pursued a managed floating of the currency which is loosely linked to the US dollar, reflecting Algeria's almost exclusive dependence on hydrocarbon exports. It is committed to supporting non-hydrocarbon export competitiveness and maintaining a low-inflation environment. During the course of 2004 the currency depreciated slightly against the US dollar (by 1.3% comparing the last quarters of 2004 and 2003) but remained stronger than in 2003 (Chart 2). The dinar, in line with the US dollar, depreciated substantially against the euro (by 13.7% between the last quarters of 2003 and 2004). Against the fourth quarter of 2002 the depreciation against the euro was even more pronounced (-17.6%). In real trade-weighted terms the dinar actually appreciated by 1.6% in 2004 but the level reached was still far below the 2002 average.

External sector developments

Algeria's current account thrived in 2004 because of the expanding hydrocarbon output and high oil prices. It reached a record surplus of USD 12.7 billion, equivalent to about 17% of GDP, up from the already substantial surplus of 15% of GDP in 2003. Hydrocarbon products accounted for more than 96% of export earnings, while the tiny non-hydrocarbon export sector was supported by a depreciation of the currency, in particular vis-à-vis the euro. While the trade balance saw a large surplus of around USD 15.7 billion, up from USD 11.1 billion in 2003, the services and income balances continued to run deficits, which increased to USD 1.9 billion and USD 3.2 billion respectively. The greater profit repatriation of foreign companies was partially offset by growing income from Algeria's massive foreign assets. The surplus in the current transfers balance due to robust workers remittances increased to almost USD 2.2 billion.

In 2004 the current account surplus made it possible to reduce Algeria's debt ratios and fed a record expansion of foreign exchange reserves (USD 42.3 billion, almost 24 months of import cover). The capital account was dominated by debt repayments of about 4.2 billion USD, new medium-term and long-term debt of 1.8 billion USD and 0.4 billion USD of net direct investment. There was hardly any portfolio investment abroad and only small inward portfolio investment. Short-term capital flows remained low and consisted mainly of export credits. The external debt ratio improved further thanks to repayments of principal and high GDP growth. It decreased from 34.9% of GDP in 2003 to 24.7% of GDP in 2004. Almost all foreign debt is medium- and long-term debt. Nevertheless, Algeria's financial position is exposed because of its almost exclusive dependence on volatile hydrocarbon and agriculture revenues.

2. Structural reforms

The reform process has stalled again despite serious deficiencies in many sectors. 2004 saw hardly any progress. Reform policies to enable private sector activity, which is hampered by red tape, were conspicuous by their absence, and the financial markets remained underdeveloped and inefficient. Huge government windfall revenue created by the recent oil price increases removed any incentive for policymakers to reform while spurring public demands for consumptive expenditure. However, the reliance on capital-intensive oil and gas production, and the use of hydrocarbon revenues to serve political clienteles and to finance unproductive (mainly public service) jobs, should be gradually reduced in order to bring about sustainable growth and employment. There were some indications in the second half of 2004 that new reform initiatives might be considered, for instance in the government's new five-year economic programme.

Trade liberalisation

Algeria started active negotiations for WTO accession in 1996 and accelerated the pace in 2000 after the election of president Bouteflika. Previous hopes that Algeria could join in late 2004 were not fulfilled. The second quarter of 2005 now appears as a more likely date for WTO membership, according to WTO representatives.[5] WTO officials declared that Algeria needs to pay more attention to privatisation, trade in pharmaceuticals and international standards relating to investment. In general, diversifying the Algerian export sector, which is dominated by hydrocarbon commodities, is a long-term challenge.

[5] Source: www.menareport.com.

The Association Agreement with the EU, which was signed in April 2002 and ratified by Algeria in March 2005, will now enter into force, probably in the first half of 2005. The agreement envisages the creation of a free trade area by immediately granting duty-free access for industrial exports to the EU and gradually removing duties on industrial imports from the EU during a transitional period of 12 years (25% tariff reduction following the agreement's ratification, 40% after a seven-year period, and the rest after 12 years). Moreover, Algeria's regional integration could be improved by joining the Agadir Agreement signed by Morocco, Tunisia, Egypt and Jordan. This would allow a full exploitation of comparative advantages and reduce the risk of welfare losses due to trade diversion.

Fiscal and public administration reforms

On the fiscal front, key reforms that need to be addressed are the improvement of public finance management and gradual elimination of the quasi-fiscal role of state-owned banks. Losses incurred by public banks, mainly due to bad loans to public enterprises, averaged more than 4% of GDP each year from 1991 to 2002.[6] The huge expansion of public sector employment to accommodate the rapidly growing labour force is inefficient and can be sustained only because of the oil and gas revenues. Furthermore, it can choke off private sector initiative.

The 2005 budget marks a positive development by decoupling expenditure from volatile hydrocarbon receipts and preparing a gradual reduction of the currently unsustainable non-hydrocarbon deficit over the medium turn. Moreover, steps have been taken to modernise the management system of the budget and increase transparency in public finances with the support of the World Bank and the IMF. The authorities plan to disclose local as well as central government finance figures in the future. Moreover, they have started to include subsidies for loss-making state enterprises in the budget rather than relying on financing via state banks which have been compensated by treasury transfers circumventing parliamentary approval in the past.

Privatisation, enterprise restructuring and the business environment

Little progress has taken place regarding privatisation. Despite announcements in 2002 that hundreds of firms would be privatised, no action has followed. Almost 15 years after the declaration of intent to introduce a market economy, the government's non-oil industrial property still includes 28 holding companies, 674 enterprises, 8 industrial groups and 11 banks and insurance companies.[7] Against this background it is unclear what effect Prime Minister Ouyahia's new declaration of November 2004 will really have. He announced that 1 200 companies would be proposed for privatisation during 2005 and, while he did not give any details about which companies these would be, he did make clear that no strategic companies such as the energy company Sonatrach, the electricity and gas distributor Sonelgaz or rail companies would be sold.

Following President Bouteflika's sweeping election victory, the plan for a reorganisation of the oil and gas sector has been revived with his support. The hydrocarbons draft reform bill of 2001 might now come closer to realisation. Its main objective is to create a more competitive market and to separate the commercial and regulatory functions held by the dominating state-owned Sonatrach since the nationalisation of the oil industry in 1971. The bill provides for the creation of two agencies to take over Sonatrach's regulatory functions. The award and development of

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[6] International Monetary Fund (2004), *Financial System Stability Assessment*, Washington DC, May.
[7] European Commission Delegation (2004), *Algeria Economic Report 2004*, Algiers.

exploration and production contracts would fall under the auspices of a contracting authority (Al Naft). Another regulatory body would be responsible for technical, safety and environmental regulations, making recommendations for the award of pipeline concessions and applying regulations governing tariffs and freedom of access to pipelines and storage facilities. Both authorities would fall under the jurisdiction of the energy minister, who would ultimately authorise exploration and production contracts.

The process of liberalising the electricity and gas sector has progressed. In January 2002, parliament passed an electricity and gas law, ending the monopoly of Sonelgaz over the domestic electricity and gas markets, and clearing the way for the liberalisation of the sector by 2005. The bill provides for the opening of electricity generation to full private ownership and the establishment of a new regulatory body, the Commission for Regulating Electricity and Gas.

Indicators on the quality of the business environment show a serious need for reform in key areas of the economy.[8] Starting a business costs about half of the regional average but is more than three times higher than the OECD average. The rigidity of employment is significantly higher than in the region or the OECD countries. Moreover, the protection of investors is relatively low, and it costs almost twice as much as in the region as a whole to enforce contracts. In fact, observers describe the legal system as dismal, with inadequately trained magistrates, inefficient administrations, no access to the latest legal texts and a lack of respect for legal procedures. These factors help nurture an informal economy as large as 1/3 of GNI (2003), compared with 27.4% in the region.

Financial sector reforms

The financial system saw hardly any reforms in 2004. It is state-dominated with rather inefficient public sector banks accounting for more than 95% of total bank assets. In general, services and products provided by the banking sector are inefficient and underdeveloped. Moreover, financial intermediation consists mainly of lending, without sufficient credit risk assessments, to state-owned enterprises.[9] These soft loans are seldom repaid, so that the banks need regular refinancing by the government (see fiscal reforms section). In the past it has provided unconditional liquidity to public banks of as high as 50% of bank credit in 1998. This undermines the stability and efficiency of the banking system, and the periodical liquidity injections also disturb monetary policy. At the same time, limited access to credit puts severe constraints on private sector financing.

The tiny private sector consists of 15 private banks which have been licensed since 1998. The largest private bank went bankrupt in 2003 and, unlike the public banks, was not bailed out. The insolvency revealed supervisory deficiencies and damaged the public's trust in private banks. In its April Financial Stability Assessment the IMF recommended privatising the public banks over the medium term with the help of foreign investors, improving the banks' operating environment, cutting intermediation costs, and modulating the hydrocarbon-induced liquidity and credit cycles that curtail banks' risk-taking. The Fund also pointed out the necessity of asset diversification since Algerian banks have to deal mainly with two highly volatile sectors, agriculture and hydrocarbon. Focusing only on short-term and highly competitive export financing was not an adequate alternative.

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[8] World Bank (2005). Source : http://rru.worldbank.org/DoingBusiness.

[9] International Monetary Fund (2004), *Financial System Stability Assessment*, Washington DC, May.

The government's reform stance was clouded in the autumn by a Prime Ministerial order requesting public institutions, including social security, insurance and pension funds, to withdraw their assets from banks and deposit them with the State Treasury. It also ordered public entities to cease dealing with private banks. These decisions further undermined confidence in the frail banking system.

Labour market and education reforms

Without labour market reforms and with only modest education reforms in 2004, tackling unemployment remains a key challenge. The large informal sector of about 1/3 of GNI might reflect to some extent the inflexibility of employment regulations, entrenched resistance of unions, and the red tape that hampers businesses. Another major employment hurdle is the lack of qualifications even in such areas as the building sector. Despite high enrolment ratios, the illiteracy rate remained above 30%. However, youth illiteracy continues to fall (to about 10% in 2002). The EU supported Algeria's reform of the educational sector in 2004 with EUR 17 million, out of EUR 55 million total MEDA support.

Fostering non-hydrocarbon private sector development is also a necessary condition for reducing the high structural unemployment rate. However, only timid steps have been taken in this direction. The implementation of a strategic development programme which would allow a competitive non-oil industry to develop is a pressing need. This is underlined by the fact that the non-hydrocarbon industrial output of the large number of state enterprises contracted in 2003 by 1.3%, in contrast to the tiny private sector, where it grew by 5%, resulting in a total growth rate of 1.2%.[10] Compared with 1993, the manufacturing sector's relative size shrank by almost 50% to 7% of GDP in 2003.

[10] Ministère des Finances (2003), *La situation Économique et Financière en 2003*, Algeria.

ALGERIA

Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% change)	2.2	2.6	4.0	6.9	5.5
Real non-oil GDP growth (% change)	..	5.5	4.2	5.9	5.0
Inflation CPI (period average)	-0.6	4.2	1.4	2.6	4.0
GDP nominal, in USD billion	54.46	54.93	55.91	66.50	82.50
GDP per capita, in USD	1750	1730	1730	1990	2376
Social Indicators					
Unemployment	29.5	27.3	25.9	23.7	17.0
Youth literacy (% ages 15 - 24)	..	89.2	89.9	..	..
Adult literacy (% ages 15 and above)	..	67.8	68.9	..	..
Under 5 mortality rate, %	..	5.0	4.9	..	..
Fiscal Sector[1]					
Total revenues, % of GDP	38.5	34.9	36.0	38.2	37.1
Hydrocarbons, % of GDP	..	23.6	22.6	26.2	26.4
Non-hydrocarbons, % of GDP	..	10.9	13.4	11.9	10.6
Grants, % of GDP	..	0.4	0.0	0.1	0.1
Total expenditure, % of GDP	28.8	31.5	35.8	33.1	31.8
Govt. balance, % of GDP	9.7	3.4	0.2	5.1	5.3
Gross Public Debt, % of GDP	63.3	58.7	57.5	48.6	43.7
Monetary sector					
Private Sector Credit (% change)[2]	-13.6	..	62.7	6.9	..
Private Sector Credit as % of total credit	..	20.5	29.8	32.6	..
Broad money (M2), % y-o-y	13.2	22.2	17.4	15.6	15.8
Degree of Monetisation (M2/GDP, %)	49.4	58.4	65.2	65.2	65.5
External sector					
Current account balance, % of GDP	16.8	15.6	10.1	15.1	16.8
Trade balance, % of GDP	20.0	14.7	9.9	14.7	16.7
Foreign direct investment, net, % of GDP	0.4	1.2	1.0	0.6	0.4
Import cover (months)	12.2	18.1	19.1	24.3	23.7
External Vulnerability					
External Debt, % of GDP	46.4	41.1	40.5	34.9	24.7
Debt Service Ratio[3]	19.9	22.1	21.1	16.1	15.0
Gross official reserves (USD billion)[4]	11.9	18.0	23.1	32.9	42.3
Broad money to reserves, %	225.7	177.1	157.7	140.4	126.6
Financial sector					
Short-term interest rate (13 weeks T-bill yield)	5.9	5.6	2.7	1.5	0.3
Exchange rate (per USD, avg)	75.3	77.2	79.7	77.4	72.0
Exchange rate (per EUR, avg)	69.5	69.1	75.4	87.5	89.6
Real effective exchange rate	-2.4	2.9	-7.8	-10.7	1.6

Source: Algerian Ministry of Finance, Central Bank of Algeria, Eurostat, IMF, EIU.

[1] Central government.

[2] Banking system credit.

[3] Debt service to exports of goods and non-financial services.

[4] According to Bank of Algeria information all official reserves are liquid.

ARMENIA

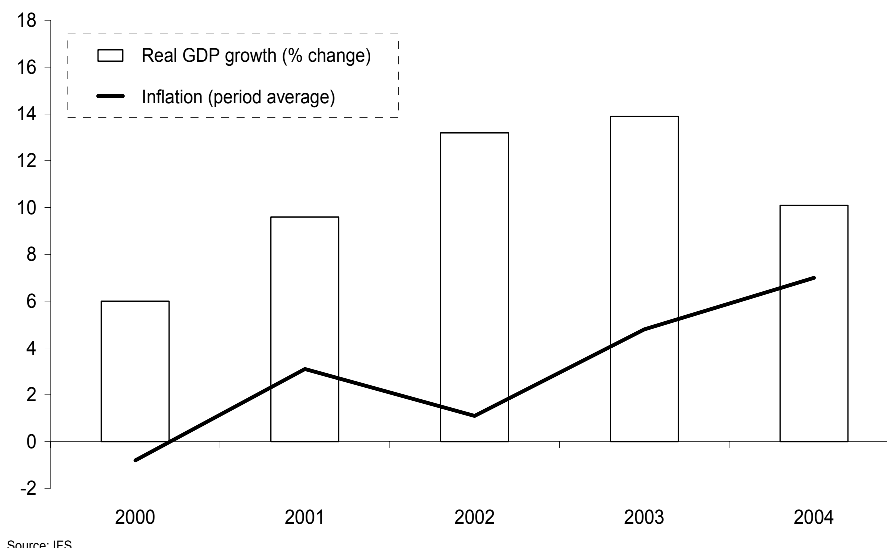
- **Armenia has witnessed a strong economic recovery over the past four years with an average annual real GDP growth rate of 11.7%. The pre-transition level of real GDP will be surpassed in 2005. Agriculture and construction made the largest contributions to GDP growth in 2004, while industrial output growth was weak.**
- **Inflation was subdued during 2004 so that the year ended with a 12-month price increase of 2% (8.6% the year before) in line with the three-percent-target of the Central Bank of Armenia. As food prices (largely imported goods) account for a large share of the CPI, fluctuations in wheat prices alone explain a considerable part of the recent changes in inflation.**
- **The current account deficit continued to narrow in 2004. The Armenian dram appreciated in nominal as well as in real effective terms, owing to an increase in workers' remittances and capital inflows. The potential loss of export price competitiveness was not yet a concern due to the real depreciation during 2000-2003.**
- **Following the inclusion of Armenia in the European Neighbourhood Policy (ENP) in June 2004, the Commission has released a Country Report on Armenia which reviews progress in the transition to democracy and a market economy. The Report will be a starting point for discussions on an ENP Action Plan with Armenia during 2005.**

1. Macroeconomic developments

Real sector developments

As expected, real GDP growth was slightly slower in 2004 at about 10% after two years of very strong economic performance (average annual real GDP growth was 13.5% in 2002-03) (Chart 1). After a severe recession and a profound transition process, which coincided with large-scale emigration, Armenia has now reached again its pre-transition (1989) level of real GDP. Agriculture and construction were driving the economy in 2004, while industrial production grew only modestly at 2.1%, partly due to disruptions in the supply of uncut stones for the diamond polishing sector, which contracted by 16%. Food processing, which is the largest industrial sector, experienced a low rate of growth at 1% mainly because of a poor harvest the year before (grapes in particular). On the other hand, the prospects for the metallurgy sector improved, as the sector was undergoing modernisation and new investment. The rebound in agriculture (+14.5%) and the continued boom in construction (+17.2% although down from +40% in 2003) compensated for the sluggish developments in the industrial sector.

The 12-month inflation decelerated from a peak of 9.5% (July 2004) to 2.0% (December 2004). The annual average rate of inflation amounted to 7.0%, well above the three-percent-target of the Central Bank of Armenia (CBA) (Chart 1). Bread and cereals have a weight of 18% in the CPI: thus the increases in the prices of imported wheat, in particular, explain the increase in inflation after mid-2003 (due to poor harvests in the whole region). In 2000-2003 inflation was under control, annual rates averaging 2%, well in line with the CBA three-percent-target. In early 2005, inflation seems to have picked up again, however.



Fiscal policy

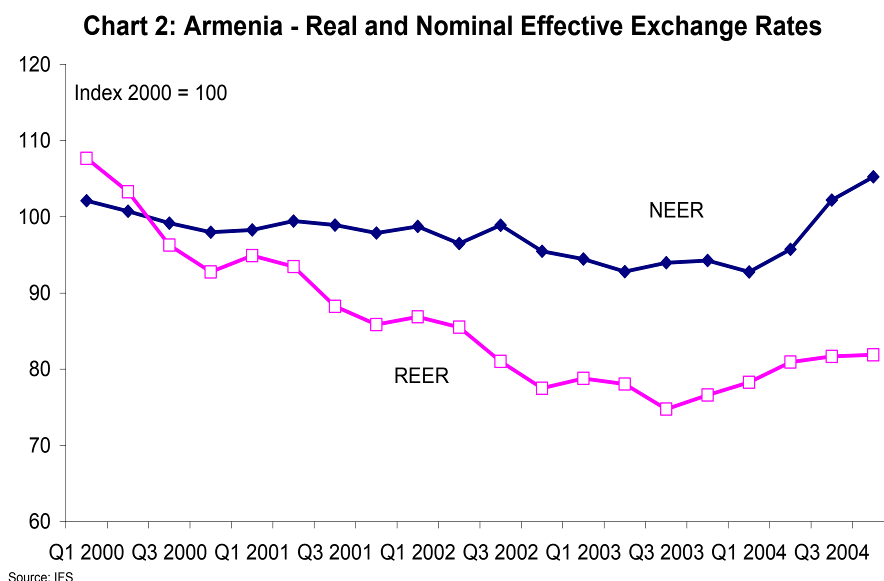
The overall fiscal balance is sound with an estimated deficit of 1.5% of GDP. However, the budget continues to depend to a large extent on external grants and concessional loans, and tax revenues have lagged behind GDP growth. A deficit of 2.6% was originally projected for 2004 but because of some delays in the implementation of planned capital spending, total expenditures were somewhat below the budgeted level. Tax revenues are estimated at 14.4% of GDP (14.0% of GDP in 2003). Nevertheless, at around 16% of GDP, total revenues are below their 2003 level because of a reduction in external grants. In 2002/03 the US based Lincy foundation financed public investment in housing, roads and cultural institutions by amounts equivalent to 2-3% of GDP. In 2004 these funds were phased out but from 2005 onwards Armenia is qualified to receive grants from the US Millennium Challenge Account, which is expected to bring about another substantial surge in public investments.

The introduction of a minimum tax on turnover (at a rate of 1%) boosted tax collection from the corporate sector, where several companies are believed to have avoided paying profit taxes by reporting losses for tax purposes. However, VAT and excise collection lagged behind overall output growth. The agricultural sector is in fact exempted from VAT until 2009. The nominal increase in current expenditure (+20%) was directed in particular to finance a rise in public sector wages, higher defence expenditure as well as higher social spending, in line with priorities set in the Poverty Reduction Strategy Paper (adopted in 2003). Interest payments fell as a result of a more concessional composition of public debt, as about 90% of public external debt is owed to multilateral creditors.

Monetary and exchange rate policy

By allowing the dram to appreciate, the Central Bank of Armenia curbed inflationary expectations during 2004. Despite the recent real effective appreciation of the dram (4.5% in 2004), the loss of price competitiveness is still considered to be relatively minor given a real depreciation of around 25% in 2000-2003. The CBA has intervened only occasionally in the foreign exchange market to smooth out short-term volatility. Although the CBA may have chosen the appropriate policy stance, it faced public criticism (also in the parliament) for the lack

of intervention during the appreciation trend. This criticism might be explained by the significant foreign-currency denominated incomes (remittances) of many Armenians. Overall monetary policy remains constrained by high dollarisation, at about 70% of all deposits. Average interest rates on bank loans are slightly below 20% owing to high risk premiums and weak financial intermediation.



In 2004 considerable progress was made in deepening the government debt market through two issues of government bonds, with maturities of seven and ten years respectively. This has also allowed the CBA to strengthen its monetary policy framework by increasing its holdings of government securities to be used both in direct sales and as collateral in repurchase contracts. The Ministry of Finance and Economy is expected to continue increasing the outstanding amount of dram-denominated government securities in 2005 which facilitates further deepening of the monetary policy instruments of the CBA for effective liquidity management. This development also facilitates eventual private debt issues in the domestic market. Given the government's relatively easy access to concessional foreign loans, there has not been a pressing need to develop the domestic security market.

External sector developments

Large trade deficits, albeit narrowing over time, have persisted in Armenia owing to its narrow base for exports and high demand for imports such as basic food stuffs. In 2004, exports totalled USD 715 million and imports USD 1 351 million. Fluctuations in the imports and exports of the diamond processing sector explain y-o-y changes in bilateral trade with various countries. Armenia's largest export markets in 2004 were Belgium (16.6% of the total exports), Israel (12.2%) and Russia (11.3%). Polished diamonds accounted for about 40% of exports in 2004 (about 50% in 2003).[1] The shares of the EU and the Commonwealth of Independent States (CIS) in Armenia's trade remained broadly unchanged in 2004 at 36% and 20% respectively.

Despite the appreciation of the dram since early 2004, which has been supported by a strong increase in workers' remittances and other private transfers, Armenia's external account

[1] New investments in metallurgy, minerals and machine building are likely to contribute to a gradual diversification of exports in coming years.

remained broadly stable. According to preliminary estimates, the current account deficit narrowed to below 5% of GDP in 2004 (6.8% in 2003). However, the trade deficit widened to about 18% of GDP as imports growth (5.6%) exceeded exports growth (4.3%). Net foreign direct investment is estimated to have increased somewhat from 2003 when net FDI reached about USD 120 million. The largest recent foreign investments have gone to the aluminium foil producer and the privatised copper-molybdenum plant. Significant new foreign investments have also been made in communications, energy, software production and tourism. The gross international reserves of the CBA are comfortably high covering nearly four months of imports.

Armenia's external debt ratio remained at a low level. In nominal terms Armenia's public external debt is at about USD 1.1 billion, equivalent to about 31% of GDP (38% of GDP in 2003). Debt service represented about 1.7% of GDP in 2004. The bulk of the debt, about USD 700 million, originates from the World Bank followed by the IMF at about USD 200 million. Armenia is expected to repay fully its outstanding debt to the European Community in 2005 (a loan of EUR 28 million was disbursed to Armenia in 1998). In February 2005, the UK government announced that it would take responsibility for paying 10% of Armenia's debt repayments to the World Bank until 2015, amounting to nearly USD 20 million, so that the country can allocate additional resources to health, education and social support.[2]

2. Structural reforms

Taking into account the current political, economic and institutional context, the Commission envisages that a future ENP Action Plan for Armenia should, *inter alia,* provide for (i) strengthened political dialogue; (ii) support for market economy reforms leading to gradual economic integration into the EU's Internal Market; (iii) further support for economic rehabilitation of conflict zones in the context of conflict settlement; (iv) increased financial support including an extension of the EIB mandate to Armenia as of 2007; (v) enhanced support for regional cooperation; (vi) enhanced cooperation in the field of justice and home affairs; (vii) intensification of cooperation in the energy, electronic communications and transport, environment and public health sectors as well as enhanced cooperation in the field of science and technology; (viii) intensification of people-to-people contacts in particular in the area of education, training and youth and also in the context of the Nagorno-Karabakh conflict. [3] Also a consideration is to be given, if progress is being made with the implementation of an Action Plan, to the possibility of a new enhanced agreement to replace the EU-Armenia Partnership and Cooperation Agreement (PCA) upon its expiry in 2008.[4]

Trade facilitation and liberalisation

Although having a liberal trade regime, Armenia has not been able to fully benefit from increased trade opportunities. Despite being a WTO member since February 2003, its isolated position, the restricted borders with Turkey and Azerbaijan, high transportation costs and shortcomings in customs procedures have weighed on Armenia's export performance.

[2] The other countries benefiting from the UK's offer are Mongolia, Nepal, Sri Lanka and Vietnam.
[3] European Commission (2005), Commission Staff Working Paper, Annex to: "European Neighbourhood Policy", Country Report Armenia, Reference: SEC (2005) 285, March. Available via the Internet: http://europa.eu.int/comm/world/enp/pdf/country/armenia_cr_0503.pdf.
[4] European Commission (2005), Communication from the Commission to the Council, European Neighbourhood Policy, Commission Recommendations to the Council for Armenia, Azerbaijan, Egypt, Georgia and Lebanon, Reference: COM (2005) 72, March.

Furthermore, in 2004 a temporary closure by Russia of a border crossing with Georgia also disturbed Armenia's trade routes. The rail connections to Russia via Georgia have been disrupted because of the Abkhaz conflict. As a positive step, the Georgian government has offered to simplify its customs and transit procedures for Armenian cargo.

In the EU-Armenia (PCA), which has been in force since 1999, the parties accorded each other Most Favoured Nation (MFN) treatment and eliminated trade quotas.[5] Armenia benefits from the Generalised System of Preferences (GSP) scheme of the EU. Since 2001 the GSP utilisation rates (eligible imports compared to effective GSP imports) have improved notably for industrial and agricultural products. At 63% the global utilisation rate is above the average rate for all GSP beneficiaries. The PCA provides for the protection of intellectual, industrial and commercial property rights. Armenia has indicated interest in being granted a market economy status under EU's Anti-Dumping Regulation.

In an attempt to diversify both exports and imports, Armenia has strengthened trade relations with Iran. The two governments decided in 2004 to construct a gas pipeline from Iran to Armenia (to be completed by 2007). The gas would be used for electricity generation at the Yerevan Thermal Power Plant which is being modernised. As a result of these investments, Armenia envisages exporting electricity to Iran. The construction of a hydro power plant at the Araks River bordering Armenia and Iran is also under preparation. Armenia is already a net electricity exporter in the region.

Fiscal and public administration reform

Due to persistent weaknesses in tax and customs administration, the gap between actual and potential revenue collection remains large. The situation is unlikely to improve substantially until the administrative structures are consolidated under the remit of the Ministry of Finance and Economy. In 2004, a two-year programme was drafted to reform some problematic areas of the administration. It aims in particular at retrieving outstanding tax arrears from companies and meeting VAT refund commitments in a timely manner. A number of VAT exemptions on imported goods were removed in 2004. The tax base was expanded to include large retail markets. Consistent with its WTO commitments, Armenia is expected to increase the use of declared transaction values for assessing customs duties and VAT. In more general terms, a major challenge, which needs to be tackled urgently, is to consolidate a large number of contradictory provisions in the tax legislation into a unified tax code.

Having completed a large array of first generation reforms in the public finance management, including the creation of a single treasury account and the development of a medium term expenditure framework, Armenia is now in the process of consolidating the overall fiscal management framework and is also preparing to introduce more ambitious new elements such as programme budgeting. However, external and internal controls and audit functions remain weak and should receive particular attention as a matter of priority.

Despite some progress, the re-organisation of numerous budget entities into state-owned non-commercial organisations was a step backwards in terms of fiscal transparency and accountability, although fiscal decentralisation was an appropriate aim. These organisations include mainly schools and hospitals but also a number of government agencies. Corrective

[5] Overall, Armenia's weighted average tariff is low at about 2.5%.

measures are now being taken to improve monitoring and auditing of these organisations within the overall fiscal framework.

Privatisation, enterprise restructuring and business environment

The private sector accounts for three quarters of GDP and employment. Armenia is generally perceived to have a favourable legal and institutional framework, but the implementation record of laws and regulations has been mixed and inconsistent. Nevertheless, the Heritage Foundation's 2005 Index of Economic Freedom assigns to Armenia an index ranking which is close to those of some EU Member States.[6]

The opposition protests in the spring 2004 and the boycott of parliament sessions by opposition deputies reflect growing disappointment of the political processes in the country. This may have negative implications for the business environment. Despite progress in structural reforms, the overall business environment is not yet conducive to more broadly based economic growth in Armenia. The business climate remains difficult for small and medium sized enterprises and market barriers are high for newly established enterprises in particular. Armenia has a highly concentrated firm structure, dominated by vested interests (which are also well represented in the parliament).

Some steps were taken in the implementation and monitoring of the Anti-Corruption Strategy (adopted at the end of 2003), but the government's commitment is still perceived to be fairly weak. In June 2004, a Council to Fight Corruption was established under the chairmanship of the Prime Minister to supervise the implementation of anti-corruption measures. The weak judiciary is one particular concern, being unable to ensure a level playing field for businesses in terms of enforcing contractual rights and obligations.

Provision of mobile communication and internet services has lagged behind other countries in the region, largely because of insufficient investment and a lack of competition. However, the long dispute involving the government and Armentel, the monopoly operator in telecommunications since the privatisation in 1997, was settled out of court in November 2004. The government subsequently issued a second licence for mobile services to another operator while the monopoly is in fact maintained with regard to data transmission services.

The government continues to focus strongly on the stabilisation of energy supplies. In addition to the gas pipeline from Iran, several new investment projects, such as the development of small and medium-sized hydropower plants are in progress. A liquidation process of Armenergo, a wholesale intermediary between energy generation and distribution, was initiated in November 2004. The subsequent direct contracting is expected to improve market mechanisms in the energy sector (regulated by the Public Services Regulatory Commission). Tariff collection for consumed energy reached nearly 100% in 2004. Armenia has not yet committed to a binding closure date for the Medzamor nuclear power plant despite the EU's offer of substantial financial assistance for securing alternative sources of energy.

The land reform carried out in the early stages of transition, led to the prevalence of small family-owned farms which absorbed redundant labour from the industrial sector. Agriculture has not, however, developed much beyond subsistence farming, as productivity remained low.

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[6] Heritage Foundation (2005), "2005 Index of Economic Freedom". Available via the Internet: http://www.heritage.org/research/features/index/downloads.cfm.

Functioning real estate/property markets as well as a wholesale market infrastructure for agricultural products are some of the prerequisites needed for further development of the agricultural sector. A cadastre has been put in place with EU support which should, in principle, facilitate the development of a mortgage-based loan market. However, the available financing remains of very short-term nature.

Financial sector reforms

The Central Bank of Armenia (CBA) continues to strengthen regulations in the banking sector and is expected to pay more attention to corporate governance issues. The CBA intervened in eight banks over the past few years. One of these (Armcommunications Bank) avoided liquidation in 2004 when it was recapitalised by new investors which also acquired its largest debtor, the Nairit chemical plant. New anti-money laundering legislation was approved by the parliament in November 2004 and a Financial Intelligence Unit for its implementation will be created at the CBA. Furthermore, transparency and efficiency need to be addressed seriously also in the judicial system to encourage the deepening of financial intermediation and new business development. Total bank assets increased considerably in 2004 but remain at a relatively low level, equivalent to about 19% of GDP.

Some of the 20 banks which were operating at the end of 2004 may have difficulties in meeting the new minimum capital requirement of USD 5 million, which becomes effective in mid-2005. However, the banking sector is attracting foreign investors, and in early 2005 new capital inflows from Switzerland, Kazakhstan and Canada have been reported.

Poverty reduction and labour market issues

As economic growth was resumed in mid-1990s, the prevalence of poverty began to lessen at the end of the decade, and in recent years more rapid progress has been visible. Households' nominal incomes increased by 17% in 2004. The average monthly salary was 40 700 drams (62 euros). The national poverty line is set at 14 300 drams (23 euros) per person per month. According to official estimates, about 43% of the Armenian population lived below the poverty line in 2003 (51% in 2001) and a significantly smaller share than before was faced with extreme poverty (8% in 2003 against 16% in 2001). The 2003 household survey showed a lower incidence of poverty in the capital Yerevan in particular. This indicates that the benefits of higher economic growth have not reached all regions of the country.

Armenia's labour force continues to decrease because of emigration and population aging. Around one million citizens, about 25% of the population, have left the country after 1990. While contributing significantly to private consumption in Armenia through workers' remittances, the emigration has produced also a gender imbalance and a loss of skilled labour.

In December 2004, the labour force was reported at 1 225 million down from 1 392 in 2002. Employment has increased slightly to 1.11 million. Self-employment accounts for a majority of employment, including subsistence farming. A notable feature of the economic recovery is that it has so far involved sectors with relatively low labour intensities. Despite the strong economic growth performance, officially registered unemployment has declined relatively little (from 10.8% in 2002 to 9.5% in 2004) while the level of unemployment indicated by household surveys is even higher at well over 20%.

ARMENIA

Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% change)	6.0	9.6	13.2	13.9	10.1
Inflation (period average)	-0.8	3.1	1.1	4.8	7.0
GDP nominal, in USD millions	1,912	2,120	2,373	2,805	3,500
GNI per capita, in USD	598	680	767	902	1,090
Social Indicators					
Unemployment (officially registered)	11.7	10.4	10.8	10.1	9.5
Poverty rate (% of population)	55.0	51.0	49.0	43.0	---
Inequality (Gini index consumption/ income)	0.30/0.64	---	0.27/0.45	---	---
Fiscal Sector					
Total revenues, % of GDP	16.5	17.0	18.8	17.8	15.7
Total expenditure, % of GDP	22.9	20.9	19.3	18.9	17.0
Central govt. balance, % of GDP	-6.4	-3.8	-0.4	-1.1	-1.3
Gross Public Debt, % of GDP	---	45.3	46.6	40.9	35.0
Monetary sector					
Domestic credit to private sector (% of GDP)	10	8	7	6	---
Broad money (M3) (% change)	38.6	4.3	34.0	10.4	22.6
Degree of monetisation (M3/GDP, %)	14.6	14.5	14.9	14.4	15.1
Dollarisation in bank deposits (%)	80	80	71	71	71
External sector					
Current account balance, % of GDP	-14.6	-9.5	-6.2	-6.8	---
Trade balance, % of GDP	-24.2	-19.8	-15.5	-15.4	-18.0
Foreign direct investment (net, % of GDP)	5.4	3.3	5.0	5.0	---
Import cover of reserves (months)	3.6	3.6	3.7	4.0	4.0
External Vulnerability					
External Public Debt, % of GDP	45.1	42.8	43.2	38.0	31.3
Debt Service Ratio[1]	10.8	9.7	9.5	7.2	6.8
Gross reserves (excl. gold, USD millions)	314	329	430	502	547
Reserves/M3	112	107	122	125	102
Financial sector					
Money market rate	18.6	19.4	12.3	7.5	4.2
Lending rate	31.6	26.7	21.1	20.8	18.6
Exchange rate (drams per USD, average)	539.5	555.1	573.4	578.8	533.3
Exchange rate (drams per EUR, average)	499.1	497.2	629.6	653.8	662.3
Real effective exchange rate (2000=100)	100	90.6	82.7	77.2	82.2

Sources: IMF, EBRD, Armenian authorities.

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

AZERBAIJAN

- **High economic growth – estimated at 10.2 % in 2004 – is fuelled by investments in the oil and gas sector, which may soon result in a quadrupling of energy production. The non-oil sector is performing well on the back of the oil-driven construction boom, though the manufacturing sector remains small. Inflationary pressures are emerging.**
- **The current account deficit stood at 27% of GDP in 2004, but was fully financed by a USD 2.5 billion foreign direct investment inflow. The current account is expected to improve next year and might move to surplus as early as 2006, due to increased hydrocarbon export revenues.**
- **The fiscal budget showed a small surplus in 2004. Public finance management has improved in recent years and the budgetary system is coming closer to international standards. The speed of change is demanding and expenditure management, accountability and transparency remain areas for priority actions.**
- **Financial sector development in Azerbaijan has been slow compared to other transition economies and state ownership still dominates the banking sector. The depth of bank intermediation is low, but gradually improving. Bank deposits increased to 13% of GDP in 2004.**

1. Macroeconomic developments

Real sector developments

Real GDP is estimated to have grown 10.2% in 2004 (2003: 11.2%), and has thus for five consecutive years been close to or above the 10% level (Chart 1). The impressive growth record is driven mainly by oil-related foreign direct investment. Domestic demand rose substantially in 2004 as a result of increasing investment and rising private consumption, caused by high wage increases. Crude oil production increased just 1% in 2004. As a result of planned increases in oil and gas extraction the economy is projected to continue with high growth rates for years to come – potentially around 15% GDP growth in 2005 and 2006.

Major oil-related construction projects were a key driver of non-oil growth in 2004. Construction grew about 42% in 2004, following similar high growth in the previous two years, and now accounts for about 16% of GDP.[1] The oil-related construction boom had positive spill-over effects on most other segments of the non-oil sector – in particular the service sector in and around the capital. Non-oil sector labour productivity has increased markedly in recent years. However, non-oil sector growth might fall substantially when oil-related construction returns to a more modest level, and the need for a supporting business environment will then become more apparent.

Agricultural production growth slowed down in 2002 after a period of considerable labour productivity improvements, and labour productivity growth may have fallen to about 5% in 2004, as efficiency gains are becoming restrained. Agriculture and forestry still employ 39% of the labour force (1.5 million people), but only account for 12.5% of GDP.

[1] Source: Economist Intelligence Unit and own calculations.

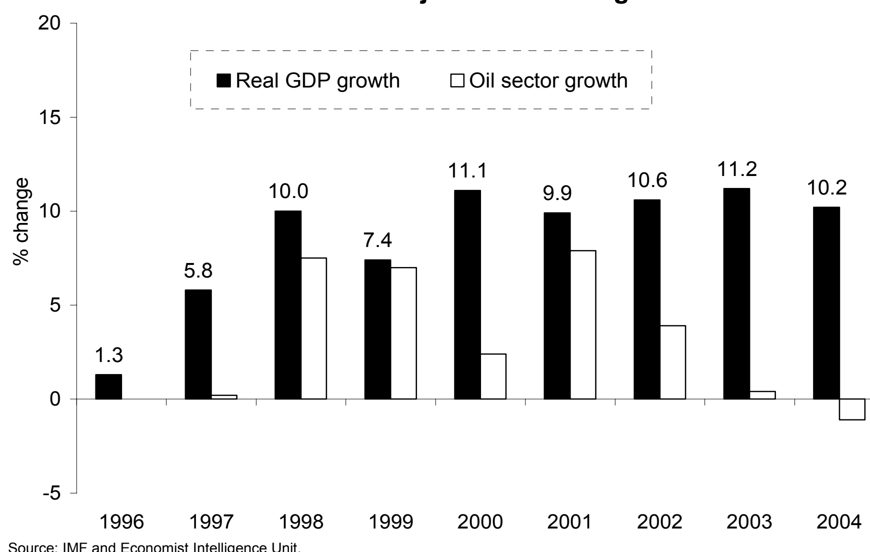
Box 1: Oil revenues – the flip side of the coin

Massive investments in the oil and gas sector should lead to a quadrupling of oil and gas extraction within the next five years. The major projects currently in progress are the Baku-Tbilisi-Ceyhan (BTC) oil export pipeline, which should be completed in mid-2005, the South Caucasus natural gas pipeline projected to be ready in 2006, the Azari-Chiraq-Guneshli oil field and the Shah-Deniz gas field, which are expected to start flowing in 2005 and 2006 respectively.

Large capital inflows on the back of increased oil production might pose a challenge for policymakers. The windfall gains from oil are relatively short-lived as oil production is projected to fall already from 2010 and dry out (or return to modest production levels) in 2025.[2] There is a serious risk of Dutch disease in the medium term, i.e. the traditional non-oil tradable sector being crowded out by an appreciation of the real exchange rate. This is especially so if the revenues from oil and gas extraction are not managed properly. Given the temporary nature of the natural resources it is particularly important that revenue spending is focused on investing in the needs of the non-oil sector. The background to this is a non-oil manufacturing sector that suffered a lot in the first years of independence due to its high costs and low quality products and is now struggling to get on track.

Average consumer price inflation increased to 6.7% in 2004 from 2.1% in 2003 as a result of emerging pressures in the economy. Large capital inflows and a growing money supply are pushing prices upwards, although so far it is mainly food product prices that have accelerated, while non-food products and services continue to show almost no price growth. In October 2004 inflation increased sharply due to one-off factors such as the VAT exemption for imported grain coming to an end, Russia temporarily closing the border and prices being increased ahead of a rise in regulated domestic energy prices.

Chart 1: Azerbaijan - Economic growth



Source: IMF and Economist Intelligence Unit.

Fiscal policy

The consolidated government budget moved into surplus in 2004, after a minor deficit in 2003, as a result of higher oil prices and restrained spending. Increasing energy revenues will help to gradually improve the budget further. The non-oil budget deficit stood at about 10% of GDP (14% of non-oil GDP) in 2004 and is projected to stabilize below 10% in the coming years. The sustainable non-oil deficit ceiling in 2005-2007, based on conservative oil price projections, is

[2] See Wakeman-Linn J. et al (2004), *Managing Oil Wealth: The case of Azerbaijan*, International Monetary Fund, May.

estimated to be well above this level. In light of this, the current spending plans are quite cautious and leave room for additional investments in health care and education.

Total government revenues equalled 40% of GDP in 2004.[3] More than half of all government revenue accrues from the oil and gas sector, and this will increase substantially in the coming years. Income taxes from both the state oil company (SOCAR) and new oil and gas fields are paid to the state budget, while government profits from the new oil and gas fields are transferred to the state oil fund (see below). Government expenditures increased slightly less than GDP in 2004. Significant wage increases – 50% in education, health and several other public sectors – were awarded in the summer of 2003 and the full-year impact of this and other salary increases affected the 2004 budget with a 34% increase in the total wage bill. Spending on health and education was increased, but is still moderate at about 0.8% of GDP and 3.3% of GDP respectively. Public external debt, which has decreased slightly from 20.1% of GDP in 2003 to approximately 17.5% of GDP in 2004, is sustainable.

The State Oil Fund of the Republic of Azerbaijan (SOFAZ) was established by presidential decree in December 1999. The main purpose of the fund is to save oil- and gas-related revenues for future generations. Under the current regulations oil fund expenditures may not exceed inflows in any given year. SOFAZ total assets amounted to USD 970 million at the end of 2004 compared to USD 815 million at the beginning of the year.[4] Azerbaijan joined the Extractive Industries Transparency Initiative (EITI) in 2003 and oil fund transparency is improving. Azerbaijan published audited reports under the EITI in March 2005 – the first country to do so.[5]

Monetary and exchange rate policy

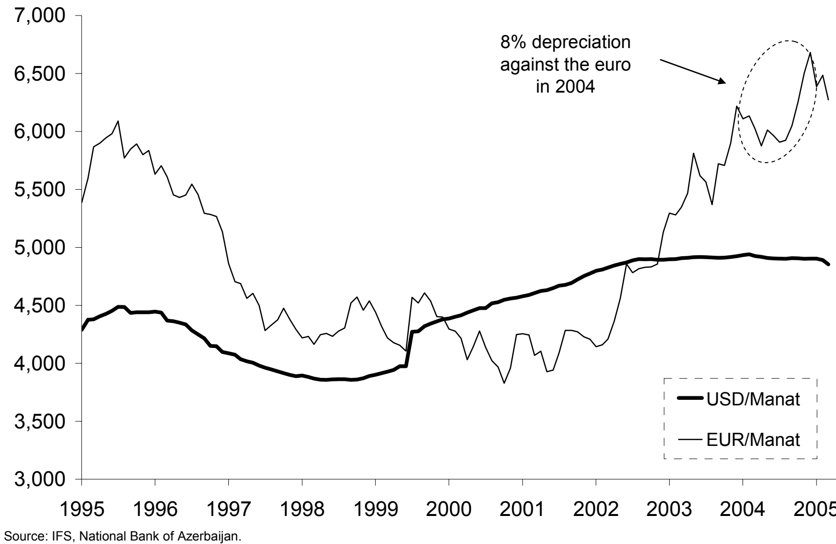
The manat is informally pegged to the US dollar, allowing for moderate exchange rate fluctuations and a modest gradual appreciation to counter increasing inflationary pressures. The National Bank of Azerbaijan aims to sterilise large capital inflows related to FDI and exports, but available policy tools are limited. During 2004 the manat/USD exchange rate remained almost unchanged with a slight appreciation (Chart 2). The real effective exchange rate depreciated in 2004 as a result of the US dollar depreciation against the euro. Official reserves continue to grow and gross international reserves amounted to USD 0.9 billion at end-2004, covering around 3.2 months of imports. The central bank has kept its refinancing rate unchanged at 7% since September 2002 despite the increase in inflation.

The money supply growth has been driven by capital inflows and supported by fundamentals, i.e. the high GDP and wage growth, and is accompanied by a financial deepening, though the stock of manat money and credit remain low compared to other transition economies. Broad money supply (M2) grew by 31.9% y-o-y in 2004, slightly up from 27.6% in 2003.[6] The economy is heavily dollarised and foreign currency savings are substantial. Monetary depth (M2/GDP) rose to 0.08 in 2004. Bank lending growth was strong (domestic credit grew 42%) albeit from a low level. Real interest rates are low and contribute to the risk of pressures building up in the

[3] Figure includes quasi-fiscal activities in the energy sector.
[4] According to SOFAZ (2004), *2004 Revenue and Expenditure Statement* (non-audited).
[5] The EITI aims to increase transparency in transactions between governments and companies within extractive industries, and to ensure that the revenues from extractive industries contribute to sustainable development and poverty reduction. The EITI was announced at the World Summit on Sustainable Development in Johannesburg, September 2002. See www.eitransparency.org.
[6] Source: IMF IFS.

booming economy. If the accommodative monetary policy is maintained it will be difficult to reduce inflation and further inflationary pressure may materialise.

Chart 2: Azerbaijan - Nominal exchange rate developments



Source: IFS, National Bank of Azerbaijan.

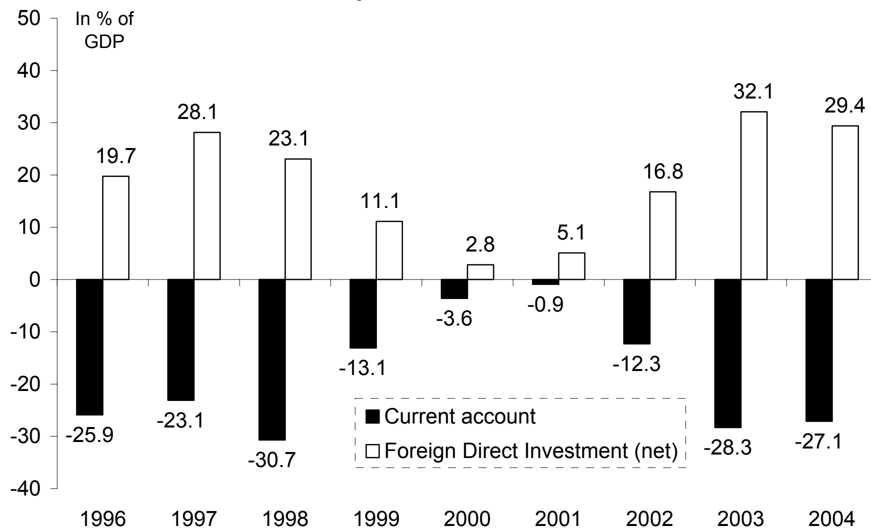
In mid-December 2004, the IMF and Azerbaijani officials announced that the country's currency operations met all the points of Article VIII, Sections 2, 3 and 4, of the IMF's Articles of Agreement. Specifically, both parties acknowledged that the Azerbaijani manat was, in fact, a fully convertible, freely-floating currency.

A new National Bank law was adopted in December 2004. The law has strengthened the central bank's independence in banking sector supervision.

External sector developments

The current account has in recent years deteriorated temporarily due to the large-scale oil sector construction imports. The current account deficit is estimated at 27.1% of GDP in 2004, slightly down from 28.3% of GDP in 2003. The current account deficit is more than fully financed by foreign direct investment net inflows, which amounted to 32.1% of GDP in 2003 and approximately 29.4% in 2004. The completion of the Baku-Tblisi-Cayhan oil pipeline and the first phase of the Azeri-Chirag-Guneshli Oil field in mid-2005 will lead to sizeable oil export increases and consequently to reductions in the current account deficit. Imports for oil sector development will gradually decrease and the first current account surplus in many years may be recorded in 2006. Foreign direct investment inflows are expected to remain strong over the next couple of years.

The EU-15 is the main trading partner for Azerbaijan both for imports (33.9%) and for exports (72.7%). A large share of Azerbaijan's oil is currently sent to Italian oil terminals. Italy therefore accounted for 41% of exports in the first 11 months of 2004. Oil products and chemicals makes up 88 % of Azerbaijan's exports. The main non-oil export commodities are food, metals and textiles accounting for 4.9%, 2.1% and 1.6% of total exports in 2003. Imports of machinery and equipment etc. for the oil and gas sector accounted for 40% of total imports in 2003 and presumably more in 2004. Other notable imports are metals and food which accounted for 18% and 11% respectively in 2003.



2. Structural reforms

Trade liberalisation

Azerbaijan's trade liberalisation efforts are encouraged by a Partnership and Cooperation Agreement (PCA) with the EU, which was signed in 1996 and entered into force in 1999.[7] Among other things the PCA limits the possibility of imposing restrictions on imports and exports. In the field of intellectual and industrial property rights the PCA requires that by the end of 2004 Azerbaijan should provide a level of protection similar to that provided in the EU, including effective means to enforce such rights, and should have acceded to the relevant multilateral conventions. Azerbaijan did not, at the time of writing, comply with this obligation. The PCA also facilitates the right to establishment of companies (at least on a most favoured nation basis) in most manufacturing and service sectors, though Azerbaijan does not fully comply with this obligation. Trade in textiles between EU and Azerbaijan is not covered by the PCA, but was covered until the end of 2004 (when the multi-fibre agreement terminated) by a bilateral agreement according to which no quantitative restrictions should be applied.

Fiscal and public administration reform

Public finance management has improved in recent years and the budgetary system has been brought closer to international standards, though much still needs to be done to improve transparency and accountability. The draft budget has increased from a 10-page overview for 2003 to a 100-page document with a breakdown by economic sector and function for 2004, and a detailed 900-page budget for 2005. The draft budget for 2004 was the first to be published after submission to the parliament and the first to be cast in a medium-term expenditure framework. The speed of change envisaged is demanding and progress in expenditure management, accountability and transparency will continue to need particular attention.

[7] Azerbaijan also initiated the process towards WTO membership in 1997, though the accession negotiations are still at an early stage.

Measures have been taken to rationalise the tax structure and broaden the tax base. Despite some progress, however, tax collection continues to be hampered by weak administration and widespread corruption. The income tax system was reformed in 2004 from a system with low, medium and high income tax brackets to a simplified two-stage tax system, and the lowest threshold was increased from 100 000 AZM (USD 20) to 150 000 AZM (USD 31) per month. The highest income tax rate is unchanged at 35%. The enterprise profit tax rate was lowered modestly, from 25% to 24%, and agricultural producers got an additional five-year tax exemption from all taxes (excluding land tax). Unregistered businesses are being targeted in order to reduce their number and hence broaden the tax base.

Domestic consumers of electricity and gas continue to receive substantial implicit subsidies and cash collection ratios in the energy sector remain low. Domestic retail oil prices were increased by about 10% in November 2004 and should gradually be increased further in order to bring them more in line with international prices.[8] This should be accompanied by compensatory social benefits to target the poor.[9] Explicit and implicit energy subsidies fell from 10% of GDP in 2003 to about 4% of GDP in 2004.

Privatisation, enterprise restructuring and business environment

Although the private sector share of the economy has increased, there is still a need for privatisation and restructuring of large, inefficient state companies.[10] Entities in the telecommunication and transport sectors are being prepared for privatisation, and tenders for the two large fixed-line telecommunication companies are expected to be announced in 2005. It is planned to turn railway and shipping companies into joint-stock companies ahead of privatisation. The state-owned power supply system is insufficient and ill-functioning, and should be improved ahead of privatisation. There are no plans to privatise the state oil company (SOCAR).

Corruption remains a significant deterrent to efficient investment and private sector development. Azerbaijan is ranked 140th out of 146 countries on Transparency International's Corruption Perception Index, indicating huge problems.[11] That said, it should be recognised that progress has recently been made in building and strengthening anti-corruption institutions and the legal framework in this area. A law "On the Fight against Corruption" was passed in early 2004 and a department for combating corruption has recently been established. Azerbaijan has also signed, but not yet ratified, the UN Convention against Corruption. However, enforcement remains insufficient and there is a serious need to simplify what is currently an over-complex and fragmented way of dealing with corruption.

Azerbaijan is working to improve its legislative and regulatory framework and to bring it closer to European standards. This is a major task, given that Azerbaijan is ranked 146th out of 189 countries on the World Bank's index for regulatory quality in 2002.[12] The ranking for the rule of

[8] Natural gas prices for households were increased by 127%.
[9] In the 2005 budget 34 billion manat are earmarked to compensate vulnerable groups for energy price increases.
[10] An increase in the private sector share of the economy from 45 % of GDP in 1998 to 63.7 % of GDP in 2004 is indicated in European Bank for Reconstruction and Development (2004), *Transition Report 2004: Infrastructure*, November.
[11] Transparency International (2004), *Transparency International Corruption Perception Index 2004*, London, October.
[12] Kaufmann D., A. Kraay and M. Mastruzzi (2003), *Governance Matters III: Governance indicators for 1996-2002*, World Bank Discussion Paper. Available via the Internet: http://www.worldbank.org/wbi/governance/wp-governance.html.

law is similar and government effectiveness is even less encouraging. Starting a business is still complicated, procedures are lengthy, contract enforcement is expensive and investor protection is limited. These conditions explain to some extent the existence of a large informal sector.[13]

Financial sector reforms

Financial sector development in Azerbaijan has been slow compared to other transition economies and state ownership still dominates the banking sector. The depth of bank intermediation activity, as measured by the ratio of total banking sector assets to GDP (0.18 in 2004), is gradually improving but is still lower than the CIS-7 average, which in itself compares badly to other regions in transition.[14] Similarly low ratios of bank deposits to GDP (0.13) and private sector credit to GDP (0.09) signal that the provision of financial services to households and the private sector is very limited.[15]

The financial services provided have been focused on the oil sector, construction and trade, while funding outside Baku, in particular for the agricultural sector, has been neglected. In order to tackle some of these shortcomings, the authorities have stepped up efforts to develop the micro-finance market. Registration of micro-finance institutions has been simplified, licence fees were reduced and a draft law "On Micro-Finance Institutions" should help to develop the regulatory and legal framework. The Micro-Finance Bank of Azerbaijan started to operate in 2002 and continues to expand.

The banking system is currently in the process of privatisation, though progress has been slow and the sector has not been adequately reformed. Non-performing loans owed by state-enterprises also complicate financial sector development. Privatisation of the state owned banks International Bank of Azerbaijan (IBA) and BUS Bank has been planned for some time, but not accomplished. Instead IBA has tended towards consolidation of its near-monopoly power. The privatisation process is crucial for the development of the banking sector and should be accelerated.

The supervision of the financial sector needs to be improved, but progress has been slow. The banking law itself, which was enacted in March 2004, is in compliance with the Basle core principles. The minimum capital requirement for banks in operation is USD 3.5 million and has been increased to USD 5 million for newly established banks. The participation limits for foreign banking capital were fully eliminated in early 2004. The national payment system has undergone improvements and work on a comprehensive electronic payment system has commenced.

Labour market reforms

Officially reported unemployment, which stood at 1.4% in 2003, appears stable at this low level. However, a survey conducted with UNDP and ILO support in May-June 2003 consistent with international concepts and methodology shows that the real unemployment rate is around 10.7%. A Programme of Regional Development, which was approved in February 2004, is centred on job creation in the regions, with an ambitious target of 600 000 jobs in three years. Another key

[13] According to the State Statistical Committee the informal economy is estimated at 18-20% of GDP, which is comparable to the average for OECD countries. Other estimates suggest a larger informal sector.
[14] See De Nicolo, G., S. Geadah and D. Rozhkov (2003), "Financial Development in the CIS-7 Countries: Bridging the Great Divide", IMF Working Paper, No. 03/205.
[15] Estimates based on IMF IFS.

task is to bring the educational system up-to-date and focus it towards the needs of the economy. Indeed, improving the quality of basic education by 2005 is a strategic objective of the PRSP.[16] The minimum wage was raised by 60 000 manat to 100 000 manat in July 2004 and again to 125 000 manat (25 USD) in January 2005, but is still below the national poverty line.

[16] Azerbaijan Republic (2004), *State Programme on Poverty Reduction and Economic Development,* Annual Report.

AZERBAIJAN

Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% change)	11.1	9.9	10.6	11.2	10.2
Inflation CPI (period average)	1.8	1.5	2.8	2.1	6.7
GDP nominal, in USD (millions)	5275	5711	6348	7341	8731
GDP per capita, in USD	653	701	773	887	1047
Social indicators					
Unemployment[1]	---	---	---	10.7	---
Public expenditures on health, % of non-oil GDP	1.2	1.2	1.3	1.1	1.4
Life expectancy at birth, years	65.2	65.2	65.2	---	---
Enrolment ratio for basic school (class 5-9)	86.5	89.6	88.8	---	---
Earnings inequality (GINI-coefficient)	50.6	50.1	---	---	---
Poverty (% living below national poverty line)[2]	---	49.6	46.7	---	---
Fiscal sector					
Total revenues, % of GDP[3]	30.2	27.5	39.6	39.4	40.2
Total expenditure, % of GDP[3]	29.6	27.4	40.1	41.9	39.1
Central govt. balance, % of GDP	-0.8	-0.6	-0.7	-1.8	1.3
Public external debt, % of GDP	22.2	20.2	20.1	20.1	17.5
Monetary sector					
Base money, % yoy	18.8	-8.7	33.9	27.0	31.5
Broad money (M2), % yoy	27.1	1.6	20.4	27.6	31.9
Private sector credit (% change)	-1.7	-17.5	16.7	28.6	26.0
Degree of monetisation (M2/GDP, %)	7.0	6.3	6.7	7.4	8.1
External sector					
Current account balance, % of GDP	-3.6	-0.9	-12.3	-28.3	-27.1
Trade balance, % of GDP	4.9	10.2	7.7	-1.4	3.2
Foreign direct investment net inflows, % of GDP	2.8	5.1	16.8	32.1	29.4
Import cover (months)	5.3	5.9	4.7	3.5	3.2
External vulnerability					
External public debt, % of GDP	19.8	20.2	20.1	20.1	17.5
Debt service ratio[4]	4.6	4.9	4.4	5.2	3.7
Gross reserves (excl. gold, USD billions)	0.68	0.73	0.72	0.80	0.93
Reserves/M2	1.8	2.0	1.7	1.5	1.3
Financial sector					
Short-term interest rate	9.5	8.4	8.6	6.9	7.0
Exchange rate (per USD, end of period)	4565	4775	4893	4923	4903
Exchange rate (per EUR, end of period)	4238	4229	5080	6195	6681
Real effective exchange rate (2000=100)	100	94	87	77	---

Source: IMF, EBRD, National Bank of Azerbaijan and own calculations.

[1] ILO labour market survey.

[2] The national absolute poverty line for 2002 is defined by a minimum consumption basket valued at 175 000 manat. Poverty figures for 2001 and 2002 are not directly comparable due to changes in methodology.

[3] Includes quasi-fiscal activities in the energy sector

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

EGYPT

- **Economic growth picked up and reached 4.4% in fiscal year 2003/04 (FY04), mainly due to an improved export performance supported by the substantial depreciation of the Egyptian pound. GDP per capita grew only modestly, while unemployment continued to rise to 10.7%.**
- **The central government fiscal deficit improved marginally in FY04 but remained at a high level (5.9% of GDP). Consequently, total public debt rose rapidly to around 121% of GDP at the end of FY04. In FY05 the deficit is likely to rise sharply due to tariff and tax reforms which are expected to improve medium-term growth and tax revenue.**
- **The trade deficit diminished, and the current account surplus improved to 4.3% of GDP in FY04 on the basis of a marked depreciation of the Egyptian pound. Pressure on the exchange rate has waned and inflation is receding markedly. CPI inflation in FY05 could be down to 5.7% from 10.7% in FY04.**
- **Whereas reform progress was only limited in FY04, the new government has embarked on an ambitious reform agenda and already enacted decisive measures in the areas of trade and tariff policy, foreign exchange market, and administered prices. Financial sector reform and privatisation were also accelerated.**

1. Macroeconomic developments[1]

Real sector developments

Economic activity picked up noticeably in FY04. Since the end of the war in Iraq, tourism in Egypt is returning to normal levels. For instance, the contribution to GDP of the hotel and restaurant sector was up by 15.4% from the previous fiscal year.[2] Suez Canal revenues also rose substantially. The trend of falling output of the oil industry continued but was compensated by rising oil prices and by the output of newly discovered gas resources. The mining and petroleum sector (which contributes around 27% to GDP) grew by 3.9%. Total GDP growth reached 4.4% in FY04 in comparison with 3.1% in the period before. Given population growth rates of 2% per year, this has translated into an only modest income per capita growth. In FY05 the economy can be expected to grow by about 5%, again mainly supported by tourism and exports but also by the stimulus of the new government's more energetic reform pace.

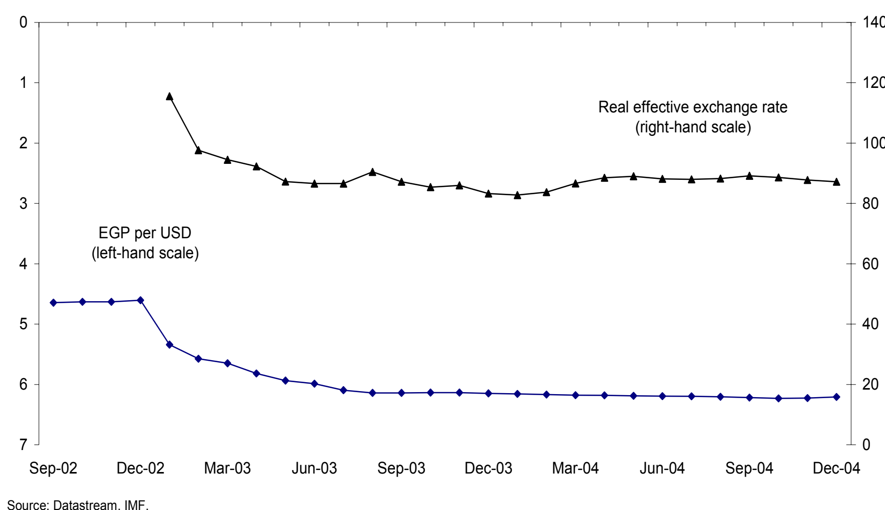
Despite some fast growing labour-intensive sectors like hotel and restaurant services, the labour market situation has worsened again in FY04 because economic growth was insufficient to create jobs for the rapidly expanding labour force (more than 600,000 new job seekers are estimated to enter the labour market annually). In parallel to rising employment, the official unemployment rate increased to 10.7% in FY04, up from 9.9% in FY03.[3] To keep unemployment from rising, the economy would need an average growth rate of around 6% per year according to the World Bank. Another challenge is that of integrating the big informal

[1] Data refer in general to the fiscal year which runs from July 1 to June 30.
[2] Central Bank of Egypt data.
[3] Preliminary government estimate. In FY03 the number of people employed rose by 0.3 million to 18.2 million.

sector which was equal to 38% of employment in FY03, against 28% in the formal private sector and 34% in the public sector (including state-owned companies).[4]

The surge of inflation continued in FY04 following the significant depreciation of the Egyptian pound since January 2003, when the currency's long-standing USD peg was given up (Chart 1). The annualised CPI rose from 4.5% in FY03 to 10.0% in FY04. The latest CPI trend indicates that inflation is receding, following the bottoming out of the exchange rate depreciation. Consumer prices are expected to rise by about 5.7% in FY05. However, the CPI understates the actual inflation rate because of price regulations (mainly for social reasons, for instance price controls on basic food items). The wholesale price index (WPI) is widely regarded as a more realistic measure for price developments because the prices it covers are less regulated. The WPI increase peaked in the first quarter of 2004 with 21.6% y-o-y and receded to 14.3% y-o-y in the third quarter of 2004.[5]

Chart 1: Egypt - Exchange rate developments



Source: Datastream, IMF.

Fiscal policy

During the last fiscal years Egypt incurred big budget deficits. The central government deficit, which is a more accurate mirror image of the public sector borrowing requirement than the general government deficit, amounted to about 6% over the period from FY02 to FY04. The problem with the general government balance is that it includes large surpluses of the Social Insurance Funds (SIFs, about 5% of GDP), which are to some extent associated with revenues of uncertain reliability and long-term sustainability. Despite the currently still favourable demographic profile, benefit payments from the SIFs already exceed social security contributions. Although some reforms are envisaged, fiscal transparency problems remain present. The government also used major state-owned commercial banks for deficit financing, circumventing a hard budget constraint.

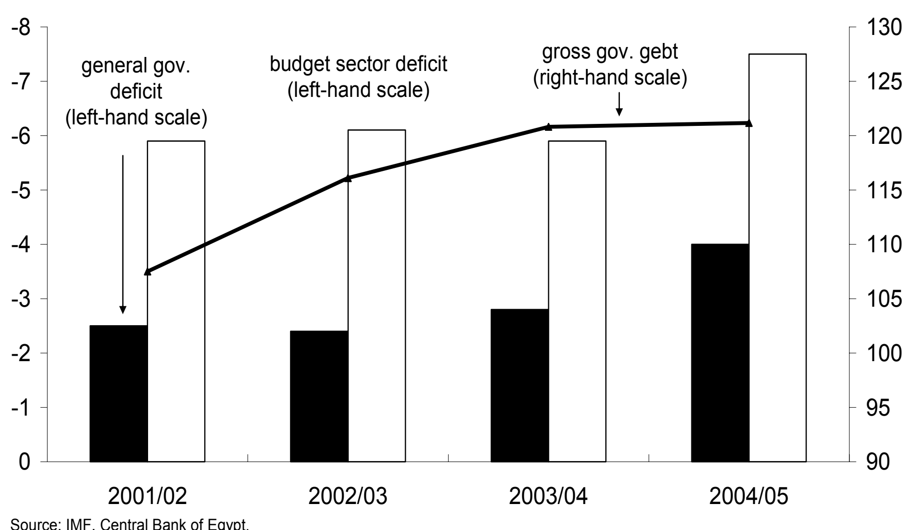
In FY04 the government began to increase wages and food subsidies to counterbalance the negative impact of the 2003 exchange-rate depreciation on the purchasing power of the population. Gross government debt, the majority of which is domestic, rose to 120.8% of GDP,

[4] Central Bank of Egypt data.
[5] Central Bank of Egypt data.

up from 116.1% in FY03 (Chart 2). The share of foreign debt remained relatively stable (about one fifth of total public debt). Net public debt also grew rapidly, to 69.2% of GDP. The high level of these debt ratios in combination with the recent fiscal deterioration raised sustainability concerns and led several international rating agencies to downgrade their outlook on Egypt's creditworthiness.

The central government deficit in FY05 is expected to rise sharply because of the drastic tariff dismantling and some tax cuts; however, these measures are part of the new government's reform programme to increase growth and tax revenue in the medium term. Revenue is expected to be up by about 7.4% in comparison with the previous fiscal year mainly because of higher income and sales tax revenues which make up the bulk of revenues (+7.3% and +8.3%, respectively), and higher income from petroleum and the Suez Canal (+9.5% and 41.5%, respectively). Customs duties might only grow by 3.3% due to tariff dismantling. Spending still expands more quickly than revenues (+11.2%), mainly because of higher wage expenditure (+10%), direct subsidies (almost doubling) and interest payments (+13.3%). Against the background of the recently adopted subsidy cuts (not included in the original budget) and the current positive growth outlook the deficit in FY05 is expected to amount to about 7.5% of GDP.

Chart 2: Egypt - Public deficits and debt (% of GDP)



Source: IMF, Central Bank of Egypt.

Monetary and exchange rate policy

The Central Bank of Egypt (CBE) is completing preparations for introducing inflation targeting as a new nominal anchor for monetary policy, substituting the exchange-rate anchor which was given up in January 2003. The Monetary Policy Co-ordination Council, which will convene quarterly and set monetary policy targets, was finally established in January 2005. In the past M2 has been used as target but the objective of a 10% M2 growth rate per annum was not met over the last years. Following the de-pegging of the Egyptian pound to the US dollar in January 2003, the pound lost about 25% of its value against the US dollar by December 2003 (Chart 1). Subsequently, the government adopted a series of measures, including foreign exchange restrictions, to stop a further slide of the currency and to alleviate the depreciation impact on consumer prices.[6] As a result, black market activities unfolded.

[6] Notably, from March 2003 (retroactive from January 2003) companies were required to convert at least 75% of their foreign currency earnings within a week of receipt at the official commercial bank rate.

During FY04 the adjustment pressure on the Egyptian pound bottomed out while the currency's fundamental position was strengthened by oil price increases and by the ongoing recovery of tourism revenues. Consequently, the Egyptian pound slowly converged to a support line of about 6.23 pound to the US dollar by October 2004 and the differential between the official rate and the black market rate, which had attained more than 16% during peak times, has recently almost disappeared. The real effective exchange rate appreciated somewhat in the course of 2004 but remained significantly below the rate before the de-pegging. In December 2004 the foreign exchange restrictions have been revoked. Furthermore, Egypt has accepted the obligation not to impose restrictions on payments and transfers for current-account transactions and not to introduce any other exchange restrictions or multiple currency practices without IMF approval, with effect from January 2005.

External sector developments

Egypt's current account surplus almost doubled to 4.3% of GDP in FY04. This was mainly due to a large increase of the services surplus, a smaller increase of transfer revenues, and a reduction of the trade deficit on the basis of strongly improved price competitiveness. Though the share of petroleum revenues was about 37.5% of exports, increasing oil prices did not fully translate into additional trade revenues because of petroleum imports equivalent to two thirds of petroleum export proceeds. Since the balance of goods and services was almost at par, the current account surplus was roughly equivalent to transfer revenues, especially to the relatively stable inflow of workers' remittances which amounted to USD 3 billion (three quarters of total transfer revenues). The US was the biggest source of remittances (about one third).

Capital exports increased strongly from USD 2.7 billion in FY03 to USD 6.2 billion in FY04. They exceeded the current account revenue by much more than 67%. Since official reserves shrank only marginally by USD 0.2 billion, the errors and omissions position rose from USD 1.4 billion in 2002/03 to USD 2.3 billion, possibly because of activities circumventing the introduced foreign exchange restrictions. Net FDI in Egypt fell from its already low level of USD 0.7 billion in the fiscal previous year to USD 0.4 billion (0.5% of GDP) in FY04. This is the lowest inflow since ten years. FDI inflows were possibly restricted due to uncertainties about the old government's policy stance which arose after a significant increase of the public debt ratio and the introduction of foreign-exchange restrictions. More than half of FDI came from the US, about 35% from Arab countries and less than 10% from the EU. Foreign reserves changed little and amounted to USD 14.8 billion (June 2004), corresponding to nine months of merchandise imports.

2. Structural reforms

The new government appointed in July 2004 has embarked upon an ambitious reform agenda endorsed by the ruling National Democratic Party and the President of the Republic. Customs tariffs have been restructured and tariffs substantially cut. The banking sector reform, including privatisation and strengthening of the financial regulatory bodies, also appears to be progressing significantly but will certainly need time to result in concrete efficiency gains. Moreover, important personnel changes have taken place in key policy areas, which should help speed up planned reforms. Some important subsidies have also been cut, and a fiscal reform is underway with a substantial reduction of the sales tax to be expected. These measures are important to spur

more investment which is a precondition for the creation of sufficient employment for the rapidly expanding population.

Trade liberalisation

Major reforms took place in the customs area. In March 2004 the Ministry of Finance adopted a plan to render the Customs Authority and procedures more efficient. Furthermore, Presidential Decree No. 300/2004 issued in September 2004 brought about fundamental changes in the customs tariffs structure. Tariff bands were reduced from 27 to 6, and tariff items from 13,000 to 6,000. Administrative and WTO- incompatible ad valorem services fees were eliminated and the average tariff rate was also substantially reduced (from 14.6% to 9.1%). It is expected that the loss of revenues due to the tariff cuts will reach EGP 3 billion. However, the reduction of tariffs is expected to bring about several benefits in terms of lower domestic prices. This could help to improve the competitiveness of domestic industries in the international markets and to increase economic activity.

Egypt continued to pursue regional trade integration in addition to the entering into force of the Association Agreement with the EU on 1 June 2004 (its trade provisions had entered into force already on 1 January 2004).[7] In particular, Egypt signed the Agadir Free Trade Agreement with Morocco, Jordan and Tunisia in February 2004. The Agreement commits the parties to remove all tariffs on trade between them and to intensify their economic cooperation by harmonising standards and customs procedures. After ratification tariffs will be reduced immediately by 80%, and within 2005 they will be completely abolished. (An important part of the Agadir Agreement is the adoption of Pan-Euro-Med rules of origin.) Furthermore, Egypt signed an agreement with Israel and the US for the establishment in Egypt of seven “Qualifying Industrial Zones” in December 2004. Goods can be exported to the US from these zones free of duty, quota or any other trade barrier, provided a minimum of 35% of the value (including labour) is added locally, of which 11.7% must be Israeli. In addition, the 17-nation Pan Arab Free-Trade Area (PAFTA), of which Egypt is a founding member, was formed in January 2005.

Fiscal reforms and public administration reform

The country’s public finances are burdened by large off-budget activities which have significantly increased the government borrowing requirement. Measures to bring them fully under control are at an early stage.[8] In particular, operations of the National Investment Bank not related to the government’s investment programme are not transparent and are insufficiently monitored. In FY04 public finances worsened because government subsidies for food and other basic import goods were increased as a compensation for the loss of purchasing power of the low-income classes due to the pound depreciation. However, in the first half of FY05 major steps were taken to reduce the subsidies bill. Subsidies on water, gas and diesel have already been cut in September 2004 (the government raised the diesel prices – which had remained unchanged for

[7] Whereas industrial exporters from Egypt benefited from duty-free and quota-free access to the EU already before, Egypt will now phase out duties on corresponding EU goods according to four schedules: tariffs on raw-materials and industrial equipment within three years, tariffs on semi-finished goods within nine years, tariffs on finished products within 12 years and on luxury goods and vehicles within 15 years. For agricultural products from Egypt existing EU import quotas have been expanded, and new quotas for products that had not enjoyed preferential treatment have been added.

[8] The World Bank recently launched a Public Expenditure Review (PER) in Egypt.

the last 10 years – by 50%). This measure is estimated to decrease the subsidies allocated to diesel by EGP 1 billion annually.

The government also has taken measures to reform the income tax and to modernise the tax and customs procedures. The tax reform aims at eliminating tax distortions and at making the income tax burden sustainable taking into consideration additional regional tax rates. The new law will unify rates for enterprise profits, subjecting all companies to a 20% tax on profits, and raise the exemption level to EGP 5,000 for personal income. The new Income Law, which is expected to be approved by the People's Assembly in its November Session, will also eliminate current tax exemptions on investments. The government's plans to transform the General Sales Tax (GTS) into a Value Added Tax (VAT) still wait for realisation. However, a fiscal reform is underway, and a substantial reduction of the sales tax has been announced.

Privatisation, enterprise restructuring and business environment

The pace of privatisation remained slow during 2003 and the first half of 2004 because of political resistance to potential job losses and the nature of the companies left for privatisation (for instance, important banks and utilities). In some cases, the negative economic situation of the companies prevented privatisation. With the exception of the Suez Canal Authority and the Egyptian General Petroleum Corporation, most state-owned companies are loss-making and in need of restructuring. Those under the jurisdiction of the Ministry of Public Enterprises were estimated to be loosing EGP 1.8 billion each year in the recent past. The results of measures adopted in 2003 and 2004 to attract private investors to public enterprises by capital increases have been limited, probably because they did not give private investors the minimum stake necessary to wield sufficient influence.

However, some positive signs with regard to privatisation are emerging. In March 2004 the state-owned Banque du Caire sold its 40% share in the joint venture Cairo Barclays Bank to the majority shareholder Barclays. This was the first significant government sale of this type in at least three years. At the same time, six companies under the Holding Company for Chemicals were sold in August 2004. Furthermore, the new Ministry of Investment Development has presented a privatisation programme which aims at attracting private investments to companies that need restructuring. It permits, in principle, the acquisition of more than 50% of the capital by private investors. The Ministerial Committee for Privatisation has proposed the selling of 66 loss-making companies in 2004 under this strategy.

Financial sector reforms

The ruling National Democratic Party presented in its last Congress in September 2004 a comprehensive financial sector reform plan. Besides the measures mentioned below for the banking sector, the reform plan aims at establishing a single financial supervision authority. A first step in this direction has been the establishment of the Ministry of Investment to which all institutions operating in the field of non-banking services have been affiliated (insurance, capital market, real estate and financial rental). The reform plan also aims at reviewing Law 10/1981 on the supervision and monitoring of insurance companies to meet international standards, to gradually reduce taxes and duties on insurance premiums, to propose one of the public insurance companies to the private sector to increase its competitiveness and efficiency and promote insurance awareness.

The banking system saw a number of smaller adjustments following the introduction of the new Unified Banking Law in 2003. Early 2004 several decrees were issued to bring the Banking Law reform to fruition: in February, the Central Bank of Egypt's new charter was issued bringing the Bank directly under the auspices of the President and obliging it to report to parliament. Furthermore, new regulations were adopted in March, mainly for the operation of the Coordination Council, the establishment and ownership of banks, the establishment of a credit collection system and the regulation of the foreign exchange market. Moreover, the CBE set June 2005 as a deadline for meeting the new capital requirement (increase of the minimum capital requirement from 100 million Egyptian pound to 500 million pound and for foreign banks from 15 million USD to 50 million USD). This new restriction is expected to trigger a consolidation of the banking system which is characterised by four state-owned banks directly controlling about 50% of all assets.

A five-year plan has been adopted recently by the CBE aiming to reform and develop the banking sector. It envisages restructuring public banks with special attention to non-performing loans as a first step for their privatisation, reinforcing monitoring and supervision regulations, and merging small banks with a limited capability to meet the minimum capital requirements. The CBE has already announced the merger of six small poorly performing banks and the sale of public shares of joint venture banks over the next two years. The revenues are to be used to increase the capital and restructure public banks. The reform plan also encompasses the privatisation of at least one of the four large public banks (Bank of Alexandria). Furthermore, at the beginning of October, the CBE gave permission to 10 banks to set up a US dollar inter-bank mechanism which should enhance the liquidity of the foreign exchange market.

Efforts continue to bring the capital market into line with international standards. Several laws were amended to reform the regulation for securitisation and to permit the emission of asset-backed securities by securitisation companies.[9] Moreover, the Capital Market Authority was given the responsibility for licensing companies and funds dealing with securitised assets. Companies traded on the Cairo and Alexandria Stock Exchange (CASE) are now required to apply international standards for accounting and disclosure. At the beginning of 2004, new membership rules were issued to increase CASE's supervisory authority, efficiency and trading transparency. Finally, on 6th July 2004 the primary dealers system for government securities became operative. It allows 13 financial institutions to underwrite primary issues of government securities and to trade them in the secondary market.

Labour market reforms

The Social Fund for Development (SFD) is currently carrying out a program to establish a network of 100 labour exchange offices around the country aiming at monitoring the labour market and giving assistance to job seekers, standardising CVs and creating an electronic labour market information system. The SFD has also managed several "Labour Pools" to help laid-off workers from privatised public companies. Furthermore, the European Commission will soon launch a EUR 33 million project for the establishment of private-public sector partnerships in the area of vocational training.

After a decade of parliamentary debate a Unified Labour Law was enacted in 2003, providing a comprehensive framework for the functioning of the labour market and labour relations. Though

[9] In particular, the Capital Market Law, Real Estate Finance Law, Central Depository Law and Mortgage Law etc.

it allows private sector companies to invest in the field of job services, no private initiatives have developed by the end of 2004.

EGYPT

Main economic indicators

	2001/02	2002/03	2003/04	for. 2004/05
Real sector				
Real GDP growth (% yoy, avg)	3.2	3.1	4.4	5.0
Inflation CPI avg, % yoy	2.4	4.5	10.0	5.7
Unemployment rate, %	9.0	9.9	10.7	11.0
GDP per capita, in USD	1283	1178	1061	1053
Fiscal Sector[1]				
Total revenues, % of GDP	27.3	27.8	27.9	27.5
Total expenditure, % of GDP	30.0	30.2	30.8	31.5
Consol. budget balance, % of GDP	-2.5	-2.4	-2.8	-4.0
Consol. budget balance, % of GDP excl. grants	-3.5	-3.4	-3.3	---
Central government balance, % of GDP	-5.9	-6.1	-5.9	-7.5
Central government balance, % of GDP excl. grants	-6.9	-6.8	-6.4	---
Gross government debt, % of GDP	107.5	116.1	120.8	121.2
Monetary sector				
Reserve money, % change yoy	5.4	21.0	24.7	---
Broad money (M2)[2], % change yoy	15.4	16.9	13.2	13.0
Credit to the private sector[2], % of GDP	53.1	53.8	54.2	---
Degree of Monetisation (M2/GDP)	85.8	95.1	98.9	102.6
External sector				
Current account balance, % of GDP	0.7	2.4	4.3	3.1
Current account balance, % of GDP excl. grants	-0.4	1.7	3.7	---
Trade balance, % of GDP	-5.9	-0.9	-0.1	-0.1
Net foreign direct investment, % of GDP	0.5	0.8	0.5	---
Net int. reserves, import cover (months)	11.6	12.0	9.9	---
External Vulnerability				
External Debt, % of GDP	33.6	36.4	44.2	40.7
Debt-to-Export Ratio, %	404.2	354.9	336.0	337.1
Debt Service Ratio[3], %	9.7	10.1	9.2	9.7
Reserves/M2, %	18.8	21.6	21.0	---
Financial sector				
Short-term interest rate (eop i.e. June)[4]	7.8	7.7	8.7	---
Discount rate (eop i.e. June)	11.0	10.0	10.0	10.0
Exchange rate (per USD, eop)	4.5	6.0	6.2	---
Exchange rate (per EUR, eop)	4.4	7.0	7.2	---
Real effec. exchange rate (1994/95=100)	104.6	83.5	86.5	---

Source: Central Bank of Egypt, IMF, Worldbank, IIF, Datastream.

[1] General government, unless otherwise indicated.

[2] Excluding exchange rate revaluation effects.

[3] Total debt service in % of goods and services.

[4] 3-months T-bill, up to October 2003.

GEORGIA

- **The Georgian economy continued to perform well in 2004. The deceleration in real GDP growth from 11.1% in 2003 to 8.4% in 2004 is mainly due to a recession in the agricultural sector. The construction of oil and gas pipelines through Georgia brought about an additional stimulus which had positive spill-over effects in the service sector.**
- **Inflation remained broadly unchanged at 7.5% in 2004, because the appreciation of the Georgian lari helped containing inflationary pressures originating from the legalisation of the economy. The current account deficit (around 7.5% of GDP) did not deteriorate as much as expected because remittances and other current transfers compensated for increased import demand.**
- **The new government reinvigorated reform efforts in several areas and significant progress was visible already during the first year in office. Georgia resumed borrowing from the IMF in June 2004 and received strong support also from the World Bank, the Paris Club creditors as well as bilateral donors, including at the Brussels donor conference.**
- **Following the inclusion of Georgia in the European Neighbourhood Policy in June 2004, the Commission has released a Country Report which reviews progress in the transition to democracy and a market economy. The Report will be a starting point for the discussions on an ENP Action Plan with Georgia in the course of 2005.**

1. Macroeconomic developments

Real sector developments

According to preliminary estimates, real GDP growth remained robust in 2004 at 8.4% despite a recession in the agricultural sector (-3.6%). Manufacturing and construction were driving growth. Industrial production is estimated to have increased by 17%. Moreover, the large oil and gas pipeline construction projects generated positive spill-over effects for the services sector. Recent estimates indicate that the share of the informal economy in total output started to decline in 2004 following the authorities' actions against tax evasion. Estimates on the share of the shadow economy range from 40 to 60%. The national accounts may therefore also reflect the inclusion of activities previously unaccounted because of methodological problems.

Consumer price inflation stabilised at an annual average of 4.8% in 2000-2003 after a peak of 19% in the aftermath of the Russian economic crisis and the subsequent devaluation of the Georgian lari. In late 2003, however, food prices in particular increased following weak harvests in the whole region (CPI +7% y-o-y in December 2003). The 12-month consumer price inflation stood broadly unchanged at 7.5% in December 2004. In early 2005 inflation appeared to have further accelerated, partly due to higher international oil prices and weather conditions. Furthermore, and perhaps more importantly, the rapid changes in the economic environment (such as government actions against tax evasion) combined with a more accommodating monetary stance have played a significant role. Establishing an appropriate macroeconomic policy mix in these circumstances is obviously a challenge, as inflation continues to exceed the five-percent-target set in the IMF-supported economic programme.

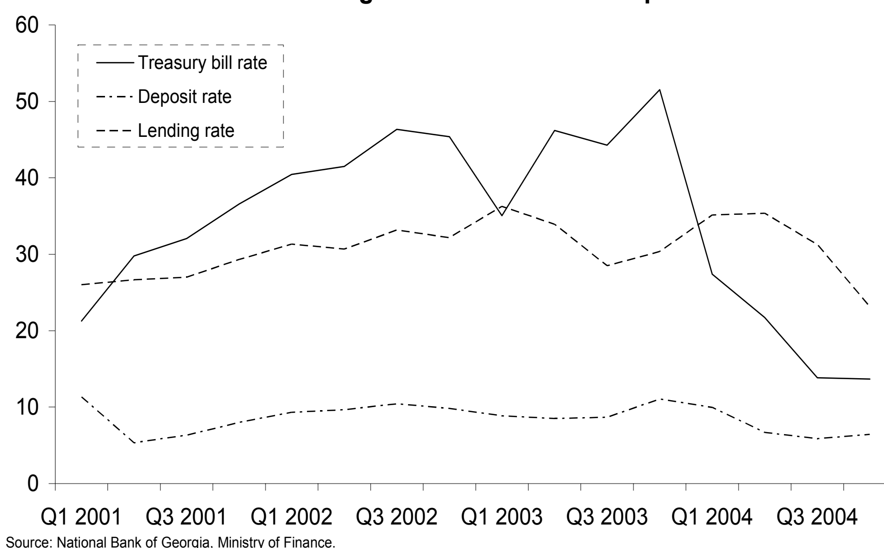
Fiscal policy

Fiscal policy was on a sound basis in 2004 owing to a strong performance in revenue collection as a result of effective measures taken by the new government against tax evasion and smuggling. Tax revenues as a percentage of GDP are estimated at about 18 % (14.5 % in 2003). The reintegration of tax collection in the Autonomous Republic of Adjara in the central government's revenue collection system, following the collapse of Mr. Abashidze's regime in May 2004, was a significant achievement.

On a cash basis, the overall fiscal deficit is estimated at around 1.5 % of GDP, as the stock of expenditure arrears was reduced rapidly. On a commitment basis, a small surplus is estimated at about 0.7% of GDP. While there was a surge in revenues, exceeding estimated amounts in the revised budget by 14%, the implementation capacity of ministries was strained so that delays in planned capital expenditures, in particular, were evident. Nevertheless, actual budget expenditures were 26% higher than in 2003. Strong growth in revenues and expenditures is projected also for 2005 so that a level of well over 20% of GDP is reached.

Privatisation proceeds increased in 2004 to the equivalent of 0.9% of GDP (0.3% in 2003), while a surge is expected in 2005 if all planned deals are closed successfully. So far, the equivalent of 3.5% of GDP is already being projected as receipts for this year. The government is inclined to allocate these extraordinary receipts immediately to finance increases in various expenditure categories (notably defence, energy sector, pensions, and education), while a more gradual utilisation of the receipts through a privatisation fund mechanism is not contemplated for the time being. In these circumstances, careful macroeconomic management is required to facilitate a smooth absorption of the additional resources. Therefore, the fiscal stance should be more supportive of the central bank's efforts to keep inflation in control.

Chart 1: Georgia - Interest rate developments



Source: National Bank of Georgia, Ministry of Finance.

The government expects that it will be able to clear all domestic expenditure arrears in 2005, consisting mostly of wages, pensions and social benefits. These arrears totalled approximately 5% of GDP at the end of 2003. Domestic public debt was equivalent to about 11% of GDP at the end of 2004 (15% the year before). As a sign of recovering confidence in the government's economic policies, yields on treasury bills have declined from a peak of 77 % (October 2003) to 16 % in February 2005 (Chart 1).

Monetary and exchange rate policy

Against the background of steady remonetisation (increase in the demand for money), the National Bank of Georgia (NBG) has maintained a broadly prudent monetary policy stance. The increase in the demand for money was reflected in high growth rates of monetary aggregates (M2: annual change +49% as of February 2005). In 2004 the NBG allowed a market driven appreciation of the lari in order to contain inflationary expectations. The NBG intervened, however, in the foreign exchange market to smooth the appreciation trend, beginning to sterilise its interventions only towards the end of the year through the limited monetary instruments at its disposal.

Nevertheless, the lari appreciated about 15% against the US dollar in nominal terms during 2004, which triggered critical comments also in the parliament given the prevalence of dollar denominated incomes and savings (e.g. from remittances). The demand for lari increased partly as a result of the government's actions against tax evasion and smuggling. Dollarisation has been persistent in Georgia, but in 2004 the share of foreign currency deposits started to decline to below 80% of all deposits for the first time in several years.

External sector developments

The increase in the current account deficit (due to high import demand for the construction of the Baku-Tbilisi-Ceyhan oil pipeline) was not as high as expected, due to strong inflows of remittances and other transfers. According to preliminary estimates, the current account deficit was about 7.5% of GDP (up from 7.2% in 2003). Gross international reserves of the NBU increased substantially during 2004, although they are still at a relatively low level covering less than two months of imports at the end of the year.

Georgia's public external debt remained broadly unchanged in nominal terms at about USD 1.8 billion, while the external debt ratio decreased substantially from 46% of GDP in 2003 to about 37% of GDP at the end of 2004. During the second half of 2004, Georgia concluded agreements with most of its bilateral creditors, most importantly with Russia, in line with the July 2004 Paris Club agreement. These agreements are expected to reduce debt service due to Paris Club creditors from USD 169.2 million to USD 46.4 million (under "Houston terms") over three years. The Paris Club creditors also are willing to consider a debt treatment under terms of the Evian Approach. This should happen when the current agreement expires provided that Georgia has demonstrated a satisfactory track record by that time.

2. Structural reforms

A future ENP Action Plan[1] for Georgia is expected to stimulate structural reforms towards the creation of a fully-fledged market economy and greater regulatory convergence with the EU. For that purpose the following actions, in the economic area, are envisaged: (i) support for market economy reforms leading to gradual economic integration into the EU's Internal Market; (ii) further support for economic rehabilitation of conflict zones in the context of conflict settlement; (iii) increased financial support including an extension of the EIB mandate to Georgia as of 2007; (iv) enhanced financial support for regional cooperation; (v) intensification of cooperation

[1] The current political, economic and institutional situation is described in European Commission (2005), Commission Staff Working Paper – Annex to: "European Neighbourhood Policy", Country Report Georgia, Reference: SEC(2005) 288, March, http://europa.eu.int/comm/world/enp/pdf/country/georgia_cr_0503.pdf.

in the energy, electronic communications and transport, environment, maritime affairs and fisheries and public health sectors as well as (vi) enhanced cooperation in the field of science, technology and innovation and of people-to-people contacts, in particular in the area of education, training and youth. Moreover, if progress is being made with the implementation of an Action Plan, there is a possibility of a new enhanced agreement to replace the Partnership and Cooperation Agreement (PCA) upon its expiry in 2008.

Trade facilitation and liberalisation

In the EU-Georgia Partnership and Cooperation Agreement (PCA), which has been in force since 1999, the parties granted each other Most Favoured Nation (MFN) treatment and eliminated trade quotas. The PCA provides for the protection of intellectual, industrial and commercial property rights (similar level of protection to that existing in the EU, including effective means for enforcement). Georgia benefits from the Generalised System of Preferences (GSP) scheme of the EU, and has been able to diversify somewhat its exports to the EU. Georgia's recent request for the special incentive arrangement of GSP accorded on the basis of labour rights protection is being assessed by the European Commission. Georgia has free trade agreements with Russia, Ukraine, Armenia, Azerbaijan and Kazakhstan.

Georgia joined the World Trade Organisation (WTO) in June 2000. Its weighted average tariff increased somewhat in 2002-2003 to about 11.3%, following the increase in the number of tariff bands from 3 to 22 and the increase in the maximum tariff rate from 12 to 30% (within the margins provided at the time of Georgia's accession to the WTO). In line with its announced outward looking growth strategies, the new government is preparing to dismantle these protective measures. According to the terms of Georgia's WTO accession, the number of tariff bands was reduced to 16 in January 2005. Parliamentary approval on further trade liberalisation will be sought in the course of 2005.

Fiscal and public administration reform

A new, liberal tax code became effective in January 2005 following the examples of several Eastern European countries. It is expected to yield efficiency and revenue gains. The number of taxes was reduced from 21 to 7 (VAT, income tax, property tax, payroll tax, excise, and gambling tax). A flat-rate personal income tax (12%) replaced marginal rates between 12% and 20%, and the payroll tax is reduced from 33% to 20%. The VAT rate will be reduced from 20% to 18% in mid-2005. Self-employed persons obtain particularly favourable tax treatment as they are exempted from income and payroll taxes. The threshold for VAT is set at 10 000 laris (about 4 000 euros). Due to social concerns, property tax is not imposed on small holdings of agricultural land or on real estate owned by low income households.

The revenue loss linked to the rate reductions is expected to be offset by higher excise taxes and the elimination of various exemptions. To boost the legalisation of the informal economy, a fiscal amnesty is provided for undeclared income and assets acquired by the end of 2003 (government officials are excluded). Only a one-off tax payment of one percent on the declared value is collected on such assets in 2005. A revision of the customs code is also planned, supported by an overhaul of the customs administration. Measures have already been taken to streamline tax and customs offices and the total number of staff has been retrenched.

Under the new Budget System Law, significant steps were taken in public finance management reforms during 2004, including the effective introduction of a single treasury account, improvement of commitment control and consolidation of extra-budgetary funds in the budget system. The VAT refund mechanism has become fully operational. Preparations for the introduction of a first Medium-Term Expenditure Framework (as of the 2006 state budget) were also launched. A large number of former budget entities will be transformed into "legal entities of public law", which is expected to increase efficiency provided that transparency and accountability in the use of public funds is respected.

Comprehensive reform programmes have been launched to re-orientate education and social assistance systems. The existing heterogeneous categorisation of social assistance will be replaced by monthly cash benefits targeted to the poorest households. The new system is expected to be operational at the end of 2005. New financial mechanisms are envisaged for higher education with equal accreditation of public and private establishments. Vocational training guided by the requirements of employers will also be an important area of reform.

President Saakashvili and the new government came to power with a strong commitment to tackle corruption and started immediately pursuing several anti-corruption and anti-smuggling actions. A hard-line approach was adopted vis-à-vis a number of well placed individuals from whom substantial receipts were obtained to the state budget (often through extra-judiciary settlements). Another highly visible campaign was directed at the traffic police force, which was radically downsized and reorganised. A Financial Police Unit was established at the Ministry of Finance to consolidate investigative functions concerning the use of public funds. While the immediate overall impact of these anti-corruption measures is fully recognised, many NGOs and other observers underlined that due respect must be paid to civil and human rights in all circumstances.

The civil service has been downsized significantly in all parts of the administration, while public sector wages are being increased. The outcome for 2004 was a reduction of 23% in the civil service workforce (about 30 000 positions), and the process is expected to continue in 2005. The number of ministries was reduced from 18 to 13 through mergers, and 18 former state departments were brought under line ministries. To lead and coordinate the next phases of the reform process, a Civil Service Council and Bureau have been set up. Their main task is to develop and implement a uniform system for selection, recruitment, training and compensation.

Privatisation, enterprise restructuring and business environment

After a period of stalling, privatisation has also been resumed with renewed attempts to bring private investment into large state-owned enterprises. A list of 372 non-strategic assets, including several objects from the Autonomous Republic of Adjara, was drawn for privatisation in the short term (2004-2006). Careful preparation and transparency of tender procedures have yet to be fully achieved, particularly in the case of large enterprises. Large state-owned enterprises are planned for privatisation in the telecommunication, transport, mining and industrial sectors. Following the sales of the Chiatura Manganese Plant and the Batumi Ocean Shipping, the privatisation process of five other major state enterprises was launched in March 2005 (including the Rustavi metallurgic plant, the Azoti fertilizer factory, and oil processing facilities in Batumi).

New legislation on land privatisation has been submitted to the parliament. About 75% of agricultural land still remains in state ownership, as the privatisation process stalled already in

the early stages of transition. With a functioning real estate market and better access to credit, it is expected that productivity in agriculture should substantially improve. Currently, agriculture is largely confined to subsistence farming. The agricultural sector has absorbed a substantial number of workers who were made redundant in the industrial sector during the transition process.

Progress is also expected in other key areas, such as the energy sector rehabilitation, which would, however, require substantial new investments over several years as only some very basic repairs have been made so far. The IMF has estimated that the energy sector's quasi-fiscal losses in 2004 were reduced somewhat to about 4.5 % of GDP (4.9 % in 2003) following a gradual increase in cash collections for consumed electricity from main customers. Measures were also taken to reduce the theft of electricity but technical losses remain large. The debt of the energy sector still has to be addressed. It is estimated at least at the equivalent of EUR 400 million at the end of 2004.

Electricity generating companies are being prepared for privatisation, starting from 2005. Possible privatisation of strategic assets such as the gas trunk line is, however, a more controversial issue. A new Regulatory Commission has been appointed to oversee the energy sector and it enjoys independence in setting energy tariffs. Overall, the setting of tariffs will be reviewed in electricity, gas, water and telecommunications sectors with a view to creating an independent multi-sectoral tariff regulating board.

Improving the business climate also appears on the government's agenda. The Georgian authorities report that currently 30 state agencies issue 65 different licences. The government intends to simplify the system of licences and reduce the number of controlling agencies aiming at ensuring transparency in the process of granting licences with a clear separation of market players and regulators. Furthermore, the Georgian Trade and Investment Agency has become active in early 2005. The EBRD is sponsoring the establishment of the Georgian Investment Council to help promote the public-private sector dialogue.

Financial sector reforms

In May 2004 Georgia ratified the Council of Europe Convention on "Laundering, Search, Seizure and Confiscation of the Proceeds from Crime" (the Strasbourg Convention of 1990), and is currently considering how to improve the anti-money laundering system in the country. A recent evaluation report notes that there has been a generally positive response following the dialogue with the Council of Europe, although the pace of progress has undeniably been slow in Georgia in putting in place an anti-money laundering system. A Financial Monitoring Service has now been established within the structures of the NBG.[2]

Financial sector reform and development have advanced significantly in recent years. The banking sector is being consolidated through increases in the minimum capital requirements for commercial banks from GEL 5 million to GEL 12 million (approx. EUR 5 million) by 2008. The NBG has also strengthened regulations on single party and connected lending. The ratio of non-performing loans to total commercial bank loans decreased from 7.5% to 5.5% during 2004. Despite this progress, many banks lack liquidity and remain undercapitalised.

[2] MONEYVAL (Council of Europe, Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures), 20 January 2005.

Poverty reduction and labour market issues

Poverty incidence has increased in the past few years. According to household surveys, 54.5% of Georgian population live below the poverty line, and 17% in extreme poverty. Some preliminary estimates for 2004 show a slight improvement, but most alarmingly there are indications of growing incidence of extreme poverty in rural areas. Regional differences remain large. The poverty rate is as high as 78% in some regions, and around 45% in the capital, Tbilisi. Higher poverty levels are in most cases associated with geographical isolation and a low intensity of arable land use.[3]

With enduring low productivity in the agricultural sector, combined with high unemployment, the vicious circle of poverty is not broken yet. Over half of the economically active population is engaged in agriculture. The very high share of food in households' spending not only excludes other needs such as education, medical care and housing but also prevents households from increasing input into farming. Total employment is estimated at about 1.8 million 60% of which are self-employed. Unemployment, according to ILO definition, was 12.7% for January-October 2004 (11.5% in 2003 as a whole). The integration of the Internally Displaced Population in the labour market represents a particular problem to be tackled.

[3] Millennium Development Goals in Georgia, UNDP, Tbilisi, 2004.

GEORGIA

Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% change)	1.9	4.7	5.5	11.1	8.4
Inflation CPI (period average)	4.0	4.7	5.6	4.8	5.8
GDP nominal, in USD millions	3,042	3,201	3,392	3,984	5,150
GDP per capita, in USD	654	695	741	876	1125
Social Indicators					
Unemployment	10.3	11.1	12.3	11.5	12.7
Poverty rate (% of population)	51.8	51.1	52.1	54.5	52.3
Social sector spending (% of GDP)	6.9	8.2	8.3	7.1	9.5
Inequality (Gini index for consumption)	0.40	0.38	0.39	0.38	---
Fiscal Sector					
Total revenues, % of GDP	15.2	16.3	15.8	16.2	20.8
Total expenditure, % of GDP	19.2	18.3	17.8	18.7	20.0
General govt. balance, % of GDP, cash basis	-2.6	-1.6	-1.9	-1.3	-1.8
Gross public debt, % of GDP	69.8	68.4	67.4	61.5	47.8
Monetary sector					
Domestic credit to private sector (% of GDP)	9.0	7.0	8.0	9.0	---
Broad money (M3), % yoy	39.0	18.5	17.9	22.8	42.6
Degree of monetisation (M3/GDP, %)	10.3	11.0	11.6	12.4	15.4
Dollarisation in bank deposits (%)	77.9	85.7	84.9	86.1	78.0
External sector					
Current account balance, % of GDP	-4.3	-6.4	-5.8	-7.2	-7.5
Trade balance, % of GDP	-13.0	-15.2	-12.9	-15.6	-17.6
Foreign direct investment (net flow,% of GDP)	5.1	3.2	4.0	8.0	---
Import cover of reserves (months)	1.0	1.4	1.7	1.3	1.9
External Vulnerability					
External Public Debt, % of GDP	51.3	51.7	52.4	46.2	36.8
Debt Service Ratio[1]	13.5	4.9	3.6	4.5	5.9
Gross reserves (excl. gold, USD millions)	109	159	198	191	383
Reserves/M3	34.9	44.9	50.4	38.7	48.6
Financial sector					
Treasury bill rate	26.0	29.9	43.4	44.3	19.2
Lending rate	32.8	27.3	31.8	32.3	31.2
Exchange rate (lari per USD, average)	1.98	2.07	2.2	2.15	1.92
Exchange rate (lari per EUR, average)	1.83	1.85	2.42	2.43	2.38

Sources: IMF, EBRD, Georgian authorities

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

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- **The Israeli economy continued to recover in 2004 (4.3% real GDP growth), allowing some increase in per capita incomes since the slump of 2001. Nevertheless, political and security risks continued to take their toll on Israel's economic performance, keeping it at the lower end of its potential.**
- **Fiscal policy in 2004 remained geared towards consolidation and the reduction of the size of the public sector. Increased revenues, coupled with public expenditure restraint, reduced the central government deficit to 3.9% of GDP (target: 4% of GDP), down from 5.6% of GDP in 2003. However, public debt remained high at about 107% of GDP.**
- **Limited inflationary pressures allowed a further easing of monetary policy in 2004. Despite the narrowing of the differential with US interest rates, the new Israeli shekel (NIS) remained relatively stable against the US dollar, indicating increased confidence in the Israeli economy.**
- **The pace of structural reforms was sustained in 2004. Ambitious reforms were carried out within the framework of the 2003 Economic Recovery Plan. In 2004 the authorities focused mainly on tax reduction, increasing competition, and reform of the pension system.**

1. Macroeconomic developments

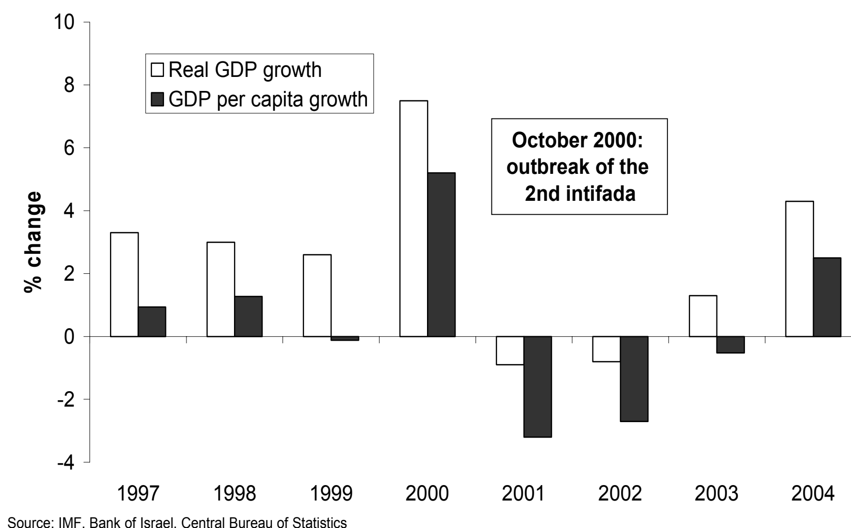
Real sector developments

The Israeli economy continued to recover in 2004, with real GDP growth of about 4.3%, up from 1.3% in 2003 (Chart 1). With this growth rate coming against a background of population growth of 1.7%, 2004 was the first year of per capita income growth since the slump of 2001, when the deterioration of the security situation, the weak external environment and the uncertain economic policy response plunged the Israeli economy into recession (real GDP growth of -0.9% and -0.7% in 2001 and 2002). Nevertheless, the political and security situation remained fragile and continued to take a toll on Israel's economic performance, keeping it at the lower end of its potential. On the social front, the welfare reforms introduced since 2003 (notably reductions in transfer payments and stricter eligibility criteria for income support) helped raise the labour market participation rate to about 55% of the working age population;[1] however, this is still low by international standards. Higher participation rates contributed to a slower reduction of unemployment rates, which declined only slightly, to about 10.4% in 2004, despite the recovery of growth and increased employment in the business sector.

Economic recovery in 2004 was led by exports, supported by higher world demand for high-tech products, and a pick-up in private consumption as monetary policy eased. The most dynamic sectors were manufacturing, particularly in the high-technology export segment in which Israel specialises, and most service industries, including tourism.[2] Growth in 2004 also benefited from an improved global economic outlook, relative calm on the security front, and the productivity

[1] Higher participation rates mainly reflected higher participation by women and more part-time jobs.
[2] The tourist sector grew by 30% in 2004, mainly as a result of reduced security risks. But the number of visitors remained well below the peak year of 2000.

gains generated by the thorough reforms undertaken since 2003.[3] By contrast, investments in fixed assets remained sluggish (except for increased inventories) and non-military public expenditure declined due to fiscal consolidation. Furthermore, security expenditures and construction activity also declined in 2004. Expectations for 2005 are of continued but moderate growth, restrained somewhat by slowing global growth and by the impact of sluggish investment in fixed assets and reduced public consumption in 2004.



2004 was characterised by a mild deflationary environment. The annual inflation rate was slightly negative at -0.2% for the second half of 2004, leading to an average increase of 1.2% for 2004, i.e. within Israel's price stability target of 1–3%. Despite rising costs of oil imports, price increases were held back by tight fiscal policies, declining unit labour costs, the strength of the currency as well as surplus production capacity.

Fiscal policy

Fiscal policy in 2004 remained geared towards consolidation and reduction of the size of the public sector. Public expenditure restraint enabled the central government deficit to be reduced to 3.9% of GDP, slightly below the target of 4% of GDP and down from 5.6% of GDP in 2003. This corresponds to a general government deficit of -4.3% of GDP, also improved compared to the 2003 outcome of -6.4% of GDP. Current revenues remained stable in real terms reflecting, on the one hand, a sharp increase in receipts from government assets and the improved economic activity and, on the other, the effect of cuts of direct and indirect taxes (see below). At the same time, efforts continued to contain expenditures, notably by the adoption of a rule limiting the rise of expenditures to 1% per year in real terms. In addition, substantial savings derived from lower investment in infrastructure and welfare reforms started in 2003.[4] Pension reforms approved in 2004 should lead to further expenditure savings in the future.

In 2004, although government financing requirements were mostly satisfied by borrowing on the domestic market, financing from abroad continued to provide an important source of financing.

[3] To counter the recession the Israeli authorities launched an ambitious Economic Recovery Plan in March 2003 geared towards reducing the government sector and carrying out broad structural reforms in the labour, product and financial markets.
[4] Notably those leading to reductions of maternity and children allowances and unemployment transfers.

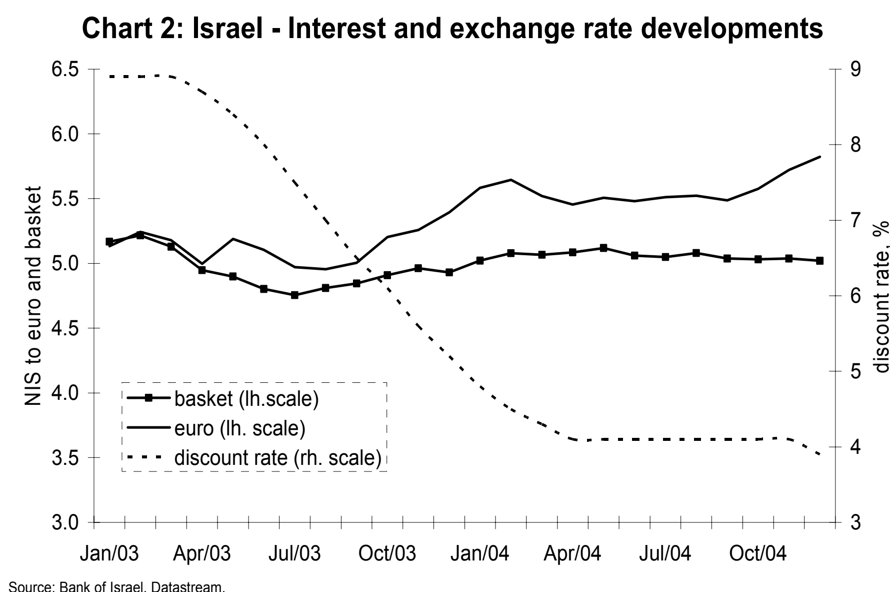
In February 2004, Israel benefited from new US loan guarantees worth USD 3 billion, conditional on additional reforms leading to a more substantial deficit reduction and privatisation. The authorities also successfully issued a number of US-denominated bonds, reflecting rising confidence in the economy. On the other hand, revenues from privatisation were lower than expected. Public debt remained high at 107% of GDP, unchanged from 2003.

The approval of the 2005 budget was, as often the case in Israel, highly controversial and led to a change in the government coalition. The budget was approved by the Knesset at the end of March, a few days before the March 31st deadline for approving the budget pending or calling for early elections. The 2005 budget envisages a deficit of 3% of GDP, corresponding to the deficit objectives agreed in the context of loan guarantees from the US and assuming 3.8% growth. [5] Amendments are foreseen to increase the deficit by a further 0.4% of the GDP in order to reflect the costs associated with the planned disengagement from the Gaza strip, notably compensation for settlers and troop redeployment costs.

Monetary and exchange rate policy

Monetary policy is formally committed to maintaining a soft peg to a USD-dominated currency basket (Chart 2). A peg to a USD-dominated basket with wide and asymmetric fluctuation bands was adopted in 1991 to limit exchange rate volatility. The euro has accounted for about 22% of the basket to date. However, monetary policy has de facto evolved into an inflation-targeting approach, and since the early 1990s the Bank of Israel has regularly announced inflation targets. By the end of 2004, no progress had been made on the plan to definitively eliminate the exchange rate band which had been announced as part of a three-stage economic recovery plan adopted in March 2003.[6]

Chart 2: Israel - Interest and exchange rate developments



Source: Bank of Israel, Datastream.

Limited inflationary pressures and relative calm on financial markets allowed a further easing of monetary policy in 2004. Through progressive cuts, the reference discount rate was reduced to

[5] The Bank of Israel forecasts slightly lower growth of 3.2% in 2005.

[6] The elimination of the band would remove the potential for inconsistencies between monetary and exchange rate policies. The IMF has recently suggested some additional improvements in the way the Bank of Israel implements its inflation targeting, including a stronger emphasis on statistical forecasting methods to assess the inflationary environment.

3.99% in December 2004, the lowest level in three years. This level is impressive, considering that interest rates were around 8% at the end of 2002. Credit to the private sector and broad money rose, reflecting the monetary easing. Despite the narrowing of the differential with US rates, the new Israeli shekel (NIS) appreciated somewhat against the US dollar due to the general downward trend of the US currency, increased confidence in the Israeli economy and attractive interest rates. Compared with the considerable volatility in recent years, in 2004 the exchange rate of the NIS was relatively stable against the reference basket, while depreciating by about four percentage points against the euro.

External sector developments

Exports of goods picked up strongly in 2004 with the improvement of the external environment and stronger demand for high-technology products, leading to a small increase in the current account surplus. In particular, Israeli exports became more competitive on EU markets with the depreciation of the NIS against the euro. However, imports also rose strongly during the same period, reflecting the ongoing domestic recovery, which led to some deterioration in the overall trade balance deficit to about -3.5% of GDP from -2.2% in 2003. The current account was expected to be close to balance (as in 2003) because of improved services exports, notably tourism and sustained inflows of foreign grants.

During 2004 Israel experienced a resumption of portfolio investments by foreigners, as a result of the renewed interest in emerging markets in 2004 and the somewhat improved security situation. On the other hand, FDI inflows declined somewhat compared to the previous year, possibly reflecting lower privatisation activity. Gross external debt is expected to have decreased to 61% of GDP from 64% of GDP in the previous year. Overall, there were no concerns about external vulnerability in 2004, as a small surplus in the balance of payments increased international reserves further to about USD 26 billion at the end of 2004. Israel's high international reserves, loan guarantees from the US and substantial holdings of foreign assets continued to provide a significant cushion against possible imbalances.

2. Structural reforms

The pace of structural reforms remained sustained in 2004 and ambitious reforms were carried out within the framework of the March 2003 Economic Recovery Plan. Following an initial phase focused on halting the economy's deterioration and taking measures to bring about its recovery, in 2004 the authorities concentrated mainly on guiding the economy towards higher growth by reducing government expenditure and taxes, increasing competition and implementing comprehensive structural changes in the public sector and in the labour market.

Trade liberalisation

Further trade liberalisation measures were enacted in 2004. Notably, in late 2004 Israel and Jordan agreed to upgrade their trade agreement with a view to total liberalisation of mutual trade by 2010. Upon its approval (expected in early 2005) the two countries will be able to cumulate of rules of origin and benefit from duty-free access for joint products exported to the EU. Also in late 2004, Israel signed a Qualified Industrial Zone (QIZ) agreement with the US and Egypt. Based on the successful QIZ model between the US, Israel and Jordan, the agreement will

provide an incentive for Israeli and Egyptian companies to co-operate by exempting joint production from US customs duties and quotas.

Fiscal and public administration reforms

Improving the efficiency of the public sector and reducing its size remained government priorities in 2004. Among other things, the authorities took steps to streamline the civil service by encouraging early retirements and reducing new recruitments. The 2005 budget foresees the outsourcing to the private sector of some public services. Corruption remained relatively low, with Israel ranking 26th out of 145 countries in the 2004 corruption perception index by Transparency International.[7]

Fiscal and public finance management reforms continued to be on the authorities' agenda in 2004. Under the 2003 Economic Recovery Plan, further tax cuts were implemented in 2004 to boost growth and employment. VAT rates were lowered by a further one percentage point to 17% in March 2004 and corporate tax rates and personal taxes on low and medium-income earners were reduced in July.[8] With respect to public finance management, some changes were introduced in 2004 to the budget classification system, so that investments in infrastructure will be recorded as expenditure rather than capital transfers. Moreover, by the end of 2004 the right of small parliamentary groups to pass bills with direct budgetary implications outside the normal budget process had not been revoked (this possibility has been suspended since 2001).

The authorities also advanced with pension reforms. In January 2004 the Knesset approved a pension law providing for a gradual rise in the retirement age.[9] Furthermore, in September 2004 three pension funds were privatised, after having been taken over by the government from trade unions in 2003. The privatisation proceeds will be used to pay the debt incurred by the old funds. Newly privatised pension funds were obliged to adopt a standard set of rules. Moreover, state employees who previously received pensions without contributing to the system are gradually being integrated into a contribution-based system. However, the creation of a universal pension system is not on the yet agenda (the pension system is not currently compulsory and, as a result, a large share of the population does not receive any pension benefits).

Privatisation, enterprise restructuring and business environment

Regulatory reforms during the 1980s and the 1990s have contributed to the creation of a generally enabling and non-discriminatory business environment. Israel ranked 19th out of 104 countries in the 2004 Global Competitiveness report by the World Economic Forum, one place up from 2003.[10] The World Bank 2004 "Doing Business Report" reveals that Israel's business environment is more enabling than that of the average OECD country on a number of counts (such as investors' protection and cost of accessing finance), while room for improvement remained in some others (including time and cost of enforcing a contract). Reductions in corporate tax rates in 2004 have also been enacted to further improve the business environment.

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[7] Transparency International (2004), *Transparency International Corruption Perceptions Index 2004*, London, 20 October.

[8] Corporate tax rates will fall gradually from 36% to 30% by 2009.

[9] By 4 months per year until it reaches 64 for women and 67 for men.

[10] Countries are evaluated on the basis of their macroeconomic environment, quality of public institutions and level of technological readiness and innovation. World Economic Forum (2004), *The Global Competitiveness Report 2004-2005*, Geneva, October.

In 2004 the authorities made further strides in increasing competition by privatising and breaking up monopolies. Measures taken included the privatisation of both the airline company El Al in December (though the government retained a golden share) and the telecom incumbent Bezeq, initial steps to reform the ports and preparations for restructuring/privatising the oil refinery company. In August 2004 the Knesset also approved legislation to start to expose the postal sector to competition by 2006, with 70% of the market to be competitive by 2009. In December 2004 the electricity system was opened up to private operators, with the possibility for the private sector to participate in electricity generation and sales. Several private producers are expected to begin competing with the Israel Electric Corporation monopoly over the next few years. On the other hand, limited progress was achieved on privatisation plans in the banking and insurance sectors.

Financial sector reforms

Although Israel's financial sector is highly developed by regional and international standards, there remains some scope for improvement. The banking sector is rather concentrated, with three institutions accounting for about 80% of banking deposits. The same three dominant banks are also the dominant suppliers of mutual and provident funds. The state still holds substantial stakes in two of the largest banks but does not exercise management control. However, the government is planning to sell its share. Furthermore, the capital market is not fully developed, as evidenced by the rather small bond market and the absence of many – in particular the more sophisticated – types of financial instrument.

In September 2004 an inter-ministerial committee headed by the Ministry of Finance released a report recommending a number of reforms to enhance competition and efficiency in the financial sector. Among other things, the report recommended that banks should sell their provident and mutual funds within three years, which should encourage foreign institutions to enter the Israeli market and foster capital market development.[11] The report also suggested setting limits on the market concentration of asset management, adopting measures to avoid conflicts of interest,[12] enforcing banks' duty to give impartial advice to investors and ensuring proper incentives for the sale of competitors' funds.

The authorities also envisage reforms in the capital market, in particular measures reducing banks' reliance on non-tradable government bonds, limiting banks' exposure to individual and connected borrowers, and removing tax and other constraints on the development of capital market instruments. The IMF noted that the development of the capital market will require strong regulation in line with international best practices, particularly focusing on full disclosure by the provident and investment funds on their investment policies and related risks.

Labour market reforms

Several ambitious structural labour market reforms have been introduced since 2003 with the aim of increasing labour market participation rates, reducing unemployment and lowering dependency on the welfare state. The reforms included reductions in income allowances to

[11] However, the IMF has expressed doubts about these plans, which may be unnecessary, represent excessive interference in the financial markets and pose considerable problems of implementation.

[12] The report recommended, for instance, preventing underwriters from serving as price-setters in a public offering of securities if they have lent large amounts to the issuing company.

encourage religious students and single parents to join the workforce, stricter eligibility conditions for unemployment benefits, reductions in the social insurance costs borne by employees (through lower allowances due to National Insurance) as well as tougher regulations on the employment of foreign workers.[13] Civil servants have not been exempted from these reforms, which should continue in 2005 with further cutbacks in the number of civil servants.

Recent developments indicate a relatively high degree of real wage flexibility. In 2004 wages in the business sector continued to decline, while workers' productivity rose. While measures by the government helped raise labour participation rates and reduce unemployment, they also resulted in social hardship in many cases. The social situation remained problematic, with almost 20% of the Israeli families living below the national poverty line.[14] There now appears to be a need to accompany labour market reforms with more active labour market policies and to strengthen the social safety net.

[13] In addition, several illegal workers were deported.
[14] 2003 data published in 2004.

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Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% change)	8.0	-0.9	-0.7	1.3	4.3
Inflation CPI (period average)	0.0	1.4	6.5	-1.9	1.2
GDP nominal, in USD bn	115.5	113.6	104.2	110.2	117.2
GDP per capita, in USD	18,256	17,505	15,773	16,400	17200
Social Indicators					
Unemployment, %	8.7	9.3	10.3	10.8	10.4
Labour participation, %	54.3	54.4	54.1	54.5	55.0
Population growth, % change	2.7	2.4	2.0	1.8	1.7
Literacy total (% of ages 15 and above)	---	---	95.3	---	---
Fiscal Sector					
Central gov. revenues, % of GDP	39.1	37.2	39.2	37.1	36.5
Central gov. expenditure, % of GDP	39.8	41.6	43.0	42.7	40.4
Central gov. balance incl grants, % of GDP	-0.7	-4.4	-3.8	-5.6	-3.9
Central gov. balance excl grants, % of GDP	-3.2	-6.5	-6.3	-8.1	-6.1
General gov. balance, incl grants, % of GDP	-2.1	-4.1	-4.5	-6.4	-4.3
General gov. debt, % of GDP	91.4	96.4	104.9	107.4	107.0
Monetary sector					
Private Sector Credit (% change)[1]	12.5	12.4	9.4	-3.6	4.4
Private Sector Credit as % of total credit	100.4	101.2	104.5	106.1	112.4
Broad money (M3), % yoy	15.3	15.5	6.1	2.2	4.5
Degree of Monetisation (M3/GDP, %)	76.1	81.1	80.5	77.7	79.0
External sector					
Current account balance, % of GDP	-1.5	-1.9	-1.8	0.1	-0.1
Trade balance, % of GDP	-2.5	-2.7	-3.6	-2.2	-3.5
Foreign direct investment flows, % of GDP	4.3	3.1	1.7	3.3	2.3
Import cover (months)	6.0	6.5	6.8	7.1	6.1
External Vulnerability					
External Public Debt, % of GDP	55.7	57.2	64.9	64.2	60.8
Debt Service Ratio[2]	18.2	13.8	12.6	13.1	12.8
Gross reserves (excl. gold, USD billions)	23.3	23.4	24.1	26.3	26.2
Reserves/M3	37.0	35.1	36.3	36.3	33.9
Financial sector					
Interest rate (eop)[3]	7.84	5.02	7.92	4.9	4.29
Exchange rate (per USD, eop)	4.0	4.4	4.7	4.4	4.3
Exchange rate (per EUR, eop)	3.8	3.9	5.0	5.4	5.8
Real effective exchange rate (negative=depr.)	8.1	-0.2	-10.0	-7.9	-4.8

Source: IMF, Israeli Central Bureau of Statistics, Bank of Israel, Israeli Ministry of Finance, Globalinsight.

[1] credit to the private sector up to October 2004.

[2] Foreign debt service in % of exports of goods and nonfactor services.

[3] Interest rate on 9-12 months T-bills.

JORDAN

- **The Jordanian economy performed strongly in 2004, with real GDP growth of 6%. Such economic performance –the strongest in the Mediterranean region - was supported by a rebound in domestic demand and by impressive export growth.**
- **With a deficit of 3.4% of GDP (including grants), fiscal performance in 2004 exceeded expectations and supported the successful completion of the Stand By Arrangement with the IMF. Nevertheless, net of foreign grants Jordan's fiscal position remained fragile with a deficit of about 13.4% of GDP.**
- **In 2004 progress in structural reforms was notably made in trade liberalisation, improvements of fiscal administration and management and financial sector reforms. On the other hand, there were some delays in privatisation.**
- **Jordan's recent strong economic performance allowed for some reduction in unemployment and poverty levels. Whether these achievements prove sustainable and further improvements are made to social conditions will depend on continuous economic growth and the reduction of regional imbalances.**

1. Macroeconomic developments

Real sector developments

The Jordanian economy performed strongly in 2004, with real GDP growth of 6%, a noticeable recovery after the disruption caused by the Iraqi conflict in 2003 when GDP growth slowed down to 3.3%. This positive economic performance – the strongest in the Mediterranean region – was supported by a rebound in domestic demand and by an impressive growth of exports at a record rate of 30%, confirming the export sector as one of the main driving forces of the Jordanian economy. Strong demand from Iraq contributed to export growth in 2004, in addition to textile exports from the Qualifying Industrial Zones (QIZ) established under a trade agreement with Israel and facilitated by the US-Jordan free trade agreement. On the production side, the main sectors driving growth were manufacturing, construction, tourism and transport, as Jordan became the regional base for many players involved in Iraq's reconstruction.

CPI inflation increased in 2004 but remained rather moderate at about 3.4% on average against 2.3% the previous year. Price rises reflected the economic recovery, the real depreciation of the Jordanian dinar (mirroring the depreciation of the US dollar to which the currency is pegged), some increases in domestic fuel prices[1] and the increase in General Sales Tax (GST) rates of April 2004. Despite Jordan being a net importer of oil, the impact of high oil prices could be contained thanks to large – albeit slowly decreasing – subsidies for energy products.

Unemployment rates declined, supported by strong economic performance, but remained relatively high at (officially) 12.5% in mid-2004 compared to 14.5% the previous year. Unemployment particularly affects the younger generation and is estimated at about 30%. The main causes of the high unemployment level have been attributed to the rigidity of the labour market and the mismatch of skills taught at school and those needed in the economy.

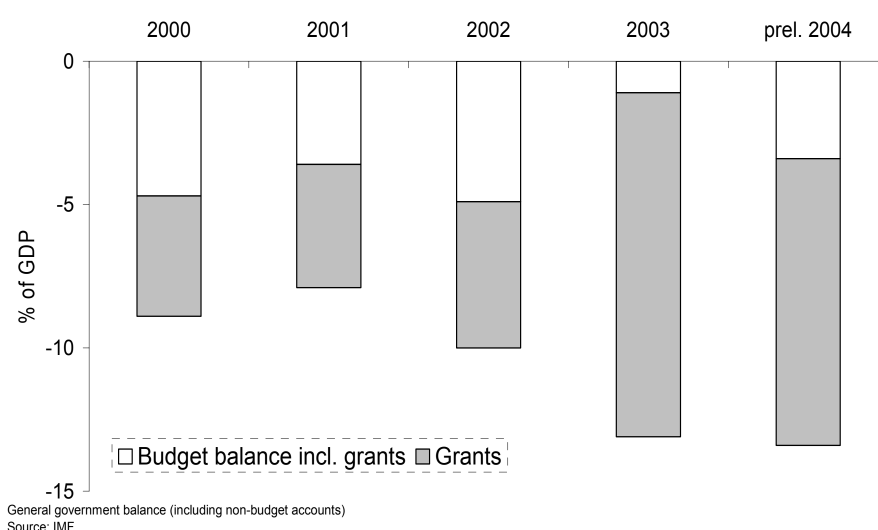
[1] Domestic fuel prices were increased by an average of 8% in spring 2004.

Fiscal policy

With a deficit of about 3.4% of GDP (including grants), fiscal performance exceeded expectations against a deficit target of 3.9% of GDP for 2004 under the IMF programme (Chart 1). In view of the country's strong economic performance and success in meeting the programme's targets, the authorities successfully completed the Stand-by Arrangement with the IMF in mid-2004 and decided not to make use of remaining financing facilities. Relations with the IMF have continued in the context of post-programme monitoring and technical assistance support.

Better-than-expected fiscal performance in 2004 can be attributed, on the one hand, to strong tax and non-tax revenues and, on the other, to efforts to contain the rise in expenditures. On the revenue side, tax collection was propped up by buoyant GST revenues from robust economic activity and a 3% hike in the GST (to 16% from 13% in April 2004). Overall, tax collection also benefited from improvements in tax administration following the merger of the departments for income and sales tax. At the same time, the authorities reigned in current expenditures, which remained broadly unchanged from 2003, while maintaining relatively high levels of expenditures on capital projects (at about 7% of GDP). The early redemption of Brady bonds and the positive growth performance helped to reduce the external and total debt stock to 67.4% and 92% of GDP respectively at the end of 2004. This in turn allowed for a reduction of interest payments on debt which were nevertheless still among the main items of spending (3% of GDP in 2004).[2]

Chart 1: Jordan - Fiscal developments



General government balance (including non-budget accounts)
Source: IMF

Despite improved performance and commendable government policies, significant fiscal challenges remain, requiring sustained efforts of consolidation and structural reforms. Net of foreign grants, Jordan's fiscal position remained weak with a deficit of about 13.4% of GDP (Chart 1).[3] Moreover, the overall fiscal performance of the general government (including off-

[2] In 2004 the authorities were slightly off-the track of their debt reduction strategy due to the depreciation of the Jordanian dinar as well as delays in privatisation. The Public Debt Law provides that total and external debt stock should decrease to around 80% and 60% of GDP, respectively, by 2006 using privatisation proceeds and increasing primary surpluses.

[3] Foreign grants declined somewhat in 2004 to a still very high 10% of GDP, down from the exceptional level of 12% of GDP in 2003 – when additional aid was granted by donors – including the EU – to counter the expected negative repercussions of the conflict in Iraq.

budget accounts) did not show an improvement compared with 2003. Financing the deficit was mainly ensured domestically, as privatisation experienced delays and net foreign financing was negative due to the early redemption of Brady bonds in 2003. Remaining challenges include reducing the heavy reliance on foreign grants as a source of government revenue, increasing the relatively low direct tax collection, phasing out large subsidies on the consumption of fuel products and reducing the still large public debt.

Monetary and exchange rate policy

In 2004 the monetary policy framework continued to be based on a de facto exchange-rate peg of the Jordanian dinar to the US dollar (1 USD = 0.709 JOD), which has been a successful strategy for promoting economic stability and attracting foreign capital in recent years. The fixed exchange rate peg was backed by relatively high international reserves of USD 4.8 billion by end-2004, corresponding to more than six months of imports.[4] In real effective terms the Jordanian dinar continued to depreciate in 2004, largely due to the weakness of the US dollar, thereby contributing to further improvements of external competitiveness since 2002.

The strength of the balance of payments, moderate inflation and reductions in US interest rates allowed the authorities to reduce interest rates to a historical low of 2.5% in early 2004 in an effort to bolster investment and growth. However, mirroring tighter monetary policy in mid-2004, the Central Bank again raised its benchmark discount rate to 3% in August and to 3.75% in December 2004. In spite of the recent monetary tightening, commercial bank lending rates continued to drop gradually, but remained high at about 8% at the end of 2004. The recent decline in lending rates and the slight reduction in banking spread seem to reflect increased competition in the banking sector as a result of greater participation by foreign banks.

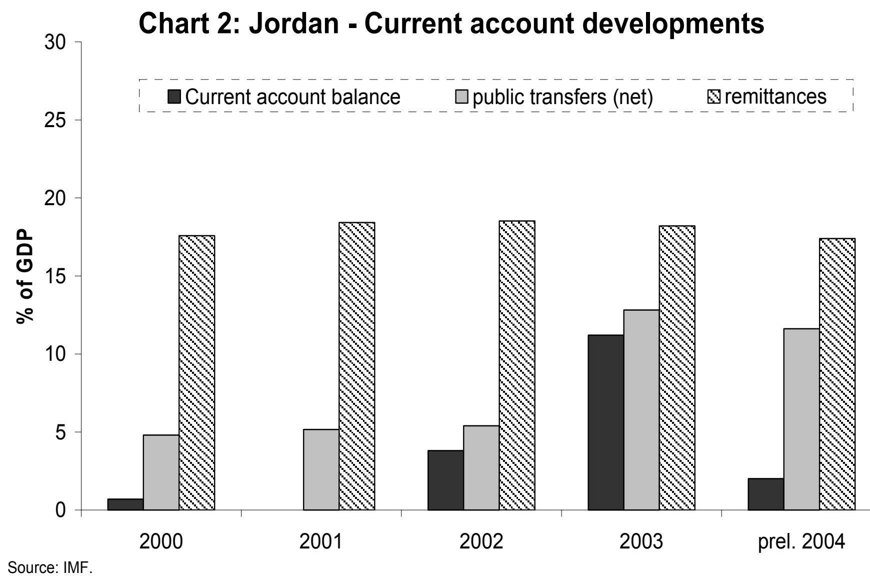
Broad money grew by more than 11% in 2004, somewhat faster than nominal GDP growth, mirroring in particular non sterilised inflows of foreign assets associated with the strong current account performance. In addition, claims on the private sector rose strongly, reflecting the general economic buoyancy and increased confidence in investment and marking a break after the uncertainties of 2003. Renewed market confidence was also mirrored in the bullish performance of the Amman Stock Exchange, whose index rose by over 60% in 2004. Despite the large increase in claims on the private sector, the private sector investment ratio (15.3% of GDP) was not only lower than expected but also lower than in 2001 and 2002. This possibly suggests that a substantial proportion of claims on the private sector has been used for non-investment purposes. This strong growth in claims was accompanied by an increase of claims on the government associated with strong deficit financing, in line with the government policy of reducing external debt.

External sector developments

Jordan's overall external position remained stable in 2004, as the deterioration of the trade balance was compensated by substantial inflows of remittances and foreign grants. On the trade side, exports picked up strongly (by more than 45% in the first nine months of 2004), in particular with the US and Iraq, which are Jordan's first and second largest export markets. In terms of product categories, Jordanian textiles and pharmaceuticals were the bestsellers. However, there are some risks that Jordan's record export performance may not be sustainable

[4] International Monetary Fund (2005), "Jordan: Post-Program Monitoring Discussion", *Country Report*, No. 05/100, Washington D. C., March.

after the elimination of textile quotas under the WTO Multi-Fibre Agreement in January 2005, unless efforts are made to raise the quality of textile products.[5] The strong export growth was largely offset by buoyant imports associated with the economic recovery and higher oil prices.[6] As a result, Jordan's large trade deficit widened to about 26% of GDP, up from 20% of GDP in 2003. Nevertheless, Jordan's huge trade deficit was more than compensated by strong inflows of foreign grants (around 10% of GDP) and workers' remittances (around 17% of GDP). [7] This led to a current account balance surplus of 2% of GDP in 2004.



The financial and capital accounts also recorded a small surplus in 2004. Outflows from the government's repayment of foreign debt and settlements of official accounts were more than compensated by buoyant FDI and some recovery of portfolio and other capital inflows. In particular, 2004 witnessed strong flows of private FDI of about 4% of GDP, mainly into Jordan's information technology and real estate sectors, stemming to a large part from Iraqi investors. Overall, the balance of payments is expected to post a surplus of about 3% of GDP in 2004, a very positive result although down from the exceptional surplus of about 12% of GDP the previous year (the latter associated with record inflows of foreign grants). Foreign reserves were at a comfortable USD 4.8 billion in 2004, equivalent to over six months of goods and non-factor imports.

Public external debt is expected to have decreased to around 67.4% of GDP by the end of 2004, from 76.4% at the end of 2003, and the debt-to-export ratio to have fallen to around 133.6% of GDP from 166.2% the previous year. Furthermore, the total debt stock also declined to about 92% of GDP from about 100% of GDP at the end of 2003. In addition to the early redemption of Brady bonds, the authorities launched debt swap negotiations with several countries, including European ones, in 2004. The reduction of external debt confirms progress towards the external debt target of 60% of GDP by 2006 as mandated by the Public Debt Law, but falls somewhat

[5] The IMF has estimated that this could worsen the current account balance by about 2% of GDP.

[6] The main contribution to import growth during 2004 came from crude oil and equipment. Imports from Saudi Arabia have increased significantly reflecting the substitution of Saudi for Iraqi oil.

[7] Currently, between 400,000 and 450,000 Jordanians work abroad. Remittances were boosted in 2004 by increasing oil prices, as most of expatriate workers are located in the Gulf Cooperation Council (GCC) countries.

short of government plans. In general, there have not been any immediate concerns of vulnerability given a relatively favourable debt profile.[8]

2. Structural reforms

In 2004 the authorities continued to pursue structural reforms with the aim of raising growth to a higher and sustainable path supportive of job creation. Progress was achieved notably in the areas of trade liberalisation, fiscal administration and financial sector reforms. Structural reforms were carried out within the framework of the National Plan for Socio-Economic Development, launched by the Jordanian authorities in early 2004 and to be implemented by 2006. The plan complements previous efforts based on the Plan for Social and Economic Transformation (PSET) launched in 2001. It covers issues such as the reduction of poverty and unemployment, public sector reform, improving basic services, reducing reliance on foreign assistance, improving fiscal performance and diversifying exports.

Trade liberalisation

During 2004 Jordan continued to pursue its integration in the global economy, with additional measures at both the regional and bilateral levels. Notably, in February 2004 Jordan signed the Agadir Agreement with Morocco, Tunisia and Egypt for the establishment of a Free Trade Area by 2006. By adopting the pan-Euro-Mediterranean protocol on rules of origin, the Agadir partners will be able to benefit from the cumulation of origin on their exports to the EU. In addition, later in 2004 Israel and Jordan agreed to upgrade their trade agreement with a view to total liberalisation of mutual trade by 2010. Upon its approval (expected in early 2005) the two countries will be able to cumulate rules of origin and benefit from duty-free access on joint products exported to the EU. This agreement will mirror and complement the Qualified Industrial Zones (QIZ) established in the late 1990s between Jordan and Israel and benefiting from the exemption from US tariffs and quotas on joint production. The QIZ have been one of the principal mainstays of Jordan's recent economic dynamism.

Trade between Jordan and Iraq gradually returned to normality in 2004. The two countries agreed to improve movement of goods to accelerate and facilitate Iraq's reconstruction efforts. Planned activities include extending an oil pipeline, upgrading border centres, constructing a highway linking the two countries, improving facilities at Aqaba port and establishing a free zone area at the border. Iraq is the second main export destination for Jordan, at about 17% of total exports, and trade relations between the two countries are very dynamic.

Fiscal and public administration reforms

Jordan's strong dependency on foreign grants highlights the need to ensure solid revenues from taxation.[9] The reforms of indirect taxation undertaken in recent years were very successful in this

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[8] More than half of the external debt carries fixed interest rates, whereby 40% has an interest of less than 2%, and 20% interest rates between 4 to 6%. The maturity of about half of all external debt is beyond 20 years, and most of the rest has a maturity between 15 and 20 years.

[9] Jordan receives substantial civil and military aid as well as oil on concessionary terms from the Gulf countries – replacing the former "oil grant" from Iraq. Despite providing a relatively reliable flow of resources for a number of years and reaching a record 12% of GDP in 2003, foreign assistance cannot be considered a structural source of revenue. Recent projections expect foreign grants to fall to 2% of GDP by 2007.

respect.[10] On the other hand, revenues from direct taxation remain low by international standards, with corporate tax revenues that are especially low and reforms of the system of direct taxation that have been rather sensitive. [11] The Jordanian authorities have recently focused on improving tax compliance and collection (initiatives undertaken in 2004 include the merging of the GST and Income Tax Departments and the automation of several tax procedures). The Jordanian authorities also have taken initial steps to improve direct tax revenues. Reforms envisaged include widening the tax base and streamlining investment incentives.

In 2004 the authorities also took steps to address the issue of energy subsidies, whose cost to the budget was estimated at 2.7% of GDP in 2004. The authorities started to gradually increase fuel prices, but apart from gasoline, these remain well below world values. In 2004 the government announced the full elimination of subsidies on energy products. A gradual approach is needed to buffer the impact on the poor and to contain inflation. Despite these announcements, the 2005 budget actually envisages an increase in expenditures on oil subsides.

In 2004, further progress in improving Jordan’s public finance management system was achieved, with the support of several international donors. This included first steps towards adopting a GFS 2001-compatible budget methodology, the compilation of data on the operations of the general government, the full incorporation of the National Social and Economic Plan in the 2005 budget, the use of binding ceilings on line ministries for the preparation of the 2005 budget, improvements in preparing budgetary aggregates and the underlying fiscal framework and budget documentation.[12] A World Bank Public Expenditure Review was completed in late 2004 and a Financial Management Reform Strategy for 2004-2007 was issued.

Privatisation, enterprise restructuring and business environment

Economic reforms undertaken by the Jordanian authorities during the last decade have helped improve the business environment. The EC and other donors provided substantial technical and financial assistance to this purpose. These efforts appear to have paid off, and the World Bank's 2004 “Doing Business report” reveals that Jordan’s investment climate is generally more favourable than in the rest of the MENA region. However, the report also points to remaining difficulties in starting a business and accessing finance for smaller businesses. Low competition in goods’ transport services is also a constraint on business activity. Preparations are underway to revise the investment laws. The announced setting up of private credit bureaux is expected to improve access to finance particularly for SMEs.

Owing to its relatively favourable business environment and its free trade agreement with the EU and the US, Jordan has become a channel for duty-free and quota-free access to major world markets, attracting a number of foreign investors (especially from Asia). The Jordanian authorities have also heavily relied on generous fiscal incentives to attract FDI and stimulate investment, but the actual effectiveness of such incentives appears to be limited. Jordan also performs commendably in terms of combating corruption. It ranks 37th out of 145 countries in Transparency International’s 2004 ranking, better than all Mediterranean countries except Israel.

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[10] The introduction of GST in 1994 was successful in making indirect taxes the main source of government income at about 50% of total revenues.

[11] Direct income taxation is a rather complex system, with widespread exemptions and tax privileges. For example, generous incentives are granted to investors although their impact has often been found to be weak.

[12] Preparations for the introduction of a Medium Term Fiscal Framework are well advanced. The budget circular for 2005-07 de facto already applies one.

Financial sector

The banking sector in Jordan is characterised by conservatism, high liquidity, and market fragmentation. Obtaining money for start-ups and small companies is difficult, and lending is essentially asset-based with high collateral requirements. Although banks remain profitable, some analysts describe Jordan as overbanked, which points to relatively limited competition. The Central Bank of Jordan (CBJ) has been keen to promote banking sector consolidation, by increasing capital requirements and encouraging mergers. Access to finance for companies, especially smaller ones, should improve with the forthcoming establishment of credit bureaux: a temporary law on credit bureaux was issued in 2004 in order to allow the establishment of private credit bureaux by mid-2005. The CBJ will ensure their approval and supervision.

Regulatory standards were tightened over the past few years. Recent improvements in banking regulation and supervision include the setting up of an early warning system for bank failures, stronger rules on banks' corporate governance (including disclosure)[13] and guidelines on the behaviour of banks managers, the introduction of a framework for prompt corrective actions and steps to strengthen the anti-money laundering framework.[14] The CBJ will soon start issuing a report on banking supervision. A creditors' deposit insurance scheme was set up and is gradually building up assets to deal with potential banking crisis. In 2004 the cabinet also approved a strategy for developing the capital market. This strategy is intended to bring about improvements at the organisational, legislative and technical levels, adopting international standards and methods in a bid to boost investment in securities.

Labour markets and social conditions

Unemployment declined as a result of positive recent economic performance but remained relatively high at (officially) 12.5% in mid-2004 compared to 14.5% the previous year. Youth unemployment remains particularly high at 30%. A few sectors of the economy (mainly in the service sectors) have shown dynamic job growth, but employment growth has been weak or negative in many high-employment sectors (public administration, education), and job losses have occurred in agriculture and mining, sectors which account for almost a third of all employment in Jordan. Jordan's labour market is characterised by a relatively low rate of participation, which has even declined recently (63.2% for men and 11.2% for women in 2003) possibly indicating discouragement about job prospects.

The main reasons for the high unemployment figures are the rigidity of the labour market (particularly with respect to the termination of employment contracts) and the mismatch between the skills taught at school and those needed in the economy. The demographic profile also presents a constant challenge to employment prospects, with a current population growth rate of 2.6%. Nearly 70% of the country's population is below the age of 29. The government's attempt to reduce unemployment through increased growth and structural reforms is reflected in its broad-ranging structural reform plans (2004-2006 National Socio-Economic Development Plan).

Despite relatively high unemployment rates, overall living conditions are relatively favourable. Jordan has achieved relatively high levels of "Human Development", among Arab countries (with a score of 90, it is currently ranked second best in the UNDP Human Development index among non-oil Arab countries) largely owing to its achievements in reducing poverty and

[13] These should be further improved with the gradual adoption of Basle II disclosure principles.
[14] Since January 2004 the CBJ regularly assesses banks' solvency and is entitled to take the necessary corrective measures, up to and including liquidation of a bank if necessary.

illiteracy. Considerable progress has been made in reducing poverty in recent years, with the share of the poor dropping from 21.3% in 1997 to 14.2 % in 2003.[15] The European Commission is finalising a EUR 30 million project to support poverty reduction through local development. This project is expected to start operations in 2005.

[15] According to the new national poverty line elaborated with World Bank support in 2004.

JORDAN

Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% change)	4.1	4.9	4.8	3.3	6.0
Inflation CPI (period average)	0.7	1.8	1.8	2.3	3.4
GDP nominal, in USD	8,450	8,940	9,449	9,952	10,918
GDP per capita, in USD	1,676	1,725	1,773	1,816	1,937
Social Indicators					
Unemployment	13.7	14.7	15.3	14.5	12.5
Life expectancy (years)	---	---	72	---	---
Literacy total (% of ages 15 and above)	---	---	90.9	---	---
Literacy female (% of ages 15 and above)	---	---	85.9	---	---
Fiscal Sector					
Total revenues, excl grants % of GDP	25.9	26.1	24.9	23.6	25.2
Total expenditure, % of GDP[1]	34.8	34.0	34.9	36.6	38.6
Budget balance, incl. grants % of GDP[2]	-4.7	-3.6	-4.9	-1.1	-3.4
Budget balance, excl. grants % of GDP[2]	-8.9	-8.0	-10.1	-13.0	-13.4
Gross Public Debt, % of GDP	100.0	96.2	99	99.6	92.0
Monetary sector					
Private Sector Credit (% change)	4.5	11.5	3.2	3.5	11.9
Private Sector Credit as % of total credit	84.6	84.2	81.3	79.5	79.2
Broad money (M3), % yoy	10.2	5.8	7.0	12.4	11.3
Degree of Monetisation (M3/GDP, %)	---	123.9	125.5	134.0	136.0
External sector					
Current account balance, % of GDP	0.7	0.0	4.5	11.1	2.0
Trade balance, % of GDP	-31.7	-22.4	-18.3	-20.1	-26.0
Foreign direct investment flows, % of GDP	8.9	1.0	0.3	3.8	4.0
Import cover (months)[3]	6.4	5.4	6.8	7.1	6.5
External Vulnerability					
External Public Debt, % of GDP[4]	85.8	79.9	81.3	76.4	67.4
Debt Service Ratio[5]	20.6	20.4	18.7	18.9	17.8
Gross reserves (excl. gold, USD billions)	2.7	2.6	3.5	4.7	4.8
Reserves/M3	---	23.5	29.5	35.3	32.3
Financial sector					
Short-term interest rate[6]	6.6	5.2	4.0	2.8	2.5
Exchange rate (per USD, eop)	0.71	0.71	0.71	0.71	0.71
Exchange rate (per EUR, eop)	0.66	0.63	0.75	0.87	0.96
Real effective exchange rate (1995=100)	125.0	132.8	122.9	114.5	---

Source: IMF, World Bank, national authorities.

[1] Includes net lending.

[2] Covers the central government and budgetary agencies. Includes non-budget account net spending.

[3] International reserves in terms of months of imports of goods and non factor services.

[4] Public external debt.

[5] Public external debt service in % of exports of goods and nonfactor services.

[6] Average deposit rate.

LEBANON

- **Many indicators point to a strengthening of growth, which may amount to 4-5% in 2004. Stronger export and tourism receipts and a recovery in construction activity, as well as a catch-up effect from the end of the Iraq war, are the driving factors.**
- **Reform commitments made at the Paris II donors' conference (2002) have been implemented more slowly and less stringently than promised.[1] Despite some improvements, the fiscal and current account deficits remained large and government debt unsustainable at around 178% of GDP.**
- **The overall general government deficit was expected to decrease to 8% of GDP in 2004 (14.6% in 2003) but remains a source of concern. The situation requires further adjustment measures to bring fiscal accounts to a more sustainable level.**
- **Following a boost in confidence after Paris II, the exchange rate peg vis-à-vis the US dollar was tested again in late 2004 due to a variety of internal and external political factors. Foreign exchange reserves decreased, while interest rates temporarily went up.**

1. Macroeconomic developments

Real sector developments

The Lebanese economy has strengthened significantly to around 4-5% real GDP growth during 2004, with strong private consumption and investment compensating for lower public spending. Private demand reached a real y-o-y growth rate of close to 18% in the first nine months of 2004 due to strengthening consumer confidence (private consumption + 11.4%) following the end of the Iraq war and significant revenue from increased tourism. Thanks to the improved geopolitical circumstances tourist arrivals grew by around 29% in the first nine months of 2004. Lower interest rates and increased non-resident Arab investment demand have supported private investment, which grew by about 22% in the first half of 2004.

The influx of capital from regional neighbours appears to have stimulated the property market and the construction sector in particular, with the latter also gaining from Iraq's reconstruction needs. The value of property transactions rose by more than 20% in 2004. Economic activity expanded despite a decline in public spending as a result of the delay in ratification of the budget law. In the absence of detailed national account data the exceptional economic performance is highlighted by the Coincidence Indicator (a proxy for economic growth, calculated by the Lebanese Central Bank), which increased more than 10% by mid-2004 compared to mid-2003, before flattening somewhat in the course of the second half of 2004.[2]

Inflation increased during 2004, leading to an average annual inflation rate of 3%. Price pressures grew in particular on the back of import price increases, namely the rise of oil prices to around USD 50 per barrel in the second half of 2004. The World Bank has estimated that a 10% increase in the oil price could add 0.4–0.7 percentage points to the Lebanese CPI when taking all

[1] Paris II: The Paris II donor conference in November 2002 raised funds to support the Lebanese government's three-pronged strategy (strong fiscal measures, faster privatisation and international support).
[2] According to the Lebanese Ministry of Finance no official GDP calculations have been made since 1997.

transmission links into account.[3] Although the depreciation of the nominal effective exchange rate stabilised somewhat in 2004, spillover effects from the 12% depreciation during 2003, mainly as a consequence of the strengthening of the euro, have had a continued impact on import price developments well into 2004. Finally, the economic recovery has also contributed, though to a minor extent, to rising prises on the demand side. In the mid- to long term, pegging the exchange rate to the US dollar is expected to continue to constrain price pressure.[4]

Box 1: Economic impact of Hariri's assassination

Former Prime Minister Hariri, assassinated on 14 February 2005, was an important symbol of the country's reconstruction drive. He encouraged foreign investors to return to Lebanon and played a key role in persuading key donor countries to attend Paris II.

Short-term impact

No substantial impact on the main economic aggregates should be expected for the time being. However, some adjustments to the 2005 scenario have to be made:

a.) Investors' confidence is impacted negatively in the first and second quarter, decreasing investment activity.
b.) Tourist arrivals are expected to decline, at least temporarily.
c.) Capital outflows and pressure on the currency might lead to a tighter-than-necessary monetary policy stance, at least temporarily.
d.) Because the government's standing weakened as a result of the current crisis, the reform momentum will be impacted at least until the election (May 2005).

Overall, the Ministry of Finance expects that the consequences of the current crisis will lower growth in 2005 to around 5%. Originally, 5.6 – 6.0% had been forecast.

Long-term risk

If the current political situation worsens and/or drags on, a fundamental reassessment of the political risk associated with the country would be possible, which could have a severe impact:

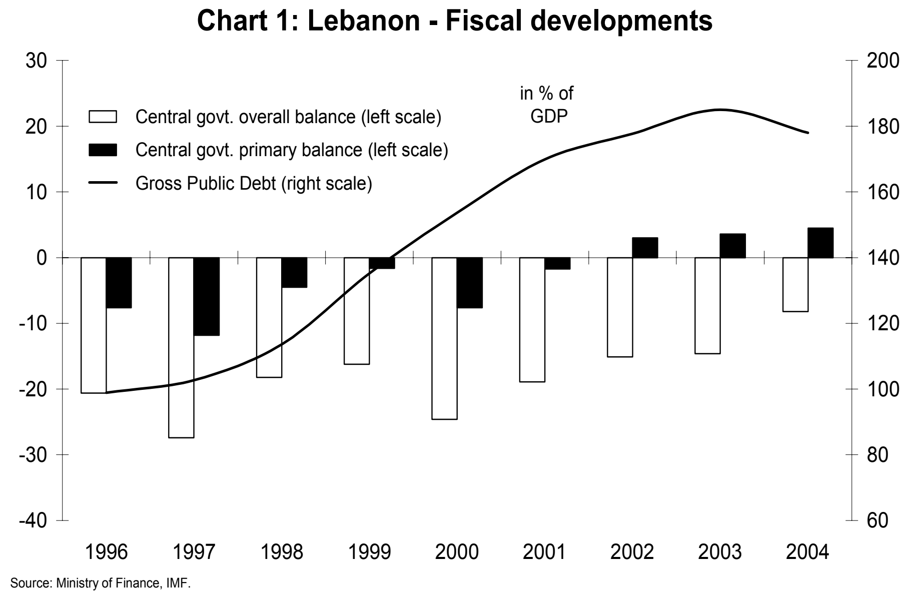
a.) The credit rating could be lowered, making debt financing (around 175% of GDP) more difficult and – in the worst case – leading to a debt crisis.
b.) Arab investment flows might be reoriented from Lebanon to other destinations.
c.) Long-term deposits could be withdrawn, which could potentially threaten the currency's stability.

Fiscal policy

Stronger revenues and lower debt service costs have reduced the overall fiscal deficit to around 8% of GDP in 2004, and the primary surplus appeared to increase. Tax collection indicators for 2004 highlight a 16% increase in comparison with the same period of last year, driven by higher VAT revenues, which may be attributed to the boost in real economic activity as well as the increase in the total value of imports. Expenditures declined modestly in the same period, as a result of substantially lower interest payments, dropping by 5.5 percentage points of GDP. Debt service was reduced in particular due to domestic interest rates having nearly halved in the past two years and to the substitution of high-cost debt maturing in 2003 with Paris II funds. Lower debt service cost helped to outweigh moderate increases of non-debt spending. The primary budget surplus improved significantly in the first six months and is expected to increase to

[3] World Bank (2004), *Lebanon Quarterly Update*, First Quarter.
[4] Monetary policy continues to be conditional to the maintenance of a peg to the US dollar, with a ± 6.5% fluctuation band. The central rate has been set at Lebanese Pounds 1.507.5 to the US dollar since 1999.

around 4.5% of GDP in 2004, though this still falls short of the Paris II commitment of 6% of GDP.



Thanks to the more restrictive fiscal stance, the negative debt dynamics appear to have been halted, at least temporarily, in 2004 (Chart 1). The total stock of gross debt is expected to decline by seven percentage points, to 178% of GDP, compared with 2003 (this would represent the first reduction since 1990). However, on the basis of the Paris II commitments, the overall debt stock was expected to have fallen to around 150% of GDP. The composition of debt continued to change slightly in favour of foreign debt (46.6% of total debt in June 2004), since the government managed to issue successfully USD 1.27 billion of eurobonds. Gross financing needs remained high, at over 80% of GDP for 2004, and are expected to remain high for the period 2005-06. This situation makes the economy vulnerable to a rise in global, in particular US, interest rates and/or to a spread widening on sovereign issues, for instance in the case of domestic political turbulence or a worsening of the geopolitical situation.

Despite some progress, further fiscal consolidation efforts are needed to restore fiscal sustainability. Donor support and domestic refinancing operations since Paris II have helped to alleviate the immediate financing constraints. But the success of the strategy in the medium term depends on continued fiscal improvement through primary surpluses and on the realisation of substantial sums from privatisation and securitisation. The lagging behind of key Paris II objectives is in part due to slower-than-expected progress with privatisation, which is the third pillar of the government's reform strategy.[5] As a consequence, interest payments, though reduced in the meantime, remain too high. Moreover, the delay in debt reduction is also due to higher-than-anticipated subsidies to Electricité du Liban. Even assuming consistent and effective policy performance, the debt stock is expected to fall only gradually.

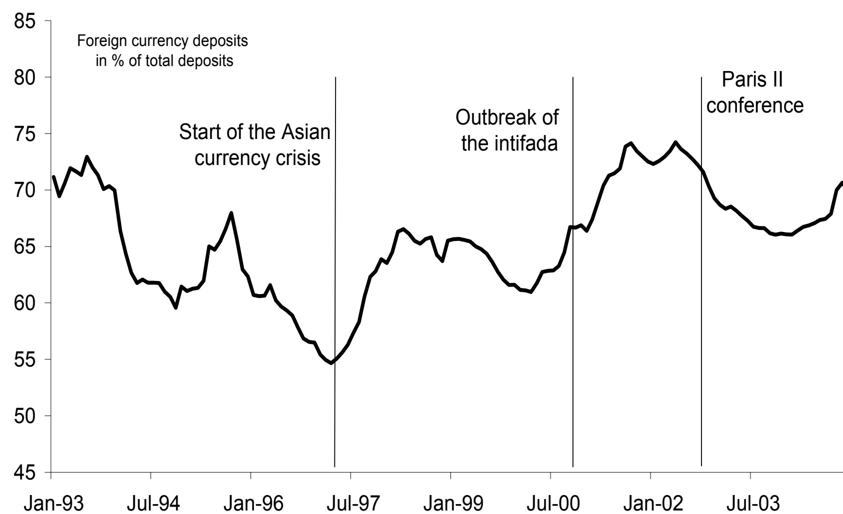
Monetary and exchange rate policy

Monetary policy continues to be based on maintaining the de facto US dollar exchange rate peg, the credibility of which was boosted, up to mid-2004, by the Paris II conference. The Lebanese

[5] The government adopted a three-pronged strategy in 2002 based on strong international support, fiscal measures and faster privatisation.

pound performed robustly up to mid-2004, reversing a two-year period of sustained downward pressure that forced the central bank to intervene constantly on the currency market to prevent the pound falling out of its official trading band of LBP 1501–1514 against the US dollar. The central bank's foreign reserves increased to USD 12.4 billion in July 2004 from USD 5.1 billion at the end of 2002, reflecting increased confidence following Paris II as well as the improved geopolitical situation in the aftermath of the Iraq war, which has stimulated capital inflows. Foreign reserves cover more than 70% of the money supply, and more than 60% even when the sovereign Eurobond holdings are deducted.[6] The favourable environment allowed a further decline in interest rates by 20 basis points until July 2004, which was, however, less pronounced than the decline during 2003.

The ongoing international pressure on Lebanon to adopt the latest UN resolution, the internal political conflict and the delay in forming the new government, as well as the recent US proposal to freeze the assets of Lebanese and Syrian officials, seem to have motivated some investors to sell maturing T-bills. Therefore, Lebanon's foreign exchange reserves declined by close to 10% or USD 1 billion to reach USD 11.3 billion on October 15 (USD 11.7 at the beginning of February 2005) and the increased demand for US dollar assets is also reflected in the increase of the dollarisation ratio of the economy (Chart 2). As a consequence, the Central Bank raised short-term auction yields (temporarily) for T-bills in order to support the Lebanese pound by mid-October. The interest rate hike follows a policy according to which the rates have been lowered to 6% during the past three years. By the end of December 2004 the situation appeared to have normalised.



External developments[7]

In 2004 Lebanon's external accounts continued to be characterised by large deficits in the trade and current account balance, reflecting unsustainable public sector deficits. Exports picked up by around 23% during 2004 on the back of strong global demand and successful export market penetration, especially after the opening up of the Iraq market for Lebanese exports (17% of total

[6] It covers more than 90% when gold reserves are included, which is usually the case in countries that have adopted a currency board.

[7] There are serious weaknesses in the balance of payments data. Exports are likely to be underreported, while service transactions and capital and financial account data reporting is incomplete.

exports in the first half of 2004) and some depreciation of the real effective exchange rate. However, imports are expected to have grown roughly at the same pace due to strengthening consumer demand and higher oil prices, which translates into a widening of the trade deficit to around 33% of GDP. Tourism continued to surge in 2004 and was driven largely by intra-regional travel but also by renewed overseas interest. As a consequence of the expected strong increase in the service balance, the current account deficit for 2004 appears to be narrowing to around 12% of GDP.

The capital and financial account was marked by receding Paris II-related inflows last year, but its balance is still expected to offset the current account deficit. Gross capital inflows dropped by around 26.6% over the first six months of 2004, to USD 3.6 billion. The decline in capital inflows is a consequence of exceptional Paris II inflows over the first half of last year, which consisted of official transfers of about USD 2.04 billion from the UAE, Kuwait, France, Saudi Arabia and Qatar. Without Paris II transfers, private inflows are estimated to have increased by 25% y-o-y in the first half of 2004 because of the general repatriation of Arab capital to the region and the need to invest profits from neighbouring oil-exporting countries. The increased oil revenues in the region also stimulated FDI inflows, amounting to USD 2.2 billion (11.6% of GDP) in 2004, mostly in the real estate sector. Overall, net capital inflows have increased reserves by around USD 260 million and have kept the reserve level above USD 10 billion.

2. Structural reforms

The outgoing government's record on economic policy was mixed, with implementation of its programme hampered by a lack of consensus among political players. The last government took office in April 2003 and put forward an economic strategy that aimed to recapture investor confidence and revive economic activity. The strategy, which in modified form was also part of the basis for the Paris II programme, had four basic pillars: (i) undertake structural reforms that further liberalise the economy; (ii) improve public finances; (iii) foster privatisation; and (iv) liberalise trade. While some measures were indeed taken to liberalise the economy and enhance its competitiveness, progress has been disappointingly slow in the area of privatisation, where the government fell short of its Paris II-announced revenue target of USD 5 billion. The negative privatisation record spilled over into the fiscal consolidation process, which advanced to a certain extent but still did not bring fiscal accounts back onto a sustainable basis. The thorough implementation of structural reform measures suffered from escalating disputes between outgoing Prime Minister Hariri and President Lahoud during 2004.

Trade liberalisation

The Association Agreement with the EU was signed in May 2002, and an Interim Agreement covering trade issues entered into force in March 2003. Since 1 May 2004, the Interim Agreement has applied to the enlarged EU (EU-25). The agreement foresees a gradual reduction in tariffs on almost all goods over 12 years with a five-year grace period. Furthermore, it establishes the necessary conditions for progressive and reciprocal liberalisation of trade in goods, the development of customs cooperation, and dispute settlement, future cooperation on competition matters, and to ensure the adequate and effective protection of intellectual property rights.

Lebanon's negotiations with the WTO are progressing and it aims to join in 2005. It is currently in the negotiating phase on both goods and services. The authorities aim to adopt all the required

legislation, notably on domestic competition and intellectual property rights, in the near future. Whether they will be capable of implementing it is still at issue, but the WTO has acknowledged progress, with a stricter implementation of copyright violation laws leading to a 60% drop in Lebanon's copyright violation cases.

The EFTA-Lebanon Free Trade Area (ELFTA) Agreement was signed on 24 June 2004 after three rounds of negotiations. The ELFTA covers trade in industrial goods, fish and other marine products as well as processed agricultural products and provides for an asymmetric dismantling of tariffs. The EFTA States will immediately eliminate duties and other restrictions for covered products, and Lebanon will gradually abolish its duties during a transition period starting in 2008 and ending in 2015, mirroring the provisions of the EU-Lebanon free trade agreement.

Fiscal and public administration reform

Fiscal reforms on the revenue side appear to have lost momentum after the successful introduction of a flat-rate VAT of 10% in February 2002. The Ministry of Finance did not introduce any new taxes or fees, or raise the existing ones, despite expectations of a VAT increase to 12%, in 2004. Further tax reforms, contrary to government announcements, were cancelled last year, partly on the basis of the argument that any additional taxes would squeeze consumption, investment and eventually economic growth. Authorities indicate that the next stage of reform, after the parliamentary election in May 2005, will see the introduction of a general income tax to replace the current "scheduler" system. Finally, an improvement of tax collection appears not to be on the agenda, although rhetorically its importance is recognised. Estimates indicate that about 44% of registered taxpayers are not paying taxes, and the shadow economy is estimated to account for around 35% of GDP.[8]

Expenditure-side reforms caused fierce political opposition and the administration has held back from pursuing more substantial cuts. Privatisation is the key to improving efficiency via the reduction of debt service expenditures and of transfers to loss-making state enterprises. In mid-2003 the government came under pressure to extend additional support to Electricité du Liban (EDL), the state-owned power generator, as it ran short of funds to purchase fuel. Financial assistance to EDL from the government and the Central Bank amounted to 2.6% of GDP in 2003 and is forecast to be 2.3% of GDP in 2004.[9] Finally, showing the political limits placed on policymaking, the 2004 budget proposed no measures to reduce non-interest-rate expenditure.

The outgoing government published a 2005 budget that includes some necessary reforms in the public sector area, although the Lebanese political reality might lead to substantial revisions before its formal adoption. The draft budget proposal finally delivered on the government's promise to consider additional structural reforms, for example, reforming the civil service and the social security and public pensions systems in order to reduce expenditures over the longer term. However, the public sector remains rather, with around 260,000 people on the public payroll (around 6.5% of the population). The first version of the 2005 budget proposals suggested closing down some public sector institutions (e.g. the Ministry of the Displaced, the Council of the South, etc.), a 3% cut in public sector salaries as well as cuts in security spending, an increase in government employees' working hours and the abolition of allowances for former

[8] Schneider, F. and R. Klinglmair (2004), "Shadow Economies around the World: What do We Now?", *IZA Discussion ¨Paper*, No 1043, March.
[9] International Monetary Fund (2004), "Lebanon: Report on Interim Staff Visit", *Country Report*, No. 04/313, Washington D.C., September.

MPs.[10] Experience with previous budget finalisations would suggest that the probability that these reform measures will be approved in the final budget is low.

Privatisation, enterprise reform and business environment

In 2004 progress in privatisation (and securitisation) was disappointingly slow and the government fell far short of its Paris II commitments. Privatisation remained controversial within the Council of Ministers and, as a consequence, the agreed 2004 budget excluded returns from the sale of state assets to the private sector and securitisation. In addition to the stalled telecom privatisation, the sale of the Lebanese Water Company, Electricté du Liban and the ports have been put on hold. Potential privatisations are further complicated by a lack of interest from foreign investors, who have been disappointed by the government's controversial cancelling of the Libancell and Cellis contracts three years before they were due to end, the deduction of 40% of the telecom revenues flowing to any new owner, a relatively high degree of corruption and shortcomings in infrastructure and political instability.[11]

The unsuccessful attempt to sell two mobile phone operating licences illustrates the difficult privatisation climate. This sale had been planned for the first quarter of 2003, but the list of qualified participants was only announced in May 2003; disagreement within the government as well as difficulties with the auctions, however, led to its abandonment in early 2004. Instead of being sold, the licences remained under government ownership, with two foreign firms appointed to run the services on the government's behalf. This sale seemed to be the most straightforward of the proposed divestments and the least politically contentious, as the mobile-phone operations are well organised and profitable, and no job losses were anticipated. The failure to execute the divestment therefore bodes ill for future attempts, unless there are major changes in the domestic political climate.

Aware of the political problems concerning the outright sale of public assets, the outgoing Hariri government has proposed to sell the future earnings of state-owned companies through a programme of securitisation. Again, however, political controversies appear to have prevented any sales, despite the past finance ministry claims that earnings from the state-owned tobacco monopoly, Régie Libanaise des Tabacs et des Tombacs, would have been securitised before the end of 2003. Initial plans indicated that the government expected to collect between USD 500 million and USD 600 million, whereby the average life of the securitisation agreements should have amounted to 10 years, securitising 65% of the projected revenues by commercial banks.

A recent assessment of the local business environment by the World Bank identifies specific regulations and policies that discourage entrepreneurial activity.[12] On the positive side Lebanon currently records a high degree of ease for businesses to secure property rights and access credit, as measured on both a regional and an OECD scale. However, indicators for 2004 note shortcomings, namely the excessive costs of starting a business, time-consuming procedures to enforce commercial contracts and a low degree of investor protection as a consequence of non-transparent disclosure of ownership and information. In the area of labour market regulation, Lebanon's flexible working hour arrangements stand out positively in the Mediterranean region, but high dismissal costs, around 50% higher than in its regional peers, still burden businesses.

[10] The Daily Star, Beirut, Lebanon, 1 October 2004.
[11] Lebanon performs poorly on The Corruption Perceptions Index (CPI) issued by Transparency International.
[12] World Bank (2004), *Doing Business in 2005: Removing Obstacles to Growth*, Oxford University Press, September.

Financial sector reform

While macroeconomic improvements are essential to the reduction of stress in the banking system, financial and banking sector reforms also play a role in strengthening the balance sheet of banks and diversifying the government's funding base. During 2004 the Banking Control Commission strengthened its monitoring activity of the banking sector, as indicated by the issuance of new regulations on a general framework for risk management consistent with Basle II, and has encouraged further foreign-currency asset diversification. The government has made progress with its plan to further develop the local capital markets in order to tap longer-term financing. Authorities have listed Eurobonds on the Beirut stock exchange and extended the yield curve of local treasury instruments to three years, and potentially to five years in the future. Moreover, they increased liquidity by reducing the frequency of auctions.

Attempts, driven partly by the Central Bank, are being made to consolidate the banking sector. At the beginning of 2004 there were 53 commercial banks operating in Lebanon, but only a few banks such as Banque Audi, Fransabank and Banque du Liban et d'Outre-Mer (BLOM) are large and internationally respected, while the majority of banks remain very small, family-owned businesses. The Central Bank has sought to encourage consolidation within the sector, especially by raising capital adequacy ratios. This has forced a number of mergers since the beginning of the 1990s. In 2004 it gave approval for the merger of two of Lebanon's largest banks, Banque Audi and Banque Saradar. Recently, the Central Bank has widened its approach beyond promoting mergers between small institutions and the country's biggest banks. Overall, the capitalisation of the banking sector as well as its profitability has continued to be high and, thanks to the economic upswing and lower interest, the level of non-performing loans decreased to around 12% of total loans in mid-2004.

LEBANON

Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% change)	-0.5	2.0	2.0	3.0	4.0
Inflation CPI (period average)	-0.4	-0.4	1.8	1.3	3.0
GDP nominal, in USD	16.4	16.7	17.3	18.0	19.3
GDP per capita, in USD	4712	4706	4803	4943	5209
Social Indicators					
Unemployment	---	---	---	---	---
Life expectancy	---	---	71	---	---
Under 5 mortality rate, %	---	---	32	---	---
Urban population	---	---	87	---	---
Fiscal Sector					
Total revenues, % of GDP	19.2	18.5	22.4	24.3	24.3
Total expenditure, % of GDP	44.2	37.6	37.5	38.9	32.6
Central govt. balance, % of GDP	-24.6	-18.9	-15.1	-14.6	-8.2
Gross Public Debt, % of GDP	153.7	169.9	177.7	185	178.0
Monetary sector					
Private Sector Credit (% change)	6.0	-0.4	2.5	-1.1	4.6
Private Sector Credit as % of total credit	50.2	45.0	46.5	44.2	43.3
Broad money (M3), % yoy	9.6	7.4	7.6	13.0	8.5
Degree of Monetisation (M3/GDP, %)	199.5	210.8	218.6	236.7	239.8
External sector					
Current account balance, % of GDP	-17.9	-21.5	-13.8	-13.1	-12.1
Trade balance, % of GDP	-31.0	-35.5	-28.6	-28.9	-32.7
Foreign direct investment flows, % of GDP	6.3	10.2	13.0	11.0	11.6
Import cover (months)	9.8	5.7	6.0	10.2	9.9
External Vulnerability					
External Public Debt, % of GDP	---	131	139	166	166.0
Debt Service Ratio[1]	12.7	13.3	12.8	17.2	---
Gross reserves (excl. gold, USD billions)	5.9	4.4	5.1	10.2	10.6
Reserves/M3	18.0	12.5	13.5	23.9	22.9
Financial sector					
12-month T-bill rate	13.4	13.4	9.1	6.9	6.7
Exchange rate (per USD, eop)	1508	1508	1508	1508	1508
Exchange rate (per EUR, eop)	1402	1341	1580	1884	2005
Real effective exchange rate (1992=100)	211.5	213.9	215.9	208.2	207.4

Source: Banque du Liban, Ministry of Finance, IMF, IIF, DRI-Wefa, Eurostat.

[1] in percent of exports of goods and services.

MOLDOVA

- **Following a very deep and very long recession, the Moldovan economy resumed growing in 2000. In 2004, GDP growth exceeded 7% thanks to steady growth in Russia and Ukraine, two of Moldova's main trade partners, and the continued strong inflow of workers' remittances. These two factors are likely to continue to exert a positive effect on the Moldovan economy for the foreseeable future.**

- **Although remittances (around 25% of GDP) provide valuable income support (notably for the substantial share of the population living in poverty), and boost domestic demand through consumption and investment in private housing, they cannot ensure long-term economic growth on their own, unless a substantial portion of them is channelled toward productive investment. This is not the case today.**

- **Despite some successes (Moldova has cut foreign debt and has resumed paying interest to Paris Club creditors), achieving public finance sustainability remains a distant prospect. Despite strong GDP growth, the fiscal stance has relaxed considerably during 2004. The general government deficit is set to widen further in 2005.**

- **In 2004, the government has adopted an Economic Growth and Poverty Reduction Strategy Paper. This document sets out a comprehensive economic policy strategy for the country and has been generally well received, but ensuring effective implementation will be critical. Moreover, the Moldovan authorities have repeatedly expressed their wish for closer integration with the EU and have agreed to a European Neighbourhood Policy Action Plan.**

- **Nevertheless, there are serious concerns about the direction of economic policy in Moldova. In practice, the policies conducted are often at variance with the goals stated. Progress on structural reforms remains slow, while administrative interference in the economy and discrimination of foreign investors has continued. A visible change of tack is unavoidable if the credibility of the announced policies is to be safeguarded.**

1. Macroeconomic developments

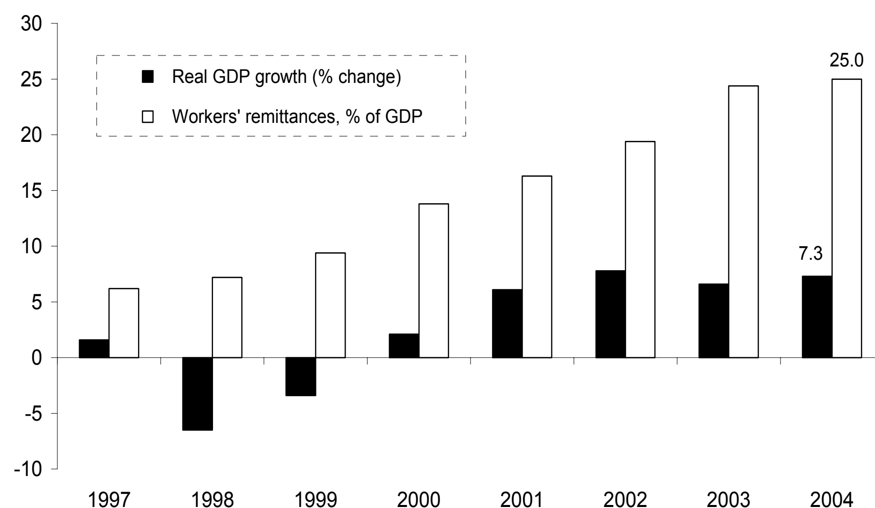
Real sector developments

Since 2000, the year when Moldova's economic decline was finally arrested, the economy has been growing steadily, despite a very fragile public finance situation and a gradual decline in FDI. In 2004, real GDP achieved a rate of growth of more than 7%, slightly above the average performance in the previous three years (Chart 1). GDP per head, thanks also to a real exchange rate appreciation, has more than doubled from its trough in 1999-2000. This result, although positive, takes place from a very low base: on current trends, it will take Moldova's GDP more than 15 years just to reach the 1991 level.

The upswing is driven mainly by domestic demand. Private consumption, boosted by booming remittances, expanded by 6.9% in real terms, more than offsetting a 17.5% decline in public consumption. Strong decline in public consumption is mostly explained by accounting changes – health insurance contributions paid by the government are accounted for as transfers to households and not any longer as public consumption. Private consumption was the largest contributor to GDP growth. Capital formation increased by a mere 3.4% on the year. The

contribution of foreign trade was, contrary to 2003, positive. It is estimated that net exports of goods and services increased by 4.7% in real terms and contributed 2.5 percentage points to Moldova's GDP growth.

Chart 1: Moldova - Economic growth & remittances



Source: National Bank of Moldova, IMF

In supply-side terms, both industry and services registered moderate increases of 5% in gross value added. The strongest performance came from agriculture, where gross value added increased by 18.3%. This is the biggest surge in the agricultural production in the last years and it follows a decline in the sector's output in 2003 (owing to poor weather conditions). Agriculture remains an important sector in Moldova (it accounts for nearly a quarter of GDP and about 40% of all employment.

In 2005, growth is projected to decelerate, which is confirmed by available indicators (such as industrial production, freight carried, retail trade turnover, etc.). Nevertheless, short-term prospects are relatively benign: Forecasters, including the IMF, expect GDP growth to be close to 5% in 2005. Some factors are likely to continue to exert a positive effect on the Moldovan economy: in particular, growth in Russia and Ukraine, two of Moldova's main trade partners, looks likely to remain strong in the foreseeable future. Nevertheless, the main factor supporting growth remains the strong inflow of workers' remittances, which have been increasing steadily on the back of strong emigration and now account for some 25% of GDP (Chart 1).

Fiscal policy

Despite the improvement in the debt-to-GDP ratio (see below), the public finance outlook remains a serious concern. The general government account in 2004 turned to a deficit of more than 1% of GDP, both on cash and commitment basis, from a surplus in 2003. It is expected to increase to 2.5% of GDP in 2005. Parliamentary elections in spring 2005 may have contributed to a marked relaxation in the fiscal stance during 2004. While revenue performance exceeded the original budget projections (owing to aggressive tax collection and higher-than-expected inflation), primary expenditure overshot the budget plans by an estimated 2.5% of GDP. With limited non-tax financing (revenue from external grants and privatisation receipts was well below expectations), the government had to increasingly make recourse to bank financing.

In the course of 2004, Moldova has managed to cut its public external debt to below USD one billion or 36% of GDP (down from 52% of GDP one year earlier). Non-publicly guaranteed external debt is of a slightly lower amount. The current level of Moldova's debt reflects a series of restructuring agreements that have reduced the value of the outstanding debt over time. The latest debt deals, all of them concluded in 2004, covered debt owed to the Russian gas supplier Gazprom (that reduced total debt by over USD 60 million), the US firm Hewlett-Packard, Turkey's EXIM Bank and Romania. Debt arrears were also reduced by half (from USD 86 million at end-2003 to an estimated USD 41 million at end-2004) through buybacks and reschedulings. Yet, arrears still represented more than 2% of GDP, out of which nearly half were new arrears accumulated in 2004.

Servicing of the debt remains a difficult and challenging task: in 2004, payments falling due amounted to nearly 20% of central government revenue. Given low foreign exchange reserves (just two months of imports) and the substantial structural current account deficit the country is expected to remain dependent on additional support from the IFIs and bilateral donors. Indeed, the large official transfers, and a high level of remittances from abroad can only partly mitigate the chronically high merchandise trade deficit, which amounted to around 30% of GDP in the past two years.

Monetary and exchange rate policy

After a positive 2002 year, in which the monetary authorities halved the increase in the Consumer Price Index (CPI) from 10% to 5%, inflation picked up markedly again in 2003. The twelve-month CPI had reached its highest point of 17% in October 2003. Inflation moderated gradually in 2004 to an end-year figure of some 12.5%, well above the target rate of 10%. Price rises are the result of strong domestic demand driven by continued large inflows of remittances and by increasing wages and pensions in the budget sector in the run-up to parliamentary elections of March 2005. Higher energy prices and an incipient tightening of the labour market have also been contributing to inflationary pressures.

The monetary mechanisms behind Moldova's inflation reflect rapid money growth resulting from the interventions on the foreign exchange market of the National Bank of Moldova (NBM) aimed at accumulating international reserves and containing the currency's appreciation. As a result of these interventions, M2 money supply growth in 2004 was nearly 45%, compared to a target of 24.1%. As for interest rates, the NBM kept the base rate constant at 14.0% throughout most of 2004. In September the base rate was increased marginally (to 14.5%).

Despite the NBM's interventions in the foreign exchange market, the leu appreciated in the course of the year: between December 2003 and September 2004, the US dollar exchange rate fell by more than 8.5%; since then, however, Moldova's currency has lost some ground, but it is still well above its level of 2003. In view of much higher Moldovan inflation, real effective exchange rate appreciation was much more significant.

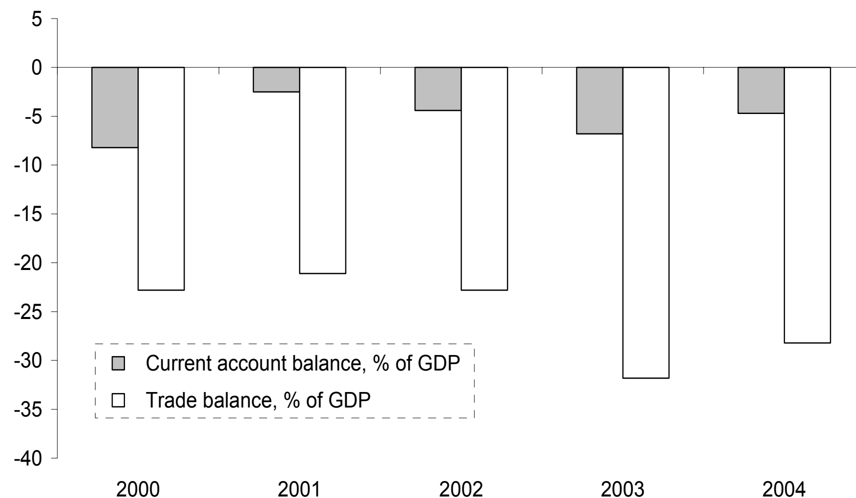
External sector developments

Given the openness of the economy (exports of goods and services were equivalent to 40% of GDP in 2004), Moldova is highly dependent on external demand. In 2004, exports continued to grow, although a strong deceleration was recorded in the first semester of 2004, when the y-o-y rate of increase dropped to 1.9% in real terms (on a national accounts basis). Some of Moldova's

main trading partners recorded strong economic growth in 2004 (in particular Russia and Ukraine, which together usually account for half or more of Moldovan exports). Strong economic growth is expected to continue in the CIS in the foreseeable future, providing a favourable backdrop to Moldovan exports. Nevertheless, partial data for 2004 show a stronger growth in non-CIS exports, despite weak GDP growth in some important export markets such as Germany and Italy.

Imports continued growing at a rapid pace in 2004, boosted by booming private consumption and by the leu's appreciation. Given that imports growth is still outpacing export growth in absolute terms (being very close in percentage terms), the trade deficit is widening; net exports are currently strongly negative at -28% of GDP. Although the deficit is large, it is sustained in part by remittances, which have grown spectacularly over the past years, from 9.7% of GDP in 1999 to some 25% in 2003-2004. Moreover, the true level of remittances may be understated by statistics. Last year, growth of officially recorded remittances outpaced that of the trade deficit, bringing down the current account deficit to below 5% of GDP (Chart 2). The correlation with the trade deficit suggests that the latter is to a significant extent driven by remittances.

Chart 2: Moldova - Current account and trade balance



Source: National Bank of Moldova, IMF.

Labour market

Over the past years, the low level of wages in Moldova has prompted massive emigration: some 600,000 out of 4.3 million inhabitant may have left the country and are residing abroad either permanently of several months a year. This emigration is also reflected, albeit imperfectly, in the shrinking of registered employment. The decline in employment accelerated strikingly in 2003, according to the Labour force survey, it fell by 9.9% on the year. The sharp drop in employment was accompanied by an increase in the unemployment rate, from an average 6.8% of the labour force in 2002 to about 7.9% in 2003. A slight improvement of unemployment in the course of 2004 was short-lived.

Emigration of such a magnitude contributes greatly through remittances to the alleviation of poverty (through provision of income support to the neediest parts of the population) and to domestic economic activity (through boost to consumption and investment in private housing). At the same time, it is a cause of social and economic disruptions. As a consequence, in the short

run, emigration results in domestic shortages of labour. In the long run, there is a risk that it may put in danger the pensions system and the whole social structure of the country.

Real wages have been increasing at a faster pace than GDP, although their growth is decelerating. In 2004 real wages are estimated to have increased by 10%, against 15% in 2003. Measured as a proportion of persons living on less than USD 2.15 a day, poverty has declined markedly over the years, from a peak of 67.6% in 1999 to less than 45% in 2002. While the primary reason for this was the pick-up in GDP, the marked growth in remittances, the decline in wage arrears and the elimination of pensions arrears have also contributed to this improvement. Given ongoing economic growth, it is likely that the poverty rate has continued declining after 2003, notably owing to the nominal appreciation of the leu and the increase in minimum pensions in November 2004, but it remains at high levels.

2. Structural policies

In the initial phases of transition, in the 1990s, when Moldova implemented successfully the first generation of reforms, it was considered as one of the most advanced reformers in the CIS. Reform momentum lapsed subsequently, not least as a result of political shifts. Although the government remains basically committed to free-market policies, implementation has generally been slow and hesitant. The most frequent complaints are that the administration tends to interfere heavily and in a non-transparent manner in business activities; that there is widespread corruption; that the burden of complying with regulations even on minor issues is extremely heavy, and, finally, that foreign investors are discriminated against or harassed. Two important foreign investors, France's Lafarge and Spain's Union Fenosa, were involved in high-profile disputes that lasted for years and were only recently sorted out (successfully).

There have been no fundamental changes in this respect in 2004 even if attempts were made to improve conditions for business activity and SME development and attract foreign investment. So, the authorities made real efforts to simplify licensing and business registration requirements and introduced new legislation on microfinance and investment (the new investment law unifies treatment of domestic and foreign investors). Also, they approved a new anti-corruption strategy and made some progress in fiscal reform. Yet, at the same time, the government's interventions in the economy remained widespread, formal and informal trade restrictions are still in place, and there has been virtually no progress in privatisation – government-owned enterprises still produce about half of the total output. The result is that Moldova's business environment is still considered to be among the most difficult in the region and investments are well below potential.

Approval of the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP)

One more attempt to accelerate the pace of structural reform in Moldova was the adoption by the government of the final version of the Economic Growth and Poverty Reduction Strategy Paper (EGPRSP) in May 2004. The EGPRSP builds upon previous Strategy Papers (an Interim Poverty Reduction Strategy Paper had been drafted in 2000, and was followed by a Preparatory Status Report the following year), from which it adopts elements such as a three-pillar strategy for implementation. The EGPRSP covers the period from 2004 to 2006; it includes a poverty diagnosis, sectoral programmes and an overall policy strategy. The EGPRSP also includes the costing of the proposed programmes within a Medium-Term Expenditure Framework (MTEF).

The document was drafted after long and extensive consultation not only among government ministries, but also with civil society, an important new feature in a country like Moldova, where there was traditionally a less participative approach. IFIs and foreign donors also supported the process. The EGPRSP is also based on a comprehensive analysis of poverty, based *inter alia* on a new population census; this will be essential in providing correct data and for effective targeting of resources, in particular given the backdrop of the large migration of the last few years.

As mentioned above, the EGPRSP is based on a three-pillar strategy:

- sustainable economic growth;
- human development;
- social protection and inclusion.

The first pillar of the strategy underlines the importance of maintaining macro stability and aims at improving Moldova's business climate. The EGPRSP foresees an acceleration of structural reforms, reform and simplification of business regulation, a resumption of the privatisation programme, and adoption of prudent fiscal and monetary policies; all this would lead to a medium-term real GDP growth rate of 5% and to an inflation rate of 6%.

In terms of the sectoral objectives, the first pillar of the EGPRSP includes policy prescriptions for various sectors: agriculture, energy, transports, water/sanitation, and telecommunications. In addition, an important goal is an overall improvement of governance through reforms of the public administration and of the judiciary, and the reinforcement of the fight against corruption.

The second pillar of the strategy aims at strengthening human development through targeted actions in the area of education and health. In both cases, the approach is common: obtaining greater value for money by channelling available funds to the neediest recipients. In education, apart from an increase in funding for basic education, this is to be realised through rationalisation of the school network, better targeting of school grants to the poor and to children with special needs, improved school transportation, particularly in rural areas. In the health sector, the priority will be the rationalisation of the medical infrastructure and the improvement of access to health services by the poor through the establishment of a system of mandatory health insurance.

The third pillar focuses on strengthening social protection and inclusion. A key element of this will be the continuation of the reform of the pension system, and a better targeting of benefits in the realm of social assistance (where a shift away from institutional treatment is also envisaged).

The link with the Medium-Term Expenditure Framework (MTEF)

The EGPRSP has an obvious link with the Medium-Term Expenditure Framework as the latter should lay out expenditure plans that are consistent with the priorities identified in the EGPRSP. The existing MTEF predates the EGPRSP, so an important next step will be to update it and integrate it with the EGPRSP. The update of the MTEF also will have to take into account the changes in the policy orientations that have intervened; for instance, the MTEF implicitly assumes a default on scheduled debt service payments to bilateral creditors; however, as of mid-2004, the government has resumed paying interest to these creditors.

In the IMF-World Bank Joint Staff Assessment (JSA) of the Moldova EGPRSP completed at end-2004, the two institutions, while giving it a cautious overall positive judgement, identified a number of weaknesses. These might be captured under two headings; (i) weaknesses of the strategy itself; (ii) and implementation risks.

Under the first heading, the JSA identifies several questions. The existing MTEF is not considered realistically capable of bringing Moldova's public finances into a sustainable footing. The JSA considers revenue projections to be optimistic; furthermore, it reports large unidentified financing and a continued default on scheduled amortisation payments to some bilateral creditors. Furthermore, the MTEF projects marked increases in public sector wages and, more generally, in public expenditure; the costing of many programmes is questionable.

According to the JSA, only about one third of the spending envisaged under the EGPRSP in the 2004-2006 period has been included in the MTEF. This calls into question the implementation of many of the measures foreseen in the EGPRSP. The apparent lack of resources suggests that the EGPRSP does not at present prioritise sufficiently between different expenditure needs.

Ownership of structural reform programmes remains an issue

Coming to the implementation risks, a major issue appears to be the ownership of the EGPRSP. While the programme itself has been generally well received by analysts, there is much scepticism about the political commitment it enjoys, not least given that it departs markedly from the government's 2001 Economic Revival Programme. It has been noted by many observers that actions on the ground seem to contradict heavily the spirit of the EGPRSP. It will now be up to the new Moldovan government that will be formed following the March 2005 parliamentary election to build a track record that will safeguard the credibility of the announced policies.

The EU Moldova European Neighbourhood Policy (ENP) Action Plan

In early 2005, the European Union and Moldova concluded an agreement on a joint Action Plan in the framework of the European Neighbourhood Policy (ENP), which aims at creating a comprehensive policy framework for the relations between the EU and its neighbouring countries. The Action Plan had been negotiated by the Moldovan government and the European Commission in 2004 and recommendation for its implementation were formally endorsed by the EU-Moldova Cooperation Council of 22 February 2005. It covers a period of three years.

The ENP Action Plan opens new partnership perspectives for EU-Moldova co-operation. The EU is offering Moldova greatly improved possibilities for cross-border cooperation, which will avoid new dividing lines and build regional cooperation on our borders. The EU is also offering Moldova a substantial degree of economic integration and deeper political co-operation. An important element in this respect will be the possibility of giving wider access for Moldovan products to the EU market through Autonomous Trade Preferences.

The EU and Moldova have jointly identified a limited number of priorities for actions, covering the strengthening of administrative and judicial capacity and ensuring respect for freedom of expression and freedom of the media. The EU and Moldova have also prioritised collaboration on economic and regulatory issues with the aim of improving the business climate and enhancing the long-term sustainability of economic policy.

The process of implementing the Action Plan will require significant efforts in Moldova for legislative approximation, structural and regulatory reform. With the endorsement of the Action Plan, the Moldovan authorities have committed themselves to this reform agenda. The pace of progress of the EU-Moldova relationship will acknowledge fully Moldova's efforts and concrete achievements in meeting the commitments contained in the Action Plan.

MOLDOVA

Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% change)	2.1	6.1	7.8	6.6	7.3
Inflation CPI (period average)	31.3	9.8	5.3	11.7	12.5
GDP nominal, in billion USD	1.289	1.481	1.662	1.957	2.595
GDP per capita, in USD	354.1	407.8	458.7	548.4	765.6
Social Indicators					
Total employment (thousand)	1,515	1,499	1,505	1,357	---
Unemployment rate	8.5	7.3	6.8	7.9	8.0
Real wages, % change	2.1	21.6	20.9	15.4	10.2
Poverty - % of population below poverty line	67.1	58.4	44.6	---	---
Inequality - Gini coefficient	0.34	0.36	0.34	---	---
Fiscal Sector					
Total revenues, % of GDP	31.0	29.2	29.6	34.4	33.8
Total expenditure, % of GDP	34.5	29.4	31.5	33.7	36.3
Central govt. balance, % of GDP	-3.5	-0.1	-1.8	0.7	-1.5
Gross Public Debt, % of GDP	84.5	72.4	65.8	57.2	41.2
Monetary sector					
Credit to the economy (% change)	40.1	35.4	35.2	44.4	22.2
Credit to the economy as % of total credit	58.3	60.6	66.7	76.9	74.6
Broad money (M3), % yoy	40.1	36.4	36	30.7	37.7
Degree of Monetisation (M3/GDP, %)	21.9	25.1	28.9	30.8	36.6
External sector					
Current account balance, % of GDP	-8.2	-2.5	-4.4	-6.8	-4.7
Trade balance, % of GDP	-22.8	-21.1	-22.8	-31.8	-28.2
Workers' remittances, % of GDP	13.8	16.3	19.4	24.4	25.0
Foreign direct investment flows, % of GDP	9.8	6.9	7.8	3.5	4.7
Import cover (months)	2.5	2.1	1.9	1.7	2.0
External Vulnerability					
External Public & Private Debt, % of GDP	123.6	105.6	101.2	89.5	63.3
Debt Service as % of exp. of goods/services	25.0	25.1	28.3	21.3	21.3
Gross reserves (excl. gold, million USD)	226.0	228.5	268.8	302.3	421.3
Reserves/M3	79.7	62.5	57.1	47.0	44.8
Financial sector					
Short-term interest rate (NBM base rate)	---	13.0	9.5	14.0	14.5
Exchange rate (per USD, eop)	12.38	13.09	13.82	13.22	12.46
Exchange rate (per EUR, eop)	11.62	11.60	14.45	16.74	16.96
Real effective exchange rate (1999=100)	106.5	99.2	90.4	94.5	95.5

Source: National Bank of Moldova, IMF, World Bank.

MOROCCO

- **Real economic growth reached about 3.5% in 2004, down from 5.2% in 2003, despite brighter prospects in the tourism industry. The slowdown is partly due to a base effect: the previous year saw rapid growth in the agricultural sector (+18%), but resource constraints prevented it from being repeated. The unemployment rate fell to 10.4%.**

- **Fiscal consolidation in combination with a general overhaul of public finances continued to pose a major challenge since the central government's deficit remained at a high level. In 2004 it reached 5.9% (including the Hassan II fund), though this drops to 3.9% if one-off privatisation revenues are included.**

- **Morocco's trade deficit widened because of higher prices for energy imports, which the modest increase of exports did not compensate for. Export growth was particularly restrained due to limited demand from the EU, Morocco's major trading partner. As a result the current account surplus was reduced to 2.2% of GDP (2003: 3.1% of GDP).**

- **Building on the Association Agreement with the EU, trade liberalisation was pushed further under the Free Trade Agreements that have been signed with the US and Turkey and the regional Agadir Free Trade Area project. Trade liberalisation has also triggered other reforms since the government took up the challenge of international competitiveness.**

1. Macroeconomic developments

Real sector developments

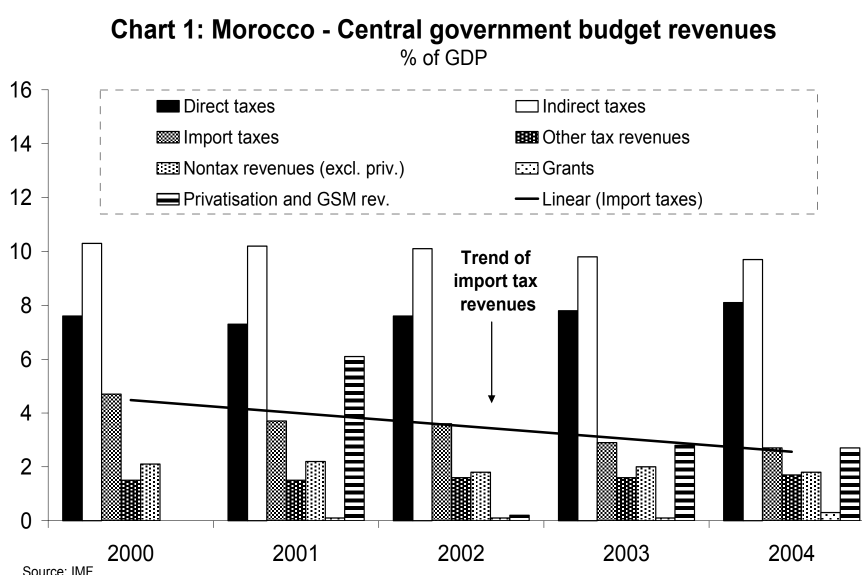
Economic growth is estimated at 3.5% in 2004, down from 5.2% in the previous year. However, the unemployment rate decreased to 10.4% in 2004. The economic slowdown is partly due to a base effect: the agricultural sector (growth +3%) was not able to repeat the expansion of 2003 (+18%) due to natural resource constraints. Manufacturing (+2%) and industrial output (+3.5%) also grew more slowly than in 2003, but the services sector perked up (+5%). The recovery of tourism, with memories of the May 2003 terrorist attack in Casablanca fading, contributed substantially to services growth. On the expenditure side, private consumption provided the strongest growth impulse (+6.1%) on the basis of increased public sector wages and satisfactory agricultural revenues, which are still very important for the economy. Over the last couple of years the agricultural sector contributed on average more than 20% to GDP, while the industrial sector and services contributed about 35% and 43% respectively.

Consumer prices rose moderately in 2004, leading to an average annual inflation rate of 1.5%. Considerable wage increases and surging energy prices, on the basis of sufficient liquidity provided by the central bank, were the main reasons for this development. The slowdown of export growth, mainly due to modest European demand, helped to contain inflationary pressures. At the beginning of 2004, producer prices displayed considerable volatility. In comparison with 1993, coal and petroleum manufacturing prices contracted by 17.4% whereas chemical products became 14.4% more expensive. The fall in the price of manufactured coal and petroleum was probably a backlash from the 33.2% price increase in the previous year.

Fiscal policy

Rising expenditure and weak revenue growth led to deterioration in the fiscal position, with a public deficit of 5.9% of GDP (excluding one-off privatisation revenues).[1] Despite the rise in corporate tax income, in particular from the recovering tourism industry, revenues grew by only 3.4%. This might be due to inefficient tax collection and to receding trade taxes caused by the dismantling of tariffs. The massive sale of 16% of government shares in Maroc Telecom was imminent but was no longer relevant for the 2004 budget. Overall, current expenditure is expected to have risen by almost 9% in 2004, driven by increased public sector wages and subsidies, the latter rising in spite of increases of some regulated prices. Greater spending on security and intelligence following the 2003 terrorist attack in Casablanca also pushed up the government bill. In addition, increasing investment in housing and roads propelled capital spending.

In general, Morocco's recent fiscal stance is not deemed to be sustainable. The revenue system needs an overhaul to overcome the inefficient VAT system, which suffers from multiple rates and many exemptions, and to compensate for decreasing trade taxes (Chart 1). On the expenditure side, apart from the ongoing civil service reform, a reform of the food subsidy system, in combination with a strengthening of the social safety net, is necessary to compress the deficit. Moreover, the private and public sector pension funds need comprehensive reform.[2] Notwithstanding the latest increases in the contribution rates for the public sector fund, both funds could be in deficit by 2010.



Monetary and exchange rate policy

Monetary policy depends largely on the country's exchange rate policy since the Moroccan dirham is pegged to a currency basket including the euro. The weight of the euro was increased to take account of intensifying trade between Morocco and the EU. Consequently, the value of

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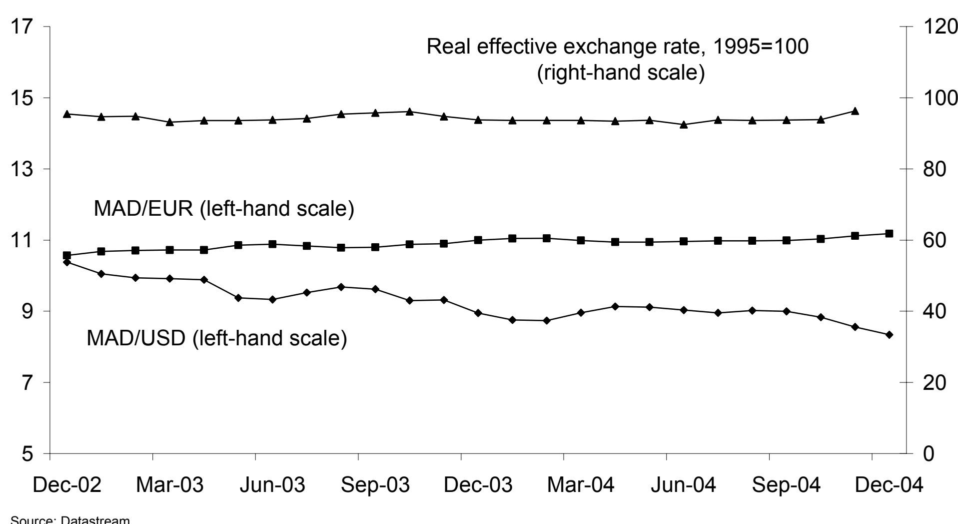
[1] This includes the Hassan II Fund expenditure which the IMF incorporates into the total deficit figure. The deficit excluding the Hassan II Fund operations might have reached 5.1% of GDP like in 2003. As a rule, the Hassan II Fund operations were included in the central government budget prior to 2002. It was then given a new legal status, similar to that of a public enterprise, and since then has not been consolidated with the government sector.

[2] International Monetary Fund (2004), "Morocco: Selected Issues", *Country Report*, No. 04/164, June.

the dinar against the euro remained fairly stable throughout 2004 and shadowed the appreciation of the euro against the US dollar (Chart 2). Overall, the trade weighted real exchange rate of the dinar also remained fairly stable. In general, the exchange rate orientation has served the country well in the past. However, a revision might be necessary in the future because of new developments such as the further dismantling of tariffs according to the Association Agreement with the EU, the Free Trade Agreement with the US, and the end of the International Multi-Fibre Agreement in 2005 which will expose the country's textile industry to intensive competition from Asian countries.

In 2004 the banking system again enjoyed abundant liquidity, because the Bank Al-Maghrib sterilised only some of the monetary expansion resulting from considerable foreign-exchange reserve increases. M3 expanded by 7.4% from October 2003 to October 2004. This helped to stabilise short-term interest rates, which stayed close to 2.3% for most of the year. In contrast, lending rates remained high, at about 11.5%, and to some extent indicated a lack of competition.

Chart 2: Morocco - Exchange rate developments



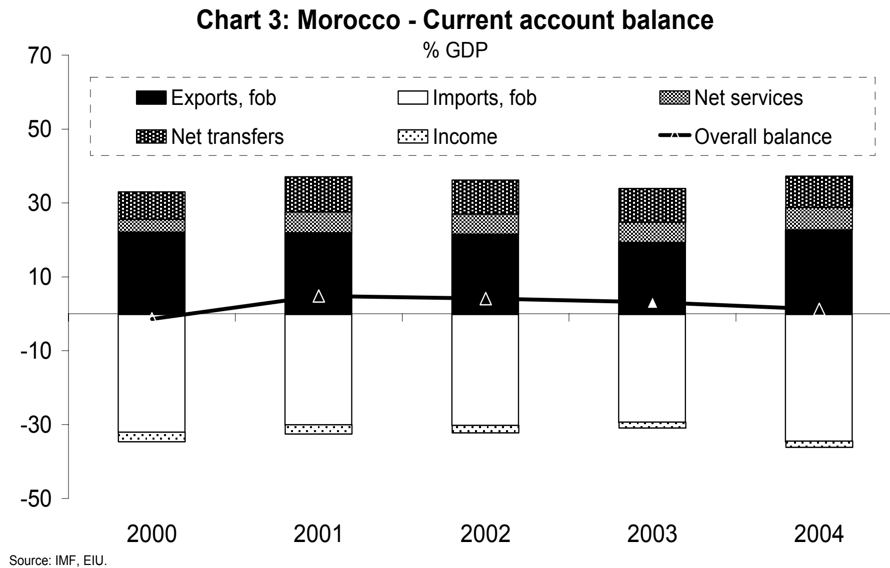
Source: Datastream.

External sector developments

The main development in Morocco's external accounts was the fact that the current account surplus receded in 2004. Increased spending on energy imports, due to high prices, and on investment goods were the main factors which reduced the current account surplus to about 2.2% of GDP (Chart 3). Moreover, food exports were low as a result of only modest import demand from the EU, Morocco's major trading partner. Since import values (up by 14%) grew much faster than exports (up by 2%), the trade balance deficit worsened from 9.9% of GDP in 2003 to 14% of GDP in 2004. Although interest payments on foreign debt remained stable at about 1.6% of GDP, the services balance surplus improved to 6% of GDP, thanks to increased revenue from tourism. Moreover, remittances again provided a solid 90% contribution to total transfer income (8.4% of GDP).

Morocco's external financing requirements remained moderate and it was possible to finance them with ease in 2004. Principal repayments due in 2004 amounted to USD 2.3 billion, slightly less than in 2003. These could be financed by medium- and long-term capital inflows of USD 1.2 billion, and by relatively large direct investment inflows of USD 1.8 billion, both somewhat smaller than in the previous year (the latter offset by only USD 0.1 billion outflows). Taking into

account small amount of portfolio inflows (USD 0.2 billion), the overall current account and capital balance allowed an increase in reserves by about USD 2.5 billion to USD 16.3 billion, representing more than ten months of imports of goods and services.



2. Structural reforms

Morocco has increased its pace of reform in the fields of government administration, trade regulation and financial markets. It is investing particular efforts in trade liberalisation, and has also taken up the resulting reform challenges for the country's international competitiveness. A series of administrative reforms is under way, partially funded by the EU and the World Bank. Considerable progress has been made in bringing the financial sector more into line with modern legislation and rules on supervision. However, employment is still relatively rigid because the new labour code, which entered into force in 2004, will bring about changes only gradually through new labour contracts. Moreover, overcoming political resistance to the reform of public finances – necessary though it is – and upgrading the country's poor infrastructure will take some time.

Trade liberalisation

Morocco has made significant progress in trade liberalisation at both the bilateral and multilateral level. Following the entry in force of the Association Agreement with the EU in 2003, trade in raw materials and industrial goods that are not produced in Morocco was fully liberalised. In addition, the gradual tariff reduction for industrial goods produced in the country was initiated. This part of trade will be duty-free by 2012. Furthermore, trade quotas for agricultural products were increased and negotiations on the trade of services liberalisation were launched.

In February 2004, Morocco, Egypt, Jordan and Tunisia signed a regional Free Trade Agreement (Agadir Agreement). It complements the hub-and-spoke system of the bilateral Euro-Mediterranean Free Trade Arrangements with increased trade liberalisation among these Mediterranean countries. According to the Agadir Agreement, the industrial and agricultural trade of the signatories will be liberalised within two and five years respectively. The Euro-

Mediterranean Free Trade Area has been further enriched by a free trade agreement, signed with Turkey in April 2004.

Another free trade agreement was concluded in March 2004 between Morocco and the US. It envisages that more than 95% of industrial tariff lines will become duty-free immediately and the remaining tariffs will be phased out over nine years. Most agricultural tariffs will be abolished over a 15-year period but quotas for sensitive products will be maintained. The agreement also includes a commitment to liberalise trade of services. In 2003, both exports to and imports from the US amounted to 5.7% of overall exports and imports respectively.

The WTO, in a report published in June 2003, sees further scope for liberalisation, in particular in the services sector, and related welfare gains for Morocco.[3] By expanding its multilateral commitments to the services sector, Morocco could make its trade regime more predictable and its economy more attractive for foreign capital, and consolidate reforms in areas in which the country has comparative advantages, such as tourism. The report also mentions that liberalisation of the agricultural sector and simplification of customs tariffs could improve economic efficiency and enhance Morocco's adherence to the WTO principles. Such reforms could include the abolition of variable custom duties and a reduction in the number and levels of tariff rates.

Fiscal and public administration reform

Morocco is carrying out key reforms which include the modernisation of the judiciary, the streamlining of investment procedures, the rationalisation of budget preparations and execution, and performance-based oversight of the public enterprise sector. The EU and IMF are in favour of a general reform of the tax and expenditure system. Moreover, the country has benefited from several MEDA budget support programmes. The government has improved the financial control of public enterprises and instated contractual relationships with them, with the aim of improving transparency and productivity. This is a further step along the road to eventual privatisation. The authorities have also requested a fiscal Report on Observances of Standards and Codes (ROSC) in order to increase transparency.

Against the background of vigorous efforts to liberalise trade, policymakers want to transform the public administration into a catalyst for development. Morocco aims to improve the efficiency of budget expenditure by decentralising government spending and increasing accountability. Moreover, it intends to give regional administrations greater flexibility, and to introduce performance oriented budgeting and auditing. The programme also includes civil-service reforms such as the improvement of efficiency and quality controls, and the limitation of the payroll. The World Bank is supporting this reform programme with a USD 100 million loan.

The efforts pursued under the reform agenda to keep the wage bill under control should help ensure macroeconomic stability and provide the practical budgetary framework necessary to implement the government's administrative decentralisation plans. These efforts include a government proposal for a voluntary early retirement scheme for 60,000 public sector employees during 2004-06, starting with 20,000 in the first phase (2004). The early retirement scheme is expected to have a net positive impact in the medium term. However, contingent liabilities outside the budget remain high, notably related to both non-performing public banks and public enterprises and the retirement system.

[3] WTO Secretariat (2003), *Report on the Trade Policies and Practices of Morocco*, Geneva, June. This report, along with the policy statement by the Moroccan Government, served as a basis for the third Trade Policy Review (TPR) of Morocco by the Trade Policy Review Body (WTO) from June 16-18.

Privatisation, enterprise restructuring and the business environment

2004 saw further privatisation progress, though some important results were expected to materialise only in 2005. In the agricultural sector the authorities endorsed an international tender for the lease of 216 square miles of land currently under the administration of two public entities (SODEA and SOGETA). The land covers 11 economic regions and 208 economic projects. The notification of the results, which are expected to generate revenue of MAD 2 billion (EUR 182 million), is scheduled for June 2005. The future private management (including by foreign leaseholders) should significantly improve the sector's organisation and capital stock.

Furthermore, the government sold 16% of its Telecom shares to the French company Vivendi in November, thereby increasing its stake to 51%. This added EUR 1.1 billion (2.7% of GDP) to the state's revenue. In December the government raised USD 1 billion by floating shares of Maroc Telecom at the Casablanca stock exchange. Other reforms included the reorganisation of the National Railway Office as a stock company and Royal Air Maroc as a holding company, thus preparing the ground for liberalisation. The monopolistic Port Administration Office and the airport handling service have also been exposed to some competition.

In 1995, the government launched its first national rural roads programme. The second programme, due to start in 2005, will target the rural poor, who live predominantly in isolated areas, and will therefore focus on road access rather than number or length of roads improved. Only 44% of the country's rural population live near roads that are accessible throughout the year. Many of the roads are impassable 30 to 60 days per year due to severe weather conditions. The main objective of this project is to increase access to roads by the rural population to 80% by 2015.[4] There will be greater participation by local government in this programme as the provinces and municipalities will be responsible for approving provincial programmes of priority rural roads.

Improving the business environment and tackling rigidities in the labour market could open up considerable potential for reducing the huge number of unemployed. The time and cost (measured as % of income per capita) to set up a business in Morocco is relatively low compared to the regional average.[5] However, the cost ratio and necessary minimum capital (also measured as % of income per capita) is higher than the OECD average. Closing a bankrupt business is also easier than the regional average but involves more time and cost than the OECD average. In contrast, employing and dismissing employees is significantly more difficult (and in the latter case also more expensive) than compared to regional peers. The overall rigidity of employment index currently stands at 70 (region: 38.7, OECD: 34.4) and the hiring sub-index at 100 (region: 22.6, OECD: 26.2). Forceful implementation of the recently approved Labour Code should however help to reduce the very high rigidity of employment and, at the same time, bring about more protection for workers.

Financial sector reforms

Morocco has a relatively well developed financial system by regional standards and has been implementing reforms to liberalise the system, although financial institutions remain concentrated in urban areas and subject to significant government influence.

[4] In June the World Bank approved a USD 37 million loan for the development of rural roads in Morocco.
[5] Source: World Bank, Snapshot of Business Environment.

The Moroccan banking system is modelled on the French system. As of mid-2004, there were 14 commercial banks. There were also two offshore banks in Tangier. Most commercial banks were partially owned by European firms. Commercial banks must, by law, be at least 51% Moroccan-owned. Furthermore, there were five government-owned financial institutions, 30 credit agencies and 12 leasing companies. The state-owned banks control approximately 43% of the banking sector's assets. The restructuring of two state-owned banks, the Crédit Immobilier et Hotelier (CIH) and the Caisse Nationale de Crédit Agricole (CNCA), is progressing. The CNCA was reorganised as a corporation by law in December 2003. In addition, the deadline for compliance with prudential regulation has been moved from January 2007 to January 2006.

Morocco has made some progress in implementing the main recommendations of the Financial Services Action Plan (FSAP): the parliament approved the new central bank and commercial banking law in 2004. The banking law establishes procedures that apply to banks in difficulties, and determines the competences of the Central Bank, which has been given extended powers to conduct inspections. Moreover, the law prepares the ground for the establishment of a new commission responsible for the supervision of banks, insurance companies and the capital market. A number of draft laws based on FSAP recommendations have been submitted to parliament. They regard the stock market, investment funds, public offerings on the stock market, the establishment of a commission drawing up a code of conduct in the equity and bond markets, and the establishment of a central depository.

On 7 January 2004 the Bank Al-Maghrib introduced a new set of monetary instruments intended to keep the money market rates more accurately in a corridor around the target rate and facilitate market interventions. In particular, the Central Bank can now use open market and swap operations to regulate liquidity, and can withdraw structural excess liquidity by actively using minimum reserve requirements.

MOROCCO

Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% change)	1.0	6.3	3.2	5.2	3.5
Inflation CPI (period average)	1.5	1.8	0.6	1.2	1.5
GDP nominal, in USD billion	33.4	33.9	36.2	44.5	49.6
GDP per capita, in USD	1200	1220	1270	1520	1710
Social Indicators					
Unemployment	13.6	12.5	11.6	12.3	10.4
Literacy total (% of ages 15 and above)	..	..	50.7	..	..
Literacy female (% of ages 15 and above)	..	..	38.3	..	..
Under 5 mortality rate, %	..	..	4.3	..	..
Fiscal Sector					
Total revenues, % of GDP[1]	26.2	24.9	24.7	24.1	24.0
Total expenditure, % of GDP	31.8	31.1	29.6	29.7	28.9
Central govt. balance, % of GDP	-5.9	-5.6	-4.5	-5.1	-5.1
Central govt. balance, % of GDP[2]	-6.4	-5.8	-4.7	-5.5	-5.9
Central govt. balance, % of GDP[3]	-2.5	-2.5	-4.5	-3.0	-3.9
Total Government Debt, % of GDP	81.5	74.8	71.5	69.4	66.4
Monetary sector					
Private Sector Credit (% change)	7.9	4.0	3.8	8.3	8.6
Private Sector Credit as % of total credit	68.5	70.9	70.8	72.5	73.8
Broad money (M3), % yoy	8.4	14.1	6.4	8.7	7.6
Degree of Monetisation (M3/GDP, %)	876.2	984.9	983.1	869.1	839.0
External sector					
Current account balance, % of GDP	-1.4	4.8	4.1	3.1	2.2
Trade balance, % of GDP	-9.7	-8.9	-8.5	-9.9	-14.0
Foreign direct investment flows, % of GDP	0.9	7.3	1.1	4.6	3.1
Import cover (months)	4.6	8.2	9.1	10.6	10.7
External Vulnerability					
External Public Debt, % of GDP	39.3	28.9	23.3	18.9	15.9
Debt Service Ratio[4]	20.1	16.2	16.5	14.2	10.5
Gross reserves (USD billions, eop)	4.8	8.4	10.1	13.8	16.3
Reserves/M3	17.4	28.4	31.3	34.2	34.8
Financial sector					
Short-term interest rate[5]	5.4	3.2	2.9	3.1	2.3
Exchange rate (per USD, avg.)	10.6	11.3	11	9.6	8.9
Exchange rate (per EUR, avg)	9.8	10.1	10.4	10.8	11.0
Real effective exchange rate (1992=100)	117.4	112.1	111.4	109.5	112.4

Sources: Bank Al-Maghrib, Ministry of Finance, IMF, World Bank, EIU.

[1] Includes tariffs earmarked for food subsidies and revenues of the road fund.

[2] Including Hassan II Fund.

[3] Including Hassan II Fund and privatisation revenues.

[4] Percentage of exports of goods, services and MRE (Public and publicly guaranteed debt, excl. early amortization on account of debt swaps.

[5] Avg. money market rate, %.

SYRIA

- **High oil prices, strong agricultural production and a more stable regional environment supported real growth rates of about 3.2% in 2004, up from 2.6% the previous year. Inflation appears to have accelerated during 2004 on the back of wage increases in the public sector and higher import prices.**
- **Economic reforms aimed at modernising Syria's planned economy and at moving towards a market economy made further progress, although at a relatively slow pace. Favourable developments in the international oil market may have decreased the pressure for structural changes in 2003-04.**
- **EU and Syria initialled an Association Agreement in October 2004. The Agreement provides for free trade at the end of a 12 years transition period and sets out a framework for the process of economic transition.**

1. Macroeconomic developments

Real sector developments[1]

High oil prices, strong agricultural production and a more stable regional environment supported growth in 2004, with real GDP growth estimated at around 3.2% compared to 2.6% in 2003. This should have allowed for a modest increase in living standards given annual demographic growth of about 2.4%. Developments in the oil sector, which accounted for over 15% of GDP and 50% of exports, continued to drive the economy. High world oil prices in 2004 allowed Syria to contain the negative impact of the progressive decline in oil export volumes and of the loss of crude oil supplies from Iraq, loss which has resulted from the destruction of the pipeline between the two countries in 2003.[2] Some reports point to a gradual decline of Syria's oil production capacity, which, to some extent, should be compensated by the exploitation of the country's substantial reserves of natural gas.[3] Real growth outside the oil sector was reportedly very low in 2004.[4]

Some inflationary pressures emerged during 2004. Indicators point to a marked acceleration of the GDP deflator to 8% in 2004, up from about 1% the previous year. Prices are expected to have risen by an estimated 10% in 2004 but, due to remaining price controls, price rises were not yet reflected in official CPI measures, which predicted consumer prices growth of about 5% in 2004, the same as in the previous year. Reasons for the expansion in prices include a 20% salary increase for state employees in May 2004, the imposition of a consumption tax and higher prices

[1] Statistical data in Syria displays major weaknesses and is fragmented. Moreover, official data is only reported with a substantial lag. Consequently, this report is based on several data sources, in particular economic reports from the EC Delegation in Syria, the IMF's IFS and WEO database, EIU, as well as press reports.
[2] Before the conflict, Syria was believed to import 150-200,000 barrels of crude oil per day from Iraq at favourable prices (both countries always denied the existence of such operations). This allowed more of Syria's oil to be exported, boosting GDP.
[3] Syria's crude oil production is reported to have dropped below 500,000 barrels of oil per day in 2004, for the first time in over a decade. Syria signed a large number of oil exploration and field redevelopment contracts in 2003, but all the major oil companies, except those already established in Syria, were absent from the bidding processes. To counter declining oil production Syria, actions are also taking in order to keep up high oil exports by switching oil-generated power plants into gas-generated power plants and increase gas and oil explorations.
[4] In the range of 0.5% according to press reports.

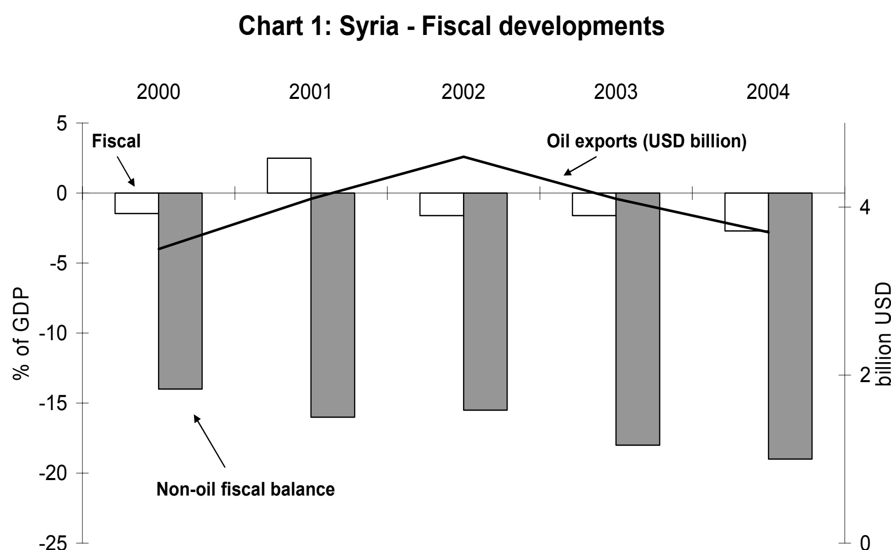
on imports invoiced in euro. In addition, the fall in real interest rates led to a sharp increase in real estate prices.

Despite government's efforts to combat the high share of unemployment, labour market conditions remained difficult in 2004 when official unemployment stood at 11%. These figures are underestimated compared to a more realistic rate around 20%. Pressures on the labour market arise from a rapid labour force growth (4-4.5% per year) associated with the young profile of the population (40% of Syrians are below the age of 15).

Fiscal policy[5]

Fiscal performance appears to have deteriorated in 2004 (Chart 1). The general government deficit (including the Price Stabilisation Fund[6]) is expected to have widened to -2.7% of GDP, up from -1.6% in 2003, mainly on account of higher current expenditures. Syria's fiscal position remains highly vulnerable to adverse developments in the energy markets. A large share of Syria's government revenues derive from hydrocarbon production (about 50% of total budget revenues). When excluding revenues from hydrocarbons, Syria's deficit is estimated at over -18% of GDP in 2004. The decline in oil exports since 2003 also appears to have contributed to the country's worsening fiscal performance.

Chart 1: Syria - Fiscal developments



In November 2004 the government approved the draft budget law for 2005. The budget totals SYP 460 billion, a 2.3% nominal increase from 2004, indicating a real tightening of fiscal policy. On the revenue side, fiscal receipts are expected to rise to about 40% of GDP (against 30% in 2004). The budget was based on an oil price of USD 21-25 per barrel and an exchange rate of 50 SYP/USD (against 48.5 in 2004) reflecting further unification of exchange rates. A novel element in the budget law is that allocations for investments were decreased and, for the first time, set at a lower level than current expenditures, which at the same time were increased.

[5] As of mid-March 2005, very limited information was available about fiscal performance of the 2004 budget.

[6] The Price Stabilisation Fund is in charge of administering price controls and subsidies over food items. A number of petroleum products (such as gas oil and fuel oil) and basic utilities (electricity, water) are sold below market prices, while key crops (such as wheat, cotton) are bought by the government at prices well above international levels.

The 2005 budget focuses on public and social welfare. It aims at improving the educational system and the skills of the labour force and, in addition, at covering increased salary payments and job creation. The budget exposes some contradictions to the previously declared policy. For instance, the budget foresees higher expenditures for civil servants' salaries reflecting higher wages and the creation of 60,000 new public sector jobs, despite public statements that the state should not remain the primary provider of employment. In addition, while the government has announced the progressive reduction of state subsidies on basic goods and public utility services, the amount allocated to the Price Stabilisation Fund in 2005 remained unchanged compared to 2004 (SYP 25 million).

Monetary and exchange rate policy

Initial steps have been taken to increase the flexibility of the monetary policy, with some limited positive impact on the real sector. Since 2003, banks are authorised to modify applied interest rates, which had been fixed for the previous 22 years. After initial cuts in 2003, additional interest rate reductions on deposits were introduced in January 2004. Moreover, in 2004 private banks were allowed to operate in Syria for the first time in 40 years. The adjustments of interest rates appear to have had a positive impact on lending activity, particularly to the private sector. In the first quarter of 2004, banking sector claims on the private sector increased by 6.6% and are expected to rise further as newly established private banks expand. Nevertheless, given the predominance of the public sector both in banking and in the market for credit, the recent changes are likely to have a limited effect on business investment decisions.

Although progress was made in liberalising the exchange rate system, the Syrian pound is not yet convertible. Since 2002, the rates applied for most current account and customs transactions have been unified at the "neighbouring countries rate" of SYP 46.00-46.50 per USD. The exchange rate used for budget calculations was unified with the exchange rate used for other public sector operations in January 2004, and was at the same time devalued from SYP 46.5 to SYP 48.5 per USD. In early 2005, the official rate of the Syrian pound was devalued to stand at SYP 50 per USD, a step towards bringing it closer to its actual value. Steps were also taken to relax the rules on the acquisition and possession of foreign currency.[7]

Despite continuous progress, several exchange rates continue to co-exist, with currency trading taking place on separate markets.[8] Most private foreign exchange transactions still occur on the parallel unofficial markets of Lebanon and Jordan, fed by Syrian workers' remittances, tourism and private sector exports. The complex exchange rate system is a major constraint on business sector activity. The authorities, who have announced that their final aim is to unify the exchange rate, are concerned about the substantial currency depreciation to which the unification of the exchange rate could lead. Syria's fears have to be seen against the background of relatively high foreign reserves. Furthermore, the Central Bank of Syria has not intervened in foreign currency markets for over a decade. The black market rate remained remarkably stable during 2004, staying most of the time at a level of SYP 52.3 – 52.4 per USD.

[7] Following the legalisation of foreign currency accounts and the conduct of foreign currency transfers in 2002, in 2004 the Commercial Bank of Syria was authorised to sell foreign currencies to frequent travellers outside the country, rather than only one time per year.

[8] As of early 2004, an official rate for public sector imports and exports and for budget calculations (SYP 48.5/USD) and an official floating rate applies to most private sector "free" imports and the "export proceeds" market (at around SYP 51-52/USD). In addition, a rate of SYP 11-12 /USD is applied to certain administrative transactions, and the calculation of the value of certain foreign debts, and a rate of about SYP 57 /USD is used on the export market (which should finance the import of certain goods).

External sector developments

At the end of 2004, the government had yet to release interim trade data for 2004 and publish full balance of payments figures for 2003. According to the preliminary information, the trade balance worsened considerably during the first six months of 2004. If confirmed, this would represent a significant worsening from the favourable position of the previous year. The deterioration in trade performance in 2004 appears to be the result of a stagnation of the Syrian exports and a surge in imports. In particular, during the first half of the year, export of mineral fuel and oil products declined, reflecting the gradual depletion of oil reserves and the standstill of hidden transit of Iraqi oil, while imports of mineral fuel and oil products surged markedly. Trade flows during the first half of 2004 confirmed the deeper regional integration with Arab countries, notably with Iraq, Saudi Arabia and neighbouring Lebanon and Jordan. The Asian countries have strengthened their position as first providers for the Syrian market at 28% of the total Syrian imports, while the EU lost market shares. EU exports mainly consisted of machinery, mechanical and electrical appliances.

The main improvements in Syria's current account are expected in the services balance as well as in the notably higher than expected tourist arrivals (mainly from Iraq). The presence of Iraqi nationals is also likely to result in an increase in private inflows to Syria, due to the fact that they finance their living expenses by drawing on hard-currency savings. Overall, the current account balance is expected to have registered a small surplus of 0.3% of GDP in 2004, a marked deterioration from the large positive balances of the previous years. FDI in Syria reached USD 150 million in 2003 – a very low level and a clear indication of the unfavourable business environment.[9] FDI from other Arab countries, notably Saudi Arabia, Lebanon and Kuwait, accounted for almost one-third.[10] In turn, about USD 15 million of Syrian FDI flowed to other Arab countries.

In late 2004, Syria reached settlement agreements on its large external debt with a number of former Soviet-block countries including Poland, Slovakia and Czech Republic. In January 2005, Syria and Russia also reached a settlement on debt to the former Soviet Union, whereby more than 70% of the debt was cancelled.[11] With these agreements, Syria has settled 97% of its international debts. According to the government, the debt was brought down to about 10% of GDP. Remaining external debt is estimated by Syria at USD 50 million and owed to Romania and Bulgaria. Syria does not publish figures for Central Bank foreign exchange reserves. Nevertheless, available estimates indicate that Net Foreign Asset stocks (for both the deposit money banks and the monetary authorities) were high at about USD 16 billion in 2004, providing a safe cushion of foreign currency.

2. Structural reforms

Economic reforms aimed at modernising Syria’s planned economy and at moving towards a market economy made further progress in 2004, albeit at a relatively slow pace. Favourable developments in the international oil market may have eased any sense of emergency for structural changes. Among the most notable developments in 2004 were the initialling of the EU-Syria Association Agreement, the reduction of diesel oil subsidies and the authorisation to private banks to operate in the country for the first time in 40 years. The 10th five-year economic

[9] World Investment Report by the United Nations Conference on Trade and Development (2004).
[10] Source: Inter-Arab investment guarantee agency.
[11] The debt settlement deal reportedly foresees that Syria will only pay back USD 3.6 billion of the debt estimated at USD 14.5 billion, i.e. 73% of the debts have been cancelled.

plan for 2006-2010, still under preparation is meant to guide Syria's transition towards the market economy by 2010. Notwithstanding the stated strategic decision to turn Syria into a market economy, the authorities continued to move cautiously in order to minimise social and economic disruptions.

Trade liberalisation

Several foreign trade liberalisation measures were taken in 2004. In October 2004 the EU and Syria initialled the Association Agreement (AA) providing for free trade at the end of a 12 years transition period, formally ending negotiations that had started in 1998. To enter into force, the AA needs to be formally signed by the authorities of the EU Member States and Syria and be ratified by their Parliaments. Notwithstanding some opposition, the AA was celebrated in Syria as a major and positive development, bringing Syria into the global economy, locking in the process of economic transition and providing it with a framework for carrying out economic reforms.

In preparation of the entry into force of GAFTA in January 2005, Syria also took steps to liberalise some protected products (such as cars, textiles, fertilisers and chemicals) and simplify import procedures. In mid-2004 Syria initialled a Free Trade Agreement with the Gulf Cooperation Council and in late-2004 concluded a Free Trade Agreement with Turkey. Additional trade liberalisation steps in 2004 included the removal of some public trade monopolies,[12] the introduction of an improved custom valuation for car imports, which should lead to a reduction of car prices by as much as 25%,[13] and a draft law amending tariffs on industrial inputs. Reforms are foreseen in the Syrian Custom department including the introduction of an automated system and the modernisation of customs procedures.

Notwithstanding progress with trade liberalisation, non-tariff trade barriers remain high, justifying the launch of specific programmes for trade facilitation. Non-tariff barriers include exchange rate policies, costly export examination procedures, complex exports repatriation obligation, cumbersome administrative and clearing procedures, unclear procedure related to certificates of origin and packing conditions. Among the actions foreseen are the modernisation of the General Custom Department, the automation of customs data and the streamlining and simplification of the present structure of the Syrian external tariff rates according to international standards.[14] The Ministry of Economy finalised a new draft law for the set-up of an Export Promotion Agency (EPA) in 2004.

Fiscal and public administration reforms

In recent years, Syria began carrying out some reforms of its fiscal system. On the revenue side, the Ministry of Finance started streamlining and simplifying the country's taxation structure. Since late 2003, corporate taxes were cut to a standard rate of 25% while penalties for tax evasions were made stiffer. In mid-2004, Syria issued a draft law scrapping the tax on machinery

[12] In particular, the government authorised private sectors to import cement (September 2004), until now monopoly of state, and to export almost all products produced by the public sector.

[13] The new method better reflects the real value of the transaction –including transport costs- and eliminates previous arbitrary measures during the valuation process as well as discriminations based on the geographical origin of the imports.

[14] As recommended by the World Bank and IMF. One of the main recommendations is the progressive reduction of the large number of Syrian tariff rates (around 23 at present) to no more than 5 different rates.

and industrial equipment, as a measure to improve competitiveness. Later in 2004, the authorities approved a law introducing a single consumption tax and replacing 10 other taxes. This is seen as an intermediate step (lasting for three years) before the introduction of a law on VAT. In addition, the new Law has introduced some changes to promote a more attractive fiscal regime for enterprises raising capital through public subscriptions.[15]

On the expenditure side, the authorities have followed a policy of gradual reduction in subsidies for consumer and industrial commodities, accompanied with a parallel rise in salaries and wages. In October 2004, the government hiked the price of industrial diesel oil from SYP 1,350 per ton to SYP 6,000 per ton (USD 115). However, this is still well below world market prices. More significant than diesel oil is the cost of subsidising fuel oil, which causes a huge drain on the country's public finances. Fuel oil is sold in the local market at about a third of its cost, with the balance borne by the state for an annual subsidy cost of USD 516 million. The lifting of subsidies on fuel oil is very sensitive as it is expected to have huge social impact. The sale of a number of strategic agricultural products is also distorted, with their sale to state marketing boards at fixed price, which often were above world prices. Some basic commodities such as bread and sugar remain heavily subsidised.

Although public administration reform has been identified as the priority of the new government appointed in September 2003, only limited steps have been made in this regard. Administrative reform was presented as a precondition and a prelude to reform in all the other domains, given widespread government intervention in the economy and inefficiencies in the public sector. As a means to reduce underemployment and corruption, the government implemented a 20% wage increase for Syria’s public sector employees and pensioners as of June 2004. Some initial steps were also taken to reform the judicial system, with a view of ensuring the competence and integrity of judges. A new law on public procurement was issued in 2004, widening international participation in public tenders.[16] These changes are expected to have a positive impact on the efficiency and transparency of public tenders.

Privatisation, enterprise restructuring and business environment

Syria maintains a sizeable public enterprise sector and a monopoly in a number of sectors, including oil and natural gas production, utilities and infrastructure, and some strategic sectors in agriculture and manufacturing. Estimates for public revenues in 2004 show an increasing number of loss-making public enterprises (losses are stated by the Prime Minister at USD 900 million). At the end of 2004 there were no plans for privatisation, but efforts were instead directed towards opening up state owned companies to private investments. Notably, the authorities had previously agreed a policy to lease public sector companies and use Build-Operate and Transfer systems for infrastructure construction. A new law was issued in early 2005 to grant public enterprises with more managerial flexibility and autonomy.

Although still very restrictive, Syria’s business environment has improved. According to the 2005 World Bank “Doing Business” report, launching a new business in Syria is very challenging in terms of procedures, time and costs implied. In 2004 the authorities submitted draft legislation on competitiveness, antidumping and the protection of infant industries. The government also finalised a new draft company law to replace the old Commercial Law issued in

[15] By reducing the tax to 15% for those who open more than 50% of their capital through public subscription. This measure may represent a step to promote the future development of a stock exchange market.

[16] For instance, having a domicile in Syria is no longer a condition for international companies to participate in public tenders.

1949. According to preliminary information, the draft text is considered as more liberal and grants founders of a company more freedom. A National Competitiveness of the economy with particular emphasis on industry. On the other hand, the long awaited new investment law is still in process.

Financial sector reforms

The financial sector is progressively been liberalised. By the end of 2004, six private banks had been authorised and three were conducting business for the first time in 40 years.[17] Foreign shareholders are entitled to own up to 49% of the shares of the new private banks, the rest having to remain in the hands of Syrian private investors. In order to further promote the development of the private banking activities, in late-2004 a new tax law was issued extending to the newly established private banks some fiscal privileges previously limited to the public bank.[18] More private banks are expected to open up in 2005.

Despite these positive developments, the commercial activities of the new private banks and their effect on monetary aggregates and economic development have remained constrained by over-regulation, high cost of guarantees and collaterals, lack of efficient inter-banking operations and a venture capital market.[19] In the medium-term, the continuous entrance of private banks is expected to loosen further government's restrictions on banking activities. Meanwhile, through a comprehensive automation process and introduction of credit card services, the Commercial Bank of Syria is currently undertaking rigorous steps to increase its competitiveness in light of the (probable) competition by newcomers.

Developments have also taken place in the insurance sector. In 2004, Lebanon's UFA Assurances was granted a license to start operations in Damascus' Free Trade Zone, thus becoming the first private insurance company in 40 years to be allowed to operate in Syria. An Insurance Supervision Commission, set-up following a presidential decree, is currently working on an insurance law establishing the legal and regulatory framework for the insurance sector. Initial preparations were also made to set up a stock market. Pressure on the government to pass capital-market legislation to allow for the creation of a Syrian stock market mounted following share issues made by two private companies in late 2004.[20]

Labour market reforms

Despite government's efforts, labour market conditions remain difficult. Unemployment estimates stand at 11% in 2004, but these public figures are well known to be underestimated compared to a more realistic rate around 20%. In addition to low growth and low employment creation, labour market tensions are caused by the rapid expansion of the labour force associated

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[17] These are Bank of Syria and Overseas, the European Bank for the Middle East Saudi-Fransi both with Lebanese participation), the International Bank for Trade and Finance (joint venture between the Jordanian Housing Bank for Trade and Finance and local Syrian investors).

[18] The tax rate on capital profits was set at 7.5%. 80% of revenues deriving from interest bearing deposit accounts in private banks have been exonerated from the profit tax.

[19] The 3% tax on bank capital increases is considered as a serious impediment to expansion. In addition, Syria's private banks were permitted to accept foreign-currency deposits, but, in order to discourage this activity; banks were only allowed to place these deposits in non-interest-bearing accounts at the Commercial Bank of Syria or at the Central Bank.

[20] The offerings were covered by existing commercial laws and made through direct subscription. Syria does not have a regulatory system for secondary trading in equities, which takes place informally.

with strong demographical growth and the young age structure of the population. Labour participation is relatively low at 53% of the working age population due to limited participation by women.

According to the World Bank's "Doing Business" indicators, the labour market displays elements of rigidity; in particular it is difficult and costly to lay off workers. Moreover, there are no legal arrangements for fixed term contracts, for flexibility in working time or for part time work. The labour market is also characterised by the absence of adequate institutional structures and by an integrated employment strategy. Job creation, education and training have been identified as key strategies by the government that came into power in 2003. Nevertheless, the long awaited new labour law has still not been issued. An agreement of cooperation with the International Labor Organisation was signed in late 2004.

SYRIA

Main economic indicators[1]

	2000	2001	2002	prel. 2003	est. 2004
Real sector					
Real GDP growth (% yoy, avg)	0.6	3.8	4.2	2.6	3.2
Inflation CPI avg, % yoy	-3.8	3.0	0.6	5	5.0
Unemployment rate, %	9.0	10.3	11.7	12.0	…
GDP per capita, in USD	1143	1168	1189	1195	1282
Social Indicators					
Life expectancy	…	…	70.3	…	…
Literacy total (% of ages 15 and above)	…	…	82.9	…	…
Literacy female (% of ages 15 and above)	…	…	74.2	…	…
Fiscal Sector					
Total revenues, % of GDP[2]	27.2	32.1	29.8	31.7	31.4
Total expenditure, % of GDP[3]	28.7	29.6	31.4	33.3	34.1
Consol. budget balance, % of GDP[2,3]	-1.5	2.5	-1.6	-1.6	-2.7
Non-oil fiscal balance, % of GDP	-14.0	-16.0	-15.5	-18.0	-19.0
Domestic debt, % of GDP	125.0	116.0	…	…	…
Monetary sector					
Money and quasi money, % change	19.0	23.5	18.5	7.7	13.4
Credit to the private sector, % change	0.3	0.4	0.7	3.1	6.2
Credit to the private sector, % of GDP	8.7	8.4	8.4	…	…
Degree of Monetisation, M2/GDP	54.2	66.5	75.7	…	…
External sector					
Current account balance, % of GDP	4.4	4.8	6.7	3.5	0.3
Balance of goods and services, % of GDP	6.3	5.0	8.7	5.2	2.1
Net foreign direct investment, % of GDP	1.4	0.5	…	…	…
Import cover (months)	6.2	7.0	8.0	9.4	…
External Vulnerability					
External Debt, % of GDP[4]	20.7	18.6	18.8	19.1	19.6
Debt-to-Export Ratio	87.1	73.2	…	…	…
Debt Service Ratio	20.9	19.5	16.3	15.5	13.1
Banking system's net foreign assets, USD bn	10.8	13.6	15.9	16.9	16.0
Financial sector					
Short-term interest rate[5]	7.0	7.0	7.0	6.0	…
Official exchange rate (per USD, av.)	46.5	46.5	46.5	46.5	48.7
Market rate (Beirut, Amman) av.	49.6	50.4	52.5	52.8	52.3
Exchange rate (per EUR, av.)[6]	43.0	41.7	44.0	52.5	60.5
Real effective exchange rate (1995=100)	109.6	113.3	…	…	…

Source: Ministry for Economic and Foreign Trade, IMF, Medstat, IIF, DRI-Wefa, EIU.

[1] Statistical data in Syria display major weaknesses and is fragmented. Moreover, official data is only reported with a substantial lag.

[2] Including grants.

[3] Including the operations of the Price Stabilisation Fund (PSF).

[4] Officially acknowledged debt.

[5] 6-month deposit rate.

[6] Calculated cross rate.

TUNISIA

- **Tunisia maintained a high economic growth rate at around 5.6% in 2004 thanks to a continued robust growth of agricultural production, a strong recovery of tourism and related services and a satisfactory performance of manufacturing exports as a consequence of steady external demand.**
- **Inflation accelerated to around 5% by mid-2004, because of several one-off shocks, before receding to below the 3% level in the fourth quarter. Despite this decline, risks related to a revival in inflationary pressures remain present due to potential repercussions of recently implemented wage increases.**
- **Preliminary data points to a further reduction of the trade and current account deficit in 2004, owing to a strong export performance and tourism revival. A successful recourse of the government to the international capital market gives proof of returning confidence of investors and has contributed to bolstering foreign-exchange reserves.**
- **The implementation of the Association Agreement with the EU, which entered into force on 1 March 1998, has advanced, in particular on economic and trade matters. It will be further enhanced by the economic part of the European Neighbourhood Policy.**

1. Macroeconomic developments

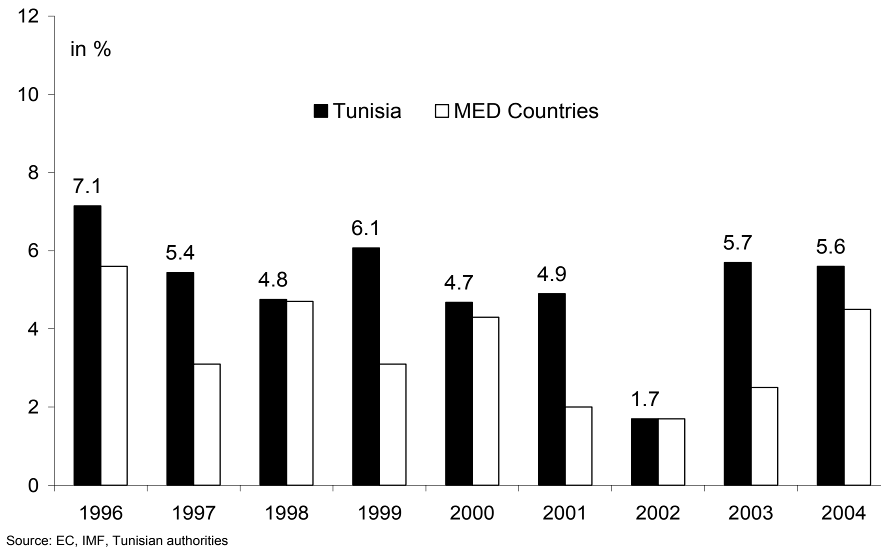
Real sector developments

Economic growth remained high, at around 5.6% in 2004, supported by a strong performance of the agricultural sector, by certain segments of the services sector and by exports (Chart 1).[1] Preliminary data confirmed that GDP output growth stood at 5.6% y-o-y in 2004, driven mainly by agriculture and a strong performance in the service sector, transportation and telecommunication being among the most dynamic segments. Following renewed confidence after the terrorist attacks in Djerba and Casablanca, the tourism sector picked up and its expansion stimulated related services industries. Moreover, the respective improvement of the employment situation bolstered private consumption. However, gross fixed investment continued to be sluggish, partly as a consequence of adjustment processes in the textile and clothing industries linked to the upcoming expiry of the Multi-Fibre Agreement at the beginning of 2005. Finally, the export sector displayed a positive momentum in 2004 due to steady external demand that stimulated in particular activities in the production of mechanical and electronical goods.

Although the inflation rate started to recede in the second half of 2004 after accelerating to about 5%, some inflationary risks remain present. The annual CPI increased to close to 5% in May 2004 due to one-off shocks before falling to below 2% in the fourth quarter.[2] Price pressures were fuelled by increases of food prices and administered prices, whilst inflationary pressure from the exchange rate diminished as the dinar stabilised against the euro during 2004. A 5% increase of energy prices during early August 2004 has not yet fully materialised in the CPI figures but it may explain the still relatively high level of wholesale price inflation which increased to 3.8% in 2004, up from 2.4% in 2003, and which may feed into CPI figures. Finally, the repercussion of the current price developments on wage policy could increase inflationary

[1] Tunisian Central Bank (2003), *The Economic Situation Periodical*, Tunis, June.
[2] Institut National de la Statistique de la Tunisie.

risks. The government raised already the minimum wage by 3% in early August 2004 to protect the purchasing power of around 280,000 public employees.[3] Wage developments like the recent hike in minimum wages and its potential impact on wage negotiations in general need to be monitored and could be a reason why inflation might stay above the Central Bank's target in 2005.



Fiscal policy

Thanks to the overall positive economic developments, the government is expected to consolidate its fiscal accounts further in 2004. The figures for the first eight months of 2004 show that the budget deficit excluding privatisation receipts stood at TUD 463 millions. This implies a 28% fall compared with the same period in 2003 and is well in line with the TUD 862 million target for the full year. The budget for 2004 aimed at reducing the deficit to 2.6% of GDP (2.8% of GDP excluding privatisation proceeds and grants). Receipts were expected to increase by around 7.8% from the 2003 level. This is below the expected nominal GDP of around 9.3%, which may reflect a certain scepticism about the authorities' tax collection capacity as well as lower customs revenues. The latter are impacted by the Free Trade Agreements with Jordan, Egypt, and Morocco, which call for the removal of tariffs by January 2006, and the progressive dismantling of tariffs on imports of industrial products from the EU until 2010 in line with the EU Association Agreement.

Expenditure increases in 2004 were influenced by short-term – electoral – objectives as well as external developments. Like in the previous year, current expenditure grew more strongly (6.6%) than capital spending on public infrastructure projects. Moreover, authorities earmarked more than 90% of the proposed increase of current expenditures for wages of civil servants, whose wage bill already accounts for 12% of GDP, consequently limiting the flexibility to adjust to external shocks. Finally, still existing subsidies for commodities seemed to be particular costly in 2004. Despite adjustments in retail prices, the recent rise of the oil price above USD 50 per barrel is expected to cause government spending to exceed the target for fuel subsidies, although this should not endanger the fiscal consolidation pace.

[3] DRI-Wefa, October 2004.

Monetary and exchange rate policy

The monetary policy framework was object of a thorough examination in view of Tunisia's global integration efforts. It consists of targeting the growth of broad money within the limits of a crawling-peg exchange rate regime. To date, the Central Bank of Tunisia (CBT) is testing a new forecasting framework for base money (operating target) and broad money.[4] In contrast to previous practices, the real exchange was allowed to depreciate during 2002/03 in order to accommodate different shocks (downturn of the global economy in 2001, 11th September 2001, Djerba terrorist attacks, drought). Although the real exchange rate stabilised in 2004, a return to periods of prolonged real exchange rate stability cannot be expected, as Tunisia aims to integrate more deeply with the world economy. Recognising the challenges of capital and financial account liberalisation, since 2002 the authorities have explored alternatives to their current macroeconomic framework. This might lead to the adoption of an inflation targeting regime, implying a more flexible exchange rate.

For 2004, the monetary policy stance has continued to be more on the accommodative side, aiming to create conducive conditions for economic growth. The monetary programme of the CBT foresees a 7.8% increase in M4, this being its main policy target (5.7% in 2003).[5] Data up to August points out an increase of 7% compared to the end of 2003 and indicates that there might be a moderate overshooting of the target. The overall acceleration of money supply reflects a return to an increasing demand for money as well as an accommodation of several one-off food and energy price increases since the second half of 2003. Furthermore, liquidity conditions have still been impacted by exchange rate developments during 2003, when the dinar depreciated further, albeit moderately, on a trade-weighted basis. Finally, interest rates remained at a low level since the mid of 2003, when the CBT cut the refinancing tender rate to 5%.

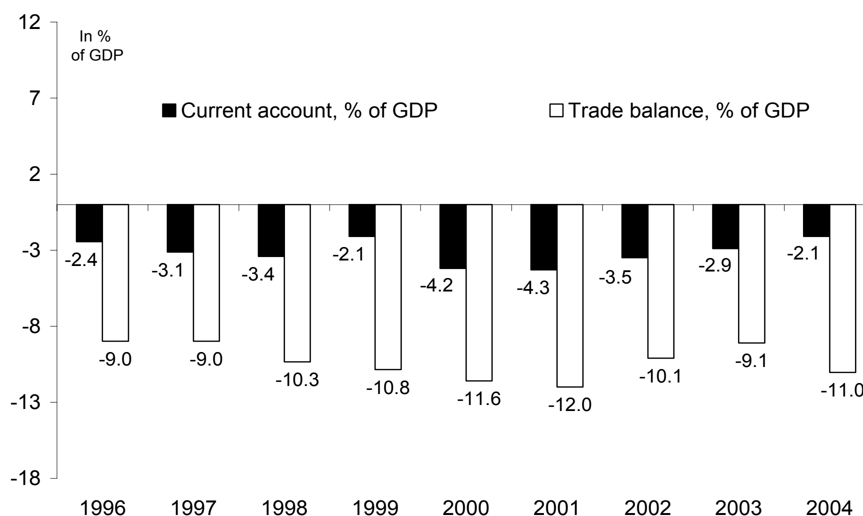
External sector developments

Following developments in the previous years, a further improvement of the trade and current account balance in 2004 is expected on the back of a strong export performance and a recovery of the tourism sector (Chart 2). Thanks to steady external demand and the impact of the real exchange rate depreciation during 2003, Tunisian exports rose by around 12% on an annual basis up to the third quarter of 2004. Strong export dynamics were noted in particular with regard to agricultural products, phosphates and equipment-related products. Import growth lagged slightly behind, despite vivid domestic demand and high oil prices. Overall, these developments are expected to translate into a trade deficit of 11% of GDP in 2004. In addition, recent data point to a strong recovery in the service balance with tourism receipts up 17% for the whole of 2004.[6] Together with a sustained inflow of remittances, this offset higher interest rate payments and led to a further reduction of the current account deficit to 2.0% of GDP in 2004.

The composition of the capital and financial account remained relatively stable in 2004 in comparison with the previous year. It is characterised by strong long-term foreign borrowing and relatively stable FDI inflows. Long-term foreign borrowing is expected to surpass its already relatively high pre-year level of around 8% of GDP, after successfully tapping the international bond market in the second quarter of 2004. Tunisia managed to obtain a seven-year, EUR 450 million loan bearing an interest rate of 4.825%. The amount was 50% higher than initially

[4] International Monetary Fund (2004), "Tunisia: 2004 Article IV Consultation", *IMF Staff Report*, Public Information Notice, No. 04/123, November.
[5] Tunisian Central Bank (2004), *Equilibre du Système Financier Projeté pour 2004*.
[6] National Statistics Institute, DRI-Wefa.

requested, with total offers of EUR 1.1 billion.[7] The recourse to external private debt in order to maintain the desired foreign-exchange level coverage contributed to an increase in Tunisia's external debt to USD 16.2 billion in 2004 whilst the external-debt ratio declined (2004: 57.4%, 2003: 64.4%). FDI increased to around 3% of GDP during 2004, while short-term capital outflows maintained a declining trend in the first half of 2004, indicating that the negative impact of terrorist attacks in the region as well as of the Iraq crisis is slowly ebbing.



2. Structural reforms[8]

Trade liberalisation

While nominal protection against imports from the EU is decreasing every year in line with the tariff dismantling measures of the Association Agreement, Most-Favourite-Nation (MFN) tariffs remain overall high. As Tunisia already started to apply unilaterally the agreed tariff dismantling scheme in January 1996, the process regarding imports originating in the EU is well advanced. In 2004 around 40% of imports from the EU were free of customs duties, while most of the others benefited either from a rate reduced to 28% of the basic rate or, for the most sensitive products, from a rate reduced to 44% of the basic duty. Average effective protection against EU imports (excl. agricultural products) decreased to 24% in 2002 and is foreseen to decrease further to 3% in 2008. However, overall MFN tariffs remained high, ranging from 22.5% for industrial goods to 68% for agricultural products. In 2004 rates applied to non-EU imports are subject to levies which, on average, were 12.7% higher than those applied to EU imports. Despite measures taken in 2004 to simplify the MFN tariff structure and to reduce average multilateral protection, Tunisia still applied various fees and duties to imports, adding on average 4% to applicable rates.

One of the major export products of Tunisia, namely textiles and clothing, is expected to come under increasing competitive pressure in 2005 when the Multi-Fiber Agreement expires. More than 40% of Tunisia's total exports earnings stem from clothing, with 75% of total textile exports bound for the European Union. The expiration of this agreement will open the European

[7] Middle East Economic Digest - (Quest Economic Database) (2004), *Tunisia: Eurobond Issue a Hit*, 12 April.
[8] Substantial input for this part has been provided by the EC Delegation in Tunis.

market to exporters from other emerging markets such as China and Bangladesh, which both have strong competitive advantages in textile production. Some indicators show that an adjustment process in Tunisia might be already well under way. The textile dominated manufacturing sector contracted by 3.7% in 2003, while planned investments decreased by more than 20% in the first half of 2004. The government of Tunisia has prepared a Trade Strategy to respond to these challenges, focussing on a. facilitating access to knowledge on foreign buyers and market requirements (WTO), b. facilitating access to pre-shipment export finance through a guarantee mechanism to share with the banks non-performance risks of emerging exporters and c. lowering transaction costs involved in trade, arising from trade clearance procedures.

Fiscal and public administration reform

Discussions are under way with regard to the distortionary effects of the current fiscal system that differentiates between on- and off-shore sectors. Currently fiscal incentives are granted to off-shore companies which target primarily external markets. This off-shore regime, designed when the trade regime was restrictive, has nowadays lost its justification, as tariff reduction place on-shore and off-shore on the same footing. Against this background, the Tunisian authorities are prepared an Action Plan that appears to have influenced the 2004 Budget Law, which includes first steps to bring the two different investment and tax regimes closer together. This process also seems to be influenced by key recommendations of the 2003 FIAS study[9], which highlights the need for a more radical reform, ultimately removing exonerations targeting the off-shore sector, in particular in view of the dismantling of all tariffs on industrial imports from the EU by 2010.

During 2004 Tunisian authorities enacted a revised version of the "Code des droits et procedures fiscaux", which represented an important step towards re-balancing the relationship between the tax administration and the private sector with a view to reduce state interference and rent-seeking behaviour. Though the World Bank assessed that the new Code still leaves scope for improvements, it provides already a much more transparent and explicit legal tax framework than before.[10] The clarification of tax procedures lifted discretionary tools of the tax authorities and should improve the overall business climate.

Privatisation, enterprise restructuring and business environment

The low level of private investment reflects business impediments. Gross fixed capital formation of the private sector amounted to roughly 13-15% of GDP in the past three years. In contrast, public sector investment activity accounts for around half of the overall gross investments, indicating the possible existence of a "crowing out" phenomenon. Barriers for a more dynamic private investment activity include, among others, the still existing strong public influence in the financial sector. The four public banks accounted for around 45% of all the assets of commercial banks, while the main insurance company, also in public hands, had a total market share of 34%. Furthermore, the opening of certain public sectors of the economy to private investment in the framework of the Xth Plan (2002-2006) remained slow and was characterised by some reticence, going in parallel with a fractious privatisation process.

In 2004 the privatisation process has not gained momentum and only slow progress with regard the larger projects could be recorded. The government has failed to attract any bidders for its

[9] The study carried out by the WB's Foreign Investment Advisory Service (FIAS) assessed the tax system and the incentive regimes, in close coordination with the Bank's MENA region department.
[10] World Bank (2004), *Country Assistance Strategy – Tunisia*, June.

33.5% stake in the ailing Banque du Sud (BS). Although four banks were pre-selected to buy BS, which is being sold as part of efforts to privatise the banking sector and open it up to international capital, no offers were made by the scheduled deadline. The authorities are in the process of trying to sell a 35% stake in Société Nationale de Distribution des Pétroles. The overall privatisation programme for 2004 contains more than 20 public enterprises or public participations according to the Budget 2004 law. It should be noted that the authorities have launched or are already preparing a number of large concession operations for new infrastructure projects (a new airport, a new port, a new water treatment plant, etc.).

A recent assessment of the local business environment by the World Bank points out some areas which compare favourable with neighbouring countries but it also identifies specific regulations and policies that discourage entrepreneurial activity.[11] On the positive side Tunisia currently records a high degree of ease for businesses to get started and to get closed, as indicated by the low number of procedures and days needed. Furthermore, it appears not to be difficult to obtain credit information as well as a high degree of legal protection for borrowers and lenders, which holds true both in a regional as well as in an OECD context. Tunisia performs very well with regard to commercial contract enforcement, where the number of procedures and the associated time seems to be even below OECD standards. However, indicators for 2004 note shortcomings in the labour market area, where the employment rigidity index is well above the peer level because of cumbersome regulation for hiring and laying-off.

Financial sector reforms

The soundness of the banking sector continued to deteriorate during 2003 compared to the previous two years. The worsening of the situation was reflected in the increased ratio of doubtful credits to overall credits to 24% at the end of 2003 (20.9% at the end of 2002). Private banks experienced an increase in non-performing loans to 21.6% (2002: 18.1%) of overall credits, while the respective ratio of public banks deteriorated to 26.7% (2002: 24.3%) in 2003. Provisioning ratios also weakened during 2003, declining to 43.1% of non-performing loans (2002: 43.9%) apparently due to an over-reliance on collateral, which is, however, difficult to recover. The authorities attributed this deterioration to the drop in tourism and the economic downturn, underlining that this deviation from the long term goal of strengthening the banking sector was expected to remain short-lived. Authorities are following IMF, World Bank and EU advice such as to expedite the recovery of collateral by reforming the judicial process, to allow the tax-deductibility of credit provisioning and to reduce state ownership in the financial sector.[12]

In the Budget 2004 the government put forward a number of measures in order to modernise and to restructure the banking system. Reform measures envisaged for 2004 comprise the establishment of a central creditor information centre which enhances risk management, the modernisation of the payment system and a new guarantee system for loans to medium enterprises in the industrial and service sector. The privatisation of the BS remains on the authorities' agenda, but its privatisation process might drag on well into 2005. Finally, authorities appear to tackle the issue on non-performing loans and the overall compliance to prudential ratios (via an increased recovery rate of collateral for credits), which should be facilitated through amendments of the civil and commercial code. In general, the opening of the financial sector to international competition remains essential for its modernisation and,

[11] World Bank (2004), *Doing Business in 2005: Removing Obstacles to Growth*, Oxford University Press, September.
[12] International Monetary Fund (2004), "Tunisia: 2004 Article IV Consultation", *IMF Staff Report*, Public Information Notice, No. 04/123, November.

especially, for an improvement of the financial intermediation process as a whole. This is important in view of the planned gradual liberalisation of capital movements.[13]

Labour market issues

Although registered unemployment has fallen in recent years, it remains at a high level and the labour market has not been in a position to cope with a high and growing number of new entrants, which is likely to peak in 2003 and 2004. Output growth would have to increase significantly in light of unchanged employment elasticity, to create enough jobs to absorb the increasing labour force (2.5% per year). Despite the unexploited productivity gains in respect to the reallocation of labour to high productivity sectors, the Tunisian private sector has not played a dynamic role in terms of job creation. Moreover, enterprise restructuring has not been sufficiently rapid in some sectors. The Labour Code introduced in 1993 increased flexibility by introducing limited contracts, part-time work, and by allowing extra hours. However, the modalities of termination of existing employment contracts are still very strict and have not been modified during 2004. Finally, collective protection nets, as well as the overall welfare system, are also characterised by some deficiencies. For instance, the integration and re-integration of the unemployed are subject to a number of uncoordinated state mechanisms, which go to the benefit of only a small number of the unemployed and seem to be missing coherence and efficiency.

[13] President Ben Ali, new programme for the 2005-2009 period.

TUNISIA

Main economic indicators

	2000	2001	2002	prel. 2003	proj. 2004
Real sector					
Real GDP growth (% change)	4.7	4.9	1.7	5.6	5.6
Inflation CPI (period average)	3.0	1.9	2.8	2.7	3.8
GDP nominal, in USD	19.5	20.0	21.3	25.0	28.2
GDP per capita, in USD	2036	2068	2181	2535	2822
Social Indicators					
Unemployment	15.6	15	14.9	14.7	13.9
Life expectancy	---	---	72.7	---	---
Under 5 mortality rate, %	---	---	26.0	---	---
Literacy, total	---	---	73.2	---	---
Fiscal Sector					
Total revenues[1], % of GDP	29.3	29.5	29.2	28.9	---
Total expenditure[2], % of GDP	32.7	32.3	31.4	32.2	---
Central govt. balance[3], % of GDP	-3.9	-3.8	-3.5	-3.5	-2.8
Gross Public Debt[4], % of GDP	60.8	62.8	61.6	60.9	59.2
Monetary sector					
Private Sector Credit (% change)	24.2	10.8	5.1	6.5	9.5
Private Sector Credit as % of total credit	89.7	91.3	91.7	92.6	91.0
Broad money (M3), % yoy	14.7	10.3	4.5	6.3	10.5
Degree of Monetisation (M3/GDP, %)	53.1	54.4	54.6	54.1	54.1
External sector					
Current account balance, % of GDP	-4.2	-4.3	-3.5	-2.9	-2.1
Trade balance, % of GDP	-11.6	-12.0	-10.1	-9.1	-11.0
Foreign direct investment, % of GDP	3.7	2.2	3.8	2.8	3.0
Import cover (months)	2.4	2.3	2.7	3.0	2.9
External Vulnerability					
External Public Debt, % of GDP	58.4	58.1	65.2	64.4	57.4
Debt Service Ratio[5]	22.6	15.6	17.2	15.1	19.0
Gross reserves (excl. gold, USD billions)	2.4	2.3	2.7	3.0	3.2
Reserves/M3	16.0	16.9	19.8	18.6	17.9
Financial sector					
Short-term interest rate[6]	5.88	5.94	5.91	5.00	5.00
Exchange rate (per USD, eop)	1.385	1.468	1.340	1.209	1.200
Exchange rate (per EUR, eop)	1.300	1.301	1.401	1.531	1.634
Real effective exchange rate (1992=100)	99.8	97.2	93.7	90.5	87.0

Source: Tunisian Ministry for Economic Development, Central Bank of Tunisia, IMF, IIF, DRI-Wefa

[1] Total revenues exluding grants including social security accounts (CSS).

[2] Total expenditure and net lending including social security accounts (CSS).

[3] Consolidated government balance excluding grants, privatisation receipts and social security accounts.

[4] External and domestic debt including social security funds' debt and public enterprises' debt.

[5] Total debt service in % of exports goods, services & income.

[6] Discount rate.

UKRAINE

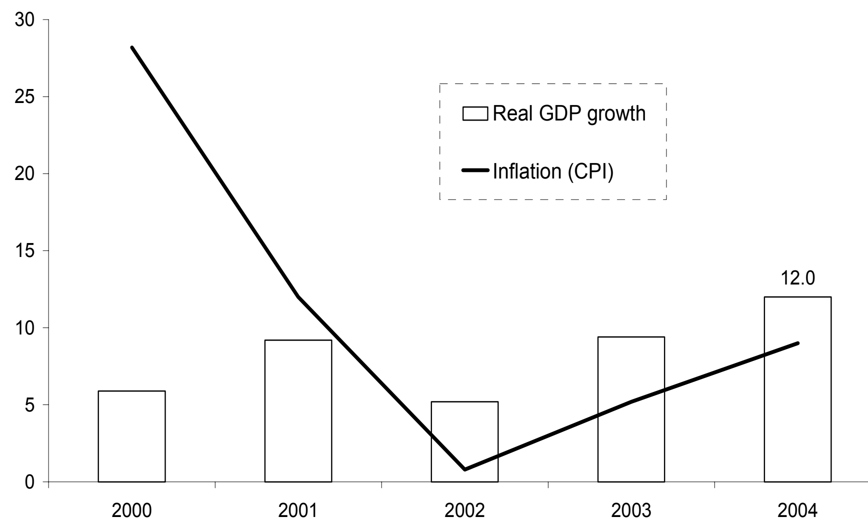
- **Economic growth accelerated to 12% in 2004 fuelled by strong external demand and high market prices for Ukraine's main exports, notably steel. The balance of payments strengthened as the current account surplus reached a record 11% of GDP. Inflation accelerated to 12.3% (8.2% in 2003). Inflationary pressures were exacerbated by loose fiscal policies in the second half of the year in the run-up to the presidential elections.**
- **The new government will have to address these emerging macroeconomic imbalances in 2005 and resist imposing another round of election-driven fiscal expansion before the 2006 parliamentary elections. It will also need to find new ways of addressing the challenges associated with structural adjustment of the economy, and these are likely to add to upward pressure on public expenditures.**
- **The new government is also expected to tackle corruption and the backlog of structural reforms, *inter alia* by making privatisation procedures more transparent and improving tax and customs administration to improve the business climate. The new government's programme already includes encouraging elements in several key areas.**
- **An Action Plan under the European Neighbourhood Policy was endorsed by Ukraine and the European Union in February 2005. To strengthen its implementation, a number of key priorities have been jointly identified in order to reach tangible results already in the course of 2005.**

1. Macroeconomic developments

Real sector developments

Ukraine's GDP reached the equivalent of about EUR 50 billion in 2004 – which is about half its level in 1989. Economic growth reached a record high rate of 12% last year (Chart 1). Industrial output grew by 12.5% thanks to strong external demand for steel, machinery and chemicals. However, a declining trend in monthly growth rates was already visible from the spring. After a poor harvest in 2003, agricultural output recovered to its normal level (+19% in real terms in comparison to 2003). Construction also picked up strongly (+18.4%). Retail and wholesale trade grew by 17.8% in real terms.

Growth continued to be driven by both strong external demand for Ukraine's main exports and robust domestic consumption and investment. While Ukraine's exports benefited from continued strong demand in its traditional export markets in the EU-25 and Russia, Ukraine also began to trade more with the rest of the world, including China. Exporters' profits further fuelled an investment and construction boom. At the same time, domestic consumption demand was supported by several factors, in particular a reduction in taxes and an increase in pensions. The progressive income tax (on a scale of 10-40%) was replaced by a flat rate of 13% in the beginning of 2004. In the run-up to the presidential election, the government increased pensions and other social transfers. These increases in benefits had not been budgeted in 2004 but the government managed to finance them out of privatisation proceeds which exceeded the amounts originally projected in the budget.



As a result of the previous government's spending decisions before the presidential elections, inflationary pressures and fiscal imbalances emerged, which the new government must address as a matter of priority in 2005. Consumer price inflation reached 12.3% at end-2004 (8.2% at end-2003) (Chart 1). Inflation accelerated towards the end of the year so that the last quarter of the year saw a 6.2% increase in the index (+2.4% in December alone). Price regulations on meat and gasoline were put in place in 2004 but these are likely to be dismantled during 2005. Inflationary pressures are also reflected in the fact that the producer price index increased by 24% in 2004. The wide gap between producer and consumer price indexes suggests that there will be further upward pressure on the latter in 2005, from the pass-through of higher oil prices for example. In January-March 2005 consumer prices increased 4.4%.

Fiscal policy

In order to contain inflationary expectations, the most important challenge is to restrain the fiscal deficit, which has been on an increasing trend since about mid-2004. Preliminary estimates for the consolidated government (including central government and local budgets) show a deficit of 3.3% of GDP for 2004, whereas a deficit of below 2% had been projected in early 2004. The 2005 budget approved in December 2004 did not fully reflect all spending decisions taken during the election campaign (concerning in particular finances of the extra-budgetary pension fund). Consequently, amendments to the budget, including increases in both revenues and expenditures, were adopted by the parliament at the end of March with a projected deficit of 1.6% of GDP.

In 2004 the impact of lower tax rates on total revenues was partly compensated by higher-than-expected GDP growth. In nominal terms, state budget revenues are set to grow by 54% and expenditures 45% y-o-y in 2005. With such high nominal (and real) budgeted growth rates, the risks with respect to the actual budget execution are considerable. When submitting to the parliament the amendments to the budget, the government revised its real GDP growth forecast for 2005 upwards to 8.2% (from 6%) and that for inflation to 9.8% (from 8.7%). As in 2004, privatisation proceeds are needed to finance the deficit of the extra-budgetary pension fund. In 2003 and 2004 the government, having regained access to international capital markets, resorted mainly to external financing. In 2005, a gradual shift towards domestic government securities in order to develop the domestic secondary market can be expected.

The dramatic increase in budgeted revenues can be attributed not only to projected strong economic growth (partly reflecting the legalisation of informal economic activities), but also to a large number of amendments to various tax laws (including cancellation of privileges, exemptions and sectoral tax breaks, and increases in excise rates). The strengthening of tax and customs administration and of state property management is also expected to have a strong impact on revenues. In particular, the privileges enjoyed by Special Economic Zones are cut drastically, as their contribution to economic development has been considered rather dubious. Expenditures, on the other hand, have increased markedly owing to the full year impact of the previous government's spending decisions in the social sphere as well as owing to new decisions to increase both minimum monthly pensions and minimum wages to UAH 332 (UAH 92.45 as of January 2004). Further increases in various social benefits have also been decided.

Monetary and exchange rate policy

Ukraine has indicated that it plans to replace its exchange rate regime of a de facto peg of the hryvnia to the dollar with a currency basket that includes the euro, reflecting Ukraine's growing trade with the EU. This policy change will lead to an increase in the share of the euro in international reserves, which totalled USD 12 billion as of March 2005. This regime change may also involve moving towards a managed float, in which case the hryvnia will trade more freely than it has since being linked to the dollar since 1998. A more flexible exchange rate policy would facilitate inflation control and better management of risks related to credit expansion. The National Bank of Ukraine (NBU) has in fact announced its readiness to consider switching to inflation-targeting as a long-term goal. The real exchange rate is substantially undervalued according to estimates by the IMF but so far the NBU has avoided any drastic policy changes.

Following a period of uncertainty during the elections at the end of last year the situation on the foreign exchange market stabilised. Households' bank deposits declined in October-December 2004 when people converted their hryvnia balances to cash dollars. The NBU was able to manage the imminent liquidity crisis by drawing massively on its foreign exchange reserves. Restrictions on deposit withdrawals and foreign exchange transactions were put in place but these were lifted at the end of the year when the situation had stabilised. In January-March 2005, household deposits grew by 20%.

In the past, the NBU did not actively sterilise the accumulation of international reserves. Rising demand for the hryvnia (remonetisation) and increases in government deposits did broadly help to match the additional supply of liquidity through the NBU. However, faced with emerging inflationary pressures in the second half of 2004, the NBU adopted a more active sterilisation policy (e.g. through reverse repos and the issuance of certificates of deposits). To tighten the monetary policy stance, the NBU also increased the discount rate three times during the year (from 7% to 9%). Nevertheless, consumer price inflation exceeded all projections.

The IMF and the EU (in the context of the European Neighbourhood Policy) have called for a review of legislation that impinges on the NBU in order to strengthen the central bank's independence. Efforts should also be made to increase transparency in communicating the monetary policy framework and operations.

External sector developments

The cumulative effect of the current account surplus in 2004, which reached USD 6.8 billion (10.5% of GDP), and past surpluses was a rapid increase in international reserves during the first half of 2004. These strong surpluses were partly a result of the NBU's policy of a de facto peg of the hryvnia/US dollar exchange rate (at an average of UAH 5.32 in 2004), leading to an estimated undervalued real effective exchange rate. In addition, the reserve build-up was fuelled by a requirement that forced exporters to sell 50% of their foreign exchange proceeds. This requirement, effective since 1998, has recently been abolished. Meanwhile, the hryvnia depreciated against the euro from UAH 6.7 to UAH 7.1 during the year. Despite the political turmoil, the gross international reserves of the NBU, at USD 9.5 billion at the end of December 2004, were still above their level of one year before and comfortably covered more than three months of imports. In early 2005 the international reserves began to increase again.

In March 2004 the IMF approved a precautionary stand-by arrangement (SBA). However, the arrangement has been off track since the autumn 2004 due to slippages in fiscal policy in the run-up to the presidential elections. Given its comfortable balance-of-payments situation, Ukraine does not seem hard-pressed to reach agreement on a possible successor arrangement with the IMF, but may nevertheless find it desirable for demonstration purposes. Ukraine's external public debt has been on a declining trend in percent of GDP since 2001 (estimated at 19% of GDP for 2004, down from 27% in 2001). Supported by strong macroeconomic fundamentals and moderate debt ratios, Ukraine's sovereign ratings did not suffer from the political turmoil: it is at present rated B+ by Standard & Poor's and BB- by Fitch/IBCA.

2. Structural reforms

In the economic area, the European Neighbourhood Policy Action Plan includes priorities for action relating, *inter alia*, to Ukraine's accession to the WTO, gradual removal of restrictions and non-tariff barriers that impede bilateral trade as well as implementation of the necessary regulatory reforms, improved tax administration and sound public finances, and improvements in the investment climate through non-discriminatory, transparent and predictable business conditions, simplified procedures and the fight against corruption. Although the Orange Revolution completely changed the political landscape in Ukraine at the end of 2004, it was agreed not to re-open negotiations on the Action Plan in order to ensure a quick start to the implementation of its key reform measures, a number of which have been identified as priorities for 2005 in the light of the government's commitment to developing democracy and a market economy.[1]

The new government will need to find new ways of addressing the challenges associated with structural adjustment. It must replace unacceptable forms of intervention by developing appropriate mechanisms for providing state aid and subsidies and minimising the social costs of structural adjustment.

[1] European Commission (2004), Commission Staff Working Paper on "European Neighbourhood Policy", Country Report on Ukraine, Reference: SEC (2004) 566, 12 May 2004. This report was the starting point for the negotiations on the Action Plan, which was endorsed by the EU and the new government of Ukraine in February 2005. Available via the Internet at http://europa.eu.int/comm/world/enp/pdf/country/Ukraine_11_May_EN.pdf

Trade facilitation and liberalisation

Ukraine has tapped new markets for its exports in the EU and more recently also elsewhere, including other fast-growing economies such as China. High growth rates have also been seen in trade with Russia (+37% in 2004), which accounted for a 41% share of imports to Ukraine and 18% of its exports in 2004. The EU-25 accounted for 32.6% of imports and 30% of exports.[2] With the conclusion the Partnership and Cooperation Agreement (PCA) in 1996, trade between the EU and Ukraine was significantly liberalised, except for steel products. Bilateral agreements on steel and textiles have been concluded, the latest in 2004 and 2005 respectively. Ukraine's imports under the favourable conditions of the EU's General System of Preferences (GSP) scheme have increased significantly since 2000 and its global utilisation rate of 57% (effective GSP imports as a proportion of eligible imports) is above the average.

Ukraine's trade-weighted average import tariff is about 7%, with a large number of exemptions further lowering the effective rate. The new government is, however, reviewing the situation so that some streamlining is expected in the course of 2005, particularly concerning the status of special economic zones. Tariff rates were cut for a wide range of imports of consumer goods in March 2005. A few export restrictions are still in place, notably for scrap metals and sunflower seeds. Ukraine has concluded Free Trade Agreements with all CIS countries except Tajikistan. The possible establishment of a future Free Trade Area with the EU is foreseen in the PCA, and in the context of the European Neighbourhood Policy an updated joint economic feasibility study on a FTA is to be launched in the course of 2005.

Ukraine applied for WTO accession in 1994, and the new government aims to complete negotiations by the end of 2005. As of December 2004, Ukraine had completed bilateral negotiations on market access with a total of 29 WTO members, including with the EU. Non-tariff issues, such as export restrictions, taxation, intellectual property, sanitary and phytosanitary measures and technical standards, are under discussion with a view to removing measures which do not conform to WTO norms by the time of Ukraine's accession. The question of ensuring reliable implementation of the legislation also features prominently in the ongoing discussions.

The agreement on the creation of a Single Economic Space between Ukraine, Belarus, Russia and Kazakhstan was ratified by the Ukrainian parliament in 2004 but its implementation remains controversial and it has not yet been implemented. President Yushchenko has made clear that Ukraine's goals of WTO accession and EU integration may not be compromised by any other agreements.

Fiscal and public administration reform

While addressing the current fiscal imbalances is an urgent task, further efforts should also be made to strengthen the public finances as a whole and to improve the accountability of budget entities. For instance the proposed amendments to the constitution concerning the Accounting Chamber (the supreme external audit body) would strengthen its functions considerably by including also the revenue side of the budget under its scope. In the context of the revised state budget for 2005, the government has begun to address some of the most pressing reforms such as rationalising state aid (by getting rid of tax exemptions and other privileges) and improving the management of state enterprises. At the same time, further efforts are needed across the board to improve budget planning and execution, and reinforce internal and external audits. For example,

[2] The EU-15 accounted for 18% (exports) and 24% (imports), while the new EU Member States had shares of 12% (exports) and 8% (imports) (preliminary data for 2004).

a comprehensive Medium-Term Expenditure Framework would be a valuable tool for prioritising public expenditures in future budgets.[3]

Privatisation, enterprise restructuring and business environment

Decisive action by the new government to improve the business climate would no doubt have a significant impact on future economic growth also by attracting more foreign direct investment (FDI). Strengthening corporate governance and dismantling uncompetitive practices would stimulate more broadly based economic growth and enterprise development, and encourage new small and medium-sized enterprises. Ukraine's tax system and a poor overall framework for the adoption and implementation of legislation have come out in several surveys as the main obstacles to progress on this front.[4]

Among other issues, serious problems with Ukraine's civil legislation and company laws were noted in an OECD study.[5] New Civil and Commercial Codes became effective in January 2004 but these are inconsistent with each other in several respects. In particular, the Commercial Code in its present form is widely considered to present an obstacle to enterprise development in Ukraine. Adoption of a new Joint Stock Company Law is still pending as well as specific legislation covering other important corporate forms.

The lack of transparency in dealing with the persistent problem of outstanding arrears on VAT refunds to exporters is something else which inhibits improvements in the business climate. In 2004 there was an attempt to solve the problem to some extent through bonds which were issued to exporters. Nevertheless, ongoing problems with VAT refunds are not likely to be resolved until the refund mechanism itself is strengthened. Proposals to this effect, including those in the 2005 budget amendments, are being put into practice by the authorities.

In May 2004, the European Commission concluded that Ukraine did not yet meet the criteria for market economy status with regards to anti-dumping investigations. This was due to state interference in pricing in some industrial sectors and some remaining shortcomings in the bankruptcy legislation. The new government has undertaken to resolve the few remaining issues as soon as possible, having already, in early 2005, repealed some problematic decisions taken by the previous government.

In 2004 revenues from privatisation reached their highest annual level since Ukraine's independence, UAH 9.58 billion, equivalent to about EUR 1.45 billion. The main assets privatised were the Kryvorizhstal steel plant, the Pavlohradvuhillia coal mine and the Azot (Severodonetsk) chemical company. Under non-transparent tender procedures, the terms of the privatisation process effectively limited the tender to domestic operators and higher bids from foreign buyers were rejected. As announced by the new government, at least some of the most controversial asset sales will be reviewed by the new government in the course of 2005, most importantly the Kryvorizhstal case. The legal provisions to be applied for re-privatisation may vary, and re-nationalisation has not been excluded in some cases. The revised 2005 state budget foresees privatisation revenues of UAH 6.99 billion. This may prove a challenging target given

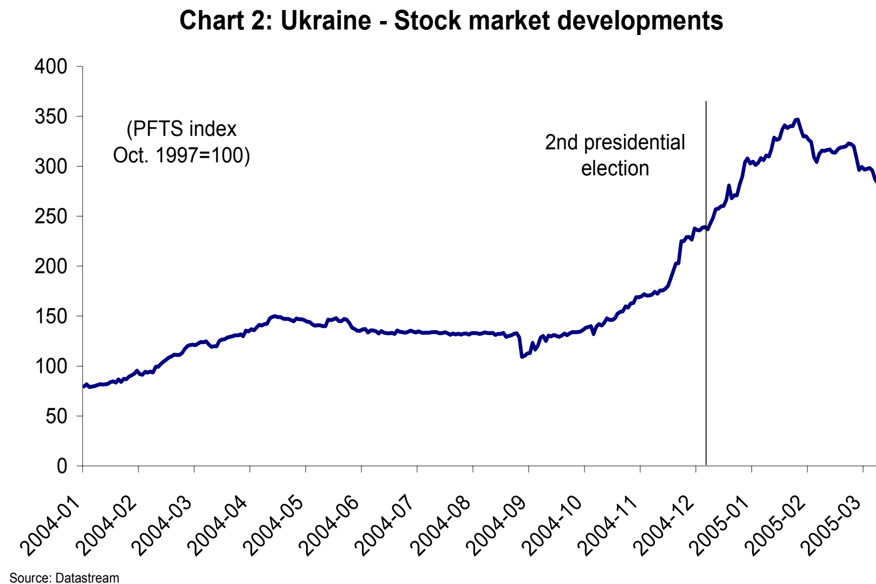
[3] "Fiscal Transparency in Ukraine", published in 2004 by the Gdańsk Institute for Market Economies, gives a comprehensive assessment of the public finance management and detailed recommendations for further reforms. The IMF's Fiscal Transparency ROSC for Ukraine also clearly highlighted the remaining problem areas (April 2004).

[4] E.g. surveys commissioned by the OECD and the European Business Association.

[5] OECD (2004), "Legal Issues with regard to Business Operations and Investment in Ukraine", October.

that the expected privatisation of some large strategic state-owned assets such as the Ukrtelecom is likely to be somewhat delayed.

The recent downturn in Ukraine's main stock market index, following a very strong rebound after November 2004, appears to be a sign of considerable uncertainty pertaining to the government's reform measures (Chart 2).



Financial sector reforms

The sudden deposit withdrawals during the last quarter of 2004 were merely a temporary setback after a period of very rapid growth. Business and household deposits grew by 42% and 29% respectively for the year as a whole. Banks also increased their lending volumes by about 30%. The NBU increased the minimum capital adequacy ratio to 10% as of March 2004. Ukraine was included in the OECD list of non-cooperating countries in combating money laundering until 2004, but has since then been removed.

Despite a strengthening by the NBU of the supervisory framework, credit quality is a concern, particularly in the light of widespread lending to related parties and weaknesses in banks' risk assessment practices. These are exacerbated by poor accounting and reporting standards in the corporate sector. Ukraine's credit-to-GDP ratio is still relatively low at 26%. Although Ukraine's ongoing credit boom can be attributed to catching up from a low level of financial intermediation, the risks are significantly higher given that institutional and structural reforms in the financial sector have lagged behind during the recent period of strong economic recovery.

Labour market issues

The high growth rates of the past have already had a positive impact on the labour market. The unemployment rate, as measured officially, appears to have been remarkably stable at a relatively low level between 3.6-3.8% of the labour force in 2001-2004. However, this indicator does not capture underlying trends in the labour market as the economic incentives for registering as unemployed are low. Estimates based on ILO methodologies do show, however, a gradual decline in unemployment from 11.8% (2001) to 9.1% (2003). Furthermore, strong

economic growth boosted real wages, which increased by 24% in 2004 (+14% in 2003). Average monthly nominal wages were UAH 590 (UAH 462 in 2003), which is equivalent to about EUR 90.

UKRAINE

Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% change)	5.9	9.2	5.2	9.4	12.0
Inflation CPI (period average)	28.2	12.0	0.8	5.2	9.0
GDP nominal, in USD billions	31.3	38.0	42.4	49.5	61.7
GDP per capita, in USD	640	780	880	1050	1370
Social Indicators					
Unemployment (ILO definition)	11.7	11.0	10.1	9.1	---
Average monthly wages (% change)	30.2	34.9	20.7	23.0	27.6
Population (% change)	-0.8	-0.8	-0.8	-0.8	---
Fiscal Sector					
Total revenues, % of GDP	33.4	33.5	36.0	37.0	35.6
Total expenditure, % of GDP	34.7	35.1	35.5	37.7	40.2
General govt. balance, % of GDP	-1.3	-1.6	0.5	-0.7	-4.6
Gross public debt, % of GDP	47.0	38.6	35.7	30.3	27.1
Monetary sector					
Domestic credit to private sector (% of GDP)	11	13	18	25	---
Private sector credit (% change)	61.3	40.5	47.3	63.4	---
Broad money (M3), % yoy	46.1	41.9	41.8	46.5	32.4
Degree of monetisation (M3/GDP, %)	19.0	22.4	28.7	35.6	36.4
Dollarisation in bank deposits	38.5	32.9	32.6	32.2	30.7
External sector					
Current account balance, % of GDP	4.7	3.7	7.5	5.8	10.5
Trade balance, % of GDP	2.5	0.5	1.7	-0.5	4.8
Foreign direct investment (net flow, % of GDP)	1.9	2.0	2.0	3.0	---
Import cover (months)	0.9	1.7	1.9	2.4	3.8
External Vulnerability					
External Public Debt, % of GDP	33.1	26.6	24.0	21.9	19.2
Debt Service Ratio[1]	10.4	8.7	5.7	6.3	4.8
Gross reserves (excl. gold, USD billions)	1.5	3.1	4.4	6.9	9.5
Reserves/M3	25.2	36.5	36.1	38.7	40.1
Financial sector					
Lending rate	41.5	32.3	25.4	17.9	17.4
Exchange rate (hryvnia per USD, average)	5.4	5.4	5.3	5.3	5.3
Exchange rate (hryvnia per EUR, average)	5.0	4.8	5.0	6.0	6.6
Real effective exchange rate (2000=100)	100	100.4	95.1	86.6	81.7

Sources: IMF, EBRD, Ukrainian authorities.

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

WEST BANK and GAZA

- **The West Bank and Gaza's growth rate decelerated in 2004 to around 2-3%, mainly as a consequence of heightened restrictions on the free movement of goods and people out of Gaza during 2004. Income per capita stabilised at the relatively low pre-2004 level, while poverty continues to affect around two thirds of the population in 2005.**

- **The 2004 budget was under constant pressure throughout the year because of far lower than expected external budget support and a rapidly growing public sector wage bill. The adjustment burden had to be borne primarily by non-wage expenditures, as recourse to the domestic financial system only partly covered the financing gap.**

- **The Palestinian Authorities cabinet (PA) adopted a One-Year Reform Action Plan in September 2004, which complements and reinforces the Action Plan that was finalised in the context of the European Neighbourhood Policy. Furthermore, the PA is finalising the Medium-Term Development Plan (MTDP) 2005-07, which will build on current reform achievements.**

- **In 2004 reform efforts continued to improve effectiveness, efficiency and transparency of PA activities, with a reorganised salary payment system for security staff, enhanced transparency of the Palestine Investment Fund (PIF), a new procurement policy and a reinforcement of both internal and external audit activities.**

1. Macroeconomic developments

Real sector developments

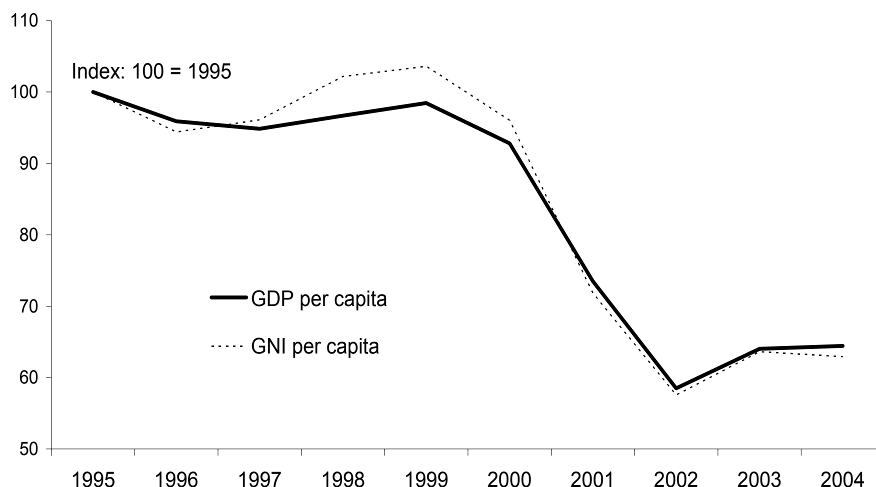
Following a severe decline since the beginning of the intifada at the end of 2000, the Palestinian economy stabilised in 2003-04, albeit at a low level, but economic activity continues to be constrained by a number of factors (Chart 1). Prime among them was the Israeli closure policy,[1] which hit the Palestine economy by leading to the collapse of tourism, preventing Palestinian workers from working in Israel, and preventing Palestinians within the territories from undertaking basic economic activities. All of this has increased transaction costs significantly.[2] Lower incomes have also forced the population to use savings to finance daily expenditures, thereby negatively impacting upon the level of investment. All these factors have had and continue to have a negative impact on domestic demand, with estimates of the decline in real income ranging from 30% to 50% over four years to the end of 2004.

Economic growth has decelerated to around 2-3% in 2004, after a relatively strong showing by the economy in 2003 (GDP growth of 5.4%). The slowdown appears to be linked to several Israeli military operations in Gaza, which were accompanied by a tightening of restrictions on the free movement of goods and people out of Gaza. As a consequence Gaza's export activity shrank in 2004, with negative repercussions on the labour market and domestic demand. 8000 jobs were reported to have been lost in 2004 and the official reported unemployment increased to

[1] "Closures" refer to the restrictions on movement of people and goods externally, between the West Bank and Gaza and Israel, and internally within the territories.
[2] The already high costs of transporting goods have doubled since lorries have to take longer routes along poor quality roads and tracks to get to their destinations.

around 40% of the labour force.[3] The economy of the West Bank, however, performed slightly better. The employment situation improved, in particular in the agricultural, manufacturing and selected service sectors, the latter profiting also from some spillover effects from the growing Israeli economy. However, the improvement was not sufficient to compensate for Gaza's lost domestic demand. In addition, during 2004 the overall security situation continued to weigh on investment activity, both in the West Bank and in Gaza.

Chart 1: West Bank and Gaza - GDP and GNI per capita developments



Source: World Bank Estimates, EIU.

Box 1: West Bank and Gaza - the World Bank's growth projection for 2004-06[4]

The World Bank has developed three illustrative economic scenarios in order to give a better understanding of the range of possible growth performances in the near term:

1. Status quo: this scenario assumes the continuation of current levels of violence and an unchanged intensity of internal and external closures.
Outcome: A continuation of the status quo would further impoverish the population. GDP growth would be negative at around -1%, and the income level would be expected to decline further.

2. A radical easing of internal closures: this scenario contemplates the progressive easing of internal closures (beginning in mid-2004) and, consequently, an economic recovery based on the internal Palestinian market.
***Outcome**:* In this scenario economic growth would increase to around 2.6% in 2006. However, the increase in economic activity would not be enough to reduce unemployment or poverty.

3. A radical easing of internal closures plus trade facilitation: this scenario envisages a progressive easing of internal closures and the facilitation of Palestinian trade with the rest of the world.
Outcome: In this scenario economic growth would accelerate to above 9% by 2006, allowing for a gradual reduction in unemployment and poverty on the back of a slowly advancing GDP per capita level.

The standard of living of a large proportion of the population stabilised at a rather low level (Chart 1). Despite positive economic growth, GNI per capita (which includes workers' remittances) declined slightly in 2004 to around 63% of the 1995 level (2003: 63.6%). High population growth, around 5%, has left the proportion of the population living in poverty more or less unchanged. Poverty levels have increased dramatically since the beginning of the intifada,

[3] World Bank (2004), *Four Years – Intifada, Closures and Palestinian Economic Crisis: An Assessment*, Washington, October.
[4] See above.

with those living on less than USD 2 per day still accounting for 63% of the population in the third quarter of 2004. Health and food consumption indicators did not improve significantly during 2004, although, according to a survey by the Palestinian Central Bureau of Statistics, these items had been reported to be priority needs for a large part of the population.[5] Remote villages continue to be the worst affected, since they struggle to maintain regular contact with goods and labour markets in Israel and the West Bank and Gaza.

2004 price developments in Gaza and in the West Bank have roughly followed price trends in Israel, although the inflation rate stood at a higher level than in Israel. The increase of the overall price level slowed down to 3% in 2004 compared to 4.4% in 2003.[6] Price pressures stem from the increased price level of commodities and continue to be nurtured by the adverse impact of the closure policy, which increases transportation costs. This fact is clearly evidenced by the rising inflation rate in Gaza, from 2.5% in 2003 to 3.2% in 2004, which was exposed to numerous military operations during 2004. Price pressures were kept under control thanks to deflationary tendencies in Israel, partly due to the shekel's appreciation against the US dollar.

Fiscal policy

Since the beginning of the intifada, the PA budget has been in crisis. The ongoing security situation has continued to negatively affect the PA's capacity to collect revenues, with Israeli transfer payments remaining largely unpaid, and with increased needs for emergency expenditure. Revenues collapsed as Israeli transfer payments, accounting for broadly two thirds of the PA's pre-intifada revenues (derived mainly from indirect taxes, VAT, import taxes, and excise taxes), were stopped at the beginning of the intifada, and only resumed on a more regular basis in 2003. Against this background, the PA has implemented a series of austerity expenditure plans to limit spending and allocate resources to areas that are crucial to maintain the viability of the Palestinian Authority. A key issue remains the disproportional size and growth dynamics of the public sector wage bill (Table 1) in the light of austerity measures.

Financing shortcomings, in particular from external donors, have kept the PA 2004 budget under constant pressure despite a favourable domestic revenue situation. External budget support amounted to USD 353 million for 2004, which is roughly half the amount expected in the 2004 budget. Although the gap was partly filled by recourse to the domestic banking sector, the remaining shortfall curtailed non-wage expenditure in particular and resulted in a smaller than expected budget deficit. The overall deficit amounted to USD 556 million for 2004, running around 20% below expectations. Finally, the transfer of previously withheld clearance revenues by the Israeli authorities, which were supposed to clear arrears by the PA, was far lower during 2004 than anticipated.

Pressures on the expenditure side were aggravated by the increase in the wage bill, while revenues performed strongly throughout 2004. Net revenues of about USD 75 million per month were barely sufficient to cover the PA wage bill of USD 72 million per month, which increased by 23% during 2004. This increase is a result of the implementation of the Civil Service Law in the fourth quarter of 2003 (general wage increase of 15%) and some (planned) hiring. As a consequence of financing constraints, non-wage expenditures were starkly depressed during 2004, while the already nearly non-existent development expenditures were more or less in line with the budget projections (USD 19 million) for 2004. Total net revenues for the first 11 months

[5] Palestinian Central Bureau of Statistics (2004), *Impact of the Israeli Measures on the Economic Conditions of Palestine Households*, April-June.
[6] Palestinian Central Bureau of Statistics, http://www.pcbs.org/

of 2004 amounted to USD 826 million (equivalent to USD 75 million per month) and are running 6.6% above budget expectations (Table 1). All main revenue components (VAT, customs, and – in particular – excises) appear to have improved in 2004. Especially noteworthy is the fact that revenues from petroleum excises have roughly doubled compared to the same period in 2003.

Table 1: West Bank and Gaza - Budget developments

in millions of US

	Actual 2003	Jan-Sep 2004	Jan-Dec 2004	Budget 2004
Revenues	747	716	924	845
Domestic	275	212	310	312
Net Tax revenues	151	116	162	157
Non-tax revenues	123	96	148	155
Gross Clearance Revenues	471	504	614	532
Expenditures	1129	968	1343	1387
Gross wages	743	649	872	868
Non-wage	350	301	449	501
PA financed capital spending	36	18	22	19
Net lending	178	84	137	126
Balance	-561	-336	-556	-668
External Budget Support	229	288	353	681*
Other financing	332	81	180	-13
Transfer of withheld clearance revenues	294	0	90	189
Net change in arrears	-46	-15	-23	-189
Net domestic bank financing	85	96	113	-13

Source: IMF, Palestinian Minister of Finance.

**Includes US $ 32 million disbursed by the EU in 2003 but paid in 2004.*

Monetary and exchange rate policy

The Palestine Monetary Authority (PMA), established in 1994, has only limited functions. It is responsible for licensing, supervising and inspecting banks; determining the liquidity requirements on all deposits held by banks operating in the self-rule areas; and managing foreign exchange reserves and foreign currency transactions. The PMA also has the power to regulate and supervise capital activities in the self-rule areas, including licensing capital market institutions, finance companies and investment funds. In any future Palestinian state, the PMA is expected to become the Central Bank. The PMA does not have the right to issue currency or to conduct independent monetary and exchange rate policies. Without a national currency, the PA is not able to use monetary and exchange rate policy instruments to address economic imbalances. The Israeli and Jordanian currencies are valid legal tender, while the US dollar remains an important currency for business transactions and as a reserve asset.

External sector developments

Palestine's external accounts remain characterised by a chronic trade deficit, which reflects its unequal trade orientation towards Israel, a narrow export base and the substantial import dependence of the domestic economy.[7] In 2004 imports accounted for around 80% of GDP, while exports stabilised at a low level of around 13% of GDP. Furthermore, the disadvantage of

[7] UNCTAD (2002), *Report on UNCTAD's Assistance to the Palestine People*, 18 November.

narrow industrial and agricultural production bases has been exacerbated by Israeli restrictions on the use of natural resources, as well as by occasional border closures. Although earnings by Palestinian workers in Israel and remittances from abroad partly offset the large trade deficits, international donor support has been needed to meet the remaining financing requirement. In 2004, these financial assistance flows have made it possible to maintain the current account deficit at its pre-year level of 17.5% of GDP despite a widening trade deficit of around 66% of GDP.

2. Structural reforms

A few key policy documents outlining the PA cabinet's reform strategy have been adopted or are about to be prepared. The PA cabinet adopted a One-Year Reform Action Plan in September 2004, covering eight reform areas. Another Action Plan, in the context of the European Neighbourhood Policy, was finalised during 2004.[8] Its economic part focuses on financial accountability and sound public finances, improving the conditions for the establishment of a functioning market economy and revitalising the private sector, and trade and regulatory issues. Finally, the PA is finalising the Medium-Term Development Plan (MTDP) 2005-07, which builds on the One-Year Reform Action Plan. The MTDP seeks to stimulate economic growth via private sector development, while trying to tackle poverty and protecting the vulnerable, and to improve governance by the PA.

Trade liberalisation

The current trade regime was defined under the Paris Protocol.[9] External trade continues to be severely limited by the current closure policy.[10] Its lifting is condition "sine qua non" for the economic revival of the West Bank and Gaza. Despite trade and co-operation agreements with Jordan, Egypt, Saudi Arabia, the EU, the US and others, which all provide preferential access for West Bank and Gaza exports, there has been almost no geographical diversification of trade. Trade liberalisation efforts form part of the recently agreed EU-PA Action Plan in the context of the European Neighbourhood Policy. West Bank and Gaza trade remains dominated by Israel. Broadly 80% of all raw materials, essential commodities, services and finished goods originate in Israel, and Israel is the destination for 95% of Palestinian exports. With respect to trade relations with the EU, the major obstacle at present is the non-recognition by Israel of the EC-PA Interim Association Agreement.

In a recent assessment of the economic situation, international donors concluded that the future of the Palestine economy lies in moving from an economy based on the export of labour to Israel to an economy that exports goods and services to Israel and other third countries.[11] Apart from Israeli restrictions on movement by Palestinians and other access problems, a number of competitiveness-enhancing measures have been identified within the area of responsibility of the PA, such as reducing high labour costs, improving skills and stimulating competitiveness at the firm and sector levels. In addition to this, the thorough implementation of existing (as well as

[8] http://europa.eu.int/comm/world/enp/pdf/action_plans/Proposed_Action_Plan_EU-Palestinian_Authority.pdf
[9] Apart from trade relations, the Paris Protocol also covers fiscal, labour and monetary relations.
[10] As highlighted in the Technical Papers on Palestinian economic revival and the Gaza disengagement plan prepared by the World Bank in late 2004. World Bank (2004), *Stagnation or Revival? Israeli Disengagement and Palestinian Economic Prospects*, December.
[11] European Commission and World Bank (2004), "Trade and Exports", *Technical Paper III*, Washington, December.

future) trade agreements, currently impeded primarily by Israeli government actions, would help enterprises to access markets on favourable terms.

If an export-based economic recovery is to materialise, a secure, predictable and efficient border-crossing regime is required in order to improve the competitiveness of Palestine exporters and attract investors. The World Bank argues that using modern cross-border cargo management facilities can permit the orderly flow of cargo, while maintaining or enhancing security.[12] Furthermore, the functioning of the existing quasi-customs union could be improved through a more coherent division of labour between the PA and Israel and by increasing the capacity of the Palestinian customs administration. Finally, an effectively functioning link between the West Bank and Gaza that allows flexible and low-cost transport would assist in establishing a proper single market between the two regions and enhance the economy's competitiveness. In fact, progress on all three issues has been identified as being among the prerequisites for increased donor assistance to ensure a Palestinian economic revival.

Fiscal and public administration reform

In 2004 reform efforts continued in order to improve the effectiveness, efficiency and transparency of PA activities. Most noteworthy is that PA security staff salaries are now paid by direct deposit to personal accounts rather than in cash and that the Palestine Investment Fund (PIF)[13] is subject to international auditing. The first annual report of the PIF was published in April 2004 by internationally certified accountants, who valued all PIF assets as of end-2003 at USD 799 million. Furthermore, other measures aiming at increasing transparency are the establishment of a department of supplies and tenders within the Ministry of Finance, charged with the execution of procurement for all ministries, and a new law on external audit. Finally, the internal audit capacities of the PA are also currently being strengthened.

As for the revenue side, a revised Income Tax Law was passed in October 2004, which was expected to enter into force at the beginning of 2005. According to the IMF the law compares favourably with international best practice. It includes taxation of Palestinian income earned abroad, three, relatively low, individual income tax rates (8, 12 and 16%) with limited exemptions, and a 16% corporate income tax rate with no exemptions. This Income Tax Law represents the first unified income tax legislation for both the West Bank and Gaza, which previously operated under different tax codes, of Jordanian and Egyptian origin. Finally, the Ministry of Finance embarked on an internal restructuring process with a view to enhancing tax collection activities.

The PA dealt intensively with the pension issue during 2004, with the Council of Ministers approving a draft Pension Law. Reform of the pension system was examined with the assistance of international financial organisations. The draft law contains parameters, institutions and management procedures that should put the public sector pension system on a sustainable footing. It has been adopted by the Council of Ministers, and the first implementing steps have already been taken, as evidenced by the establishment of a Pension Project Coordination Unit within the Ministry of Finance. The Palestinian Legislative Committee's (PLC) budget and finance committee has begun debating the draft Unified Pensions Law. However, a separate security services pension law has been passed by the PLC and signed by the President. The

[12] World Bank and Services Group / USAID (2004), *Borders and Trade Logistic*, Washington, December.
[13] Established in 2000 through the transfer and consolidation of all commercial assets and investment holdings previously managed by the Palestinian Authority.

security services pension law is currently being assessed for compatibility with the unified pension law and with regard to its fiscal implications.

Reform of the public administration, including the civil service, is central to improving governance, as it addresses cross-cutting issues affecting public institutions in various sectors. A long-awaited Civil Service Reform was finally launched in 2003, including the transfer of the appointing authority from the General Personnel Council to the Ministry of Finance. A personnel registry is also to be established for each ministry with a job description to match each position, grades are to be compressed and other changes also made in order to move towards a merit-based, transparent system. However, as a result partly of this reform, but also of other factors, the public sector wage bill increased by more than 20% to USD 72 million per month in the first 11 months of 2004.

Privatisation, enterprise reform and business environment

There is an urgent need to accelerate the economic and financial legislative reform agenda by completing the legal and regulatory framework, as well as by improving institutionalisation within private sector organisations to better reflect private sector needs and to ensure full compliance with a sound regulatory framework. The priorities are: (a) harmonisation of all economic laws to ensure they are mutually compatible; (b) ensuring compatibility with the requirements of the multilateral trading system; (c) developing the required implementing rules, procedures and forms; and (d) improvement of the whole private sector institutional framework.

There still remains considerable work to be done on the administrative, legal and regulatory framework, as well as on the implementing rules for most newly promulgated legislation. It is necessary to establish or simplify processes and procedures on the basis of well-established rules and regulations. Most newly drafted as well as existing legislation lacks appropriate implementing rules. The institutional capacity for implementation needs to be enhanced and public governance in the realm of inter-agency/inter-ministerial coordination stepped up.

In the area of competition policy, regulatory structures are in transition. Many of them have been inherited from Jordan or the British mandate. Applicable legislation may differ between the West Bank and Gaza, as was the case with the income tax system. Despite the fact that unification of the different legal bases is on the Palestinian Authority's agenda, a new regulatory framework, including a new Competition Law, has not yet been adopted.

Currently USAID, the European Commission and GTZ (Deutsche Gesellschaft für Technische Zusammenarbeit) are the major donors to the Palestinian private sector. USAID is currently providing technical assistance to SMEs through an enterprise revitalisation programme, focusing on SME start-ups, turnaround situations, financial facilitation (expected to leverage substantial amounts of domestic and international financing), business development services and capacity building, and job creation. The programme ends in September 2005 but is expected to be refinanced. The programme targets enterprises of all sizes in the trade, manufacture and service areas. Selected banking and financial industries are also on the USAID support agenda.

In terms of direct support to the private sector, the European Commission has allocated EUR 30 million for emergency support to SMEs in the West Bank and Gaza and East Jerusalem. The funds are managed by the Palestinian Development Fund (Palestinian Banking Corporation groups) and are aimed at providing financial relief and working capital assistance to SMEs in Gaza and the West Bank and East Jerusalem. This project was still ongoing during 2004. In

addition, the EC is considering providing initial support in the areas of trade policy management and trade facilitation as well as in the economic and financial regulatory framework and the strengthening of private sector institutions. Finally, as well as the European Commission, Germany, through GTZ, is providing assistance to SMEs (especially micro-enterprises) through Small Enterprise Centres which provide both counselling services and technical assistance on customs legislation.

WEST BANK and GAZA

Main economic indicators

	2000	2001	2002	2003	prel. 2004
Real sector					
Real GDP growth (% yoy, avg)	-5.4	-15.3	-9.0	5.4	3.0
Inflation CPI avg, % avg	2.8	1.2	5.7	4.4	3.0
Unemployment rate[1], eop	14.4	25.5	31.3	25.6	27.5
GDP per capita, in USD	1410	1117	889	973	979
Fiscal Sector					
Revenue[2], % of GDP	21.4	7.4	9.4	21.5	24.4
Expenditure[3], % of GDP	32.3	35.5	39.4	38.3	40.8
Public sector wage bill, in % of GDP	---	18.4	20.8	20.9	23.0
Overall fiscal balance[4]	-10.9	-28.1	-30.0	-16.8	-16.4
External budget support	1.2	14.4	15.1	7.4	9.2
External sector[5]					
Current account balance, % of GDP	-8.2	-6.6	-15.8	-17.5	-17.5
Trade balance, % of GDP	-68.8	-68.2	-57.0	-62.3	-65.8
Exports[6], USD million	867	560	465	465	500
Imports[7], USD million	3404	2671	2489	2800	2963
Financial sector					
Israeli Shekel (per USD, eop)	4.04	4.41	4.70	4.40	4.30
Israeli Shekel (per EUR, eop)	3.76	3.91	4.96	5.40	5.80
Jordanian Dinar (per USD, eop)	0.71	0.71	0.71	0.71	0.71
Jordanian Dinar (per EUR, eop)	0.66	0.63	0.75	0.87	0.96

Source: Palestine Central Bureau of Statistics, IMF, World Bank, EIU, UNCTAD, Datastream.

[1] As a percentage of the labour force.

[2] Excludes accrued clearance revenue not transferred by Israel in 2001-02, and transfers from accum. stock in 2003.

[3] Includes donor financed and PNA financed capital expenditure.

[4] Excludes net lending.

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

[6] Exports of goods an non factor services.

[7] Imports of goods an non factor services.

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