

# 8

## The Euro-Med Economies in the Early 2010s: Two Coasts in Crisis

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### I. Introduction

The Euro-Med<sup>2</sup> is facing one of its toughest years. Structural problems, that earned the North Mediterranean economies the unenviable acronym of PIGS (Portugal, Italy, Greece and Spain), and grouped the Southern Mediterranean countries among the world's most autocratic regimes, have been compounded by the debt crisis in Europe and by unrest and revolutions in the Arab world.

Although both coasts remain in a state of flux, this paper attempts to describe the current situation in the region and offers some thoughts on the challenges and prospects facing the Euro-Med. By way of summary, and if history can be of any use, we can make two observations. First, it might take the best part of the next two decades, or even more for the European economies of the region, to get back to where they were before the global financial crisis and the ongoing debt crisis, assuming there are no aggravating events in the meantime (e.g. the break-up of the

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<sup>2</sup> The paper uses *Euro-Med* to refer primarily to the Southern EU members and the Arab countries of the Euro-Mediterranean Partnership that aims to strengthen EU relations with the countries in the Mashreq (Middle East) and Maghreb (North Africa) regions. Its membership consists of the 27 European Union member states and 16 partner countries (Albania, Bosnia and Herzegovina, Croatia, Israel, Monaco, Montenegro and Turkey, as well as the Arab countries of Algeria, Egypt, Jordan, Lebanon, Mauritania, Morocco, the Palestinian territories, Syria, Tunisia).

eurozone or an international event such as a recession in the US). Even for the advanced and better governed economies of the world, the most authoritative, and typically most optimistic, international financial organisation expects that “the post-2008 crisis increase in debt-to-GDP ratios of 25-30 percentage points would require fiscal adjustment over the next twenty years, to first stabilise and eventually return public debt to pre-crisis levels relative to GDP”.<sup>3</sup> The prospects may well be even bleaker for the PIGS.

Secondly, the “Arab Spring” and the move towards democracy may take much longer than a “season” to bear fruit as the transition of Eastern European countries suggests, in terms of producing accountable, transparent governments, and sustainable, equitable economic outcomes. Notwithstanding their political justification, the recent and rather generous economic concessions the Arab governments made, to appease their citizens following the political upheaval, have all come against a background of declining fiscal space and recessionary economic outlooks. While financial issues are currently seen as mainly a European problem, corrections in the Arab asset markets have already started taking place with a decline in Tunisian markets of 14 percent since the beginning of 2011, and an even greater decline in the more troubled Egyptian market (21 percent).

The implications of these developments for the Euro-Med are likely to be far reaching. What appeared to be a promising start towards the beneficial integration of the North and South Mediterranean coasts is now endangered by the European debt crisis and the Arab political crisis. Both sub-regions seem, so far, to be adopting crisis reactions rather than structural responses. Hopefully, this will only slow down the process toward the Mediterranean integration, but will not stall it permanently.

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<sup>3</sup> Lipsky, John, 2011: “The Challenges of Economic Policy Cooperation”, Kurt Viermetz Lecture - The American Academy, Berlin, 21 June.

## II. In the North of the Mediterranean

It can be debated whether the creation of the European Economic Community (EEC) with six members, in 1957, and later the European Union (EU) in 1993 having increased in size to 27 members today, was the single most important factor in Europe not experiencing a war for more than 75 years, for the first time in its millennia long history. What is more certain is that the European Union has been the greatest experiment in social engineering the world has ever known. The economic and social benefits have been many, at regional and country levels.

The creation of the Euro brought additional benefits to the 17 (of 27) EU member states that joined the single currency.<sup>4</sup> Until the recent debt crisis and the emerging fears of the break-up of the Euro, the Eurozone benefited from stability and growth as inflation decreased, trade and foreign direct investment grew, public budget deficits fell and productivity, as well as job creation increased. Further potential gains were envisaged from improved coordination, greater fiscal discipline, improved crisis management mechanisms, faster internal convergence (from further flexibility and better integration of European markets, including financial markets) and greater external coordination.<sup>5</sup>

Despite its successes in many respects, the European region entered the first decade of the 21<sup>st</sup> century with two evolving, in fact unfinished, agendas. First, the integration of its less developed economies in the periphery was less than complete, despite significant injections of funds from the wealthier members that aimed to structurally avoid the perpetuation of a two-speed Europe. Second, the introduction of the Euro resulted in a unified monetary policy among the Euro members backed by firm institutional arrangements, that is, the European Central Bank

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<sup>4</sup> The Euro is also used in six other European economies, namely Andorra, Kosovo, Monaco, Montenegro, San Marino and the Vatican.

<sup>5</sup> de Lecea, Antonio, 2010: "Real Economic Benefits of EMU", Presentation for the Federal Reserve Bank Conference 'The Euro and the Dollar in the Crisis and Beyond', Dallas, 17 March.

(ECB). However, fiscal policy was left very much at the discretion of individual countries, as long as the budget deficit and public debt did not exceed 3 percent and 60 percent respectively of GDP. This proved to be an incomplete fiscal architecture.

In addition to these two home-grown pre-existing fiscal and structural challenges, the global financial crisis of 2008 added another issue Europe had to address, that is, the regulation of the financial sector. If coordination were not enough of an issue during normal times, delivering Euro-wide coherence, across the whole spectrum of fiscal, monetary, and financial policies, and synchronising them with trade, industrial, private sector development, labour and migration policies in the context of the varying characteristics and national interests of the EU member states, is now an even more challenging task, given the looming banking and sovereign defaults in Greece, Ireland, Portugal, Spain and more recently Italy.

Leaving this task to the policy makers of Europe, analytically it is worth identifying the drivers of the crisis in the PIGS. On the one hand, there is the banking crisis that has affected not only Europe but also the global economy. Even within Europe alone, the interconnectivity of the banking system is alarming. As shown in Figure 8.1, it does not make much difference in which country the bubble bursts; a default in one country is likely to be sufficient to bring the whole European banking system to its knees. Given that readers are probably quite familiar with the financial crisis, expanding further on this issue in the limited space of this article may be of limited value.

On the other hand, the case of Greece stands alone. The reason for this is that the initial cause of the crisis is not excessive leverage of its banking sector, but the size of its public debt. Focusing on the Greek case is instructive for the discussion on the Arab states which follows, as it combines issues of underdeveloped private markets (if not crony capitalism) and weak governance.

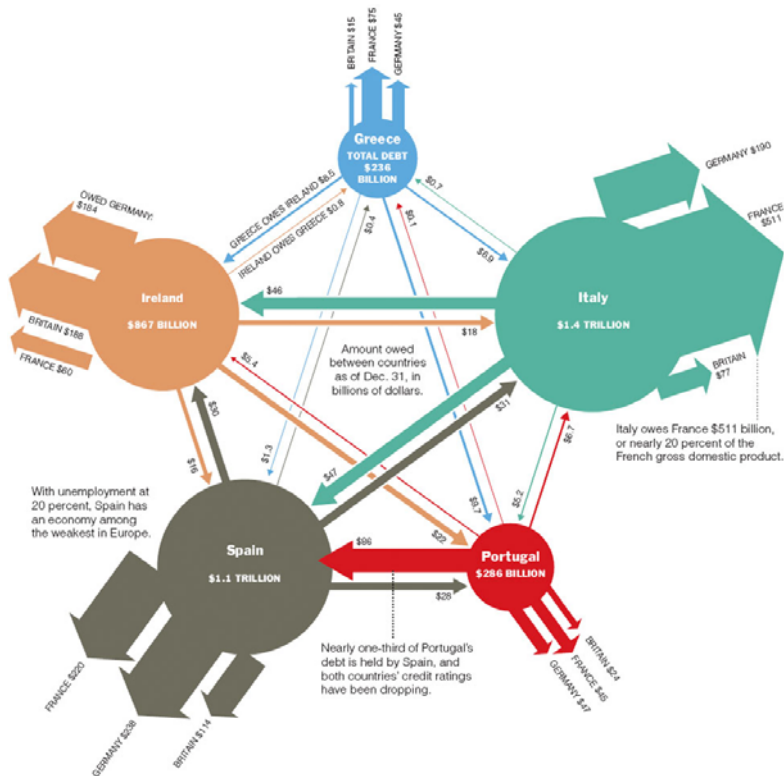
As in many Arab countries, the dictatorship in Greece (1967-1974) violated the political rights of its citizens. However, one could say that the restoration of democracy violated the economic rights of the Greeks. The first Conservative administration (1974-1981) adopted some populist measures in an attempt to forestall the ascendance of the Socialists, who were nevertheless elected in 1981 – the year Greece joined the European Union. By the time the Socialists lost power in 1990 the debt had increased to 71 percent of GDP (from 26 percent in 1981).<sup>6</sup> This increase took place despite the massive injections Greece received through the Mediterranean regional, structural and agricultural funds of the EU, which aimed to reduce the short-term disadvantages of joining the “Single Market”. Most of these funds and the rising debt were used for patronage and clientelist purposes, and only a few achieved their desired objectives.<sup>7</sup>

In addition to failing to modernise the economy and improve governance, alternating Conservative and Socialist administrations in the 1990s increased the debt to around 100 percent of GDP by 2004, the year Greece hosted the trophy project of the Summer Olympic Games in Athens. Much of the increase in debt after that date has to do with the ease with which Greece borrowed in the European bond markets, having previously joined the Euro in January 2001.

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<sup>6</sup> The figures quoted in this paper: Bank of Greece, 2011: *Bulletin of Conjectural Indicators 137 (May-June)* (Athens: Bank of Greece Printing Works).

<sup>7</sup> Since Greece joined the EU in 1981, it largely failed to modernise its economy in key dimensions (such as competitiveness, export diversification, productivity and so on) compared not only to Portugal and Spain but also to Turkey. See Bahri, Yilmaz, 2011: “Foreign trade Specialisation and International Competitiveness of Greece, Portugal, Spain and Turkey”, Paper presented at the 30<sup>th</sup> Seminar for Euro-Med Diplomats, Malta, 13-16 May.



**Figure 8.1:** The Credit/Debt Links in the PIIGS, 2010

Note: PIIGS = Portugal, Ireland, Italy, Greece and Spain

Source: Bank for International Settlements (quoted in *New York Times* 1 May 2010).

Before joining the Euro, markets required a premium for bonds denominated in the Greek national currency (the drachma), due to the structural weaknesses of the Greek economy. After joining the Euro, Greece was able to borrow effectively at the same rate as Germany. For example, the real long-term interest rates on government debt for Greece bottomed at 0.3 percent<sup>8</sup> in 2003, compared to 6.4 percent in 2010 after the seriousness of the Greek situation became known.

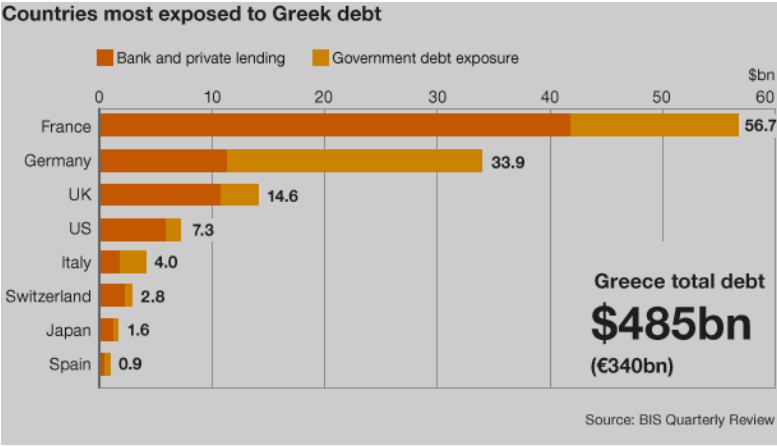
<sup>8</sup> Real long-term interest rates deflated by GDP.

The bubble created by the increase in the public debt and a concomitant expansion in private credit by the banks for housing and consumer spending, brought the total (public and private) debt to nearly 300 billion Euro, or nearly 130 percent of GDP by 2009 (Figure 8.2), with France being the most heavily exposed creditor country. Nevertheless, this bubble at first had a positive effect on the labour market. Employment increased from 4.1 million in 2000, to 4.9 million in 2009 following economic growth rates that were much higher than the corresponding average in the rest of Europe.

However, the rapid economic growth in the 2000s was the result of overheating and domestic inflation that was running at 50 percent more than in the Eurozone. The harmonised index of consumer prices (HICP) was 3.4 per annum for Greece, but only 2.4 percent in the Eurozone from 2000 till 2008. Rising inflation can be misinterpreted by firms as rising demand for their products, and thus encourage them to hoard and overpay workers, despite the underlying falling trend in output. Indeed unemployment kept falling, but so did productivity. This suggests there were few, if any, structural factors that caused the rather impressive rate of decline in unemployment, that was faster than market conditions would warrant.<sup>9</sup>

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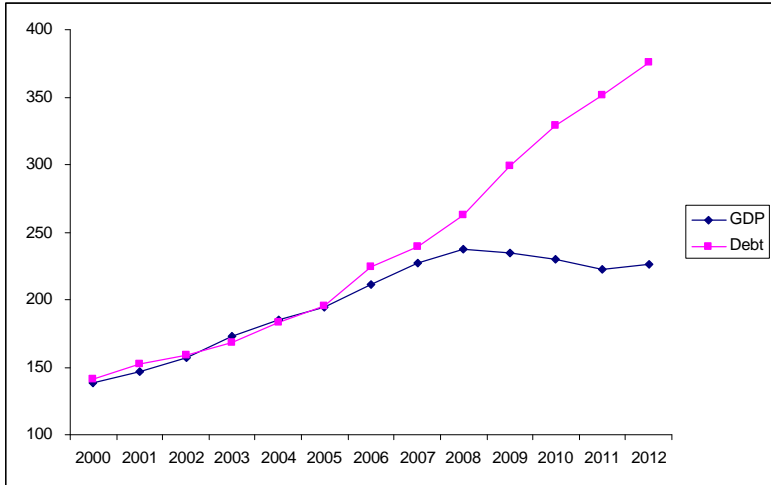
<sup>9</sup> This chain of events is not unique to Greece or Europe. Similar bells are ringing also for the vibrant BRICs (Brazil, Russia, India and China). See for example, Fontevecchia, Agustino (2011, July 17). Brazil: A Bubble in Labor Markets. *Forbes*. Available at: <http://blogs.forbes.com/afontevecchia/2011/07/13/brazil-a-bubble-in-labor-markets/?partner=alerts>.



**Figure 8.2:** Countries most exposed to Greek debt  
*Source: Seeking Alpha, 2011 “Greece Continues to Pose a Major Risk”. Available at: <http://seekingalpha.com/article/275995-greece-continues-to-pose-a-major-risk>.*

Figure 8.3 confirms the lack of any multiplier-type effect of the excessive borrowing upon GDP growth: the economy was increasing by exactly the same amount as the increase in debt until the mid-2000s, before the economy started heading for a crash. Demands for wage increases in the private sector, and the historically bloated public sector (perhaps less in terms of size of employment and more in terms of acquired benefits and legacy costs – such as pensions), were not easy to deny in the tense political climate of Greece, which made it tempting for political parties to defer corrective action until they left office.





**Figure 8.3:** Greek Gross Domestic Product and Government Debt in Euros (Current market prices, billions)

Note: 2011-2012 projections

Source: EUROSTAT - Annual Macro-Economic Database of the European Commission's Directorate General for Economic and Financial Affairs (AMECO).

This is indeed what happened, and as soon as the Socialists were elected to power in 2009, they announced that false national accounting practices by their predecessors had masked the size of the Greek fiscal crisis. The budget deficit that was officially reported to be around 6 percent in 2009 was re-estimated at 11.5 percent and subsequently confirmed to be more than 15.4 percent.<sup>10</sup> Greece was, in simple terms, insolvent though it has been treated so far as illiquid, for reasons discussed below.

<sup>10</sup> Similarly, the Conservative government elected in 2004 spared no time in disclosing that its Socialist predecessor had cheated on its Euro “entry exam” in 2000, having claimed that its deficit was less than 3 percent of GDP (the Euro zone upper limit) - something that has not been the case for a single year since Greece’s joining the Euro. That the EU took no action against this repeated violation other than asking Greece to tighten up its bookkeeping and attempting to strengthen the monitoring function of EUROSTAT (the EU’s statistics watchdog) is puzzling and has given rise to many conspiracy theories. See for

The time for massive fiscal correction was ripe, but not in the form of sovereign default. This would have jeopardised the Euro whose demise was (at the time of writing this paper, prematurely) expected in many quarters. In plain terms, Greek bonds have been downgraded by the international rating agencies to “junk” status (CCC); the risk premium for investing in Greek bonds (spread) increased to more than 2,000 basis points - equivalent to an insurance premium of 2 billion for a 10 billion Greek bond (compared to 50 million for an equivalent German bond).

A first “rescue” package of 110 billion Euros<sup>11</sup> was agreed upon in May 2010, with combined funds from the troika of the European Union, the European Central Bank and the International Monetary Fund (IMF), under an adjustment loan designed and supervised by the latter. The adjustment involved successive austerity waves that included budget cuts, tax increases, public sector redundancies, pension and benefit reductions and privatisation of state assets expected to fetch 50 billion Euros by 2015. This contributed to an increase in official unemployment from 380,000 in 2008, to nearly 630,000 in 2011 (from 8 percent to 16 percent of the labour force) and a decline in real output at a rate of 4.5 percent in 2010, with a further 3.8 percent contraction expected in 2011.<sup>12</sup>

The performance of the rescue package was already “off course” by June 2011, when an additional package of another 109 billion Euros was agreed by the troika at an EU summit, very much at the same time that Portugal was also downgraded to junk status, while Spain and Italy were accentuating austerity packages.

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example, Wyplosz, Charles (2010, February 5). My Big Fat Greek Conspiracy Theory. *Financial Times*.

Available at: <http://www.ft.com/intl/cms/s/0/da5c40da-1283-11df-a611-00144feab49a.html>, or Cendrowicz, Leo (2010, February 26). What Caused the Euro Crisis? *TIME*. Available at:

<http://www.time.com/time/world/article/0,8599,1968308,00.html>.

<sup>11</sup> Greek GDP was estimated to be around 220 billion Euros in 2011.

<sup>12</sup> International Monetary Fund (IMF), 2011: “Greece: Fourth Review under the Stand-By Arrangement and Request for Modification and Waiver of Applicability of Performance Criteria”, *IMF Country Report* 11/175: 9.

Despite the second rescue package, Greece was further downgraded only days after the summit, to one notch above default and remains insolvent today. The IMF forecast is that the Greek debt-to-GDP ratio will peak at 172 percent in 2012 (including state asset sales), while the measures agreed at the summit are expected to reduce the debt-to-GDP ratio to 120 percent in the next five years. Even that amount is deemed too high for Greece to sustain, amidst prospects of initially negative and subsequently slow economic growth.<sup>13</sup>

The Greek rescue package defies economic reasoning and can only be justified on European political grounds. The introduction of the Euro came without adequate provisions for harmonizing fiscal policies across the region, that would avoid situations like the ones that became known only after the Greek debt crisis. If Greece were “too big to fail”, Spain (and Italy) are “too big to rescue” on existing arrangements for cross-country official support.

The Greek crisis now calls for a pan-European solution, but agreements at a European level are difficult to achieve. The temporary bail-out of Greece will hopefully allow the Europeans to do just this: explore and agree on how divergent fiscal policies, across the members of the euro, can become compatible with a single monetary policy overseen by the European Central Bank. Indeed, Europe, led by France and Germany, has started talking about ways to ease the debt repayments of Greece (and potentially other countries) through voluntarism, extension of the repayment period, private sector participation and the like. These measures were previously dismissed outright.

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<sup>13</sup> According to some estimates, the stabilisation/reduction of the debt-to-GDP ratio at the pre-crisis levels of 106 percent (in 2007) would require the Government to generate sizeable primary surpluses for many years in the future. See Korliras, Panagiotis G.; Monogios, Yannis A., 2010: “Asymmetric Fiscal Dynamics and the Significance of Fiscal Rules for EU Public Finances”, in: *The Journal of Economic Asymmetries*, 7,2 (December): 139-169.

This is, perhaps, as far as one can go, in presenting the current situation in the Southern European economies. The implications of the evolving crisis in these economies for the Euro-Med, are discussed (or rather, speculated on) after a review of the recent developments in the Arab states.

### **III. In the South of the Mediterranean**

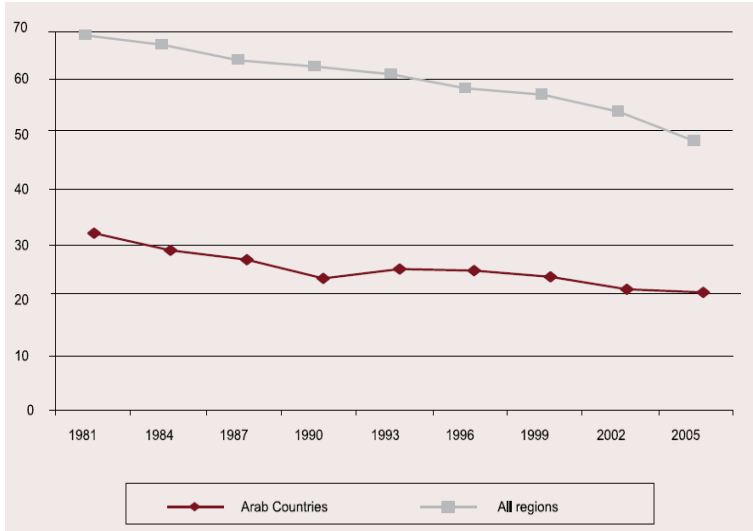
The region-wide effects of the European banking crisis, which were accentuated by the debt situation in Greece, can be easily explained by the interconnectivity of the region's economies through the monetary and banking systems (Figure 1). Similarly, the East Asian crisis in 1997 had common roots in excessive leveraging in that region, due to the lack of financial and capital controls. And the systemic changes in East European countries, which began in 1989, can be linked to the pent up disappointment of their citizens with their political regimes, that could no longer be sustained after the Soviet Union lost its status as a superpower and regional guardian.

However, the “Arab Spring”, that started with the self-immolation of a Tunisian street vendor in protest of the harassment and humiliation inflicted on him by the arbitrary behaviour of officials, is more difficult to attribute to a single factor.<sup>14</sup> For example, neither the Tunisian nor the Egyptian uprisings was the result of mass or increasing poverty, nor does this seem to be the case for other countries that are at various stages of unrest, ranging from protests to civil war (e.g. Algeria, Morocco, Jordan, Yemen, Bahrain, Syria, Libya, and so on). If

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<sup>14</sup> The global financial and economic crisis of 2008 did not affect the Arab countries much. See Tzannatos, Zafiris, 2009: “The Global Financial, Economic and Social Crisis and the Arab Countries: A Review of the Evidence and Policies for Employment Creation and Social Protection”, Paper for the Arab Employment Forum, ILO, Beirut, 19-21 October. Available at: [http://www.ilo.org/public/english/region/arpro/beirut/downloads/aef/global\\_eng.pdf](http://www.ilo.org/public/english/region/arpro/beirut/downloads/aef/global_eng.pdf).

anything, the Arab region has some of the lowest poverty rates in the world that have been declining over time (Figure 8.4).<sup>15</sup>



**Figure 8.4:** Poverty rates in the World and Arab countries (% living below \$2/ day, \$ PPP)

*Source: Bibi, Sami; Nabli, Mustapha, 2010: Equity and Inequality in the Arab World (Cairo: Economic Research Forum).*

On the contrary, the last decade or so has been labelled as the Arab renaissance, in the sense that the region experienced economic growth rates and employment creation not seen since the booming years of the 1970s, following the then increase in the international price of oil (Figure 8.5). In this respect, there are some similarities between the recent Arab uprising and the revolution in Iran in 1979, which took place very much on the back of rising prosperity, like in many Arab countries prior to the crisis. As with Iran, in most Arab countries the economy was

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<sup>15</sup> The decline in poverty elsewhere was faster than in the Arab region, but it started from a higher level and is disproportionately affected by the fast economic growth in China.

growing rapidly after the adoption of economic liberalisation policies – an issue discussed in more detail below.

Asia and Pacific	GDP	Employment	Arab countries	GDP	Employment
China	10.5	0.9	Bahrain	6.7	2.2
India	7.0	2.4	Kuwait	7.9	2.9
Indonesia	5.4	1.7	Oman	4.6	2.3
Japan	1.4	-0.1	Saudi Arabia	4.2	3.2
Korea Republic	4.4	1.4	United Arab Emirates	7.9	5.0
Malaysia	5.7	1.8	<b>Average</b>	<b>6.3</b>	<b>3.1</b>
Mongolia	<b>8.2</b>	<b>3.2</b>	<b>Ratio</b>		<b>49%</b>
Pakistan	5.3	3.7	Jordan	7.3	4.4
Philippines	5.3	2.8	Lebanon	4.8	2.1
Sri Lanka	6.0	1.7	Syrian Arab Republic	4.2	4.0
Thailand	5.2	1.7	<b>Average</b>	<b>5.4</b>	<b>3.5</b>
Viet Nam	7.6	2.0	<b>Ratio</b>		<b>65%</b>
<b>Average</b>	<b>6.0</b>	<b>1.9</b>	<b>Average (All)</b>	<b>6.0</b>	<b>3.3</b>
<b>Ratio</b>		<b>30%</b>	<b>Ratio</b>		<b>55%</b>

**Figure 8.5:** Annual Employment and Output Growth Rates and Their Ratio (Employment Elasticity), Asia, 2001-2008

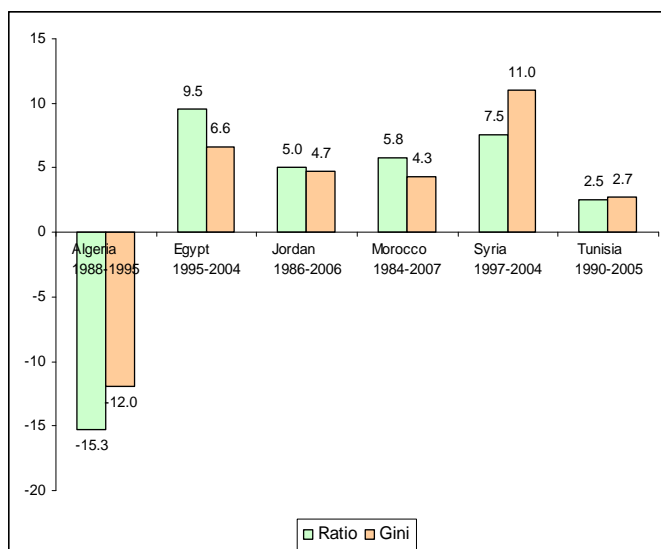
*Source: Constructed from Table 1, p 13 in “Building a Sustainable Future with Decent Work in Asia and the Pacific”, Report of the ILO Director-General prepared for the 15th Asia and the Pacific Regional Meeting, 4 -7 December 2011, Kyoto.*

Another common thread, that has been cited with respect to the concurrent uprisings in many Arab countries, is that inequality has been rising over time. Leaving aside whether inequality reached the same critical level in so many Arab countries at more or less the same time, the evidence in this respect is as scanty as it is contradictory. As the Figure 8.6 shows, in all but one of the regional countries for which information is available, the richest quintile of the population increased their distance from the poorest, while inequality (measured by the Gini coefficient) also increased. However, Figure 8.7 also shows that the poorest quintile increased its share of national consumption, in all but one of the listed countries.

So, the jury is still out also with respect to this explanation, with one caveat: the inequality indicators used in these two comparisons are based on income and consumption (i.e. flows) and miss an important aspect of inequality, that is, wealth (i.e. a stock). Could it be that it was unequal wealth accumulation that gave rise to the frustrations leading to the Arab protests? Although

the inequality measures discussed previously provide an inconclusive picture, there are consistent reports of excessive wealth concentration among leaders and their families in many Arab countries, especially in Tunisia, Egypt, Libya and Syria. Thus, an attractive hypothesis is that it might be a perceived sense of unfairness and voice among citizens, as well as a lack of accountability of the autocratic regimes that led to the Arab uprisings, as discussed later on.

Percentage Change in Inter-Quintile Ratio (Richest/Poorest Incomes) and the Gini Coefficient (Consumption) Selected Arab Countries 1980s-2000s

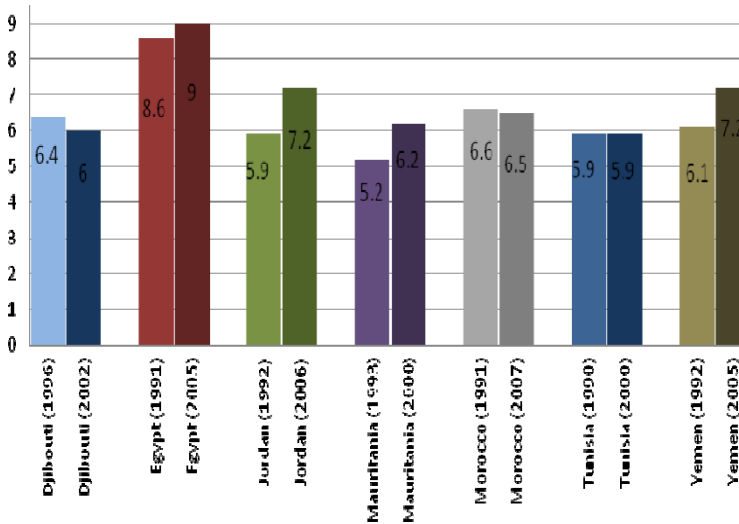


**Figure 8.6**

Source: Constructed from Sami Bibi and Mustapha Nabli, 2010: *Equity and Inequality in the Arab World* (Cairo: Economic Research Forum).

It is therefore likely that the uprisings have to do more with rising political discontent regarding the autocratic regimes, in which economic factors played a role. For example, the policies that led to the revival of many Arab economies since the 1990s were introduced after decades of statist and paternalistic practices,

adopted at various points since the 1950s. These policies created economic tensions that the autocratic political regimes attempted to address, through neoliberal economic policies. Such policies are known to downplay their social implications in the short run, in the expectation that there will be sufficient trickle-down in the long run.



**Figure 8.7:** Share of poorest quintile in national consumption for selected Arab countries.

*Source: Constructed from ESCWA, 2011: National and Regional MDGs Priorities for the attainment of the MDGs in the Arab region (Beirut: UN).*

Thus, a wave of economic reforms was adopted on the premise “economic reforms first, political reforms after”. This clearly suited the autocratic regimes, as it did not threaten their survival and interests, at least in the short-run. It also suited the international community that values economic opportunities through overseas investment and trade as much as political stability, especially in the fragile geopolitics of the Arab world.



History has now undermined the usefulness of this approach. In fact, this approach was based on false premises from the beginning. More specifically, economic reforms of the neoliberal nature, introduced in the Arab region in the last 10-15 years, assumed that there is a private sector worth the name. As a corollary, the private sector should be able to deliver more goods and services at lower prices to the citizens. As a result of this thinking, reforms were introduced based on privatisation (or perhaps more appropriately, de-nationalisation), openness of capital accounts, fiscal consolidation through expenditure cuts, privatisation of social services including pensions, and so on. Following the adoption of reforms, the recent performance of many Arab countries indeed appeared impressive in historical terms (Figure 8.5).

The positive picture conveyed by output and employment growth reported in Figure 8.5 is complicated by the fact that short-term private returns,<sup>16</sup> mostly accrued to the establishment's insiders, as the move away from state-owned enterprises toward a private sector-led model often favoured investors, who were either part of or willing to conduct deals with the elites. Further, the jobs created were "out of sync", with the rising education qualifications and expectations of emerging middle classes.

The fast growing and increasingly educated labour force was left with few opportunities for decent employment. Youth unemployment was decreasing over time, including the period before the uprisings (Figure 8.8), but unemployment among educated workers kept increasing. Unemployment continued to affect workers at all levels of income and education, while across the world (not unexpectedly), unemployment has declined among wealthier households and more educated job seekers.<sup>17</sup> Even when

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<sup>16</sup> The drivers for growth were typically real estate, construction, financial and banking sectors that mainly benefited only a few (at times foreign) investors.

<sup>17</sup> Montenegro, Claudio E.; Hirn, Maximilian L., 2009: "A New Disaggregated Set of Labour Market Indicators Using Standardized Household Surveys from Around the World", *World Development Report Background Paper*, World Bank.

Arab citizens found employment locally, the wage premiums for education were the lowest compared to other world regions.<sup>18</sup> Many skilled Arabs emigrated, an indication that their skills were not in demand locally, but that they had the qualifications to compete in the more technologically advanced countries such as Europe, the US, Canada, Australia and the oil-rich Gulf Cooperation Council economies.<sup>19</sup> To add insult to injury, Arab employers continued to complain about the ill-preparedness of job seekers, and the poor quality of the output of the education system. At the same time, they seem the least prepared to train their own workers (Figure 8.9), passing the blame on to the education system and the attitudes of youth.<sup>20</sup> Productivity growth in the Arab region was among the lowest in the world, in fact, it was lowest in the Middle East sub region (Figure 8.10).

The seemingly strong economic performance in the Arab region over the course of the last two decades, may have therefore given rise to an increasing sense of rising inequality and unfairness. Although employment creation was indeed impressive, in many cases it took place not through decent jobs but through rising informality (Figure 8.11). In turn, citizens continued to rely on emigration. The Middle East and North Africa region is experiencing one of the highest rates of skilled emigration in the world, with higher-educated emigrants averaging around 9 percent

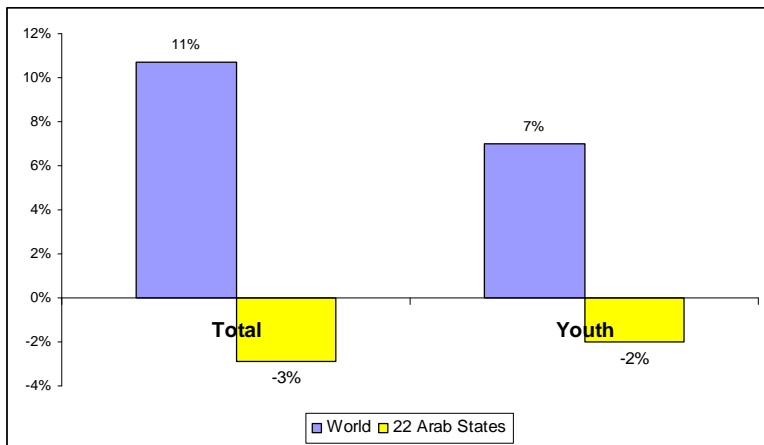
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<sup>18</sup> World Bank, 2007: *The Road Not Travelled: Education Reform in the Middle East and North Africa* (Washington, D.C.: The World Bank).

<sup>19</sup> See the debate with new ideas for a post-crisis macroeconomic framework in: International Monetary Fund (IMF) (2011, March 8). IMF Triggers Debate on Crisis Lessons. *IMF Survey Magazine*. Available at: <http://www.imf.org/external/pubs/ft/survey/so/2011/RES030811A.htm>.

<sup>20</sup> Tzannatos, Zafiris, 2011: "Labour Demand and Social Dialogue: Two Binding Constraints for Creating Decent Employment and Ensuring Effective Utilisation of Human Resources in the Arab Region?", Paper presented at the Expert Group Meeting on Addressing Unemployment and Underemployment in the Islamic Development Bank Member Countries in the Post-Crisis World, Islamic Development Bank, Jeddah, 9-10 May. Available at: <http://www.sesric.org/imgs/news/image/557-theme2-ilo.pdf>.

of the domestic high skilled workforce.<sup>21</sup> Perhaps, the situation can be summarized in the observation that, despite the guided economic reforms, the region failed to compete on a global scale; by the mid-2000s the Philippines alone, had more manufactured exports than the Middle East combined.<sup>22</sup>

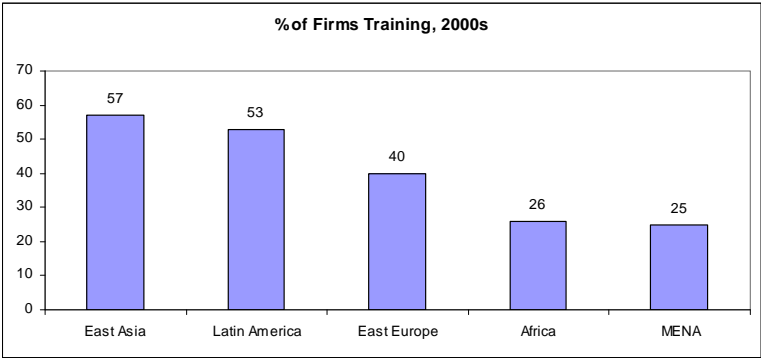


**Figure 8.8:** Change in Total and Youth Unemployment Rates, Averages for World and Arab States, 2007-2010

Source: Constructed from Tzannatos, Zafiris; Haq, Tariq and Schmidt, Dorothea, 2011: “The Labour Market in the Arab States: Recent Trends, Policy Responses and Future Challenges” in ILO (Ed.): *The Global Crisis: Causes, Responses and Challenges* (Geneva:ILO).

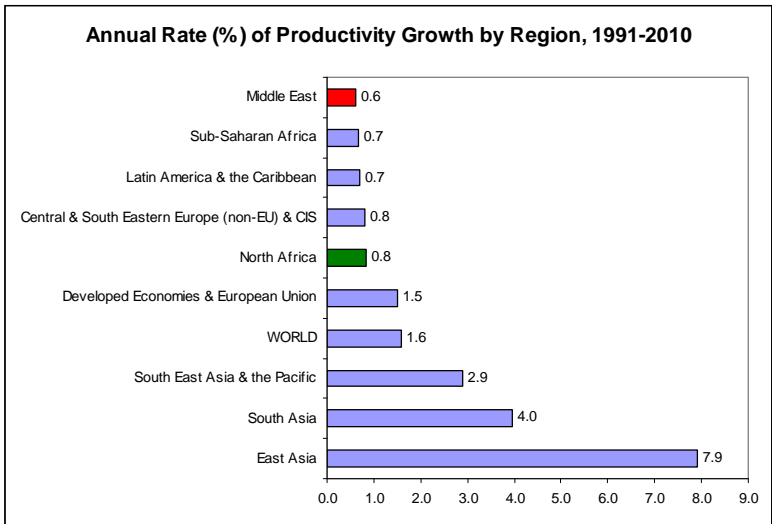
<sup>21</sup> Docquier, Frédéric; Johansson de Silva, Sara; Marfouk, Abdeslam, 2010: “Skilled Migration from the MENA Region: Trends, Impacts and Policy Responses”, in: World Bank: *Labor Migration from North Africa. Development Impact, Challenges and Policy Option* (Washington: World Bank): 93-102.

<sup>22</sup> Noland, Marcus; Pack, Howard (Ed.), 2007: *The Arab Economies in a Changing World* (Washington DC: Peter G. Peterson Institute for International Economics).



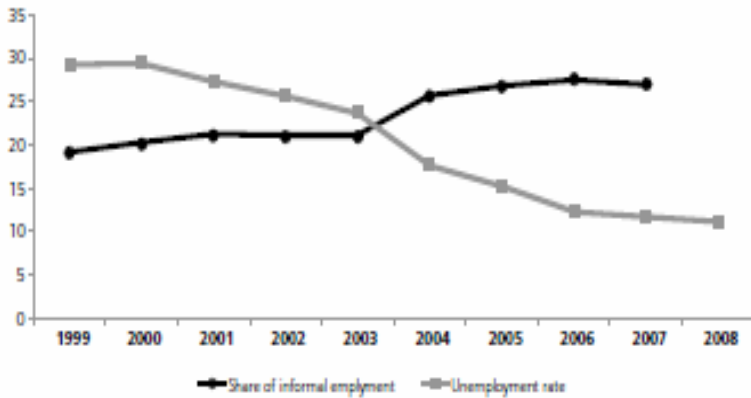
**Figure 8.9: Arab Firms Train Least**

Source: Authors' calculations based on Almeida, Rita K.; Aterido, Reyes 2010: "The Investment in Job Training: Why Are SMEs Lagging So Much Behind?", Social Protection Discussion Paper 1004, World Bank, Washington.



**Figure 8.10: Low Productivity Growth in the Arab Region**

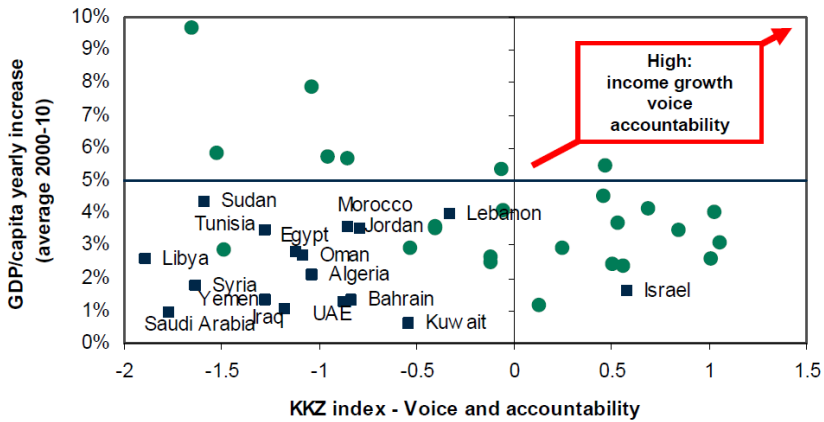
Source: ILO, 2010: Trends Econometric Models (Geneva: Employment Trends Team).



**Figure 8.11:** Changes in Informal Employment and Unemployment rate in Algeria, 1999-2008

Source: Achy, Lahcen, 2010: “Trading High Unemployment for Bad Jobs: Employment Challenges in the Maghreb”, *Carnegie Papers 23*, Carnegie Middle East Center.

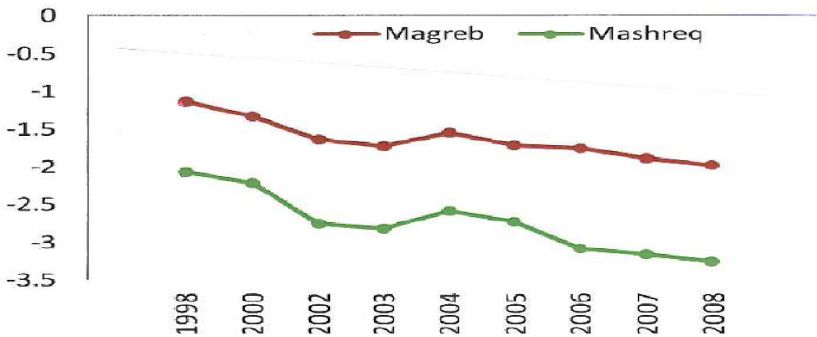
While the economic reforms were, to some extent, addressing the employment concerns of citizens, albeit in an incomplete way, there were limited outlets for the citizens to express their concerns amidst reduced public investment and privatisation of social services. In fact, a striking common characteristic of the Southern Mediterranean region is depicted in Figure 8.12: all regional economies (except Israel) are located in the “wrong quadrant”. This suggests, on the one hand, that fast economic growth was not sufficient to increase *per capita* incomes as fast as in other regions (due to relatively high population growth) and, on the other hand, Arab countries have low levels of voice and accountability. In fact, voice and accountability continued to decline over time in both the North Africa and Middle East regions (Figure 8.12 and 8.13).



**Figure 8.12:** Citizens in Arab Countries Have Seen Slow Increases in Incomes and Have Low “Voice” While the Accountability of Governments Can Increase

Note: The Kaufmann-Kraay- Zoido Lobaton index is a subjective one that takes into account freedom of expression, freedom of association, and free media as well as the perceptions of citizens regarding the extent to which they are able to participate in selecting their government.

Source: Constructed from “Emerging Market Monthly Roadmap: Positioning for Bad News” by Crédit Agricole Corporate and Investment Bank, 2 March 2011.



**Figure 8.13:** Changes in the Index of Voice and Accountability for Arab Sub-regions 1996 to 2008

Source: UNDP calculations based on World Bank data quoted from El-Mikawy, Noha (2011) “Governance Deficits in Arab Countries”, in: (UNDP): Arab Human Development Report 2011. Empowerment. (Cairo: UNDP, i.p.).

#### IV. Linking the Two Coasts of the Mediterranean: Challenges and Prospects

While the causes of the European debt and financial crisis are clear, those of the political crisis in the Arab world are more complex. However, the difficult fiscal situation in the Southern Mediterranean may prove to be not that dissimilar to that in the Northern Mediterranean. With Arab governments now tempted to buy peace with new spending packages, the fiscal stability of the region’s economies is in danger. If the beneficiaries of the *ancient regimes* or those who oppose change are able to regroup, it will make it difficult for Arab Governments to adopt measures that could contribute to inclusive economic growth, a commodity which has been in short supply in the region for many years.

Another similarity is the influence of international politics and economic considerations upon country and regional outcomes. In the case of Greece, what is clearly a case of insolvency is treated

as a case of illiquidity – even after it received the second rescue package.<sup>23</sup> Clearly, Greek politicians have shown little accountability in increasing the budget deficit and allowing the ballooning of the public debt, while they falsified the national accounts in order to enter the euro initially, and subsequently keep borrowing. However, there is a balance between the rights of creditors vis-à-vis those of debtors (in this case citizens).<sup>24</sup> The successive loans provided to Greece have some of the characteristics of *fraudulent conveyance*. This is the case when a creditor makes a loan, knowing the debtor cannot pay in the normally expected course of events, while expecting an even greater return from the loan (e.g. refinancing a mortgage expecting to foreclose the property). Creditors can be said to be using debt leverage for Greece to sell off public assets at below market prices, having extended credit beyond the country's ability to pay or roll its debt over, by replacing bad old loans with newer ones under conditions that are still unlikely to lead to solvency.<sup>25</sup> As argued earlier, the slow death of Greece is nevertheless serving a Euro-wide purpose, that is, in allowing the development of

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<sup>23</sup> According to Stiglitz Joseph E., Nobel-winning economist, “If Europe comes together with an appropriate framework, that will enable a default to be avoided, but there’s every sign that Europe won’t do that, so the likelihood of a problem down the line is very significant”, in: Donadio, Rachel (2011, June 29). Greece Approves Tough Measures on Economy. *New York Times*. Available at: [http://www.nytimes.com/2011/06/30/world/europe/30greece.html?\\_r=1&pagewanted=all](http://www.nytimes.com/2011/06/30/world/europe/30greece.html?_r=1&pagewanted=all). In the same article, Kenneth S. Rogoff, a former chief economist at the IMF, is quoted to have said the Greek infusion of aid would only buy a little time and “Greece is basically being bribed not to default. But as long as Greece doesn’t grow briskly for a sustained period, it’s in hot water”. And according to rating agencies Greece has an 80 percent probability of defaulting.

<sup>24</sup> This is recognised in development practices, for example, by the adoption of the High Indebted Poor Countries Initiative (HIPIC) by international donors and the International Financial Institutions (IFI’s – like the IMF and the World Bank) since the 1990s. The HIPIC created a framework for creditors to provide debt relief and thereby reduce the constraint on economic growth and poverty reduction imposed by the debt build-up in these countries.

<sup>25</sup> Hudson, Michael (2011, June 13). The Financial Road to Serfdom: How Bankers use the Debt Crisis to Roll Back the Progressive Era. *The Global Realm*. Available at: <http://theglobalrealm.com/2011/06/15/the-financial-road-to-serfdom-how-bankers-use-the-debt-crisis-to-roll-back-the-progressive-era/>.



sustainable crisis management mechanisms, should larger economies than Greece<sup>26</sup> come to rest on the Procrustean bed.

Similarly, Arab countries that found themselves in the middle of the storm have experienced seemingly different political treatment, both by the international community and their regional neighbours. For example, while in Libya there has been active external military support to topple the regime, in Bahrain there has been suppression of the uprising, while a “wait and see” attitude has been adopted in Syria.

The political future of the Southern Mediterranean is difficult to assess, also because the Arab countries are at different stages of unrest. For example, in some countries there are no visible signs of unrest (e.g. Lebanon), in others some unrest is lurking (e.g. Algeria, Jordan, Morocco), and in Syria protests and repression have reached critical proportions. In two countries, revolts have removed long standing regimes (Egypt and Tunisia) and Libya is in a state of civil war. While there is probably no going back, the political future of the Arab region is highly uncertain. What is more certain is that the economic implications will not remain confined to the Arab region.

It is clear that both coasts will face hard budget constraints in the coming year, and probably for decades to come. The pressure to stabilise the fiscal and banking systems in Europe is bound to be felt for decades. Though Spain was considered to be the more likely successor of Greece, Italy is reported to be under more immediate threat. The nearly 2 trillion Euro sovereign debt of Italy is three times as much as that of Greece, Ireland and Portugal combined, and dwarfs the amounts available in the European Financial Stability Facility (EFSF)- the Euro’s rescue fund.<sup>27</sup>

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<sup>26</sup> At the time of writing, Spain had come to be considered less safe than Egypt while the spreads (risk premium) for government borrowing were increasing for Italy. See *The Economist* (July 30 2011) 24.

<sup>27</sup> While this chapter is going to print, there were indications that the funds of the EFSF may be replenished to reach 2 trillion Euros while a “haircut” of the order of 50 percent of the Greek public debt may be agreed by the European

While the ECB can be expected to maintain control in monetary policy, common regulations for the banking sector may be less easily agreed to, while fiscal policy may pose challenges which have already proved too much for European level coordination, even during good times. The search for previously unknown solutions will surely continue, particularly in the areas of how to address cross-border/ cross-jurisdiction issues, as well as in how to rebalance growth between the fast and slower economies of the eurozone.

On the Arab side, the uprisings have produced recessions in the regional economies, while demands for immediate improvements in social conditions are rising at a time when the economies can least afford them. Most likely, the investment climate will continue to deteriorate, at least in the critical short-run period. Yet, governments have made concessions to appease their populations and neutralise risks that are far in excess of what can be reasonably expected to be sustainable – even in a tranquil political climate experiencing good governance. This could even threaten the oil-rich economies that already face large current account and fiscal imbalances.

The crises on the two coasts of the Mediterranean may affect their relationship, and could also have global effects. There may be trade and migration effects within the Euro-Med (and beyond). For example, most of the exports of the non oil-producing Arab economies go to the group of the EU15 countries. Increased migration from the affected Arab countries to the EU is already taking place. One could expect further increases in the number of migrant workers, including refugees and undocumented migrants, in the southern nations of the EU – countries that are still suffering from high and increasing unemployment rates and excessive fiscal austerity. If not brought under control, the fiscal/banking crises in the PIGS will affect Europe, and with it the other regions.

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authorities. These developments support the view expressed earlier in this chapter that the initial *economic* assessment of the debt crisis in Europe and also of the rescue package Greece was inadequate.

Continuing political unrest in the oil-exporting countries could have a strong negative impact on the global economy. Already, analysts estimate that the turmoil may have added 25 percent to the price of crude oil.<sup>28</sup> A protracted increase in oil prices could threaten the global economic recovery, which is probably not even past its midpoint.

If there is a silver lining in all this, it is equally a challenge. Both coasts of the Mediterranean are in active search for a new economic model that would rely less on unfettered markets and more on a sensible regulatory role for governments. In Europe, as elsewhere, the economic policies practised from the 1980s - until they showed their intellectual bankruptcy in 2008 - are being reconsidered, and beginning to recognise the difference between unregulated markets and social markets. Similarly, in the Arab region there is a loss of faith in the kind of liberal economic reforms that were adopted in the last two decades. Hopefully, both searches will come up with prescriptions that singularly pursue fast economic growth, at the expense of inclusive development and social justice.

Yet, the question remains whether there is enough time to come up with alternatives to old medicines, as both coasts of the Mediterranean may find it tempting to adopt short-lived crisis reactions instead of sustainable structural responses.

As Keynes apparently once said: “The market can stay irrational longer than you can stay solvent.”

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<sup>28</sup> Dadush, Uri; Muasher, Marwan (2011). The Middle East Bailout [Electronic Version]. *National Interest*, (March-April).