The Effects of the International Crisis on Mediterranean Countries

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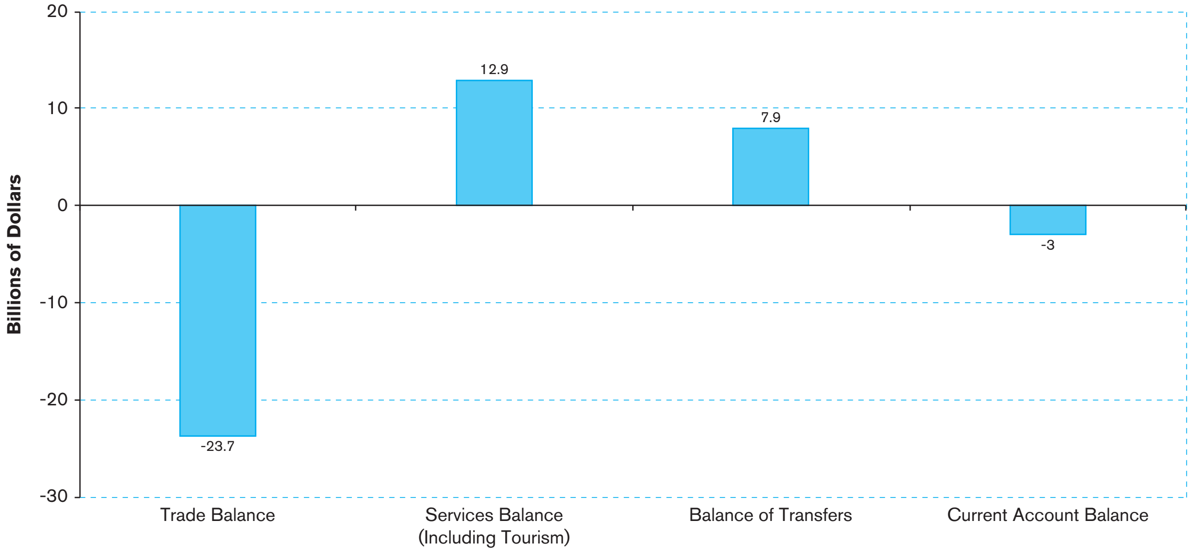
The Mediterranean Partner Countries (MPCs) have entered an economic crisis for which they have no direct responsibility whatsoever, considering their weak engagement on international capital markets due to a nearly generalized lack of capital account convertibility. This crisis – originating as a purely financial crisis in industrialized countries having developed a credit bulimia leading to a crisis, first of interbank liquidity, then of credit and finally of final demand – is aggravated by a crisis of raw materials and food staples (crude oil, bread wheat, vegetable oil, sugar) essentially associated with market imbalances, but also with speculative trends on the futures markets.
Until the past few months, one could believe that the EU's Mediterranean Partner Countries had succeeded in cushioning the effects of the crisis, though at the price of an increase in budgetary deficit and a decrease in growth. However, recent events have demonstrated that the damage went deeper and the sensitivity of populations to declining living standards that may seem bearable in wealthy countries was decisive in South Mediterranean countries, considering the generally precarious living conditions in certain places. This was aggravated by endemic difficulties that the indicated growth regimes were incapable of overcoming:

- The lack of food security: after forty years and the successive revolts in Egypt, Morocco and Tunisia in the late 1970s, the population's sensitivity to variations in the price of the basic food basket is evident;
- Climbing unemployment rates among university graduates despite strong economic growth rates: in Tunisia, 9% of Masters' degree holders were unemployed in 1999 compared with 22% in 2008, whereas this country is a "success story" insofar as growth rate;
- Regional imbalances, which have grown;
- Growth accompanied everywhere by a rise in inequalities (cf. FEMISE 2010 Report).

In this context, the crisis, which has had little impact on the MPCs in the financial sphere, has had – and will have for some time to come – a significant impact on the real economy of the countries in the region via exports, tourism, foreign direct investment (FDI), remittances by workers abroad and prices. The most important point is that the recession in EU countries has led to a dramatic drop in foreign demand in a context where the balance of the transfer equation of the MPCs vis-à-vis the EU was already problematic. If we consider the transfer equation reflecting the MPCs' relations with the rest of the world, its fragility is indeed clear (cf. Galal, Reiffers 2010).

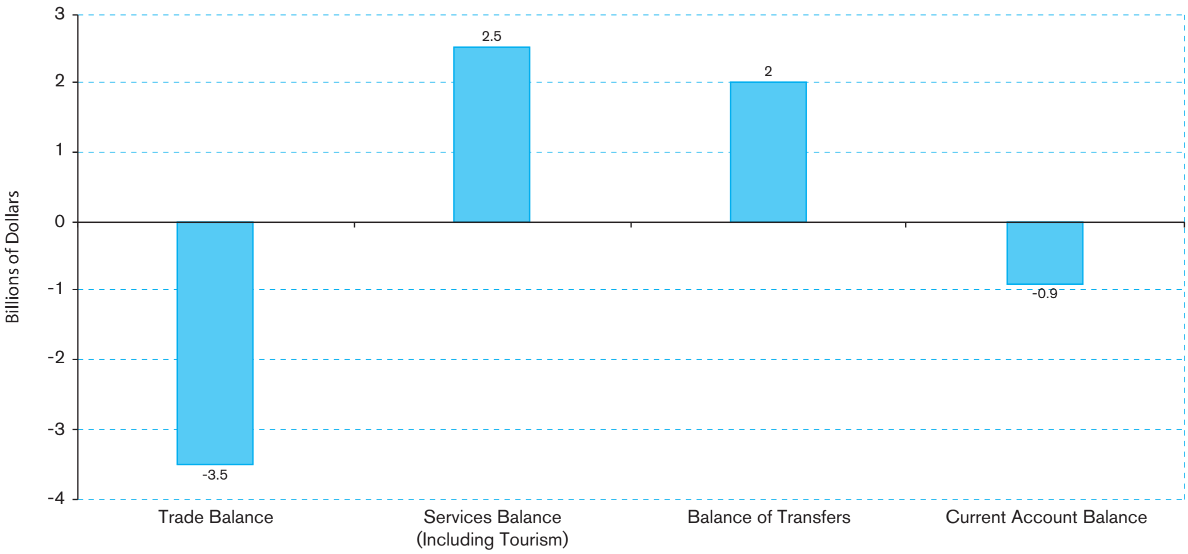
- Apart from Algeria, the MPCs' trade deficit vis-à-vis the world is 50 billion dollars;
- Their trade deficit with the EU varies from 20 to 30 billion dollars with oil (this is a competitive edge that the EU has nowhere else in percentage of trade concerned);
- The current account is balanced on the global level through services (approximately 18 billion in tourism in periods of peace and some 24 billion in migrant remittances);

CHART 6 **Transfer Equation: Egypt**



Source: Economist Intelligence Unit (EIU).

CHART 7 **Transfer Equation: Tunisia**



Source: Economist Intelligence Unit (EIU).

- But the current account balance is always in deficit, on the order of 10 billion;
- Establishing equilibrium in the balance of payments is always difficult; it is done via foreign investment, while exceptional financing has been needed in the past few years.

Charts 6 and 7 show the same set of variables in billions of dollars for the two leaders of the Arab Spring, namely Egypt and Tunisia, in late 2010.
Since then it has been quite clear that if the trade balance continues to deteriorate due to pressure differences between internal demand in the South and the North, and if positive expectations are not quickly restored (with their effect on tourism, emigrant remittances and foreign direct investment), the mechanical effects of the crisis will be greatly amplified.

The Crisis Arrives Just When the MPCs Were Beginning to Converge with the EU

The crisis has made its appearance just when the countries in the Mediterranean Region were experiencing a marked improvement in their economic situation since the Barcelona Process was launched.

Significant evolution in the structure of trade, the growing openness to FDI and significant reforms are the main causes behind this improvement.
More particularly, the role of FDI has doubled: in the first place, it has made the Mediterranean an area of capital attraction allowing the region to catch up from its lagging situation in the 1990s, and in the second, it has contributed to the integration of the MPCs into the world economy, producing a domino effect insofar as comparative advantages, technology transfer and improvement of domestic human capital levels. Moreover, customs tariffs have gone down, numerous trade agreements have been signed and trade has taken on increasing importance in the GDP over the past few years.
One could note as well a process of institutional and standard of living convergence with the Northern neighbours and higher growth rates, obtained in the majority of cases thanks to growth regimes that were increasingly based on total factor productivity (TFP) and less on capital. Finally, the MPCs have implemented rigorous monetary and budgetary policies and inflation control and have been making efforts towards debt reduction.

The Crisis Is Patent in Real Income Effects

Due to the manner of participation in international trade and the weak opening of the capital account (the only countries close to the opening of capital are Egypt, Israel and Jordan), the crisis has not been felt in the MPCs as it has in other regions more involved in international finance. Restrictions to capital movements have thus protected the MPCs, the weak integration of their financial systems with international finance having partially isolated them from the crisis. There has thus not been any real depreciation of financial assets. Hence, the inter-bank market, stock exchange indices and credit have not experienced a depression comparable to that in other regions.
Nonetheless, the shock has been substantial, affecting the countries in the region in two ways. Firstly, through the rise in petrol and staple food prices, the latter having risen by 25% in 2008 whereas it represents 60% of household consumption in poor, rural areas. Though this abrupt rise in the prices was absorbed, it still raised the poverty levels in certain MPCs; for instance, in Egypt poverty rose by 12% following this inflationist effect. Secondly, there was a lasting shock following the decrease in external demand and revenue remittances (primarily from the EU) – expressed through a decrease of exports associated with the fall in external demand, and a decrease in emigrant remittances, tourism and net inflows of foreign direct investment – that has directly affected GDP growth.

Restrictions to capital movements have thus protected the MPCs, the weak integration of their financial systems with international finance having partially isolated them from the crisis

The crisis thus had the following immediate effects in the Mediterranean Region in 2009:

- A fall of nearly 30% in goods exports and therefore an aggravation of trade deficits;
- A very slight decrease in tourism proceeds despite a rise in number of visits. An effect can be noted of substitution to the benefit of proximity making European tourists choose the MPCs as their holiday destination; yet current data indicates that the decrease in tourism revenue could be considerable in the summer of 2011;
- A decrease in remittances of 6% on average;
- A decrease of nearly 40% in FDI.

The latter element certainly gives the most cause for concern, as direct foreign investment has been a major factor of growth over the past few years following the strengthening of national attractiveness vis-à-vis foreign capital. In this difficult context, the MPCs will have to maintain a high level of internal demand and move towards the consolidation of a South-South market, currently little developed, in order to revive the inflow of FDI.

Growth, Employment and Budgetary Balance

The direct effects of the crisis have taken the form of weakened growth, which has had consequences on employment - the unemployment rate remaining high – and on budgetary deficits, which have in-

TABLE 1 **Effects on Growth, Employment and the Budget**

	Growth Rate (average annual %)					Unemployment Rate (%)					Fiscal Balance (% of GDP)				
	2000-2007	**2008**	**2009**	**2010**	**2011**	**2000-2007**	**2008**	**2009**	**2010**	**2011**	**2000-2007**	**2008**	**2009**	**2010**	**2011**
Algeria	4.1	3.6	2.2	4.1	3.2	20.1	11.3	10.2	9.9	10.0	7.4	9.0	-5.5	-3.5	-5.1
Egypt	4.6	7.2	4.7	5.1	4.1	9.9	8.7	9.4	9.7	8.6	-7.2	-6.8	-6.6	-8.0	-12.0
Israel	3.1	4.2	0.8	4.5	3.8	9.3	6.1	7.5	6.7	6.5	-2.6	-2.2	-5.2	-3.7	-2.8
Jordan	6.1	5.8	2.4	3.2	3.8	14.0	12.7	12.9	13.4	13.1	-10.2	-9.6	-12.3	-8.4	-8.1
Lebanon	3.9	9.3	8.5	7.5	5.9	18.0	20.0	20.0	s.d.	s.d.	-13.8	-9.8	-8.6	-5.4	-7.6
Morocco	5.1	5.6	4.9	3.2	3.6	14.4	9.6	9.1	9.8	9.9	-3.8	0.4	-2.1	-4.0	-4.4
Syria	5.1	4.3	5.0	4.0	4.6	10.8	10.9	8.5	8.3	8.1	-2.0	-2.5	-2.8	-3.2	-0.6
Tunisia	4.9	4.6	3.1	3.4	2.6	14.6	14.2	12.6	14.0	14.1	-2.9	-0.8	-3.0	-5.0	-6.6
Turkey	4.4	0.7	-4.7	8.1	5.2	9.6	11.0	14.1	12.0	12.0	-7.4	-1.8	-5.5	-3.6	-3.3
MPCs (average)	**4.6**	**5.0**	**3.0**	**4.8**	**4.1**	**13.4**	**11.6**	**11.6**	**10.5**	**10.3**	**-4.7**	**-2.7**	**-5.7**	**-5.0**	**-5.6**
MPCs (median)	**4.6**	**4.6**	**3.1**	**4.1**	**3.8**	**14.0**	**11.0**	**10.2**	**9.9**	**10.0**	**-3.8**	**-2.2**	**-5.5**	**-4.0**	**-5.1**

Source: EIU, IMF.

creased following the implementation of support programmes.

On the whole, growth in the MPCs remained positive in 2009. Nonetheless, it suffered a shortage of foreign revenue and the growth rate fell to an average of 3% in 2009 (as compared to 5% in 2008 and 4.6% on average for the 2000-2007 period). Growth rates grew in 2010 under the stimulus of recovery measures, as, for instance, in countries such as Turkey and Egypt, reaching an average of 4.8% in the MPCs. Hence, despite the magnitude of the crisis, the policies followed have managed to maintain the major macroeconomic balance in the short term.

The majority of the MPCs have chosen to maintain internal demand through the budget. Naturally, this choice has put them under major deficit pressure (5.7% and 5% in 2009 and 2010 against only 2.7% on average in 2008). Even Algeria, which had had a considerable budgetary surplus thanks to its oil resources, faced a deficit approaching the MPC average in 2009. Thus, the possibilities of support through the budget in coming years are limited, especially for the MPCs that are progressively ceasing to enjoy a good sovereign debt rating (these are the cases of Egypt and Tunisia). The possibilities of limiting the social impact of the crisis via public intervention are therefore diminished.

With regard to employment, the rate of job creation over the past few years has corresponded only to the need for covering new arrivals on the job market. As of 2006, the reduction of unemployment has slowed (-0.8% in 2006, -0.4% in 2007) to give way to a rise in 2008 (0.25%). On the whole, the MPCs have never really followed a strategy of labour market improvement. The absence of a strategy for promoting scientific and technical studies has contributed to unemployment among young university graduates while at the same time, the private sector lacks skilled labour. FEMISE has calculated that, at a constant activity rate, the MPCs would have to create at least 22 million jobs by 2020 only to maintain the current situation (cf. FEMISE Research Report FEM3d-02 and FEMISE 2007 Annual Report). Unemployment has remained on average unchanged from 2008 to 2009, always under the symbolic 10% mark (official figures). In 2010, the employment rate decreased on average, but it seems that in a certain number of MPCs (namely Egypt, Jordan, Morocco and Tunisia) the growth rates were not high enough, neither quantitatively nor qualitatively, to modify the dynamic of job creation.

Current Accounts and Foreign Reserves

The effects of the crisis are also felt in the current accounts. The weakness of exports has led to greater current account deficits in the majority of the MPCs. Thus, whereas the region registered a current account surplus in the 2000-2007 period, in 2009 it had a deficit of 4.1%, which was to remain nearly unchanged in the years to come.

This suggests that the MPCs will find it harder to pay the debt service denominated in foreign currencies. If the trade balance remains negative and there is no inflow of foreign capital, the lack of liquidity will be felt and reserves could experience a significant decrease.

TABLE 2	Effects on Current Accounts and Foreign Reserves									
	Current Accounts (% of the GDP)					Foreign Reserves (months of imports coverage)				
	2000-2007	2008	2009	2010	2011	2000-2007	2008	2009	2010	2011
Algeria	16.4	20.1	0.3	4.2	2.6	21.6	34.2	35.1	33.8	31.6
Egypt	1.9	-0.8	-1.7	-1.6	-7.3	6.8	7.5	7.2	7.5	7.8
Israel	1.9	0.8	3.9	3.2	2.0	5.7	8.0	9.4	9.7	9.4
Jordan	-3.5	-10.3	-6.0	-4.3	-3.0	6.3	6.7	8.8	8.7	8.3
Lebanon	-13.1	-13.7	-22.9	-20.3	-15.4	18.6	22.9	17.7	s.d.	s.d.
Morocco	1.9	-6.4	-5.9	-7.7	-7.9	7.8	7.2	6.7	6.6	6.8
Syria	3.7	0.1	0.7	1.6	2.0	6.3	7.3	5.2	s.d.	s.d.
Tunisia	-2.8	-4.2	-3.0	-2.3	-3.5	3.0	5.0	5.7	5.2	4.8
Turkey	-3.4	-5.7	-2.3	-6.4	-6.1	4.8	5.7	4.6	4.9	4.6
MPCs (simple average)	**0.3**	**-2.2**	**-4.1**	**-3.7**	**-4.1**	**9.0**	**11.6**	**11.2**	**10.9**	**10.5**
MPCs (median)	**1.9**	**-4.2**	**-2.3**	**-2.3**	**-3.5**	**6.3**	**7.3**	**7.2**	**7.5**	**7.8**

Source: EIU, IMF.

FEMISE has already indicated that countries with flexible exchange rate regimes and more developed financial markets should theoretically be better off (Algeria, Egypt, Morocco and Tunisia). Nonetheless, the social unrest that broke out in Egypt and Tunisia will lead to a decrease in the budgetary leeway for pursuing adequate monetary policies and thus the countries that have been "role models" insofar as monetary policy are no longer safe. In addition, the rise in the prices of food and energy simply increases the risks incurred.

We note in passing that the position of international finance remains limited in the balance of payments of the MPCs. This poses a major dilemma: on the one hand, recourse to international capital markets seems necessary to meet financing needs and maintain the volume of investment, but on the other hand, this recourse requires capital account convertibility, and therefore greater volatility and greater dependence vis-à-vis market expectations in a tense social and political context.

The Post-Crisis Period

The Need for a Growth Dynamic Based on Total Factor Productivity (TFP)

For a long time, the growth rate of the MPCs has been dominated by the accumulation of capital. Yet extensive accumulation of capital can have a negative effect on productivity in the long term.

In any case, as the near entirety of the economic literature indicates, differences in income per capita can be ascribed in the long term mainly to differences in productivity. An increase in productivity that does not negatively affect employment (that is, total factor productivity – TFP) can facilitate macroeconomic management and purchasing power can be maintained through raised wages indexed to productivity. Finally, there is a link between productivity and profitability of firms.

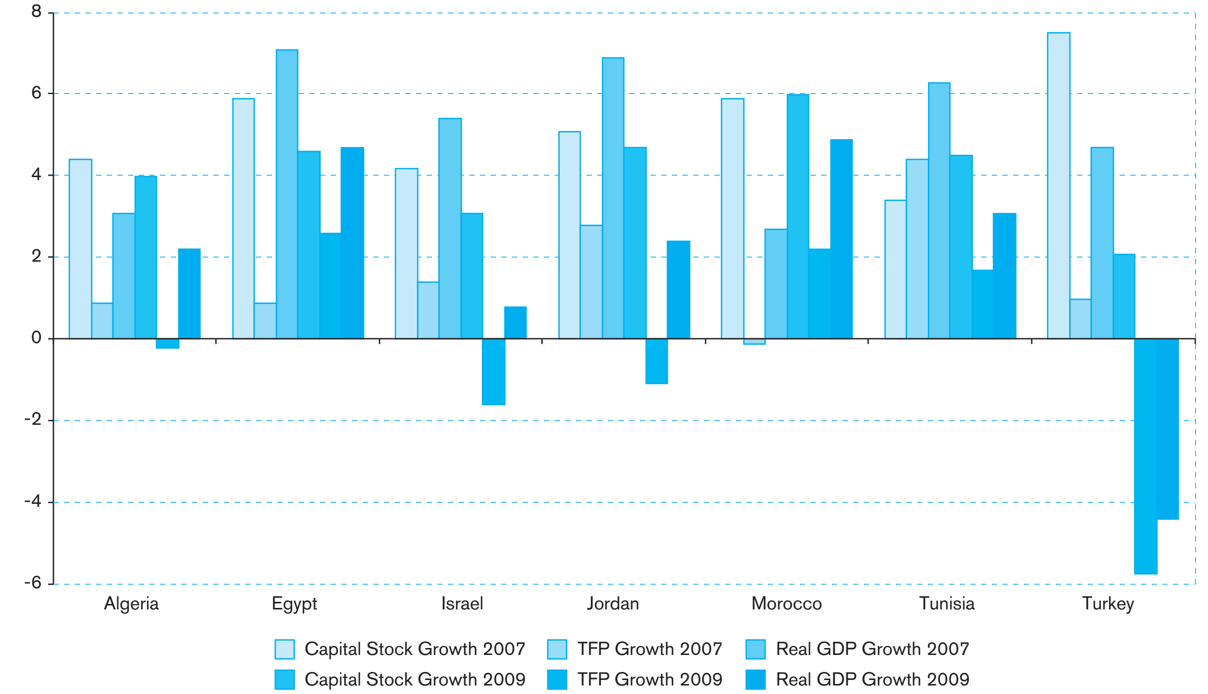
It has been indicated (cf. Ahmed Galal and Jean-Louis Reiffers 2010) that the contribution of TFP in the 1980s and 1990s was zero at best, with the exception of Tunisia and Israel. Since the mid-1990s, however, it has risen, particularly in Lebanon, Tunisia, Egypt and Israel. Efforts have been made in Morocco, Turkey and Jordan, whereas Algeria and Syria are still behind. On the whole, increase in total productivity has occurred in parallel with an increase in MPC attractiveness for FDI.

Chart 8 shows that Egypt, Tunisia and Morocco were the countries registering the highest TFP growth rates during the crisis. These same countries maintained the highest growth rates in the region in 2009. This seems to confirm the idea that productivity is the most decisive factor for sustainable growth.

In the best of cases, some countries enjoy significant investment rates (30.1% in Jordan, 30.3% in Morocco and 20.2% in Tunisia in 2010) in addition to significant TFP growth.

The crisis should thus be overcome by developing new vectors of growth based on the TFP, not only allowing growth rates to be maintained but also allowing the ever-increasing challenge of

CHART 8 **Growth of Capital Stock, of TFP and of Real GDP – 2007 and 2009**



Source: EIU.

TABLE 3 **Investment Rates in the Mediterranean Partner Countries (MPCs)**

	Investment Rates (%)			
	2000-2007	**2008**	**2009**	**2010**
Algeria	22.4	29.2	38.0	34.1
Egypt	17.9	22.3	19.3	17.9
Israel	18.1	18.4	16.7	17.0
Jordan	23.9	31.3	30.4	30.1
Lebanon	20.6	n.d.	n.d.	n.d.
Morocco	25.0	33.0	30.7	30.3
Syria	24.3	n.d.	n.d.	n.d.
Tunisia	23.7	24.9	26.8	28.2
Turkey	20.9	19.9	16.9	19.2
MPCs (simple average)	**21.9**	**25.6**	**25.5**	**25.3**
MPCs (median)	**22.4**	**24.9**	**26.8**	**28.2**

Source: EIU, IMF.

employment in the Mediterranean to be met. Specifically, the MPCs will have to:

- Better allocate their factors towards sectors with greater productivity by agreeing on greater mobility (of people and capital), which involves continuing to liberalize product and factor markets; and
- Foster innovation and training so as to improve the quality of factors used, which entails developing an economy based on knowledge.

Recent unrest in the region, however, could curb the MPCs' capacity to maintain their attractiveness for FDI and thus reduce the latter's ripple effects.

Conclusion

The crisis and the events following it suggest three concluding remarks:

The first is that a new growth model must be implemented. In a sense, we are dealing with an economic and social transition equivalent to the one occurring in the late 1980s in East Block countries. The point is to go towards a more democratic type of capitalism. This implies a certain number of major changes: political reforms allowing improved expression of needs, improved transparency and elimination of corruption, development of opportunities for youth, regional balance and a greater reduction of inequalities.

The second is the return to structural policies. International opening should continue, but it should be accompanied by incentive policies using public and private funds and aiming at new sectors and the knowledge economy. Moreover, these policies should not only be concerned with increasing trade gains, but also with compensating the losing parties due to such opening (sectors, qualifications, territories), something that has been neglected far too long by advocates of international liberalization.

The third is the need for regional integration. The transfer equations shown above reveal just how strong interdependence is between Europe and its neighbours. The urgency is to support ongoing political developments and contribute to consolidating positive expectations (European investors, European tourists, youth from the South), which will be key factors in overcoming the crisis. Needless to say, in view of the trade surpluses gained by our countries, it is in the common interest to strengthen a system of interdependence that is already well-established. And there is even more reason to do so since the South Mediterranean countries, as we have indicated, are not in the least responsible for the crisis affecting them.

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