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Emerging from Crisis: the Mediterranean Neighborhood

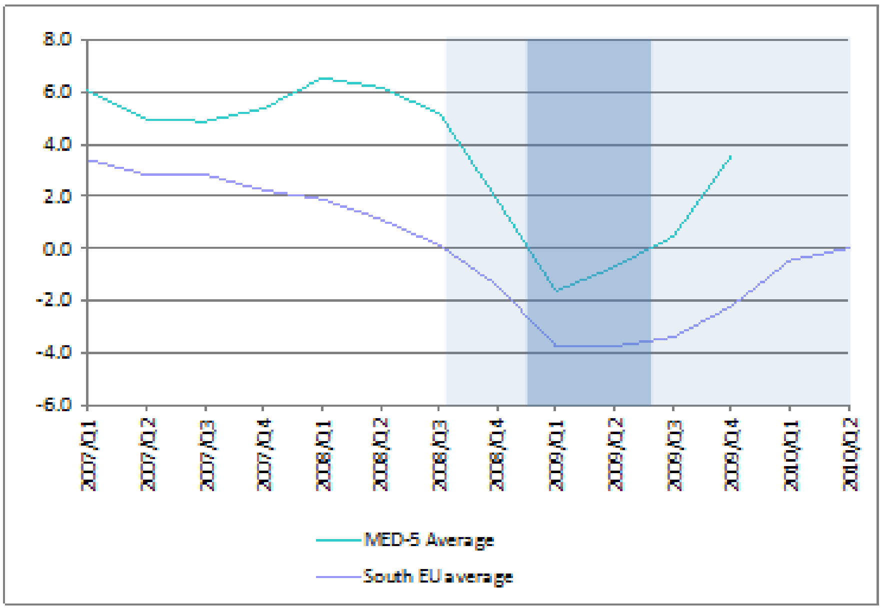
By Leonor Coutinho*

The global financial crisis of 2007-2010 battered the entire world economy, but the impact was uneven across both regions and individual countries. Due to a lower degree of financial integration, developing countries seem to have been far less affected by the crisis, even though it is too early to understand its full effects or make an accurate assessment. This apparent resilience has been observed among the Mediterranean (MED) neighborhood countries (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestinian Authority, Syria and Tunisia) of the European Union (EU). The underdevelopment of the region's financial markets has been as much of a short-term blessing as it may prove to be a long-term curse. With decreased investment coming in from abroad, strengthening financial markets in order to better utilize domestic savings is a strategy that will continue to pay off in the long run. Another crisis mitigating factor for several countries in the Mediterranean neighborhood has been higher government consumption, which could come at the long-term cost of higher inflation, and may put price developments at the forefront of the region's worries, along with the longstanding problem of high unemployment.

Assessing the Crisis

In the case of the MED countries, data is too limited to undertake a full-fledged analysis of the economic effects of the crisis, but some inferences can be drawn from the available information. For instance, when comparing GDP developments in five MED neighborhood economies (Egypt, Israel, Jordan, Morocco and Turkey) with those in the four core Southern EU Mediterranean economies (France, Greece, Italy and Spain) one discovers that the MED region (in unweighted average terms) grew faster before the crisis, became afflicted by the crisis much later and started to rebound earlier and at a more rapid pace (see Figure 1).[1] A similar picture emerges for Tunisia, particularly when looking at available industrial production data. However, the MED average conceals important differences across countries like Turkey and Tunisia, which have stronger trade links with the EU and, therefore, were more adversely hit by the crisis. A similar story comes out from available quarterly employment data.

FIGURE 1: ANNUAL GROWTH OF REAL GDP, IN%, MED-5 VS SOUTH EU-4 2007-10



Source: IMF IFS Database

Impact on External Trade and Unemployment

The most important channel for transmitting the crisis to the region has been external trade. EU-MED trade links have dragged exports down with the contraction in EU partners' outputs. According to the European

[1] Unweighted averages are considered here due to the small number of countries included in the analysis. Weighting the data by GDP weights would give a disproportionally large weight to Turkey and the resulting regional average would just be mimicking developments in Turkey.

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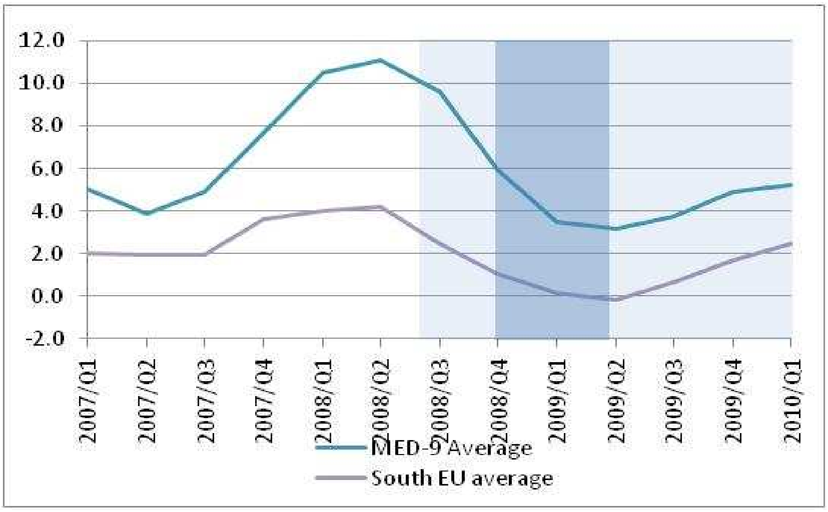
Commission[2], exports in the region fell sharply in 2009 and in line with contractions in global trade. However, preliminary figures for 2010 suggest that a rebound should be in place, following economic recovery predictions for most of the EU. In oil exporting economies (mostly Algeria and Libya) oil revenues have declined on the account of lower demand by industrial countries. This should return to normal levels as the recovery gains steam.

Despite the contraction in EU-MED trade, the impact of the crisis appears more persistent in regional unemployment figures. For both the MED countries and the South EU Mediterranean region, unemployment rates have increased at the onset of the crisis. The difference is that in the South EU Mediterranean countries unemployment has continued to rise whereas in the MED countries rates have stabilized albeit at above pre-crisis levels. Since unemployment rates were already high in the MED region prior to the crisis, near double digit levels, reducing unemployment will probably be one of the major challenges linking countries on both sides of the Mediterranean.

Rising Regional Inflation

During 2008 the rate of price increases was relatively high in the MED countries, due to high commodity prices and the elimination of food and energy subsidies (i.e. Syria and Jordan). By 2009, inflation rates came down from their 2008 peak. According to the International Monetary Fund (IMF), Average Consumer Price Inflation (CPI) for the region was about 4%, compared to approximately 9.7% in 2008. There were signs of a 2010 rebound, however, Egypt returned to double digit inflation and Turkey approached double digits by the second quarter of 2010.

FIGURE 2: CPI INFLATION RATES, MED-9 VS SOUTH EU-4, 2007-10



Source: IMF IFS Database

Overall, inflation is higher in most of the MED region than among its main industrial trading partners. Given the *de facto* currency pegs that were adopted in several of the MED countries, this has translated into appreciation of real effective exchange rates which can hamper competitiveness and slow export recovery.

To some extent, inflation trends in the MED region are also related to increases in government consumption, especially in Egypt, and a steady deterioration of public finances. Therefore, it is important to distinguish between net oil exporting countries (Algeria and Libya), where inflation and government deficit dynamics are mostly driven by developments in the oil markets, and net oil importing countries. Government balances in MED net oil importing countries have improved more or less until 2006, but have since been deteriorating. These developments are similar to developments in the South EU region, where budget deficits improved until 2007 under pressure of the Stability and Growth Pact, but deteriorated once the economic crisis unfolded. Budget deficits in the MED block started to deteriorate well before the financial crisis, suggesting that other structural factors were to blame for this trend. As a result, improving fiscal policy frameworks and the quality of public finances will become major challenges for the region in the coming years.

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[2] European Commission, Occasional Paper on the EU Neighbourhood Policy, April 2010.

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