# Navigating Energy Inflation in the Southern Mediterranean: Challenges and Opportunities for Producing and Importing Countries

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The continuing Russian war on Ukraine has a profound impact on the world economy, most notably in the southern Mediterranean region. The southern Mediterranean countries, plagued for decades by governance problems in import-dependent and fragile economies, have been hit hard by the Russian invasion of Ukraine. The region's external vulnerability has been further exacerbated by the surge in energy, cooking oil and food prices caused by the ongoing conflict in Ukraine. By 2021, wheat supplies from the Russian Federation and Ukraine amounted to about 25 percent of world wheat exports, more than 60 percent of global sunflower oil and 30 percent of barley exports. With Russia and Ukraine together providing around 75 percent of wheat imports for Egypt and Lebanon, 40 percent for Tunisia, and in excess of 30 percent and 20 percent for Jordan and Morocco respectively, these countries in the region have faced a severe food crisis. The spillover effects of the Ukrainian war have also coincided with a heavy drought during the 2021 harvest, making further wheat exports necessary for many countries in the region (FAO, 2022).

At the time of writing, however, the impact of Russia's ongoing war on Ukraine is far from uniform across the southern Mediterranean. While some countries have been severely affected by increases in energy, cooking oil and food prices, as a result of disruptions in the supply of basic commodities from Russia and Ukraine, others have found new opportunities to offset some of their losses through increased demand for their own energy exports. As Europe seeks alternative energy sources, the geographical proximity, abundant resources and existing infrastructure of the southern Mediterranean have made it an attractive choice for the EU's gas diversification efforts. The region's oil and gas exporters have not seen a significant hike in the cost of fuel, and are well placed to capitalize on higher export revenues in the short to medium term. Conversely, energy and oil-importing countries in the region are experiencing negative spillovers, creating still more social and economic pressures.

## Egypt's Fragile Economy amidst Energy Self-Sufficiency and External Shocks

Following the massive gas discoveries in its offshore areas in 2015, Egypt achieved gas self-sufficiency in 2019. While 65 percent of Egypt's gas production is consumed domestically, the remaining 35 percent is earmarked for export to fill the current account deficit gap, and to finance Sisi's debt-driven mega-projects. As argued elsewhere, debt-financed infrastructure investment has hurt economic growth, and over-investment in unproductive projects has led to monetary expansion and economic and financial fragility in Egypt in recent years. As the regime relies heavily on foreign and domestic borrowing to finance mega-projects, the debt-to-GDP ratio has increased significantly over the years, reaching 90 percent by the end of 2020. A regressive tax system places a disproportionate burden on low- and middle-income taxpayers to repay foreign and domestic loans plus interest. As a result, the poverty rate rose dramatically from 27.8 percent in 2015 to 32.5 percent in 2018, while consumption levels fell by 13.7 percent in urban areas and 5.1 percent in rural areas (Mandour, 2020).

The war in Ukraine hit Egypt amid such alarming macroeconomic conditions. With around 85 percent of its wheat coming from Russia and Ukraine, Egypt is the world's leading importer of wheat. In 2021, Egypt's total wheat imports were over 6 million tonnes, of which 4.2 million tonnes came from Russia and 651,400 tonnes from Ukraine (Dawoud, 2022). When the war in Ukraine disrupted the supply chain, the soaring cost of bread became a matter of serious concern for the Egyptian government.

Since the rule of Gamal Abdel Nasser, the bread subsidy programme has traditionally been part of the social contract between the State and its citizens. Successive governments have left bread subsidies unchanged, fearing popular unrest in the wake of memories of 1977, when the government's decision to abolish bread subsidies sparked violent street protests, leaving nearly 100 people dead and hundreds injured. Under the existing scheme, more than 70 million Egyptians – two-thirds of the entire population – qualify for state-subsidized bread. According to the Minister of Supply and Internal Trade Ahi El-Moselhi, the bread subsidy programme, which requires 9 million tonnes of wheat annually and had cost the government $5.5 billion before the war in Ukraine, added nearly $800 million after the war due to the increase in wheat prices (Dawoud, 2022). Despite Sisi's attempts to raise the price of subsidized bread as part of the aggressive neoliberal measures required by the standby agreements with the IMF in 2016 and 2020, his plans to reform the subsidy system have been delayed as a result of rising prices following Russia's invasion of Ukraine. With inflation rising to five-year highs, Egypt first fixed the price of non-subsidized bread in March 2022, and began selling bread at reduced prices to those outside the food subsidy system in an attempt to head off mass demonstrations in January 2023 (Hendawi, 2023). The Egyptian government's plan to increase the area earmarked for wheat cultivation by the end of 2024 remains a medium-term strategy that fails to address the immediate needs of a growing population.

Reduced tourism inflows and a surge in capital outflows have also exacerbated Egypt's foreign currency shortage problem. After having borrowed more than $13bn from the Gulf states, Egypt also requested further support from the IMF through its new Resilience and Sustainability Trust. In December 2022, the IMF subsequently approved $3 billion in aid for Egypt following a series of reforms, including a flexible exchange rate regime. Since then, the Egyptian pound has devalued by more than 50 percent against the US dollar, and inflation has jumped to 26.5 percent (Monaim, 2023). Egypt's liquefied natural gas (LNG) production has also increased amid higher prices. Egypt is the 13th largest natural gas producer in the world and the fifth largest in the region, producing 6.7 billion cubic feet per day. Egypt's natural gas exports reached $8.40 billion in 2022, representing a 171 percent jump from $3.5 billion in the previous year (Zawya, 2022).

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Following Russia's invasion of Ukraine, the EU pledged support for Egypt and Israel in their efforts to increase gas production and exploration in their territorial waters. Subsequently, in June 2022, the EU, Israel and Egypt reached an agreement to boost sales of liquefied natural gas to EU countries seeking to reduce their reliance on Russia. Under the signed agreement, Israel will first expand its gas exports to Egypt. The gas will then be processed at Egyptian plants in Damietta and Idku, before being shipped to Europe as LNG. Considering the vacant capacity at Egypt's LNG terminals, this route has proven to be the most cost-effective solution. The deal has also been hailed as "an important milestone" in cooperation between Egypt, Israel and the EU (The Arab Week Daily, 2022).

A gas deal would undoubtedly promote wider cooperation between Egypt, Israel and the EU, and contribute to Egypt's long-held ambition to become an energy hub. However, the extent to which a gas deal would reduce Egypt's economic fragility under the current administration remains in doubt. Gas revenues are unlikely to be sufficient to cushion the rising cost of imported commodities, as the Sisi government continues to prioritize its debt-funded megaprojects at the expense of the majority of the population and to increase foreign debt.

### Israel's Gas Industry in a Changing Global Landscape

Israel, a crucial signatory to the EU gas deal, has also been hit by the rise in the price of imports from Russia and Ukraine. Israel's annual inflation rate was recorded at 5.3 percent 2022, the highest rate since 2008. However, soaring global demand for natural gas has also led to a substantial increase in earnings for Israel, which is eager to boost production and increase its political clout.

The discovery of two major offshore gas fields, Tamar and Leviathan, in 2009 and 2010, respectively, transformed Israel from a net importer of fossil fuels to a self-sufficient gas producer. After achieving domestic self-sufficiency, the Israeli government and natural gas developers secured an agreement to export 40 percent of Israel's natural gas abroad. In 2016, Israel signed a $10 billion deal with Jordan to export gas for 15 years, and began exporting gas to Egypt in 2020. A year later, Israel and Egypt amended the $15 billion deal to increase the deliveries to 85.3 billion cubic metres over 15 years (Español, 2022).

As with other coastal states in the eastern Mediterranean, the discovery of hydrocarbons in Israel has raised environmental and marine protection concerns, with drilling causing serious environmental damage and disturbance. Israel has recently set a target of producing 30 percent of its electricity from renewable sources by 2030, with a focus on solar energy and achieving zero carbon emissions by 2050, while phasing out coal by 2025. The Ministry of Energy's "Roadmap to a Low Carbon Energy Economy by 2050" involved connecting Israel's energy grid to Egypt, the United Arab Emirates and Europe via Greece and Cyprus. In December 2021, Israeli Energy Minister Karin Elharrar announced that Israel will halt exploration of offshore natural gas fields until at least the end of 2022 and will accelerate the development of renewable energy. Only six months after pledging to suspend all drilling for a year, however, Israel has announced the resumption of natural gas exploration in the Mediterranean due to the global demand for natural gas caused by the war in Ukraine. Explaining Israel's decision to resume drilling, Karin Elharrar was reported as saying: "We and the Europeans agree that the most strategic way to deal with the current crisis is to accelerate the development of renewable energy. Nevertheless, we can't ignore the world's need for natural gas, both in the immediate and medium term." (Fisher, 2022)

As part of its efforts to increase gas production to meet global demand, Israel also signed a maritime agreement with Lebanon in October 2022, brokered by the US. The agreement demarcated each country's territorial waters and exclusive economic zones, giving Israel full ownership of Karish while Lebanon retained full rights to Qana. The production of natural gas from the Karish field is expected to further enhance Israel's energy security by providing a greater volume of gas for export, as the Karish and Tanin fields account for about 75 billion cubic metres of natural gas, compared to Israel's annual domestic consumption of about 12 billion cubic metres (Surkes, 2022). Israel has further plans for the expansion of its production capacity at the Leviathan field through the construction of a floating liquefaction plant.

### The Challenges of Hydrocarbon Production in Algeria: Implications for Europe's Energy Security

The conflict in Ukraine has also had a spill-over effect in the southern Mediterranean Maghreb, leading to higher food and hydrocarbon prices in the region. The repercussions of the Ukraine War, however, have not been felt in the same way in Algeria, Morocco, Tunisia and Libya. Among these countries, Algeria is better situated to reap the revenues from exporting its gas. Algeria is also less threatened by the rise in wheat prices, with Russian and Ukrainian imports accounting for only 3 percent of the country's wheat imports.

Algeria's limited production capacity remains a major challenge for the country to increase its gas exports to Europe

Algeria's hydrocarbons account for around 20 percent of GDP, 40 percent of the national budget and more than 90 percent of export earnings between 2015 and 2020 (USDS, 2022). The country's hydrocarbon export revenues climbed to 34.65 billion in 2021, compared to $20 billion in 2020 (Serrano, 2022). By 2021, Algeria was already the EU's third-largest gas importer after Russia and Norway, exporting around 83 percent of its gas to Europe. It was therefore unsurprising that, following Russia's invasion of Ukraine, Algeria has emerged as an obvious destination in Europe's quest for energy security. Algeria has two gas pipelines exporting gas to Europe through Spain. These are the Maghreb-Europe Gas Pipeline (MEG), which passes through Morocco, and the Medgaz pipeline, an offshore gas pipeline between Algeria and Spain. The total capacity of the Trans-Med and MedGaz pipelines to Europe is 42bn cubic metres. The Maghreb-Europe pipeline, which runs through Morocco and beneath the Straits of Gibraltar, was closed on 1 November 2021 due to increased tensions between Algeria and Morocco. Following the suspension of the Maghreb-Europe gas pipeline, plans have been made to extend the capacity of Med-Gaz to 10 billion cubic metres (Rashad, 2022).

With its favourable climatic conditions and geographical proximity, Morocco represents a viable alternative for the EU, seeking to diversify away from fossil fuels

Nevertheless, Algeria's limited production capacity remains a major challenge for the country to increase its gas exports to Europe. It will require years of exploration and development, as well as further restructuring of the energy industry to attract new investment, before Algeria's production can be substantially boosted to generate enough gas in the short-term to satisfy surging European demand (Fakir, 2022). With this caveat in mind, however, owing to the recent increase in energy revenues, amounting to around $50 billion in 2022, Algeria's ruling military regime has managed to cope relatively well with rising food prices and a burgeoning cost of imports. In February 2022, President Abdelmadjid Tebboune, ordered a tax freeze on certain consumer food products, and introduced a new $90 monthly unemployment payments as well as some medical benefits for first-time jobseekers aged 19-40. Oil revenues continue to be a lifeline for Algeria's ruling military regime, but the country's rentier model of governance leaves Algeria trapped in an unsustainable economy (Boubekeur, 2022).

## Price Shocks, Drought and Renewable Energy Opportunities in Morocco

The price escalations caused by the Russian invasion of the Ukraine, combined with the most severe drought in the country in three decades, hit Morocco even harder. Even though Morocco imports no more than 20-30 percent of its wheat from Russia and Ukraine, a sharp decline in the domestic wheat harvest due to the drought has left Morocco vulnerable to global price shocks. On 20 February 2022, the 11th anniversary of the first protests of the Arab uprisings in the country, the rising cost of living triggered a wave of protests in Morocco's big cities. Alarmed by the growing discontent, King Mohammed VI launched a financial support mechanism ($1.01 billion) to ease rising prices and the effects of the devastating drought on the agricultural sector, which employs around 45 percent of the country's workforce. As many analysts have pointed out, such measures were doomed to be ineffective in correcting the decades of harmful economic policies that have favoured water-intensive industries and the production of food for export, while leaving the rest of the country dependent on imports of wheat and other foods (Yee and Alami, 2022).

Morocco's economy has been further strained by rising hydrocarbon prices, as it is a net importer of around 90 percent of its energy needs. While Morocco's heavy reliance on imported oil, gas and coal has exacerbated the country's fragility, its growing renewable energy capacity, which represents around 37 percent of its electricity generation mix, has also created some opportunities for the country to mitigate some of the costs of its dependence on imported hydrocarbons. In 2009, Morocco first adopted its National Renewable Energy Strategy to increase the share of renewable electricity capacity to 42 percent by 2020. The country has revised its strategy with a target of 52 percent of installed power generation capacity to be from renewables by 2030 (IEA, 2019).

With its favourable climatic conditions and geographical proximity, Morocco represents a viable alternative for the EU, seeking to diversify away from fossil fuels, the price of which has soared in the wake of Russia's invasion of Ukraine. In October 2022, Morocco and the EU signed a green partnership deal to enhance cooperation on addressing climate change and to accelerate renewable energy projects. Morocco is expected to be the EU's largest supplier of hydrogen after being listed by the International Renewable Energy Agency (IRENA) as one of the world's top five countries with green hydrogen production potential (North Africa Post, 2022). In January 2021, Morocco launched its National Green Hydrogen Strategy, setting a target of a 4-percent share of the global market by 2030. Recognizing Morocco's great potential to generate the vast amounts of solar energy needed to produce hydrogen, European countries, particularly Germany, have invested in Morocco's energy transition. The German-Moroccan Hydrogen Agreement was signed in 2020, with the aim of constructing a green hydrogen production plant in Morocco, financed by the German Development Bank. Although the agreement stalled in 2021 due to Morocco's suspension of diplomatic relations with Germany in response to Berlin's position on Western Sahara, the project resumed in December 2022 following the new German government's acceptance of Western Sahara's autonomy formula (Reyes, 2022).

The revival of the German-Moroccan Hydrogen Agreement reveals that Morocco's export-oriented renewable energy projects have strengthened the country's diplomatic bargaining position by undermining the UN peace initiatives in Western Sahara. Large-scale renewable energy projects, heavily concentrated in occupied Western Sahara, further impose various costs on the local population through forced evictions and land acquisition processes, and the rights of the indigenous Sahrawi population continue to be violated.

## Escalating Prices and Political Turmoil in Tunisia and Libya

Among the Maghreb countries, Tunisia appears to have been hit hardest by the global price increases related to the Ukraine war. Soaring prices for wheat imports have squeezed the government, which has to subsidize bread and fuel for the country's 12 million people. As a net importer of gas and oil, Algeria has also been exposed to rising global prices. To make matters worse, the Ukraine conflict has caught the country in the midst of political turbulence. Since President Kais Saied bypassed the elected parliament in July 2021, and grabbed expanded executive powers, the country has also been engulfed in political infighting.

Tunisia's current political turmoil has further weakened its fragile economy, which in turn has deepened its massive debt. Mired in debt and facing high levels of inflation and unemployment, Tunisia has been in negotiations with the International Monetary Fund for several months over a loan of almost two billion dollars. Since cutting spending through the incremental dismantling of subsidies is one of the conditions imposed by the IMF, securing the IMF loan is expected to cause a severe social explosion. Tunisia's largest union, the General Union of Tunisian Workers (UGTT), rejected the IMF proposal, warning that it will fuel a wave of strikes and protests.

While the war in Ukraine hit Tunisia in the middle of its drift towards authoritarianism, Libya was on the brink of civil war. The country was plunged into disarray since the fall of Muammar Gaddafi more than a decade ago, torn by internal conflict between rival factions vying for power. In February 2022, when the Tobruk-based Parliament elected Fathi Bashagha as the new Prime Minister of the interim government, claiming that Dbeibah's Tripoli-based government had ceased to exist since elections had not been held by the scheduled date, Abdelhamid Dbaiba refused to relinquish power before the elections, thus bringing the country once again between two governments.

The stability of export earnings therefore depends on the end of the ongoing military conflict in Libya

As Libya depends on wheat imports from Russia and Ukraine, the price of wheat and flour spiked as much as 30 percent within the first week of Russia's invasion of Ukraine. In response to the rise in food prices, the Ministry of Economy and Trade introduced coercive measures, such as price controls on flour, and increased the level of strategic wheat stocks to provide flour mills with at least three months of full production capacity (Reliefweb, 2022). With the ninth largest known oil reserves in the world, the war in Ukraine has also created an opening for Libya to increase its oil exports, however the political turmoil in the country has prevented it from fully exploiting this potential. Oil fields and installations have repeatedly been the target of attacks in the ongoing fighting between rival political forces. The closure of the El Feel and Sharara oil fields by Haftar's forces alone deprived Libya of 330,000 bpd and a loss of more than $34.69 million per day alone (Reuters, 2022). The stability of export earnings therefore depends on the end of the ongoing military conflict in Libya.

## Conclusion

The rising cost of oil and gas itself has a ripple impact on the price of transport and commodities, which in turn is a source of inflationary concern in the southern Mediterranean countries. The surge in oil prices has pushed oil-importing countries to devalue their currencies, further eroding incomes in the region. The potential anger that fueled the 2010-2011 protests could flare up again with rising food prices, high energy costs and the imposition of taxes, combined with a continued failure to deliver on political reform. In the case of Lebanon, for instance, the disruption to supply chains caused by the war in Ukraine has only served to aggravate Lebanon's existing woes, including hyperinflation and a collapsed banking system. Increasing costs of basic commodities, coupled with shrinking purchasing power and disruptions in the delivery of basic services continue to exacerbate grievances. In the same vein, the persistent dependence on imports and the constraints imposed by the ongoing Israeli military occupation have further deepened the food crisis in Palestine in the wake of the Ukrainian conflict. The living standards of millions of people in heavily aid-dependent countries such as Syria, Lebanon and Palestine have been further eroded as the crisis in Ukraine has pushed these countries down the priority list for donor governments and global humanitarian aid. The lack of access to affordable food continues to worsen for the majority of people in these countries.

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