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Ten Years of the Barcelona Process: Economic and Social Development since 1995

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ÍNDICE

Ten Years of the Barcelona Process: Economic and Social Developments since 1995[1]

- **So far, progress in achieving the economic objective of the Barcelona Process has been mixed. Although some economic successes as well as improvements of overall life quality could be achieved since 1995, progress towards "the creation of a Euro-Mediterranean area of shared prosperity" has been moderate.**

- **On the positive side, Mediterranean countries' global trade integration has made some progress since 1995, providing benefits to the population and higher competitive pressure on enterprises. Mediterranean countries' trade growth was above the world average for the past years, allowing for an increase of their market share in global trade.**

- **Furthermore, most countries have achieved a relatively high degree of macroeconomic stability since 1995, a necessary though not sufficient condition for growth. Notably, the average inflation rate fell from around 12% in 1995 to around 3% in 2003 and 2004. Progress in fiscal consolidation was more modest.**

- **However, despite these successes, the catching-up process in income levels between the Mediterranean region and the EU has not sufficiently advanced since 1995.[2] Although the average income level of Mediterranean countries increased by around 35% since 1995 it remained at around 18% in PPP terms compared to the EU income level.**

- **The slow pace of structural reforms may explain why the overall economic performance has been somewhat unsatisfactory. At the same time, it must be recognized that the Barcelona process focused to a large extent on tariff reduction and has not provided a sufficiently strong set of incentives for structural reform.**

- **By complementing and building on Barcelona, the new European Neighbourhood Policy has the potential to address this structural reform deficit, by focusing also on beyond-the-border reforms.**

1. Introduction

The year 2005 marks the 10th anniversary of the Barcelona Declaration, which initiated the Euro-Mediterranean Partnership (also known as the Barcelona Process). The 1995 Euro-Mediterranean Conference of Ministers of Foreign Affairs held in Barcelona had the vision of "turning the Mediterranean basin into an area of dialogue, exchange and cooperation guaranteeing peace, stability and prosperity". The Barcelona process was conceived as resting on three pillars: a political and security partnership, an economic and financial partnership, and a social, human and cultural partnership. More specifically, the second pillar is dedicated to the creation of an area of shared prosperity with a focus on improving living conditions, accelerating the pace of

[1] This article was prepared by Michaela Dodini and Gerhard Krause.

[2] The terms Mediterranean countries or Mediterranean region in this paper refer, if not stated otherwise, to the Mediterranean countries participating in the Euro-Mediterranean Partnership. These are Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and West Bank and Gaza. Although the term West Bank and Gaza is used on an equal footing with other country names, West Bank and Gaza has the status of a "territory". Turkey, which is a recognised EU candidate, and Cyprus and Malta, which are new Member States, are not covered in this paper.

socio-economic development and reducing the development gap in the Euro-Mediterranean region.

This article aims at assessing progress towards the objectives of the second Barcelona pillar, i.e. the creation of an area of shared prosperity. To that end it analyses and assesses the evolution of a number of indicators (e.g. prosperity, living conditions, employment and social conditions such as education, health and gender for the EU Mediterranean partners during the period 1995 – 2004). In the third part, the article examines improvements with regard to preconditions for a growth-conducive environment since 1995, such as regional macroeconomic stabilisation, Mediterranean countries' integration into the global economy (at-the-border-reforms) and overall structural reform progress (beyond-the-border reforms).[3] The annex contains a brief description of the Barcelona process and EU instruments to promote reforms in the region.

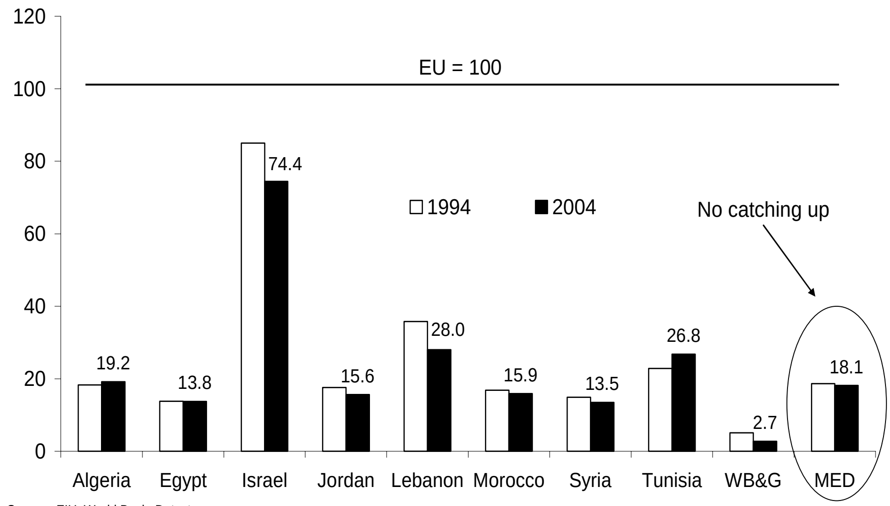
2. Progress on the way towards an area of shared prosperity

Prosperity

Overall, the Mediterranean region hardly caught up at all in terms of income level per capita with the EU in the period 1995-2000. Average GDP per capita in PPP terms for the Mediterranean region was USD 3750 in 1995 and increased to around USD 5000 in 2004. However, the prosperity gap did not close at all in this period as the Mediterranean income level in relation to the EU income level remained at around 18% (Chart 1). Since 1994, a marked positive convergence could be noted only for Tunisia, whose relative income level advanced by four percentage points to 26.8% of the EU level in 2004. For most other countries average per capita income growth lagged behind the EU's per capita growth rate, leading – in particular in Israel, Lebanon and the West Bank and Gaza – to a divergence from EU per capita income levels.

Chart 1: Convergence in income levels

GDP per capita in PPP terms relative to the EU



Source: EIU, World Bank, Datastream.

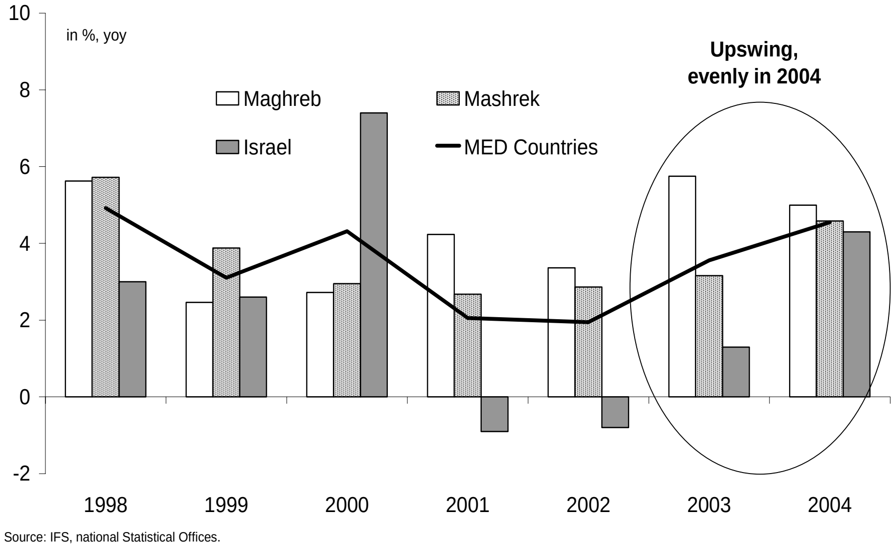
In most Mediterranean countries, the relatively (though below potential) good growth performance of the 1990s did not translate into a significant increase in per capita income levels,

[3] The article of A. Baecker in this publication (page 24) provides more details on progress in trade liberalisation, while the article of F. Hansen (page 52) assess a key aspect of the beyond-the border reform agenda, namely Mediterranean countries business environment.

relatively large population increases. Since the 1995 Barcelona Declaration, Mediterranean countries have had average growth of 3.9% per year compared to an EU average of 2.2% per year. This needs to be considered against the background of relatively high population and labour force growth rates at 2.1% and 3.0% on average per year respectively, in the same period. Consequently, the income gap for all Mediterranean countries even with the EU countries with the lowest income per capita (Greece and Portugal) remains high, with the notable exception of Israel, whose income level corresponds to 74% of the EU average level in 2004 (PPP terms).

Macroeconomic stabilisation efforts, some progress in structural reforms and more favourable commodity prices lifted the average growth rate above 5% in the period 1994-96, and GDP growth remained comfortably above the 3% level until the end of the decade. In 2001-02, the average regional growth rate declined sharply to below 2% due to the economic slowdown in the EU and the US, the impact of September 11th (tourism, investment), country-specific shocks (e.g. droughts) and a worsened security situation in the Middle East. In 2003-04 economic growth strengthened to above 3%, albeit with wide differences within the Mediterranean region, thanks in particular to a more conducive global environment and higher oil prices (Chart 2).

Chart 2: Real economic developments in the MED region



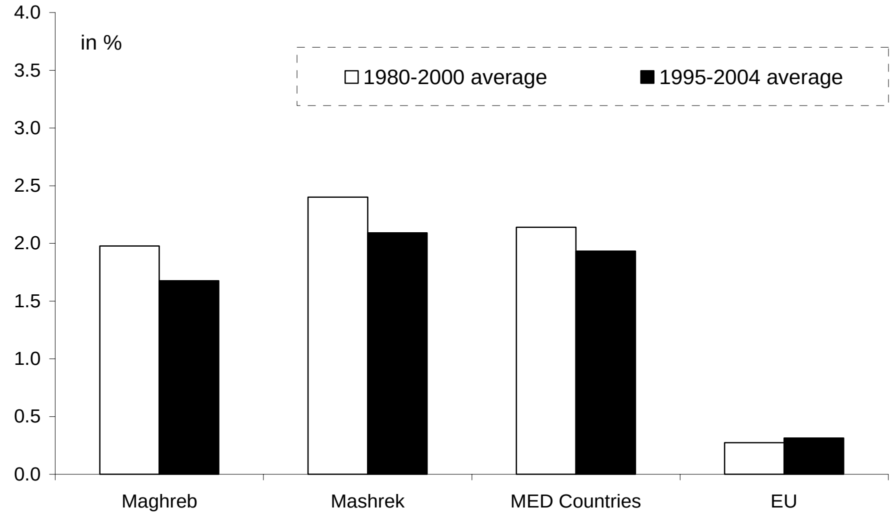
Individual country performance has varied significantly since 1995 and might be explained by a combination of various external and country-specific factors.[4] On the positive side, Tunisia's GDP growth averaged 4.8% per year; the origins of this can be traced back to a series of economic adjustment programmes which focused on prudent macroeconomic management, a gradual liberalisation of domestic prices, a downsizing of the public sector and trade liberalisation. On the negative side, Morocco's and Lebanon's growth performance barely reached the 3% level for the period 1995-2004, which translated into a relative decline in the income level. In the case of Morocco this was mainly due to external developments (six droughts in ten years, slow European growth) as well as stagnation on the structural reform side, while Lebanon's poor performance relates to macroeconomic imbalances, persistent structural and administrative impediments and the deterioration in the geopolitical environment.

[4] Krause, G. (2003), "Basic Economic Characteristics and Selected Economic Trends of Mediterranean Countries" in "Economic Review of EU Mediterranean Partners", *DG ECFIN Occasional Paper*, Nr. 2, January.

Population growth and employment

As mentioned above, high population growth explains partly the lack of convergence of Mediterranean income levels with the EU income level, despite growth rates well above the EU average. Although the population growth in the Mediterranean countries is gradually slowing down, it continues to grow relatively rapidly at 1.9% on average per year in the period 1995-2004 (1980-2000: 2.1%), in contrast to the relatively stagnant populations of EU Member States, which increased by 0.3% on average per year in the same period (Chart 3). The strongest reduction in annual population growth rates since 1995 was recorded in the three Maghreb countries, which dropped by between 0.4 and 0.8 percentage points to below 2%. Syria and Jordan also experienced strong decreases, although both countries continue to display the highest growth rates in the region, with 2.5% and 3.1% respectively. The population growth rates of all other countries broadly stabilised.

Chart 3: MED and EU - Population growth rates



Source: OECD, Worldbank.

Overall, officially reported unemployment rates remain high, ranging from around 11% (of total labour force) in Egypt to 28% in West Bank and Gaza. Actual unemployment is substantially higher than the officially reported figures, due to the poor quality of labour statistics and some existing under-employment in the agricultural sector. Unemployment was somewhat reduced in the years immediately after the 1995 Barcelona Declaration, but this positive development was partly reversed since the end of the 1990s. The weighted average official unemployment rate for the region declined by around one percentage point to 12.5% in 1998-99 on the back of favourable growth developments. However, the regional unemployment rate was later forced back to its original level as economic growth declined to below 2% in 2001-02.

Although overall population growth has started to slow down, there is a substantial time lag involved before this evolution influences labour force growth. As a consequence, Mediterranean countries will have to cope with a labour force that is expected to continue growing 2.9% on average up to 2010. Syria, Algeria, and Jordan are expected to experience the strongest labour force growth rates this decade, averaging between 3.4% and 3.8% per year.

Labour participation in Mediterranean countries has remained at a relatively low level since the mid of the 1990s, while a clear – though slow – rising trend of female participation could be observed. The average participation rate of the Mediterranean labour force has remained at a level of close to 50% since the second half of the 1990s (Table 1).[5] The relatively unchanged level of the labour force participation rate needs to be considered against the background of rapidly growing labour forces. Female employment as part of the total labour force rose from around 29% to 32% during the past few years, affecting all Mediterranean countries, except for Egypt, and was particularly pronounced in Israel, the West Bank and Gaza, Tunisia and Algeria.

Table 1: MED region - Employment indicators

	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia	WB&G
Year	1996	1994	1994		1997	1995	1998	1997	2001
Participation rate (Pop.)	27.4	30.4	---	---	34.0	36.0	28.3	32.4	---
Participation rate (Lab. force)	44.9	48.9	53.6	---	46.8	52.0	49.7	48.6	38.8
Year	2001	2001	2003			2003	2002	2003	2002
Participation rate (Pop.)	27.8	30	---	---	---	37.4	31.9	35	20.5
Participation rate (Lab. force)	n.a.	44.9	54.5	---	---	51.9	53.3	---	38.1

Source: International Labour Office, DG ECFIN calculation.

Poverty and selected social indicators

Several Mediterranean countries continue to experience **poverty incidence**, notwithstanding their relatively good progress in meeting the Millennium Development Goal of "eradicating poverty and improving lives" in the last decade. Poor people, defined as the percentage of the population living below USD 2 per day, ranged from around 7% in Jordan and Tunisia to 44% in Egypt[6]. National poverty indicators point to a positive evolution in Algeria and Egypt, where the proportion of the population poor people living in poverty declined by ten and six percentage points respectively in the second half of the 1990's. On the negative side, Morocco saw the proportion of people living below the national poverty line increase by six percentage points to around 20%, probably due to insufficient economic growth. Poverty is particularly marked in rural areas and in the West Bank and Gaza, the latter being heavily affected by the difficult security situation.

Life expectancy in the Mediterranean region has broadly increased by 2-4 years since the second half of the 1990s, leading to an average life expectancy of more than 70 years in most Mediterranean countries (Table 2). Improved health conditions, notably for children, have contributed to higher life expectancy in the Mediterranean region. Whereas overall health expenditure is generally lower than that in the EU, the share of private health expenditure in the Mediterranean region is relatively high.

Significant improvements have been recorded in **child health** during the past ten years. All Mediterranean countries have successfully reduced child mortality rates and, overall, seem to be on track to meet the Millennium Development Goal of reducing the under-five mortality rate by two thirds between 1990 and 2015.[7] Child immunisation against measles has also increased, except in Algeria. Despite the progress made, there is little scope for complacency about health conditions in the Mediterranean. Child malnutrition due to widespread poverty is still a problem in some areas of the Mediterranean region, such as Algeria and Syria. Maternal mortality levels

[5] Average participation rates were calculated as arithmetic averages.
[6] World Development Indicators (2004) using 1997 data for Jordan, and 2000 data for Egypt and Tunisia. No data is available for Israel, Lebanon, Syria or the West Bank and Gaza. National poverty indicators show a brighter picture for Egypt (poverty rates of 17% in 1999/00), and a worse one for Morocco and Jordan (respectively, 13% and 15%).
[7] Millennium Development target 5.

also remain very high in some countries, notably Morocco. If the incidence of tuberculosis (TB) is taken as a proxy for general health conditions, the picture for the Mediterranean region is rather mixed (Table 2): while some countries have been successful in reducing the incidence of TB to European levels (Jordan, Israel and Lebanon), very high rates have been registered in others (such as Morocco).

Table 2: MED region - Health indicators

	Life expectancy at birth		Public health expenditures (% GDP)	Private health expenditures (% GDP)	Under-five mortality rate		Malnutrition - weight for age (% of children under 5)	Maternal mortality ratio (per 100,000 live births)	Incidence of tuberculosis (per 100,000 people)
	1995	**2001**	**2001**	**2001**	**1995**	**2002**	**2000**	**2000**	**2002**
Algeria	69	71	3	1	55	49	6	140	52
Egypt	65	69	2	2	71	39	4	84	29
Israel	77	79	6	3	7	6	..	17	10
Jordan	70	72	5	5	37	33	..	41	5
Lebanon	69	71	..	..	34	32	..	150	14
Morocco	66	68	2	3	61	43	..	220	114
Syria	68	70	2	3	36	28	7	160	44
Tunisia	71	73	5	2	37	26	4	120	23
WB&G	70	73	..		..	..	..	..	*27*
Simple average MED	**69**	**72**	**4**	**3**	**42**	**32**	**5**	**117**	**35**
Lower middle income	68	69	3	3	49	40	9	440	164
MENA	66	69	3	2	67	54	..	165	57
Sample EU Member States									
Austria	77	79	6	3	7	5			15
Belgium	77	79	6	3	9	6			14
Czech	73	75	7	1	8	5			13
Hungary	70	72	5	2	12	9			32
Italy	78	78	6	2	7	6			8
Netherlands	77	78	6	3	6	5			8

Source: WB 2004 WDI. Data for other years have sometimes been used depending on availability.
Data for low & middle income countries for maternal mortality and incidence of tuberculosis.

Some improvements were recorded in facilitating **access to water and sanitation** in the Mediterranean region, which is generally better than compared to their neighbouring peers. 2000 data reveals that the Mediterranean region was making steady advances towards achieving the Millennium Development Goal of halving the proportion of people without sustainable access to safe drinking water and basic sanitation by 2015.[8] However, significant weaknesses remain in the delivery of these basic services. In 2000, only 70% of Moroccans had access to sanitation facilities, and 80% of the population in Morocco, Syria and Tunisia had access to good quality sources of water. Access to water and sanitation facilities, as well as to other basic services, is sometimes problematic in areas of high population density. Some small Mediterranean countries such as Israel, Lebanon, and the West Bank and Gaza are characterised by high and increasing population density. Density is clearly lower in the larger Mediterranean countries, but people tend to be concentrated in cities, where labour prospects are more attractive, or in the limited rural areas which are fertile.[9]

Progress in reducing **gender** disparities in the Mediterranean region has continued since the second half of the 1990s but there remains substantial room for improvement. Female participation in the education system has continued to rise during the past ten years (Table 3). In particular, the gap between girls' and boys' participation in primary and secondary education is gradually closing, with particular progress made in Algeria, Egypt and Tunisia. In some countries (Jordan and Lebanon) girls are even more numerous than boys in primary and secondary schools in the year 2000. Looking at performance in 2001 and 2002, Mediterranean

[8] Millennium Development target 10.
[9] Arable land represents less than 3% of total land in Algeria, Egypt and Jordan, and about 15-20% of land in most other Mediterranean countries.

countries appeared well on track to meet the Millennium Development Goal of eliminating gender disparity in primary and secondary education by 2005.[10] Nevertheless, despite this progress, in several Mediterranean countries the literacy rate of young women remains lower than that of young men. In Morocco only 60% of young women were literate in 2002.

Female participation in the labour force is relatively low in the Mediterranean region, although somewhat higher than the average for the MENA region.[11] In 2002, women represented about 30% of the total labour force in most Mediterranean countries after modest increases of participation rates since the mid-1990s. Female participation is particularly low in non-agricultural sectors (about one quarter of total employment in those sectors) and seems to be stagnating. The lower education and labour participation may explain, in addition to entrenched traditional role models, why women in Mediterranean countries are hardly represented in political life, particularly in Lebanon and Egypt.[12]

Table 3: MED region - Gender equality

	Ratio of girls to boys in primary and secondary education		Ratio of young literate females to males (% aged 15-24)		Literacy, young female (% of female aged 15-24)		female labour force (% of labour force)		Share of women employed in the nonagricultural sector (%)	Proportion of seats held by women in parliament (%)
	1995	2000-01	1995	2002	1995	2002	1995	2002	2000-02	2003
Algeria	86	99	85	91	77	86	25	29	*12*	6
Egypt	77	*93*	77	..	57	..	29	31	*20*	2
Israel	99	*100*	100	100	99	99	40	42	*49*	15
Jordan	96	101	99	100	98	100	21	26	*21*	6
Lebanon	..	102	94	96	..	..	28	30	..	2
Morocco	72	*85*	69	79	50	61	35	35	*27*	11
Syria	86	92	78	84	73	93	26	28	*17*	12
Tunisia	89	100	88	93	84	91	30	32	..	12
WB&G	..	..	..	..	..	..	..		..	..
Simple average MED	**86**	**96**	**86**	**92**	**77**	**88**	**29**	**32**	**24**	**8**
Lower middle income	*88*	..	96	*98*	93	..	43	43	…	..
MENA	81	*91*	84	85	82	..	26	29	..	..
Sample EU MS										
Austria	91	*97*	..	..	..	..	40	40	*44*	34
Italy	95	*98*	100	100	100	100	38	39	*41*	12
Belgium	99	*106*	..	..	..	..	40	41	*45*	35
Greece	95	*101*	100	100	100	100	37	38	*41*	9
Hungary	98	*100*	100	100	100	100	45	45	*46*	10
Poland	95	*98*	100	100	..	..	46	46	*47*	20
Spain	102	*102*	100	100	100	100	36	37	*39*	28

Source: WB 2004 WDI. Data for other years have sometimes been used depending on availability.

Public spending in ***education*** in the Mediterranean region is substantial and amounts to more than 5% of GDP, above the average spending of lower-middle income countries (Table 4). However, due to the large cohorts of young people (more than 30% of the Mediterranean population is below the age of 14), there appear to be pressures on available resources. If the currently high education outlays are to be made financially sustainable, spending will have to be made more efficient and resources for education from non-government sources mobilised.

Participation in education has improved since the second half of the 1990s. Notably, net enrolment of children in primary education has increased in most Mediterranean countries and it is generally better than the average for lower-middle income countries and the MENA region. Starting from a low level, Jordan and Morocco made particularly significant progress in raising children's, and particularly girls', enrolment in primary schools, but efforts need to be sustained to achieve universal enrolment. Progress was also achieved in the Mediterranean region in raising enrolment rates in secondary and tertiary education. However, although better than the

[10] Millennium Development target 4.
[11] The term MENA is used by International Financial Institutions to refer to all countries of the Middle East North Africa region and is larger than the term Mediterranean countries (See Footnote 2).
[12] Some EU Member States also record a relatively low score in this area.

average for the MENA region and low- to middle-income countries, enrolment rates in secondary and tertiary education remain far lower than in the EU, pointing to the need to raise the level of education beyond primary education to close the human capital gap.

There also remain problems with the efficiency of educational systems and outcomes in the Mediterranean region. Mediterranean countries appear to be falling short of the Millennium Development Goal of universal primary school completion by 2015.[13] Although improving, primary completion rates remain particularly low in the West Bank and Gaza and still below 70% of the student population in Lebanon and Morocco. Youth literacy has continued to improve since the second half of the 1990s in all Mediterranean countries and especially in Algeria, Morocco and Syria, but efforts need to continue to raise levels further, particularly in Morocco.[14]

Table 4: MED region - Education

	Public spending on education (% of GDP)		Net enrollment ratio in primary education (% of relevant age group)		net enrollment in secondary education		Primary completion rate (% of relevant age group)		Youth literacy rate (% ages 15-24)		Internet users (per 1000 people)
	1995	**2001/02**	**1995**	**2001/02**	**1995/96**	**2000/01**	**1990**	**2001/02**	**1995**	**2001/02**	**2002**
Algeria	5		95	95	56	62	82	*96*	84	90	16
Egypt	5		93	*90*	67	78	*77*	91	66	..	28
Israel	7	7	..	*100*	..	88		..	99	100	301
Jordan	8	5	67	91	41	80	*102*	*98*	98	99	58
Lebanon	3	3	76	90	..			68	..	..	117
Morocco	6	5	72	88	..	31	47	68	62	70	24
Syria	3	4	91	98	39	39	98	*89*	84	95	13
Tunisia	6	7	98	97	54	68	75	98	90	94	52
WB&G	..	..	..	..	..	..	..	*66*	..	..	30
Simple avg. MED	**5**	**5**	**85**	**94**		**64**	**80**	**84**	**83**	**91**	**71**
Lower middle income	4	4	96	*91*				*97*	95	*97*	46
MENA	5		87	*83*	62	54		*91*	88	*87*	37
Sample EU MS											
Denmark		8		*99*		89		..		..	513
France		6		*100*		92		..		..	314
Greece		4		*95*		85		..		100	155
Hungary		5		*90*		87		..		100	158
Italy		5		*100*		88		..		100	352
Poland		5		*98*		91		*95*		..	230
Spain		..		..		93		108		97	156

Source: WB 2004 WDI. Data for other years have sometimes been used depending on availability.

Education systems in most Mediterranean countries, with the exception of Israel, also appear to be lagging behind the requirements of modern societies. The mismatch between education provided in schools and the actual needs of the employers contributes to high levels of youth unemployment in the region. Low rates of enrolment in secondary and tertiary education are among the factors contributing to the low level of high-tech skills in most Mediterranean countries and the relatively slow catching up of IT services.

In many Mediterranean countries, problems in the education system are compounded by the "brain-drain" phenomenon. The result is low skills availability, which in turn is one of the determinants of the region's modest technological and scientific performance. With the

[13] The Millennium Development target 3 foresees that by 2015, children everywhere, boys and girls alike, should be able to complete a full course of primary schooling. Primary completion rate is the ratio of the total number of students successfully completing (or graduating from) the last year of primary school in a given year to the total number of children of official graduation age in the population. Because it measures the coverage of the education system and the educational attainment of students, the primary completion rate is a more accurate indicator of human capital formation and the quality and efficiency of the school system than are gross and net enrolment ratios.

[14] Literacy in the 15-24 age group.

exception of Israel, where high-tech industries have been the main driving force of the economy, Mediterranean partners lag behind in knowledge creation and use. R&D investment as a percentage of GNP is generally low (0.19% in Egypt and 0.45% in Tunisia compared to around 2% in the EU in 2000), and so is the share of high-tech in total manufactured exports (0.6% in Syria, but 11% in Tunisia). Technology transfers (through FDI and licensing) seem to be the preferred way of acquiring knowledge for many of these countries.

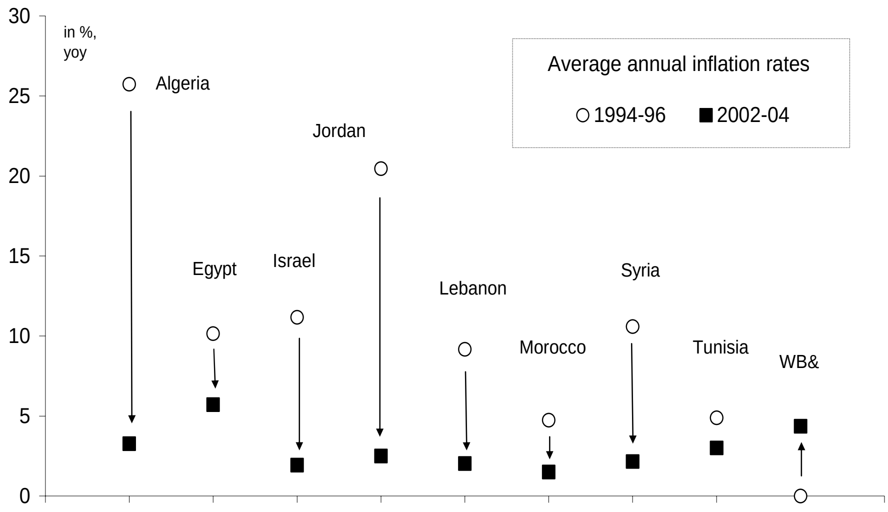
3. Creating conditions for greater prosperity — an assessment of some key areas

This part of the paper assesses progress in some of the areas considered important for growth, investment and employment. The countries that have successfully combined more trade with higher growth and human development tend to have some key features in common. They have gradually opened up their economies as part of a broader development strategy based on two main pillars: (i) improving the investment climate for the private sector to generate jobs and (ii) empowering people, especially through better education. Macroeconomic stability, open and outward-looking economies and a friendly business environment are therefore some of the characteristics generally associated with successful development strategies.

Macroeconomic stability

Mediterranean countries have achieved some progress in obtaining and maintaining **macroeconomic stability** since the Barcelona Declaration, although challenges need to be met to preserve these achievements in the future. Reaching a higher degree of macroeconomic stability was mainly attributable to reinforced monetary policies, while the contribution of fiscal policy remained modest. The recent increase in oil revenues has not been accompanied with fiscal consolidation in oil- exporting countries, while in oil-importing countries fiscal policy remains largely dependent on external assistance. The absence of forceful fiscal consolidation course is the weak link in the overall macroeconomic policy mix, which puts a question mark on the sustainability of the achieved results. Finally, the absence of sound fiscal policies prohibits Mediterranean countries to develop a higher capacity to absorb external shocks.

Chart 4: Progress in disinflation in MED countries



Source: DRI-WEFA.

Mediterranean countries have experienced a remarkable **disinflation process** over the past decade. The average inflation rate fell from around 12% in 1995 to around 3% in 2003 and 2004 (Chart 4). A comparison of average inflation rates in the early 1990's and the past five years reveals that the fall in inflation has been particularly pronounced in Algeria, Jordan, Israel and Syria, where double-digit rates have been compressed well below the 5% level. In most cases the disinflation process has been mainly based on tighter monetary policies, often relying on pegged exchange rate as nominal anchors. The contribution of fiscal policy to this outcome has been modest as fiscal deficits have declined only slightly over the period. Subdued world prices of most imports assisted in this process in the second half of the 1990s, but the impact of this factor has been reversed recently as oil prices climbed well above the USD 40 level.

In 2004, as in 1995, **exchange rate policies** in the Mediterranean countries were very diverse but in each country they played an important role in the conduction of monetary policies. The prevailing exchange rate regimes can broadly be classified into three categories[15] : soft pegs (Jordan, Lebanon, Morocco and Syria), exchange rate bands (Egypt, Israel) and managed floating exchange rates (Algeria, Tunisia). Most exchange rate regimes and financial systems are protected by restrictions on capital flows. Since 1995, only a few Mediterranean countries have followed the global trend towards a higher degree of flexibility (e.g. Egypt), and then only cautiously; only minor advances in capital account liberalisation could be observed. Given that all Mediterranean countries can be classified as small, open economies, exchange rate developments are crucial in determining inflation performance, which might partly also explain their "fear of floating".

The extent to which market forces are free to determine **exchange rates** as well as the choice of the **reference currency** varies significantly among Mediterranean countries. In Syria, several administered exchange rates of the pound still coexist, while the Israeli shekel is almost completely market-determined, although within broad exchange-rate bands of +/- 50%. Finally, the US dollar has been able to maintain its predominance as the reference currency in the region, reflecting the existing inertia in the global financial system due to network externalities, the importance of dollar-based trade such as petroleum exports and imports, and political motivations. The euro has taken over the lead from the US dollar only in Morocco and Tunisia in terms of becoming the reference currency for the respective exchange rate system.

Following a relatively successful **fiscal consolidation** course up to the end of the 1990s, fiscal performance net of grants has deteriorated in a number of countries (Table 5). The recent increase in oil revenues has not been accompanied with fiscal consolidation in oil- exporting countries, while in some oil-importing countries fiscal policy remains largely dependent on external assistance. As a result of lower-than-expected growth and depressed revenues, but also due to higher expenditure in some cases, the average fiscal budget deficit increased to around 4.4% for Mediterranean countries in 2002-03.[16] In particular, Egypt's general government deficit has widened markedly since 2001 on account of declining revenues and rising expenditure. A sharp fiscal deterioration took place in Israel during 2002 and 2003, as a result of lower revenues linked to the economic slowdown and higher defence expenditure since the upsurge of the second intifada. Fiscal performance also worsened in Jordan because of a shortfall in receipts associated with the difficult regional situation. Finally, Syria's fiscal position deteriorated in 2002 and 2003 on account of higher expenditure.

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[15] This DG ECFIN classification is based on the de-facto management of the exchange rate. De-facto exchange rate management may differ from officially announced exchange rate regimes (as also used in the IMF's Classification of Exchange Rate Arrangements and Monetary Policy Frameworks).

[16] Preliminary data and estimates for fiscal data for 2004 indicate that the weighted average fiscal deficit was lowered by one percentage point.

Table 5: General government fiscal balances excluding grants (% of GDP)

	MED	Algeria[1,2]	Egypt[3]	Israel[1,4]	Jordan[5]	Lebanon[1]	Morocco[1,6]	Syria[7]	Tunisia[8]
1997	---	2.3	---	---	-7.3	-27.4	---	---	-4.4
1998	---	-3.8	---	---	-9.7	-18.3	---	---	-3.0
1999	---	-2.0	-0.6	-5.1	-7.0	-16.2	-4.5	---	-3.9
2000	-2.3	9.7	-1.8	-3.2	-8.9	-24.6	-6.4	-1.5	-3.9
2001	-4.0	3.0	-2.7	-6.5	-8.0	-18.9	-5.8	2.5	-3.8
2002	-4.5	0.2	-3.5	-6.3	-10.1	-15.1	-4.7	-1.6	-3.5
2003	-4.3	5.0	-3.3	-8.1	-13.0	-14.6	-5.5	-1.6	-3.5
2004 est.	-3.3	5.2	---	-6.1	-13.4	-8.2	-5.9	-2.7	-2.8

Source: calculations based on IMF Article IV consultations. Data for 2004 are estimates or projections.

All data exclude revenues from privatisation.

[1] Central government balance.

[2] Including the balance of special accounts and net lending to the Treasury

[3] The fiscal year runs in Egypt from July to June. Therefore, for example, data for 2002 refers to the period July 2001 to June 2002.

[4] For 2002, 2003 and 2004 the balance is calculated using estimates of foreign grants.

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

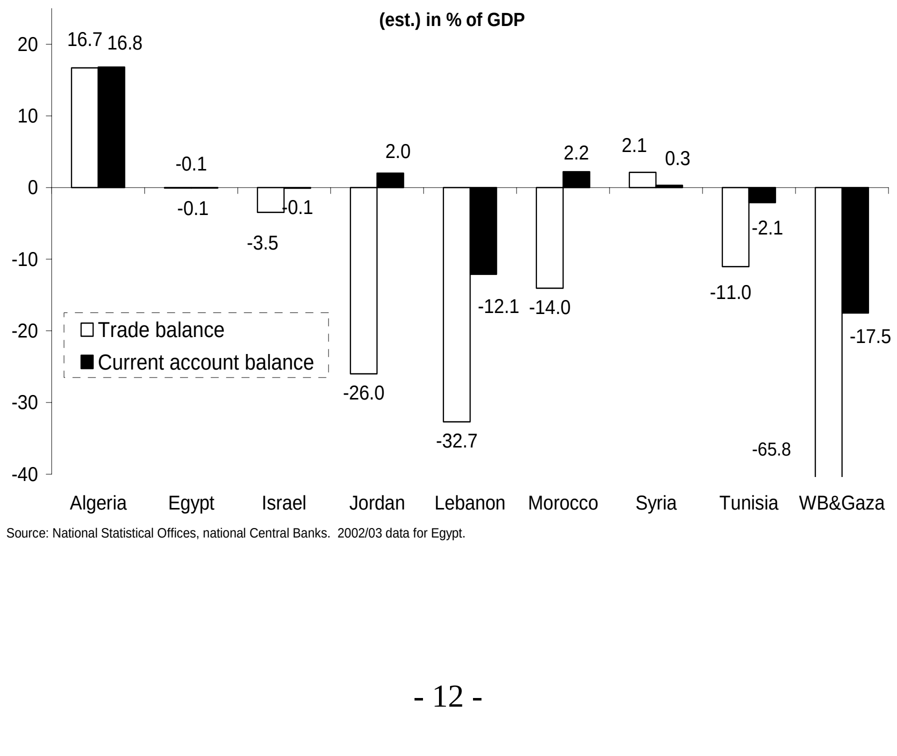
[6] Including other special treasury accounts and Fond Hassan II expenditures.

[7] Consolidated budget balance including grants and operations of the Price Stabilisation Fund (PSF).

[8] Including special funds, the fonds de concours and the social security accounts.

Recent fiscal developments highlight the Mediterranean region's low capacity to adjust to external shocks and reveal upcoming challenges. Notably, fiscal revenues (except Algeria) in almost all Mediterranean countries have been weakened in the past years due to declining mineral wealth, receding customs revenues on the back of trade liberalisation, and reduced earnings from state enterprises as a consequence of the slowly advancing privatisation process. Although all Mediterranean countries have increasingly relied on taxes on the sale of goods and services to compensate for the decline in revenues, in most of them revenues from direct taxation are relatively low because of the frequent use of exemptions, large informal sectors and widespread evasion. The Mediterranean region also faces considerable rigidities on the expenditure side, including high costs related to the provision of public services (via a large civil service), large direct income support and price subsidies and in some cases high expenditure on interest payments on debt.

Chart 5: MED external account balances in 2004



Source: National Statistical Offices, national Central Banks. 2002/03 data for Egypt.

In line with a better handling of macroeconomic policy instruments Mediterranean **external accounts** have displayed an overall improvement since 1995, but a high degree of variety continues to characterise balance-of-payments structures (Chart 5). The average trade deficit declined to close to balance, supported in particular by higher commodity prices since the end of the 1990s, while the average current account balance moved solidly into surplus. Looking at the country level, large discrepancies emerge. Israel's and Tunisia's economies featured minor current account deficits in the past five years, while Jordan and Syria recorded small surpluses in this period. The highly volatile current account balances of Algeria and Egypt have been reacting sensitively towards changes in the oil price, as these countries are the strongest oil exporters in the region. The chronically high current account deficit of Lebanon, exceeding 20% of GDP for most of the last decade, is exceptional and gives grounds for concern.

The absence of a strong fiscal consolidation course highlights the region’s low capacity to adjust to external shocks. This might be also one reason for continued high external account volatility, nurtured by several factors, albeit to varying degrees. Firstly, the region’s trade patterns are influenced by hydrocarbon price changes, as countries either have significant oil and/or gas exports (Algeria, Egypt and Syria) or are dependent on petroleum imports. Secondly, the region’s agricultural import demand has shown erratic swings due to irregular weather conditions. Furthermore, the external balance of some countries is supported by strong tourism revenues and by substantial transfers/remittances of non-residents to their home country from the Gulf countries and Europe; in Jordan, for example, these flows amount to 20% of GDP. Along with revenue from tourism and merchandise exports, these transfers/remittances represent very significant sources of foreign exchange earnings in the region, unlike FDI, which has remained at a very modest level.

Integration into the global economy[17]

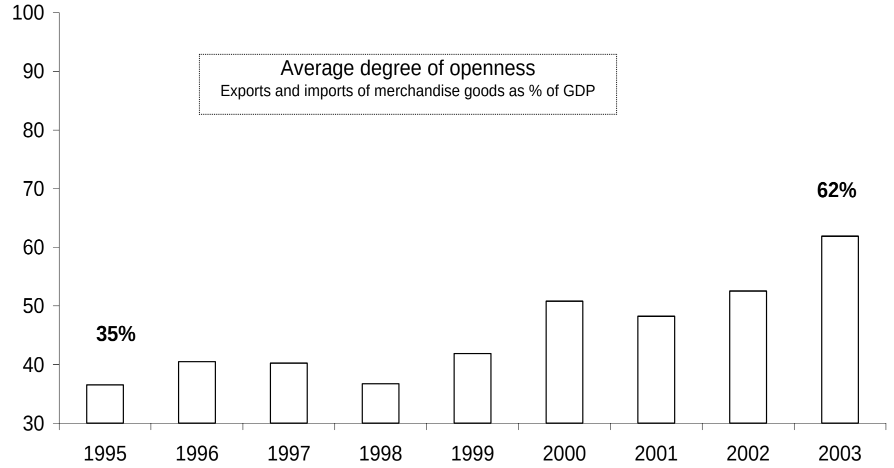
Mediterranean countries appear to have increased their trade openness to the world, but recent developments need to be interpreted with caution (Chart 6). The average degree of openness (exports and imports of goods as a proportion of GDP) is around 62% of GDP in 2003, significantly up from around 36% in 1995. Lebanon and Tunisia are now the most open economies in the region, with degrees of openness ranging from 80 to 100% of GDP since 1995, while Egypt and Israel display the lowest degree of openness (between 25% and 40%). The rise in Mediterranean trade reflects a number of factors including unilateral trade preferences granted by the EU, increased EU aggregate demand, early trade liberalisation by some Mediterranean countries such as Jordan and Tunisia, and in some cases special factors like the strong dependency on aid-funded imports (West Bank & Gaza). However, two qualifications need to be made. First, the price of oil distorts the overall picture and oil and non-oil goods should ideally be treated separately. Second, for a more complete picture of trade openness, trade in services would need to be included.

Trade integration with the world, which stagnated up to the second half of the 1990s, appears to have made some progress since 1995.[18] On average, Mediterranean countries increased their exports and imports of goods by around 60% between 1995 and 2003, outperforming world trade, which rose by 46% in the same period. This represents a clear distinction with the past, where world trade (1980-2000: increase by a factor of 5.3), displayed higher growth rates than Mediterranean trade (1980-2000: increase by a factor of 4.1). Since the Barcelona Declaration,

[17] For a detailed discussion of the impact of the Barcelona process on trade, see Baecker A. “The impact of the Barcelona Process on trade and foreign direct investment” page 24.
[18] Source: IFS DOTS.

the highest trade (in goods) increases have been observed in Algeria and Egypt, while for most other Mediterranean countries trade growth has been in line with the growth of world trade.[19] This relatively positive evolution allowed Mediterranean countries to somewhat increase their market share in total world trade from 1.2% in 1995 to 1.3% in 2003. Notwithstanding this positive development, their world market share remains lower than it was in 1980 (2.3%).

Chart 6: Degree of openness of MED countries



Source: DRI-WEFA, IFS, IIF.
Excluding West Bank and Gaza.
The data source, IMF DOTS, allows a cross-country comparison, while beeing at the same time covering only merchandise trade. The inclusion of trade in services would therefore increase the degree of openess for each country.

Table 6: Trade integration with the EU

Exports to the EU in % of total MED exports

	MED	Maghreb	Mashrek	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia
1980	51.4	50.6	55.8	44.4	50.2	50.4	3.5	---	68.7	69.7	76.5
1990	57.1	73.4	42.0	69.9	43.4	39.9	6.0	39.8	73.1	46.7	85.9
1995	48.1	67.3	52.8	64.8	45.8	31.3	5.1	22.6	58.9	57.0	78.5
2000	51.6	70.5	56.5	66.5	56.7	28.7	6.4	30.4	68.9	68.3	88.4
2003	46.7	65.9	48.8	59.3	40.6	26.9	2.9	16.0	68.4	46.1	80.6

Imports from the EU in % of total MED imports

	MED	Maghreb	Mashrek	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia
1980	62.9	73.2	52.7	72.8	49.4	50.0	52.8	---	69.6	57.4	78.4
1990	58.0	67.0	46.5	65.9	47.1	56.5	40.9	45.2	64.2	51.5	72.2
1995	50.6	64.0	45.1	59.3	38.9	52.3	33.2	47.3	---	34.4	70.3
2000	53.4	71.2	42.9	62.0	41.6	48.4	41.6	47.5	74.7	43.5	76.6
2003	45.9	66.8	43.3	63.2	34.7	40.8	25.1	53.5	---	31.6	71.0

Source: IMF Direction of Trade Statistics, Commission services calculation.

The EU is the main trading partner for the Mediterranean countries, although its weight decreased in the last decade after remaining broadly stable during the 1980s (Table 6). Overall trade of Mediterranean countries with the EU fell from 58% of total Mediterranean countries' trade in the period 1980-90 to around 52% in 2000, with broadly similar declines in both exports

[19] Both Algeria and Egypt are late-comers since the ratification of the Association Agreement took place only recently in Egypt, while for Algeria it is expected for 2005.

and imports.[20] The EU share fell further towards the 45% level in 2003, but recent years might represent more a cyclical movement due to the high oil price in particular, rather than a continuation of this declining trend. Trade diversification away from the EU has occurred most strongly in Israel, Jordan, Syria and Egypt, while Tunisia and Morocco have maintained their strong trade links with the EU. In general, the EU Member States remain the dominant trading partners for Maghreb countries, as two thirds of export and import activities are conducted with the former 15 EU Member States. The countries with the weakest trade links with the EU are Israel and Jordan, with the latter exporting less than 10% of its total exports to the EU.

A high level of protectionism in the trade regimes of Mediterranean countries can still be observed despite recent liberalisation measures. In 2003, as in 1995, six out of the eight Mediterranean countries for which data is available had trade regimes that could be classified as "repressed".[21] The free flow of goods and services with third countries appears to be mostly constrained by a combination of high tariffs on imports, substantial informal non-tariff barriers such as complicated, lengthy and non-transparent customs procedures and a certain degree of corruption in the customs services. Despite the downward trend in tariff rates during the last 20 years, the Mediterranean region is still one of the most protected in the world. Relatively high costs and poor quality of transport facilities represent additional non-tariff barriers to exports to the region.[22] Only Israel appears to have a level of non-trade barriers similar to the EU and has an average tariff rate close to that in the EU.

Box 1: The EU-Mediterranean Association Agreements[23]

The implementation of trade liberalisation measures has been stimulated by the Euro- Mediterranean Partnership, which calls, among other things, for the establishment of a Euro-Mediterranean Free Trade Area by the end of this decade. The process of trade liberalisation provided for by the Association Agreements between the EU and Mediterranean countries consists of several steps, of which the most sensitive and the widest-ranging still have to be implemented.

The Barcelona Declaration of 1995 set 2010 as the target date to complete the Euro-Mediterranean Free Trade Area. However, full trade liberalisation will occur later than 2010 given the length of the transition periods foreseen in the bilateral Association Agreements, the time frame for their ratification and the need to progress with the South-South dimension. The agreement between Egypt, Jordan, Morocco and Tunisia on a regional free trade agreement (Agadir agreement, signed in 2004) is a notable development with respect to regional integration.

The bilateral Euro-Med Association Agreements include a trade liberalisation commitment by the Mediterranean partners which complements the tariff-free treatment (for industrial goods) already granted to their exports to the EU since the mid-1970s and which is preserved under the Agreements. Under the terms of the Agreements the partners gradually remove all tariffs on imports of industrial products from the EU over a period of 12 years (15 in the case of Egypt). The specific time schedules for tariff dismantling differ depending on the sensitivity of the goods in question.

[20] Source: IMF, Direction of Trade Statistics. The change in the oil price distorts somewhat the overall picture and should be taken into account when assessing developments.
[21] Heritage Foundation (2002), "2002 Index of Economic Freedom".
[22] FEMISE (2001), "Economic Transition Process and the Implementation of the Euro Mediterranean Partnership", *FEMISE Report*, September.
[23] For further information on the Euro-Mediterranean Partnership, the Barcelona Declaration and the Association Agreements: http://europa.eu.int/comm/external_relations/med_mideast/intro/index.htm.

Market-oriented reforms and governance

Over the past decade, some progress has been achieved with regard to the implementation of structural reforms.[24] Many indicators have been established to measure countries' progress in market-oriented reforms and to allow cross-country comparisons, sometimes leading to different conclusions. For instance, the Fraser Institute's "Economic Freedom of the World" index points to remarkable progress by the Mediterranean region in implementing reform between 1995 and 2002 (Table 7).[25] Overall, according to this index Mediterranean countries have in recent years reached the level that the countries that recently acceded to the EU had in 1995. According to this index, most of the improvement can be observed in Jordan and Israel, mainly as a result of a strengthened legal framework, increased freedom to trade with third countries and greater monetary stability. By contrast, despite some reform efforts and progress, in 2003 Syria came only 103th out of a sample of 123 countries.[26] Algeria's progress also appears modest; it is ranked only 118th, due to weaknesses in all five categories of the index.[27]

Table 7: Indices measuring reform progress in MED countries

	Fraser Institute[1] Econ. Freedom Index		**Heritage Foundation**[2] Econ. Freedom Index		**World Bank**[3] Governance Index	
	1995	**2002**	**1995**	**2004**	**1996**	**2002**
Algeria	3.82	4.56	3.68	3.31	-0.97	-0.81
Egypt	5.80	6.19	3.69	3.28	-0.19	-0.37
Israel	5.71	6.63	2.90	2.36	0.87	0.56
Jordan	6.06	7.03	2.90	2.73	0.07	-0.01
Lebanon	---	---	2.96	3.13	-0.20	-0.44
Morocco	5.90	5.90	3.03	2.93	-0.12	-0.05
Syria	4.39	5.35	4.15	3.88	-0.72	-0.66
Tunisia	5.95	6.31	2.98	2.94	0.03	0.11
West Bank and Gaza	---	---	---	---	0.07	-1.02
Israel	5.71	6.63	2.90	2.36	0.87	0.56
Maghreb[4]	5.22	5.59	3.23	3.06	-0.35	-0.25
Mashrek[4]	5.42	6.19	3.30	3.26	-0.20	-0.50
MED Countries[4]	**5.38**	**6.00**	**3.20**	**3.07**	**-0.13**	**-0.30**

[1] The Fraser index runs from 1 to 10. Higher values reflect institutions and policies conducive to freedom for economic activities.

[2] The Heritage index runs from 1 to 5. A score of 1 indicates an institutional framework and a set of policies that are most conducive to economic freedom while a score of 5 indicates signifies a set of policies that are least conducive.

[3] The WB scales run from -2.5 to +2.5, whereby higher values reflect better policies.

[4] Arithmetic average.

The index of the Heritage Foundation, which also measures economic freedom, in 2004 comes to a more pessimistic assessment for Mediterranean countries, indicating only modest

[24] Each country section contains a more detailed description of the pace and quality of structural reforms.

[25] The Fraser's Institute index reflects whether institutional characteristics and the set of policies pursued are conducive to freedom for economic activities and, hence, for growth. It does not cover Lebanon or the West Bank and Gaza. Data retrieved from Gwartney, J. and R. Lawson R., with W. Park, S. Wagh, C. Edwards and V. de Rugy (2002), *Economic Freedom of the World: 2002 Annual Report*, Vancouver BC. Available via the Internet at www.freetheworld.com,,

[26] Economic reforms gained some new momentum since 2001, but remain rather piecemeal and erratic.

[27] Fiscal burden, legal framework, access to sound money, freedom to exchange with foreigners and regulation of credit, labour and business.

improvements since 1995 (Table 7).[28] According to the Heritage Foundation, most countries still belong to the category "mostly un-free countries". Some progress was observed in Israel, Egypt and Algeria, mostly as a result of an improved monetary policy framework and a strengthening of property rights, while Tunisia hardly advanced and Lebanon even moved slightly backwards in the past seven years. According to this index, the reform efforts of Mediterranean countries compare even less favourably with those of the former ten accession countries.

Both the Fraser Institute and Heritage Foundation indices reveal that freedom of economic activity in the Mediterranean is still constrained by numerous factors, including a high fiscal burden, strong government intervention in trade, a high regulatory burden and a relatively weak legal framework. Along with trade restrictions[29], the fiscal burden – measured by a combination of the size of government expenditures and the tax rate – is one of the areas where the least progress has been achieved (in particularly in Israel, Egypt, Algeria, Syria). Furthermore, substantial public ownership of enterprises and large public consumption distort private sector activity. As a consequence of these constraints on economic activity, black market and informal activities are prevalent among Mediterranean countries, with the overall size of the informal sector estimated to vary between 30% and 70% of GDP.[30]

The FEMISE network of Euro-Mediterranean economic institutes, drawing on the Fraser Institute and Heritage Foundation indices, also commented on the slow pace of economic transition in Mediterranean countries and, additionally, evaluated the structural reform progress in the Mediterranean region in the light of the Barcelona Process.[31][32] While recognising the structural reforms undertaken in the region, notably to improve the business environment for foreign investment, FEMISE points to the need to enhance other reforms, particularly in the areas of trade, competition, corporate taxation and liberalisation of network industries. The companion article in this publication on “Business climate in the Mediterranean region” highlights the main challenges faced by the business sector in the region.[33]

The governance index[34] developed by the World Bank echoes reform challenges raised by the two other indicators and reveals that in Mediterranean countries a heavy regulatory burden continuously constrains private sector development (Table 7).[35] The effectiveness of policymaking is impeded by low perceptions of the quality of public services and the competence of civil servants, the civil service’s exposure to political pressure, and governments' weak commitment to their policies. Furthermore, economic activity appears to be affected by excessive regulation and market-unfriendly policies (e.g. price controls) and corruption. Sub-indices for regulatory quality and corruption display the highest discrepancies in relation to EU standards, reaching values of -0.26 and -0.14 on a scale of +/-2.5.

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[28] Source: Heritage Foundation 2002 Index of Economic Freedom.
[29] International Monetary Fund (2002), *World Economic Outlook 2002: Trade and Finance*, Washington D. C., September.
[30] Friedmann, E. et al. (2000), "Dodging the Grabbing Hand: The Determinants of Unofficial Activity in 69 Countries", *Journal of Public Economics*, 76: 459-493, June.
[31] FEMISE (2001), “Economic Transition Process and the Implementation of the Euro Mediterranean Partnership", *FEMISE Report*, September
[32] FEMISE (2005), *Le Partenariat Euro-Méditerranéen, 10 Ans Après Barcelone: Acquis et Perspectives*, ERF, Institut de la Méditerranée, February.
[33] Hansen F., “Business climate in the Mediterranean region”, page 52.
[34] Governance is defined as the capacity to effectively formulate and implement sound policies, and the respect of citizens and the state for the institutions that govern interactions among them.
[35] Kaufmann, D., A. Kraay and M. Mastruzzi (2003), "Governance Matters III: Governance Indicators for 1996-2002", unpublished *World Bank Discussion Paper*.

According to the same World Bank study, the quality of Mediterranean countries' rule of law progressed up to 2000 but fell back below its 1996 level in 2002. It is clear that there are challenges with regard to the safeguard of property rights, the enforcement of the commercial code and the application of rules on market entry and exit. The average score for Mediterranean countries on the rule of law index is 0.03 (scale of +/- 2.5), which shows just how much room for improvement remains. In particular, the effectiveness and predictability of the judiciary is rated rather low by the population. The accession countries (which scored 0.72 in 2002) did striking better in this respect, in particular in the light of the fact that they only started their transition towards a market-oriented legal framework at the beginning of the 1990s.

Financial sector development has progressed in comparison to 1995, but most countries' financial sectors continue to display distortions, which may be, at least partly, explained by the significant presence of state banks and direct intervention.[36] Credit allocation to the private sector in Mediterranean countries continues to be on average below the EU level and is particularly low in Algeria and Syria[37], as a result of the dominance of their public banking sectors. In these countries, credit to the private sector as a percentage of overall domestic credit remains below the 50% level. This also holds true for Lebanon, where private banks have directed their lending to financing the government's substantial fiscal deficits, crowding out private sector activity. Often, the allocation of a substantial share of funds to investment projects in state hands has led to capital misallocation, with political priorities being favoured over economic considerations, resulting in the build-up of bad loans (accumulated losses during the last years amount to more than 12% of GDP in Algeria). Elevated spreads between deposit and lending rates clearly reflect the presence of these distortions.

4. Concluding remarks

So far, progress in achieving the economic objective of the Barcelona Process has been mixed. Although some aspects of overall quality of life may have undergone a significant change for the better, overall progress towards the objective of "the creation of an area of shared prosperity" has been moderate. Despite an increase of around 35% of the income level per capita (PPP terms) in the period 1995-2004, the prosperity gap between the Mediterranean region and the EU did not close, as the Mediterranean income level in relation to the EU income per capita level remained at around 18%. Although the Mediterranean regional growth rate in the period 1995–2004 compares relatively favourably with the EU's growth performance, relatively large population increases prevented income levels from catching up.

On the positive side, some aspects of well being have improved in the past ten years. Health conditions have broadly improved in the region, with significant improvements in child health and overall life expectancy. Furthermore, progress in raising access to water sanitation could be recorded for most countries, while at the same time Mediterranean countries appear to be on track to meet the first Millennium Development Goal of "eradicating poverty and improving lives". Finally, Mediterranean countries' population growth rates are gradually declining towards a more sustainable level, while authorities have started to tackle gender disparities, as evidenced by slowly rising female labour market participation and school enrolment rates.

There is evidence that Mediterranean countries have made progress in integrating themselves into the global economy, while managing to successfully achieve/maintain macroeconomic

[36] Sala-i-Martin, X. and E. V. Artadi (2002), "Economic Growth and Investment in the Arab World", *Columbia University Discussion Paper*, No. 0203-08, New York.

[37] The country article on Syria provides a comprehensive description of the Syrian banking system.

stability. The trade liberalisation provisions of the Association Agreements have assisted Mediterranean countries to start or intensify the opening of their trade regimes. Mediterranean trade growth seems to have been above average world trade growth for the past years, with Mediterranean countries increasing their average degree of openness to the world. As for macroeconomic stability, Mediterranean countries have registered a remarkable disinflation process over the past decade, with the average inflation rate falling from around 12% in 1995 to around 3% in 2003-04, while fiscal accounts were consolidated only to a certain extent.

However, many indicators show that the implementation of structural reforms with a view to establishing a fully functioning market economy has been slow in most Mediterranean countries since 1995. This slow pace of beyond-the-border reforms did not keep pace with the trade liberalisation agenda and may explain why the overall economic performance was rather unsatisfactory, particularly in leading to higher income levels. Economic activities have been stifled by a burdensome regulatory framework and a lack of transparency and efficiency in the public sector, difficulties relating to contract security and enforcement, rigidities with regard to the purchase of real estate and weaknesses in the financial sector and labour markets.

The way forward – the European Neighbourhood Policy[38]

The European Neighbourhood Policy might contribute to tackle this structural reform deficit, by focusing also on beyond-the-border reforms, in addition to trade liberalisation. The ENP aims to lift the level of relations with EU neighbours from traditional trade and cooperation toward closer economic integration. On the economic front, the ENP "offers" neighbours:

1) enhanced preferential trade relations, leading in the medium-term to FTAs (this is more relevant for NIS countries as MED countries already enjoy duty free access to EU markets for industrial products);
2) "a stake" in the EU Internal Market based upon progress in implementing the *acquis* and other accompanying reforms;
3) increased financial and technical assistance through the European Neighbourhood and Partnership Instrument (ENPI);
4) improved interconnection with the EU in sectors such as energy, transport and the information society;
5) the possibility to participate in some EU programmes (such as research, education).

The perspective of a stake in the Internal Market (still to be defined) is the most novel aspect. For the first time, the possibility of participating in the Internal Market is offered to non-European countries which are economically and socially very different from the EU.

The ENP has the potential to deliver economic benefits for the neighbours via various channels. The reduction of tariff and non-tariff barriers should bring about efficiency gains and improve welfare. Liberalisation of trade in services should be particularly beneficial given the neighbours' background of inefficient or underdeveloped services. Increased prospects for market access for agricultural goods would also contribute to growth. Increased financial and technical assistance and improved regional interconnection should enhance the framework conditions for sustainable economic growth. In addition, the ENP should promote adherence to sound macroeconomic and financial sector policies. Finally, the ENP has the potential to anchor neighbouring countries' economic policies by bringing them closer to the EU economic model.

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[38] This section draws on a forthcoming DG ECFIN paper "The economic dimension of the European Neighbourhood policy" by Michaela Dodini and Marco Fantini.

Box 2: European Neighbourhood Policy – State of play

Relations between the EU and the Mediterranean partner countries have intensified through the ENP launched in 2003. The policy is designed as a new framework for relations with the EU's eastern and southern neighbours and is built on existing relations and reciprocal commitments (including the Euro-Mediterranean partnership). The ENP aims to develop a zone of prosperity and peace, a "ring of friends" with whom the EU enjoys close, peaceful and cooperative relations. In the economic front, this is to be achieved through additional trade liberalisation and the prospect for Mediterranean countries of a stake in the EU's Single Market, accompanied by enhanced financial and technical assistance. The provision of these complementary incentives to the Mediterranean countries will depend on their concrete progress of demonstrating shared values and effective political, economic and institutional reforms.

Table 8: ENP - State of play in the MED region

	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Tunisia	Syria	WB&G
Country reports		yes	yes	yes	yes	yes	yes		yes
Action Plan			yes	yes		yes	yes		yes

Source: European Commission

The European Neighbourhood Policy is implemented via bilateral, mutually agreed, Action Plans, based on extensive Country Reports. As of March 2005, Country Reports and Action Plans have been completed with the first group of seven countries - Moldova, Ukraine, Morocco, Tunisia, Jordan, Israel and the Palestinian Authority. The Action Plans were approved by the Commission in December 2004 and, to enter into force, have to be endorsed by the relevant Association or Co-operation Councils. Implementation of the Action Plans will be monitored through sectoral sub-committees as well as the economic dialogues. These mutually agreed Action Plans specify reform objectives for each of the Mediterranean partner countries as well as EU support. Country Reports have also been finalised for the second wave of countries (Egypt, Lebanon, Armenia, Azerbaijan and Georgia). In the economic field, particular emphasis is put on progress in the establishment of a fully functioning market economy through structural reforms as well as macroeconomic stability.

Preparations have also advanced on the European Neighbourhood and Partnership Instrument (ENPI). In September 2004 the Commission tabled a proposal to the Parliament and Council for a regulation establishing the ENPI with an allocation of € 14.9 billion for 2007-13. The ENPI will replace TACIS, MEDA and a number of thematic programmes covering the EU neighbouring countries. It will also finance cross-border programmes bringing together regions of MS and partner countries with a common border. The Action Plans will be the reference for drawing assistance priorities. The ENPI will also support the EU-Russia strategic partnership.

Annex I: EU tools to foster market-oriented reforms

The Barcelona process may be expected to contribute on economic and political changes in the Mediterranean partner countries via commonly agreed reform objectives and which in sociology is known as "socialisation".[39] Commonly agreed reform objectives provide incentives for certain achievements, e.g. the pursuit of specific policies, with material and social benefits offered by the EU, such as financial and technical assistance (MEDA), institutional ties, market access and political dialogue. Through altering the benefits and costs facing political actors, these incentives may widen the scope for reforms and prosperity in partner countries. On the other hand, socialisation may be defined as a process of inducing behavioural and identity changes through interaction with a partner (government, business, civil society, students) resulting in social learning, emulation of a model, and drawing the lessons of other's experience. Sustained interactions among both experts and policymakers between the EU and the Mediterranean partners are expected to lead to a convergence of expectations on many issues, including controversial ones (e.g. democracy, human rights).

When assessing developments since 1995, many other factors need to be taken into account apart from the Barcelona process. Most of the Mediterranean partner countries are relatively small, open economies, and as such they are exposed to global developments and external shocks. The global economic cycle, oil and commodity prices and, most of all, the growth prospects of the largest trading partner in the region – the EU – influence the performance of numerous economic indicators in the Mediterranean region. Moreover, partner countries continue to be exposed to highly volatile climatic conditions which can have – in the short term – a strong impact on the outcome of economic indicators.

There is also a considerable time lag with regard to the operationalisation of the Barcelona objectives. In the economic domain, the Barcelona process is driven forward by the conclusion and implementation of Association Agreements and, more recently, by the conclusion of Action Plans in the context of the European Neighbourhood Policy. The first Association Agreements entered into force in 1997 and 1998 for Tunisia and the Palestinian Authority. The Association Agreements with Algeria and Syria still need to be ratified (Algeria) and fully signed (Syria). Once in force, the Association Agreements foresee a relatively long transitional period for implementation and full reciprocal trade liberalisation. This has repercussions on the speed and scope of a country's overall economic path. Moreover, the benefits of certain measures, e.g. structural reforms in the field of competition, or changes in the institutional and legislative framework, only materialise in the medium term.

a.) Change through financial incentives

The EU's MEDA programme is a major tool for creating financial incentives for reform in the Mediterranean region. MEDA I, which ran until 1999, provided project financing worth over EUR 3.4 billion. About 45% of the funds were allocated to projects in support of economic transition, private sector development and support for structural adjustment. Under MEDA II, scheduled for the period from 2000 until 2006 with a budget of EUR 5.35 billion, free trade and economic reforms remain at the core of Community financial support. The main priorities of MEDA II are to assist the Mediterranean partners to implement free trade with the EU and to achieve sustainable economic growth through macroeconomic and structural reforms. MEDA

[39] DIFD, "European Neighbourhood Policy: Enhancing Prospects for Reform in Mashreq Countries", unpublished discussion paper. Maybe: Emerson M. and G. Noutcheva (2005), "From Barcelona Process to Neighbourhood Policy – Assessment and Open Issues", CEPS Working Document, No. 220, March.

resources are also targeted at alleviating the negative effects which this process may have on the most vulnerable groups of society.

The grants from the MEDA Community budget are complemented by lending operations from the European Investment Bank (EIB).[40] The Bank has provided loans of about EUR 9 billion to the region. A Euro-Mediterranean Investment Facility (FEMIP) was set up within the EIB, which started to operate in September 2002 and was officially launched in October 2002. A further EUR 8-10 billion in loans was offered to the Mediterranean partners under the terms of this facility up to 2006. FEMIP encompasses all EIB lending operations in the Mediterranean with the principal aim of promoting private sector development. It also provides MEDA-funded risk capital and technical assistance to support investment projects.

b. Change through policy dialogue

As for socialisation, the Association Agreements concluded with Mediterranean partners established a rich bilateral institutional framework for the implementation of respective commitments. This framework includes the Association Council (Ministerial), the highest political body, and provides political guidelines for the future of the relationship between the partner countries and the EU. The Association Committee (senior official level) prepares the Association Council and acts as an arbitrator for unresolved issues within working groups. The work at the technical level is split up into a number of working groups. Regional Euro-Mediterranean dialogues on political, economic and cultural fields complement the bilateral activities and represent one of the most innovative aspects of the partnership.

In the economic area, "Economic Dialogues" between the European Commission and the authorities of the partner countries take place periodically to complement the permanent dialogue by EC Delegations in the region. Since the introduction of the European Neighbourhood Policy the role of the Economic Dialogues includes monitoring the Action Plan implementation with regard to macroeconomic stabilisation and structural reforms. The EC Delegations, present in all Mediterranean countries, have a regular exchange of views on economic issues with the local administration in the context of implementation of the National Indicative Programme which defines the EU's individual financial aid measures and, where already available, the Action Plan.

[40] Source: http://www.eib.org/.